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PRIVATE EQUITY AND CORPORATE FINANCE

ALTERNATIVE TYPES OF FINANCING – THE REFERENCE SOURCE FOR ENTREPRENEURS AND INVESTORS

FOR YOUR BUSINESS

14 Years FYB FINANCIAL YEARBOOK

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Inheritance Tax Aspects of the Valuation of Private Equity Funds

The regulations of the German Inheritance Tax Law have occupied fiscal courts for many years and recently even the Federal Constitutional Court with growing intensity. For a long time, the legislature, however, did not manage to draft an inheritance tax concept capable of consensus.

On 22 September 2016, the Mediation Committee of Bundestag and Bundesrat agreed upon a compromise proposal on the inheritance tax. The German Bundestag confirmed the proposal agreed upon on 29 September 2016. The Bundesrat will deal with the amended law on 14 October 2016.

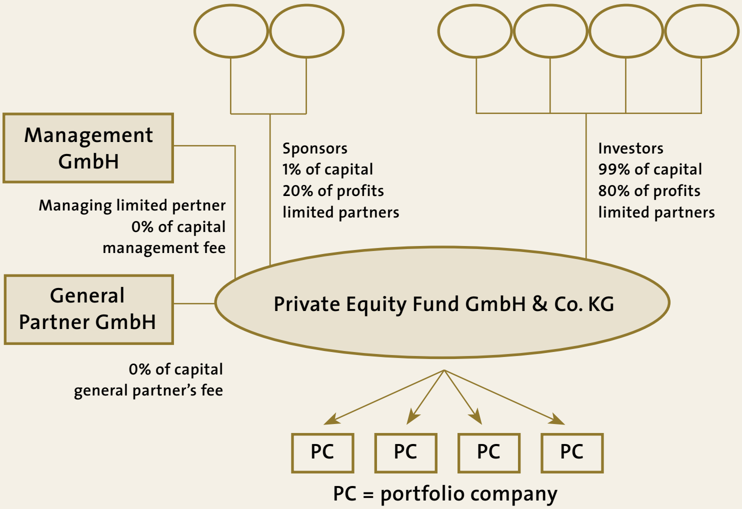
Although the discussions do not affect the valuation of participations in private equity funds, it gains more and more importance in the everyday taxation practice. Interests in private equity funds are transferred by a lifetime gift and/or by way of succession. For lack of statutory provisions on the valuation of (interests in) private equity funds, consultants and advisors are faced by some challenges – particularly as regards a multitude of private equity funds to be valued – which, however, allow some degree of discretion.

I. Essential principles of private equity

1. Basic structure of a private equity fund

Generally, different groups of persons participate in a typical private equity fund. The investors provide the capital, the sponsors start the private equity fund and the management company manages the individual private equity investments. The sponsors normally participate in the capital of the private equity fund on

a small scale, but their share in the results is disproportionately high (so-called “carried interest”). – In Germany, venture capital and private equity funds are usually formed as limited partnerships (GmbH & Co. KG). The following principles, however, apply to foreign partnerships analogously.



Source: BLL

2. Carried interest

Carried interest is a particular component of the sponsors’ profit share and regularly designed as disproportionate profit share in the partnership agreements. The carried interest for the benefit of sponsors is normally due as soon as the investors have been fully repaid their capital contributions (often plus the so-called “hurdle rate”). After this has happened (“full pay-out”), in most cases only 80 %

of any subsequent distributions from private equity funds are made to investors and 20% to sponsors. If the current market value or market value exceeds the capital share of a private equity fund due to meanwhile created hidden reserves, the sponsors have also obtained (at first latent) carried interest entitlements as only the allocation formula agreed upon in the partnership agreement is relevant after the full pay out.

3. Other particularities under the partnership agreement or virtual particularities of private equity funds

Restriction on the transfer of interests

Partnership agreements of private equity funds generally provide for the requirement of the written consent of the management to transfers of interests. The management has often the unconditional right to refuse a third party as prospective purchaser. The restriction on transfer has a strong value-decreasing effect in practice as the transfer to a third party always depends on the management's consent and as the management has hardly a fundamental interest in agreeing to a change of partners.

Exclusion of investors' rights of termination

Besides the restricted transferability, partnership agreements of private equity funds normally also provide for the exclusion of termination rights. It is thus impossible for investors to withdraw from the private equity fund (for example for compensation). The investors are then bound to the private equity fund for the fund's term. As a consequence, the investors cannot dispose of their contributed capital and also not respond to changing framework conditions or markets to that extent which has a value-decreasing effect on the interest in the private equity fund.

Consequences in case of non-payment of called capital

In the event of investments and/or to cover expenses, the management of a private equity fund makes a capital call and the investors pay the respective tranches of their commitments. If investors do not pay the called capital within the periods stipulated in the partnership agreement, defaulting investors risk the (partial) forfeiture of their contributions. Defaulting partners are then expelled from the partnership for payment of the remaining amount of their previously made contributions. These impending sanctions imposed in case of non-payment of the called capital have a significant value-decreasing effect on the value of the interest in the private equity fund, too.

Sale of an interest on the secondary market

The intended sale of an interest in a private equity fund on the so-called secondary market is subject to de facto restrictions as there is only a limited number of prospective purchasers on the secondary market for private equity participations. The return of interests in the fund is excluded, too, which has a value-decreasing effect on the interest in a private equity fund as well.

No adequate trading platform in the form of a functioning stock exchange

There is, moreover, no adequate trading platform in the form of a functioning stock exchange for private equity participations. Stock exchanges for funds mainly list purchase offers and indicative prices for closed-end fund participations in real estate and vessels on their websites. Private equity participations are offered only occasionally. Therefore, it is often difficult in practice to find a prospective purchaser at all who is then also accepted by the management as subsequent investor, provided that the transfer is permissible. If a purchaser can be found, the question arises as to how much the fund participation is worth.

II. Valuation of private equity participations under inheritance tax aspects

The valuation of an interest in a private equity fund under inheritance tax aspects results from the German Inheritance Tax Law in conjunction with the German Valuation Law. For lack of a codification of statutory provisions on the valuation of interests in a private equity fund, the general provisions on the valuation of asset managing and commercial partnerships, and thus the provisions on the so-called "fair market value" ("gemeiner Wert") basically apply.

1. The fair market value as general valuation standard of the German Valuation Law

The fair market value is the fiscal general clause for the required valuation of assets. The fair market value is determined by the price which could be achieved in case of a sale in the ordinary course of business depending on the quality of the asset. In this regard, all circumstances affecting the price have to be considered. The fiscal concept of the fair market value is equal to the economic concept of the "current market value" or "market value".

2. The fair market value of non-listed shares in corporations

■ Value derived from sales transactions

The fair market value of non-listed shares in a corporation is primarily derived from actual sales transactions among third parties that took place less than one year ago (so-called "sales comparison approach").

To derive a value from sales transactions, several sales transactions have to be generally compared. Even a single sales transaction may be sufficient if the share has been sold at a price which does obviously not contradict the fair market value of the remaining shares.

The legal requirement of "deriving the fair market value" implies that the desired value does not have to correspond with the actual purchase price. Under particular circumstances the actual purchase price has to be adjusted if the situation requires.

If there was no sale of the asset to be valued in the ordinary course of business, the price has to be estimated in consideration of all factors affecting the price and by excluding any extraordinary or personal circumstances. In this context, the law generally permits:

- the valuation in consideration of the earnings prospects; or
- the valuation on the basis of another accepted method which is customary also in the ordinary course of business for non-fiscal purposes.

The simplified capitalised earnings method, which is also permissible under law, is not explored hereinafter, particularly as the tax authorities do basically not permit this method with regard to more complex structures, such as private equity.

Valuation on the basis of the earnings prospects of the corporation

The capitalised earnings method can be applied when determining the fair market value of all assets which generate future earnings. In this context, the fair market value is to be determined by capitalising the earnings.

In practice, it is, however, very difficult to determine the future success of portfolio companies and the effective interest rate (for discounting) and to consider uncertainties. Particularly early-stage participations in a company in the venture capital field do not generate a cash flow. For lack of earnings and due to the described difficulties in gathering the required information, the investor is usually not able to determine the value on the basis of the capitalised earnings method.

Valuation on the basis of another accepted method

Valuation may also be made in accordance with another method which is customary also in the ordinary course of business for non-fiscal purposes.

Within the scope of the quarterly reporting to investors, current values are determined quarterly at private equity funds. These are calculated either in accordance with the Invest Europe (formerly EVCA) principles or the Standards of Financial Accounting Standards as adopted by the Financial Accounting Standard Board (FASB) in the U.S. for American and Asian private equity funds.

The sum of the current values of the individual portfolio companies results arithmetically in the net asset value (NAV) of the private equity fund and represents the current market value or market value of the portfolio company of the private equity fund before factors, if any, affecting the value of the interest are taken into consideration.

These methods applied within the scope of the quarterly reporting thus apply generally accepted valuation principles to determine the current market value of the portfolio company of an interest in a private equity fund and are therefore an appropriate starting point for deriving the fair market value of the interest in the fund.

3. Provisional result: NAV as starting point for deriving the fair market value

As already mentioned, there is no codified approach to value participations in private equity funds under inheritance tax aspects. The reduction of the valuation of a fund participation to the valuation of the participations the fund holds in companies, i.e. its shares in corporations, does not go far enough as this approach completely neglects the particularities of private equity and of interests in closed-end private equity funds.

The NAV of a private equity fund, in contrast, provides a very good starting point for the following process of deriving the fair market value of an interest in a private equity fund since the fund's management generally determines the current values, i.e. the current market values or market values of the individual portfolio companies and thus the sum of the NAV of a private equity fund, on the basis of accepted valuation methods.

Private equity funds, however, normally have – as already mentioned above – some particularities which are listed below again in a short summary:

- Possible burden due to latent carried interest of the sponsor;
- Restricted transfer of the interest in the private equity fund;
- Exclusion of investors' rights of termination;
- Consequences in case of non-payment of called capital;
- Difficult sale of an interest on the secondary market;
- No adequate trading platform in the form of a functioning stock exchange.

These particularities regularly affect the tax or current market value of the investment significantly in case of the sale of an interest in a private equity fund, particularly in combination with the factors described below that also affect the value.

III. Factors affecting the value in case of the sale of an interest in a fund on the secondary market in practice

Stock exchange environment

The current global and regional stock exchange environment in general and the stock exchange segment of the respective portfolio company in particular significantly influence the valuation of the portfolio company and the interest in the private equity fund. It has, however, to be considered that any changes in the global or regional stock exchange environment after the valuation date at the end of the quarter until the time when the quarterly reporting is prepared are shown only in the following quarterly report, or the report after next in case of fund-of-fund structures, and thus only with a respective delay.

Cash flow until the end of the term of the private equity fund

The cash flow expected until the end of the term of the private equity fund also affects the valuation of the interest in the private equity fund. This includes outstanding capital calls and particularly the additionally payable, regular quarterly management fee, if applicable. If the investment cycle of a private equity fund has just started, numerous capital calls and thus a major part of the required capital contributions are still to be made. High outstanding payment commitments tend to result in a high decrease in the value of the interest in a private equity fund.

Early-stage vs. late-stage investments of private equity funds

In practice, the managers of a private equity fund determine whether they invest the committed capital in early-stage or late(r)-stage portfolio companies.

An early-stage investment (venture capital) is characterised by the fact that the (initial) valuations of these companies are still relatively low in general since no, or hardly any, revenues are generated.

The potential development opportunities, if any, of these companies are faced by a relatively high risk of default if the companies do not develop according to the plan and if their values have thus to be adjusted or fully written off.

In case of participations at later or late stages of a company (growth capital or buyouts), the companies already generate significant revenues and require the capital to further grow, to realise acquisitions, to enter new markets, etc.

With regard to these companies, the risk of default decreases because of the advanced stage of this kind of company. For this reason, they are higher valued and the private equity fund has to pay a higher purchase price when acquiring shares in such companies.

In practice, venture capital funds, however, suffer from higher discounts in the value due to the participation in early-stage companies and the risk of default related thereto than private equity funds that invest in more mature companies.

- **Volume of the private equity fund**

The total commitment volume of a private equity fund also affects the valuation of an interest in a private equity fund. In practice it can be observed that private equity funds with smaller fund volumes tend to be traded by purchasers with higher discounts than medium-sized or large private equity funds.

- **Seller's commitment amount**

Experience has also shown that the absolute amount of the commitment in a private equity fund affects the value as well. Purchasers of interests in private equity funds distinguish, in practice, between smaller commitments of up to € 1 million, medium commitments between € 1 million and € 5 million, and higher commitments of more than € 5 million.

Specific particularities of private equity funds

In addition to the aforementioned criteria, purchasers of interests in private equity funds also take the fund's strategy, the diversification of the fund's portfolio, and the rate of return of the funds previously managed by the management team into consideration.

Summary of results

There are no statutory provisions on the valuation of participations in private equity funds under Inheritance Tax Law so that the general provisions and the valuation standard of the fair market value have to be applied.

The generally possible valuation of the individual portfolio company of a private equity fund by the investor on the basis of the DCF method is not feasible given the non-availability of the required information at the investor's level, on the one hand. On the other hand, this valuation approach does not sufficiently take the particularities of private equity fund participations into consideration.

Fund reporting is prepared by the respective manager of a private equity fund on the basis of an accepted valuation method and thus fulfils the requirement of "another method which is customary also in the ordinary course of business for non-fiscal purposes."

When determining and deriving the fair market value within the meaning of the German Valuation Law, factors, if any, affecting the value have to be considered with regard to the net asset value of the private equity fund.

We would be happy to respond to the further developments and selected current commercial, fiscal and regulatory issues in detail again in the FYB Financial Yearbook 2018.

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