PODCAST: Investment Management Update – Exit Strategies

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Categories: Benefits, Financial, Funds

[Brian Dolan]
Hi, this is Brian Dolan, I'm with the law firm Pepper Hamilton. Each month Pepper partner Greg Nowak hosts a webinar for West LegalEdcenter which focuses on issues that are affecting private funds and their managers.

You can download a copy of the PowerPoint slides that the presenters went through by visiting Pepper's insight center at www.pepperlaw.com where this podcast is posted. Thank you.

[Gregory J. Nowak]
This is Gregory Nowak from Pepper Hamilton. I am a partner in the New York and Philadelphia offices of the firm. We're a full service law firm, looking out for all of your legal needs.

Today I am joined with two of my colleagues from Pepper Hamilton, Paul Porretta and Kate Winslow and then two distinguished guests, Frederic Way from Barclays and Rich Giuliano is chief operating officer of Emerald Asset Management.

So, Kate, tell us a little about yourself. Ladies first.

[Katelyn D. Winslow]
(Laughs) Kate Winslow, I'm in the Philadelphia office of Pepper Hamilton and I focus most of my work on executive compensation, employee benefits which includes both deferred comp, noncomp and deferred comp, and qualified plans.

[Gregory J. Nowak]
Paul.

[Paul L. Porretta]
Thank you, Greg, my name is Paul Porretta. I'm a partner in the New York office of Pepper Hamilton. I also specialized in executive compensation and employee benefits. I do quite a lot of work with 401(k) plans and employee stock ownership plans.

[Gregory J. Nowak]
Also known as ESOPs which will be part of our topic of conversation today. Rich Juliano.

[Richard Juliano]
Thanks, Greg. I'm Rich Juliano and I'm the chief operating officer at Emerald Asset Management, an institutional money manager located in Pennsylvania. I specialize in paying legal fees to friends at the table today. (all laugh) We have just done a transaction and we are, were, a 100% employee owned company.

[Gregory J. Nowak]
And Fred.

[Frederic Way]
Thanks, Greg. My name is Frederic Way. I'm a director at Barclays Capital working inside of our financial institutions group specializing and covering asset managers. I've been doing it for about 11 years now. We cover asset management companies from here in New York, but do so globally.

[Gregory J. Nowak]
Okay, well, thank you all. And our topic today is exit strategy for the asset management firm. And, what you'll see as we go through the discussion is, we have a unique take on what is meant by an exit strategy. It could be an exit strategy for an individual. It could be an exit strategy for the entire management team. It could be a restructuring of the firm. It could be a self-sale, where in fact you turn the firm into an employee-owned firm as Emeril did a few years ago by installing an employee stock ownership plan. So we're going to start off with an overview of compensatory equity and I'm going to ask Kate to sort of walk us through a general description of what do we mean by compensatory equity.

[Katelyn D. Winslow]
So generally compensatory equity is equity given to employees for services rendered to the employer. You're not subject to the carried interest exception. You're not giving compensatory equity to a kind of investment, it's sweat equity. So particularly focusing on an LLC, there social or taps? entity in general. You're looking at profit interests or capital interests. Those are your two basic compensatory routes in a pass-through entity.

[Gregory J. Nowak]
So, picking up on my long ago history as a tax lawyer, it used to be if I gave someone property as compensation for services rendered, they'd have taxable income.

[Katelyn D. Winslow]
Sure.

[Gregory J. Nowak]
Now if I put restrictions on that property that say it's not vested, or if reversed the company at book value, then they don't have a tax incidence until those restrictions lapse, right?

[Katelyn D. Winslow]
Mmm-hmm.

[Gregory J. Nowak]
But, if I give someone a partnership interest as compensation, that's **not** treated in the same way as stock, correct? There's no need to value it today even though it is a grant property. Now why the distinction?

[Katelyn D. Winslow]
Well, it depends on which interest you're granting at that point, but if you were to give a capital

insurance that would be taxable, as it does have technically a value on day one, your capital account.

[Gregory J. Nowak]
So I have to look at what would happen if I turned around and sold the interest?

[Katelyn D. Winslow]
Correct; yes.

[Gregory J. Nowak]
So if I sold the interest then I would get zero because it was truly based on future appreciation, then there's no taxable event.

[Katelyn D. Winslow]
That's correct.

[Gregory J. Nowak]
Well, there's a taxable event, but it's zero. Which one is it?

[Katelyn D. Winslow]
That is correct. So it's, the IRS has said that a profit interest which is an interest in the future profits of the entity, if structured correctly is not a taxable event. Sometimes we will make prophylactic 83(b) elections just in case it doesn't meet the structure and at that point you potentially have a tax moment which is zero.

[Gregory J. Nowak]
What's an 83(b) election?

[Katelyn D. Winslow]
It oddly enough says I want to be taxed instead of when the property is up, I want to be taxed at grant, which when you are granted profit interest you can actually, you are not taxed until the actual property vests. Now why would you accelerate the taxation of anything? Because the value on day one is hopefully going to be the lowest, number, value of that interest you're going to grow. And so if you are taxed at zero at ordinary income rates on day one but you are taxed at long-term, hopefully capital gains rate on the appreciation, it's a much better tax vehicle for the employee.

[Gregory J. Nowak]
So in contrast to a stock option where you don't get any equity value and where the increase in value is going to be ordinary generally?

[Katelyn D. Winslow]
Generally, yes.

[Gregory J. Nowak]
So here there's the possibility that while the income attributable to the ownership of the LLC interest, the partnership interest, would be ordinary going on, if the partnership interest gives you

a right to share in the enterprise value at some later point in time, that may be capital gain, is what you're telling me?

[Katelyn D. Winslow]
Correct. If structured correctly and not structured correctly, but an 83(b) election is made that is essentially the treatment.

[Gregory J. Nowak]
So if you look at slide 6, those of you who are following along with the materials, we have 1, 2, 3, 4, 5 different types of equity that Katelyn has identified here. We have restricted stock, nonqualified stock options, capital interests, profits interests and carried interests.

So what's the difference, I think we've talked about the first three. What's the difference between a profits interest and a carried interest.

[Katelyn D. Winslow]
So the carried interest is essentially a type of profits interest that the IRS has said, gets even more preferential treatment than even profits interest, so it needs to be, it's essentially an interest in the actual, excuse me, the profits and the fund. If the profits interest in that the award of the interest, shares in future profits of the actual fund, but it is specifically awarded to GPs in a private equity fund, it's specifically limited to investment type of vehicles, so as you will note the new tax law has changes.

[Gregory J. Nowak]
So let's talk about the Tax Cut and Jobs Act, this is slide 7 for those following along. Leading up to that in the Fall of 2017, there was a lot of fear that carried interest would be all of a sudden considered ordinary income. Now, putting this in context, the IRS went after these types of things about 30 years ago in the Sol Diamond case. And then after that, it was like 15 years and they went after it again in the Campbell case. And then it took another 15 years and all of this hubbub about whether or not carried interest should be taxed as ordinary income. Now, if you own property, someone grants you property or you buy that property, the fact that you used your services for which you've been taxed, you know, compensation you received for your services to be taxed. Once you buy the property, why would not the future appreciation be capital, right? That's the theory. However, when you look at some of the "profits" derived by private equity and hedge fund managers over the years, you saw tax regulators and more importantly, people who run public pension plans and others saying, wait a minute. That's a lot of compensation to be given to someone simply because they went along for the ride. Now, it's an asymmetrical compensation return, remember. They only make money if there's money to be made. If the value of the investment does not go up, they get nothing.

[Katelyn D. Winslow]
Correct.

[Gregory J. Nowak]
And so the risk profile of that, in my view, takes it out of the compensatory characterization.

What you really have is a lot of sour grapes, but I'm editorializing. So what did the Tax Cut and Jobs Act do?

[Katelyn D. Winslow]
So essentially, to sum it up in one sentence, it increased the holding period for a couple of partnership interests to receive long term capital gains treatment from one year to three years. Meaning, that if you are holding this applicable partnership interest in applicable trader business and you dispose of that interest, within one year, two year, two and a half years, you're not going to receive as you would have previously long term capital gains treatment.

[Gregory J. Nowak]
But what constitutes disposition? Okay, think about it this way, I own a carried interest in a fund, the fund owns 20 different asset properties. Normally if each of those properties is sold, there's going to be a gain or loss recognized by the fund. I still hold my profits interest but is that gain going to flow through to me as capital or is it going to flow through to me as ordinary until I hit the three-year holding period?

[Katelyn D. Winslow]
So, it's enough kind of where the regulations have been a little unclear. Is the interest that you're counting the stable period for the actual interest of the partnership, is it the actual asset that has been disposed of by the partnership as a whole? Essentially people in the industry have stated that it's likely that as long as the partnership is held for three years, you can get long-term capital gains treatment on an outfit that is sold under that holding period, however, that is still unclear.

[Gregory J. Nowak]
And, of course, this is talking about the federal taxation. Many states piggyback off of federal tax treatment, so if it's income for federal purpose, it becomes income for state. Other states like Pennsylvania has different rule with a complete independent definition of what is income and what is not income. And so, obviously, those who have carried interest after the Tax Cut and Jobs Act, this is the first year that it was effective, right? 2018?

[Katelyn D. Winslow]
That's correct.

[Gregory J. Nowak]
So filing positions are going to have to be taken beginning in January of 2019 with respect to the filings you're doing for 2018, so it will be a very interesting Spring, it seems to me, as we try to parse out the impact of the Tax Cuts and Jobs Act.

[Katelyn D. Winslow]
Absolutely.

[Gregory J. Nowak]
So, toggling from the compensation component, let's talk about a more organized way for investors, excuse me, managers to participate in the value of their firm. They can do that, I'm assuming, through non-compensatory grants of equity or, you know, the owner of the firm could parcel out pieces of equity and as Rick is going to talk about later with respect to the OZ

transaction, but a more organized way to do that is an ESOP. So Paul, tell us about ESOPs and how they work.

[Paul L. Porretta]
Thank you. So, certainly an ESOP can be used as a tool of corporate finance and may be an integral part of an exit strategy for asset managers or asset management company, but you got to start at the definition of an ESOP and an explanation of what it actually represents. So an ESOP is an employee stock ownership plan. That's a term that comes right out of the Internal Revenue Code, and it's a tax-qualified retirement plan that's designed to invest primarily in qualifying employer's security.

[Gregory J. Nowak]
Right, so let's take a timeout there. Now, a lot of terms of art there.

[Paul L. Porretta]
Yeah.

[Gregory J. Nowak]
Okay, first of all, the ESOP is governed by the Tax Code.

[Paul L. Porretta]
Correct.

[Gregory J. Nowak]
It's a qualified retirement plan, just like a defined benefit plan or just like a 401(k) plan.

[Paul L. Porretta]
Correct. It actually is a defined contribution –

[Gregory J. Nowak]
Right.

[Paul L. Porretta]
– retirement plan. And not only is it subject to numerous requirements under the Internal Revenue Code, as an employee benefit plan it's also subject to ERISA.

[Gregory J. Nowak]
Okay, so we're talking Department of Labor rules, nondiscrimination rules, participation, limitations, all of those things that would normally be considered part of a normal retirement plan administration.

[Paul L. Porretta]
Right. And then something to bear in mind, if I may interject, it's not only extensive IRS and Department of Labor rules but also what is often extensive IRS and Department of Labor scrutiny.

[Gregory J. Nowak]
I thought you were going to say lore.

(Laughter)

[Gregory J. Nowak]
You got the law and the lore. But go ahead.

[Paul L. Porretta]
Yes, yes. And so another important aspect of this to bear in mind at the outset is that a company forming an ESOP is going to have certain fiduciary duties and responsibilities that will have to be looked at carefully throughout the process.

[Gregory J. Nowak]
So I'm going to turn to Rich here for a second. Rich, you live this, right, as the chief operating officer of a company that has an ESOP? Tell us about how difficult it is. Is it going to change your life, or is it something that is relatively easily managed?

[Richard Juliano]
It's like any plan you put in place. Initially, there's time and effort, the docking a plan and getting things up and running, but after the initial thrust you have the same requirements you have to follow. 5500, like you do with your 401(k) plan. You have to do a highly comp test. The only difference here, you have to get an outside evaluation done. But the reality is, it's not that hard to manage once it's up and running.

[Gregory J. Nowak]
So let's talk about the benefits of an ESOP.

[Richard Juliano]
Yes.

[Gregory J. Nowak]
Paul.

[Paul L. Porretta]
So, you know, bear in mind that an ESOP can be formed by a public company or a nonpublic company. It can be formed by a C corporation or an S corporation. But today I think we'll focus on how it works for nonpublic companies and, in particular, for an S corporation.

[Gregory J. Nowak]
Now, Rich, that's what you had, right?

[Richard Juliano]
We had an S corp. A hundred percent owned.

[Paul L. Porretta]
Okay, so, consider that in an ESOP transaction and ESOP formation, the stock is held by a tax-

qualified trust, and if it's a leveraged ESOP, which is a common structure, you know, the ESOP trust will typically owe money to the company which has taken a note in consideration for the stock that is transferred. The company makes contributions to the ESOP each year in an amount – and this is a legal requirement – that is not less than the principal and interest that's due on the ESOP loan. That company contribution to the ESOP is going to be tax deductible, as would a company's contributions to a pension plan or a 401(k) plan. Then –

[Gregory J. Nowak]
But isn't that limited, and isn't that the big knock against traditional ESOPs, that you need a very broad employee base in order to be able to pay enough into the ESOP through the normal retirement contributions to amortize the debt?

[Paul L. Porretta]
Could be. You know, there are certain caps on the amount of contributions – 25% of total compensation for the eligible employees. And it's hard to sort of pinpoint a sweet spot for ESOPs in terms of its size, but for a number of reasons it may be a good alternative for a company that has, well, let's say more than 30 employees, and it certainly could be hundreds or thousands of employees. But let me just touch on that smaller end of the scale and particularly in connection with S corps and fill out my answer to your question, Greg, on the advantages of forming an ESOP.

So, as we discussed, a company's contributions to an ESOP are tax deductible. But, moreover, an S corporation can sponsor an ESOP. Now, of course, in an S corporation, you can't have more than a hundred shareholders, and the shareholders can be individuals, or they can be a tax-exempt trust, such as an ESOP. So therefore, you know, an ESOP can be a shareholder of an S corporation. And if you have a corporation that is 100 percent owned by the ESOP, well, then, the corporation is owned by a tax-exempt trust, and as a result the company is basically going to have no taxes.

[Gregory J. Nowak]
Right. So hold on a second here. I want to make sure I understand this.

[Paul L. Porretta]
That usually opens people's eyes.

[Gregory J. Nowak]
Absolutely.

(Laughter)

[Gregory J. Nowak]
So I've now created a structure where I have a subchapter S, and I only had one shareholder. That shareholder is an ESOP trust. The ESOP trust is a qualified plan. When I realize profits inside of the S corp, it doesn't matter whether I get a deduction or not. The profits flow through on the K-1 to the ESOP and, voilà, there's no tax.

[Paul L. Porretta]
Oh, yes, that's essentially how it works.

[Gregory J. Nowak]
What about inflated business income taxes. Is there an exception for that?

[Paul L. Porretta]
That can get a little bit more complicated. But I want to back up and just explain something, you know, in case the audience could be easily tripped up by some of these details. So, when you have an ESOP, of course the participants are the employees of the company, and every year the eligible participants will receive an allocation of ESOP stock to their account. But, so long as the stock is within the trust, the shareholder is the ESOP trust, and that's what Greg had referred to in saying that there's just one shareholder. And further, when a participant in the ESOP is eligible to receive a distribution, the company is not going to distribute actual shares, for a number of reasons. It may be prohibited in the bylaws, and it may be that the company doesn't want numerous people walking around with their shares, so instead the ESOP or the company redeems the stock and then pays out cash to the employee. So I just wanted to clarify that, that the employees who participate in the ESOP will see in their account statements an allocation of stock, but that's really just the recordkeeping within the plan; the shareholder remains the ESOP trust itself.

[Gregory J. Nowak]
So, when an employee retires who's a participant in the ESOP, they have an account, as you said. It's like a defined contribution account. It has a value in it represented by shares of company stock, right? But it's like any other distribution from a retirement plan. At that point, they will have taxable income as they receive distributions.

[Paul L. Porretta]
That's correct.

[Gregory J. Nowak]
And their distributions are going to be ordinary income as opposed to capital gain.

[Paul L. Porretta]
Yes, that's also correct.

[Richard Juliano]
However, they can roll it over, similar to a 401(k), into an IRA and then continue to defer that until –

Until they have the required distributions.

[Gregory J. Nowak]
They have the mandatory distribution.

[Richard Juliano]
One thing that's really important that Paul touched about here, and this is very cumbersome for

our employees to understand, is they did not get shares of stock. They got beneficial ownership in the company. Shares in the trust.

[Gregory J. Nowak]
Right.

[Richard Juliano]
So the shares that they were allocated were beneficial ownership in the trust, and it took a little while to get employees to realize that they didn't get the legal stock certificate, but they got a certificate that said these are the beneficial interests that you own.

[Paul L. Porretta]
Right.

[Gregory J. Nowak]
Now, then, so it's almost like cash settled option, right?

[Paul L. Porretta]
Yeah, that's correct. And I do want to circle back to the comments that were made about the size of an ESOP, and an important rule for S corporations is a provision under the Internal Revenue Code Section 409(p), which will limit the extent of allocations to certain disqualified individuals in the ESOP, and in a nutshell what this means is, if a participant in the ESOP has share allocations that are greater than 10% of the total or with family attribution is more than 20%, then the plan would fail its Internal Revenue Code Section 409(p) test, and the tax penalties can be onerous. So, as a result, and you kind of do the math, if you have an ESOP with ten or fewer participants, and it's an S corp, you're likely going to run into this problem, and for S corporation ESOPs with, you know, let's say 15 or 20 or 25 participants, they're going to need to look closely at this requirement from year to year to avoid the compliance failure. Another point I wanted to touch on following what Rich had explained about distributions and shares is that the Internal Revenue Code allows an ESOP to impose certain restrictions on distributions that you don't see in 401(k) plans. So, for example, an ESOP can provide for a general restriction on distributions until the acquisition loan that was used in a leveraged ESOP to acquire the shares until that loan is paid off. And that could be 20 years down the road.

[Gregory J. Nowak]
But that's actually a good thing.

[Paul L. Porretta]
That's a good thing. And the reason why the Internal Revenue Code allows that is that otherwise a company might be faced with kind of a run on its money in the early stages after it formed its ESOP that could seriously disrupt the cash flow to the company. Now to just relieve the fears that some people may have of these restrictions on distribution, there are exceptions for people who hit normal retirement age, people who reach age 70-1/2 and they have required minimum distributions as you do under your 401(k) plan and then there are other special exceptions to that restriction. But it is a general restriction on distributions.

[Gregory J. Nowak]
But Rich it's important that, you know, the ESOP is set to remain live because if all the shares are allocated, then how do you attract new people, right.

[Richard Juliano]
This is a calculation that Paul spoke of for the principal and interest to determine the allocation of shares, a little pie to the amortization of the loan between the ESOP and the company. In our case we had a 20 year amortization. So our shares would not be fully allocated for 20 years. Which would cover a lot of us and then some. So the reality is the shares are not fully allocated for 20 years because of the loan being in place.

The other benefit that I would add as a practitioner, is that that loan became a very critical point for our company because there is an exclusion, so you're allowed to defer as an individual, a maximum of, I think it's $55,000 per year, to HAS, 401(k) §125, it's an aggregate limit. Our ESOP value was escalating at a very high rate over the years and the value that an employee was getting from an ESOP, was greater than $55,000. It would have put them over the limit and because we had the loan in place, we had an exclusion, and I doubt you guys might know the technical exclusion and I don't, we were able to continue to allow people to put in their 401(k), HAS and use the §121 plan, which could have been disastrous in our company because the non-cash they were receiving in the ESOP and then the inability not to defer any real income currently, would have made people very unhappy. But the loan became a very good thing for us because we were able to hide behind that.

[Paul L. Porretta]
And yes, that's the important point,

[Gregory J. Nowak]
By design, that the loan is there.

[Paul L. Porretta]
Part of that, too, I think needs some epic explanation. So, as Rich has implied, a company can sponsor both an ESOP and a 401(k) plan. And the reason why a company may want to have those two types of plans side-by-side include, that an ESOP, typically, will not provide for any employee contributions. They are employer contributions only and usually it's available to all employees in place, employees are not able to waive participation, whereas the 401(k) plan might also be made available so that the employee can contribute his or her own money into the plan and have it available for loans or what have you. And again, as Rich has said, nevertheless, if you sponsor more than one defined contribution plan, such as a 401(k) plan and an ESOP, there is a limit on what are called annual additions. Pursuant to the Internal Revenue Code, currently that's $55,000 a year, I am sure many of you are familiar with that limit, and there are some additional allowances for what are called catch-up contributions. But what some companies face when they're doing really well, a good problem to have, is that the ESOP allocations combined with an employee's 401(k) contributions, are coming up against that limit.

[Gregory J. Nowak]
So let's take a step back. To create one of these things, you're looking at a firm that has at least

10 employees, ideally maybe 20, that has a compensation base that's broad enough that's not going to be completely bumped out by the maximum contribution limits. Which are what, $250 or $275 a year, includable compensation, so if everybody is making $275 that's great – a little more right, cause you're going to be capped out at $275. But in order to get there, you have to restructure your current firm. So if you're opening an LLC and ESOP on an LLC isn't going to work, because that's not going to get you the benefit that you want for tax purposes.

[Paul L. Porretta]
And you need shares.

[Gregory J. Nowak]
And they need to be shared, right.

[Paul L. Porretta]
That would be employer stock.

[Gregory J. Nowak]
And stock is defined by state law, not by IRS rules, I presume. So that means it has to be a corporation. And you want the S Corp. Now there's a peculiarity of the S Corp. statute that says you have to be an S Corp. for the entire year once you make the election and you cannot have bad investors. Like let's say you have a foreign investor who is ineligible to be a shareholder in an S Corp. They would have to be squeezed out by December 31, assuming you're a calendar year taxpayer, of the prior year. So that on the first day of the year, you're pristine clean and everybody is an eligible shareholder and then you make the S election, which can be retroactive if you do it by a certain time and I think it's March 1 or whatever that date is, but in order to clean it up, what we're often seeing is, it needs to hurry up, squeeze out merger and eliminate any of the pretenders to the equity, if you will, prior to the ESOP formation. Rich you pointed out that the value to your ESOP was going up so fast that without the debt there would have been a problem under these contribution limits. So when you put the ESOP in, 5, 6 years ago?

[Richard Juliano]
6 years, 2011.

[Gregory J. Nowak]
Yeah, the value of the firm was $13.08 a share. The second year, it was $13.74?

[Richard Juliano]
$.44 cents.

[Gregory J. Nowak]
$.44 cents. The third year?

[Richard Juliano]
Ah, $27.00.

[Gregory J. Nowak]
Okay so doubled in value in 3 years. The fourth year?

[Richard Juliano]
I think it was $67.

[Gregory J. Nowak]
So a 5 times increase in value in 4 years. And then at the end of the fifth year?

[Richard Juliano]
$83.

[Gregory J. Nowak]
Right, so you're seeing a continuing theme here. Now, attributable to reinvestment of money in the business. In your people, in new products, in expansion. Where did the money come from?

[Richard Juliano]
Uncle Sam. Quite frankly I think reality far from ours or any asset management firm, we don't have equipment, we don't have machinery that we're buying so we can't go out and spend it on that. And at the end of every year, you had a good year, you look at what you have and you say I don't want to pay Uncle Sam, let's pay ourselves. You comp it out in bonus and you move on. You don't put any money away for a rainy day. And so for us, what we were trying to do was grow the firm, stop paying Uncle Sam and we were able to put a very good comp package in place for everybody, with variable compensation bonus arrangements that moved as the market moved. So you would not get hurt. Only as it went up everyone did well and we were able to put money away for a rainy day. In the case of 2001, 2008, we had cash.

[Gregory J. Nowak]
And also reinvest in the business, hire more people, buy/acquire product. Acquire, so it essentially gave you the ability to have a war chest.

[Richard Juliano]
Right.

[Gregory J. Nowak]
And just so we're clear. It's not that Uncle Sam doesn't get paid. They get paid later. It's a deferral mechanism and it also forecloses capital treatment. So it's going to be ordinary income on the back end. So it's a deferral and an increase in rate, but nevertheless, in the short term, enabled the firm to significantly increase the value of the firm by reinvestment in the firm. Now people say I can do the same thing by going to a private equity firm or to a bank. The problem with both of those strategies is you're using after-tax dollars to repay the bank or to give the private equity firm it's share and those after-tax dollars have to come from somewhere. Now if you do it properly, maybe you'll have some depreciation or amortization expenses to offset income. It's not quite the same thing as when you don't have to worry about the tax man at all. Which is what this structure is designed to do.

So if we go to slide No. 16, leverage ESOPs, Paul you mentioned the debt component. Tell us a little about the extent to which the ESOP can use leverage. It's 100% right?

[Paul L. Porretta]
Correct, and so the way in which, well let's say 100% leveraged ESOP would be structured is – that again, the ESOP trust would take out a loan, often as structured whereby the company is essentially getting a loan –

[Gregory J. Nowak]
Time out – a loan from whom?

[Paul L. Porretta]
Yeah, the loan could be from the company that sponsors the ESOP, it could be from the shareholders who are selling the stock –

[Gregory J. Nowak]
In the form of an installment loan?

[Paul L. Porretta]
Yes.

[Gregory J. Nowak]
So we're financing by the employees.

[Paul L. Porretta]
Yes.

[Gregory J. Nowak]
And that could be a 20 year note.

[Paul L. Porretta]
Correct. Or sometimes a company will get outside financing for the ESOP loan.

[Gregory J. Nowak]
Now Rich in your particular case, you did a combination of all of those things, right? You had some internal company debt, you had some financing through long-term purchases and you also had bank debt. So how did that all work out.

[Richard Juliano]
So essentially what we did is we looked at mathematically what we were paying in taxes each year. We did a calculation of what 7 years, (coughing) principal interest over 7 years, and that's what we went to the bank and borrowed. And then the difference, the delta of the valuation, was a shareholders' note, a 20 year note.

[Gregory J. Nowak]
And how did that impact the cash flow of business?

[Richard Juliano]
There was a neutral. Zero impact to the cash of the business because we were already

distributing the money to pay taxes and we distributed the money to pay taxes and we pay bank. We had a zero impact cash loan.

[Gregory J. Nowak]
And your reinvestment capital is the delta between the bank debt and the growth of the business?

[Richard Juliano]
That's exactly right.

[Gregory J. Nowak]
To the extent you can reinvest in the business and grow it, you have a greater opportunity. (coughing) Excuse me everybody, I'm about to lose my voice here. Okay, now obviously it's not all flowers and cherries. I mean there are some restrictions and limitations, most important of which is you need to have an independent trustee.

[Richard Juliano]
Correct.

[Paul L. Porretta]
Yes and before we get carried with all the tax advantages of the ESOPs, as we mentioned at the outset, you have to bear in mind that at its essence, an ESOP is a tax-qualified retirement plan and subject to rules and scrutiny from the IRS and the Department of Labor. And so in forming an ESOP, best practices would be to start with the appointment of a trustee. Now a couple of factors to keep in mind for the trustee, the trustee should be, of course, independent from the company and its shareholders. The trustee should ideally be a professional trustee or an institutional trustee. And the trustee will need to have discretion in the ESOP transaction.

[Gregory J. Nowak]
So in the ESOP transaction but also as you say on Slide 21, with respect to sales to third-parties.

[Paul L. Porretta]
Exactly.

So this of course is because the ESOP trust, as you know, owns the shares, and the ESOP trustee will have fiduciary duties to the employees who participate in the ESOP. And so the trustee is going to follow the requirements under ERISA for several matters concerning ESOPs, the most important one is the valuation of the stock. And that's probably Step 2 in the ESOP formation process. So you have appointed a trustee, and by the way that is an appointment that should be conducted outside the discretion or decision of the selling shareholders, now you have an independent and preferably professional or institutional trustee, that trustee will then go out and engage an independent appraiser. Independent appraiser has a special meaning under ERISA and an ESOP will need to have an independent appraiser and an independent appraisal of the company stock throughout the life of the ESOP. But in the initial ESOP stock purchase transaction, the trustee will engage an independent appraiser and emphasize something right there, it's the trustee that engages the appraiser, not the company. Even though the company pays for it.

[Gregory J. Nowak]
The company pays for everything, right? (laughing)

[Paul L. Porretta]
Right. The independent appraiser will report solely and exclusively and confidentially to the trustee. The appraiser will go in and of course receive extensive diligence from the company in order to perform the valuation, but at the end of the independent appraiser's process, for the initial transaction, they'll provide a report to the trustee, that will never be shared with the company or the selling shareholders, and that will lead to the offer and acceptance process in the ESOP stock transaction. Then in subsequent years, after the ESOP is formed, the trustee will continue to engage an independent appraiser, he might change appraisers from year to year, but after the initial ESOP transaction, the appraiser's report will not be confidential.

[Gregory J. Nowak]
Okay, this is all well and good, but let's say that the parties decide that they either want to bring on a distribution partner or they want to expand the business or they want to go to the next generation and the want to exit the ESOP. On slide 24 I asked the obvious question, but why would you want to exit the ESOP. And if you do, you have to think about essentially buying out a retirement plan, whatever that fair value is.

[Paul L. Porretta]
Correct.

[Gregory J. Nowak]
And once you buy it out the cash goes into the allocated accounts of the employees and they would turn it over to an IRA, presumably, or go into distribution status?

[Paul L. Porretta]
Yes.

[Gregory J. Nowak]
Okay, now there's another option. Which is to keep the ESOP in place, keep the S Corp. in place and you create a joint venture underneath, where, whoever your equity partner is, is coming in and the equity partner effectively buys interest in a joint venture from the S Corp. So your tax planning structure stays in place, your accounts for your employees stay in place, all of those tax benefits that you get stay in place, but we create a new joint venture entity that's an LLC partnership flow through, and we contribute the operating business to that joint venture. So if you look at the slides that begin on slide number 26, the shareholders essentially would create a new structure, we're going to convert that target into an LLC and when all is said and done, if you turn over to slide number 29, you end up with a joint venture, which is the new LLC, taxed as a partnership, you have your private equity fund or bank or whoever, that's the triangle off oC the right owning a piece of that LLC, the operating entity, and you still have your shareholder, namely the ESOP, and your S corp. as the continued owner of whatever percentage of that business that you would have.

Rich, you guys recently went to a transaction very similar to this, did you not?

[Richard Juliano]
Absolutely. It looks quite familiar.

[Gregory J. Nowak]
And the structure you ended up with is a private equity firm owning a portion of the operating business, but the employees and everyone else remained an employee of an ESOP through a cyclonic arrangement with the operating business, correct?

[Richard Juliano]
Correct.

[Gregory J. Nowak]
So, again, structures like these are possible. They allow you to avoid the close-out of the ESOP and the funding that would be required, but nevertheless continue to maintain the integrity of the ESOP because, at least in this structure, all of the people who work in this business are still employees of the "employer" that's sponsoring the ESOP.

[Richard Juliano]
Yes.

[Gregory J. Nowak]
So, with that background and all the legal structures, what I would like to do now is turn to our guest from Barclays, who is going to walk us through a couple of equity recycling case studies and then we're going to talk about some market multiples for your exit strategies. The question we always get is "Is it bigger than a bread box?" So, tell us about some of the case studies that you've been working on in terms of equity recycling.

[Frederic Way]
Sure. Thanks Greg. So what I would like to start with is a recently announced transaction in the form of the restructuring of OZ Management, which is formerly Och-Ziff Management publicly traded hedge fund, founded by Dan Och. So the transaction which was announced about 10 days or so ago, really contemplated 3 key elements. One was an equity realignment, which we'll touch on in a second, the second of which was sort of a balance sheet, restructuring and an acceleration of debt pay down, and a third of which was a C-Corp. conversion from their existing partnership.

Uhm, so going back to the most important piece, which is the equity realignment, what was the problem? The problem was a couple fold. One was the existing partners, at the time, the existing partners today do not have previous transactions, they didn't really have any equity in the game. So they didn't have any skin in the game and as a result felt like they were working for the original founders, who, at the time of the IPO continued to own a significant majority of the business and had never really contemplated an equity recycling program. And so as the generations shifted and as people started to retire, there became increasingly large problem around the total cost base of the business as new people became partners and as people grew and their salaries increased, such did the cost structure on the business and that sun setting off of the prior ownership and the units held by the prior ownership was never really contemplated.

So what ended up happening in the form of this transaction was the existing, aging holders, that were the founding shareholders of the business, gave up 35% of their units, their A units, for a give up and compensation from the existing executive managing directors and in to perpetuity effectively, so they're going to give up that comp basically forever for the benefit of that 35% economics.

They, they being the current executive managing directors, are going to now become the largest shareholders in the Och-Ziff pro forma Och-Ziff group. So, you know, holistically, you know what we're seeing as a benefit of this deal is that, as part of this sort of realignment, people are feeling a lot better about sort of how we as an existing management group can be motivated and excited about creating value in the equity and in the stock going forward, because now they're aligned, not only with the retired folks, but they're also aligned with the public shareholders.

[Gregory J. Nowak]
So when you boil it down, what you had was sort of a combination of Katelyn's compensatory equity being shifted from an older generation to the new managing directors and senior executive staff in exchange for a contribution in and that contribution in was their foregone salary.

[Frederic Way]
Correct. And the important thing to note there as well, as part of this holistic restructuring you know, the existing management also wanted to ensure that the business was well structured into the future and what that also meant and what it also contemplated was an acceleration of pay down of debt, and an acceleration of sort of restructuring of the balance sheet because they also wanted to ensure that the business was aligned properly on the balance sheet side of the equation such that over time as economics grew and as the business improves, that their equity is obviously increasingly valuable and growing in a way that they, you know, think is appropriate for what they traded off, which was ultimately that comp.

[Richard Juliano]
Now Katelyn, did they have to do an 83(b) when they were doing (laughing).

[Katelyn D. Winslow]
(laughing) That's a good question. I was going to ask something similar in that the recycling of the equity from the older generation to the new generation, how was, that kind of like a white elephant exchange or was it some employee communication or if hold-out was there, what was that process.

[Frederic Way]
Yeah I mean tax people are probably better placed to answer that than I am but to the best of my understanding, the way it works is that, the profits interest in a business remains in the existing unit holders, so that they're effectively giving them economic units until those units book up in the future. The existing profits interest for those units because they're going into what's called, you don't need to go into all the nuances, but into what's called a distribution holiday for a period of time. Those profits and interest will continue to remain with the retired managing directors until those profit interests ultimately book up into a share over time. So there's no tax implications day one effectively.

[Gregory J. Nowak]
So this sort of goes back to the discussion we had early on with a grant of an equity interest if it has no value on the date of grant, you would file an 83(b) in order to set the value at 0 in a taxable exchange and it sounds as if the new members are essentially getting future growth after the distribution holiday.

[Frederic Way]
Correct.

[Gregory J. Nowak]
So that would further defer the current value for the period of the distribution holiday because they're not getting that and so therefore the value of their interest would be lower.

[Frederic Way]
And again, getting back to the taxable question, it's only taxable upon that book up and upon the moment at which it turns into a unit post the holiday.

[Gregory J. Nowak]
Now the important thing also to keep in mind here in these structures and in a couple of case studies that Rick is going to walk us through, is these are 0 subgains. There's only so many dollars on the table, right. And in Rich's case they were able to use the tax deferrals that are presented by the ESOP structure to take those dollars that would otherwise be spent, to pay them and use them for debt service and also to reinvest in the business. In this case, the current management team forwent salary, so there were those dollars left in the business, and also there is a distribution holiday. So again, we're using the chips that are on the table in order to refinance the equity.

[Frederic Way]
Exactly.

[Gregory J. Nowak]
Exactly. So, a very important lesson to keep in mind – each of these transactions are 0 subgains. If you bring in an outside party, like if I have an equity firm or a bank they need to be repaid. And so just like any other financing structure, unless it's internal, those structures will require you to have cash flow budgets and use that cash flow to amortize the debt over time. I guess the message there is there is no free lunch. Right? But in, as Rich's situation proves out, properly structured, the increase in value can be substantial. The enterprise value of the firm because of the reinvestment of the firm, pay down of debt and also the expansion of the product lines and the people. So tell us about equity recycling case, Firm 1.

[Frederic Way]
Yeah sure. So there's 2 cases I'd like to touch on, one is Firm 1. The first of which, I think it's a relatively straight forward program that they put in place. They put this program in place later in their evolution. They were founded in the 60s but the program really was only sort of put into action in the late 90s. The way it works is it's a 4-year sunset in the management company. So effectively that's the cash flows and the management company itself. The second piece of the

equation is carried participation and we'll touch upon that again in the next case study but the way that that works is their carried participation for two funds remain in place and basically linearly drop off as each fund is put into a back door, the money is gone to work. So the way that it works – let's just use some numbers – if they had 10% in Fund 1, the next fund they would have is 5% or something along those lines and then the third fund they would have 0.

[Gregory J. Nowak]
This is a very traditional structure by the way for real estate management firms that have multiple funds over time with different backing vintages for employees. Not something you can do, for example, in a registered fund firm like Emerald, that has primarily registered mutual funds and large separate accounts where your backend participation is not as easily created.

[Frederic Way]
And I think that's consistent around most, most of them are alternative management firms, private equity firms, real estate firms, infrastructure firms, things like that that have larger portions of back end participation.

The next case study is Firm 3. This one's a little bit different. There is no management company participation after a partner or principal leaves. There's no real sun setting so to speak for that piece of the cash flow string. There is however a retention by that individual in their sort of vested carried interest and so they will retain that but they will not retain any future participation in carried in any fund that will come post their retirement.

[Gregory J. Nowak]
Okay, so let's talk about some market multiples, again, is it bigger than a bread box and the key things that we're seeing. Obviously we're seeing massive gyrations in the value of the equity markets, especially the public equity markets, with a big run up from last November until say May and then since May we've had a significant downturn, where now we're deemed to be in correction although today there's a big bounce in the Dowell. So what happened to market multiple?

[Frederic Way]
Yeah, sure, so quickly the way to think about it for publicly-traded asset managers, they're trading right now at an all-time low relative to you know, really five year or really full historic average. We're talking about multiples in sort of the 10X type range for a forward PE. Now it's important to sort of juxtapose that with what you see in a private setting, where multiples for M&A deals have remained pretty constant and pretty flat I'd say over the last five-ish years. We're seeing multiples for, like an average across all transactions, of being around 10X EV/EBITDA and that's normally priced off of Run EBITDA which means existing assets which are in the grounds today at the time the transaction annualized and adjusted for compensation and expenses.

[Gregory J. Nowak]
Just to put this in historical context, when I was EVP running an M&A Department for an asset management shop out of London between 1999 and 2002, our average multiple was, get this, 20

to 22 of EBITDA, often forward priced, so we're talking about go-go markets, go-go pricing and very, very different world then.

[Frederic Way]
The good old days.

[Gregory J. Nowak]
The good old days, exactly. So keepings. What are we seeing in terms of acquisition multiples for you know traditional equity shops, for alternative asset shops, for what you're seeing in the market place?

[Frederic Way]
Yeah, sure, so the last page in our slide deck touches a little bit on sort of themes of transactions and where they're coming from. The first 3 themes are really buyer themes and the last theme is a supply side theme, where's a deal is coming from or where the asset is coming from. The first of which is consolidation and focus on cost. You know you're seeing a lot of asset managers who are under pressure for a number of different reasons, whether it be fees, costs, distribution issues, etc.

[Gregory J. Nowak]
So what's your normal erosion rate when you're doing a consolidation for costs in terms of clients leaving, being put on watch lists, and otherwise being frozen out, breakage essentially from the acquisition?

[Frederic Way]
Yeah, breakage, I mean, it really depends, it's situational, on how much overlap we see in a deal. We average when we do our own modeling somewhere between 10 to 15% but that's for a business that doesn't have huge amounts of overlap, huge amounts of basically product concentration, that are similar.

[Gregory J. Nowak]
So Rich when you did your deal, you needed to go out obviously and get a proxy with the mutual funds, how long did that take to get to the necessary 15.1%?

[Richard Juliano]
Four months.

[Gregory J. Nowak]
Four months. And that's with a proxy solicitor and with a fairly friendly shareholder base.

[Richard Juliano]
Proxy solicitor, very friendly and all hands on deck. Calling everybody to get the votes in. Yeah, fortunately it was over the summertime.

[Gregory J. Nowak]
Yeah, the rule change that went into effect about 10 years ago with the SEC that eliminated typical broker vote, which was intended to be a shareholder populist vote, but it's just backfired

horribly because it's impossible to find shareholders in order to get them to vote. Because you own omnibus accounts and even though the brokers cooperate and get the information, it's still virtually impossible to get these people to act and that means transactions that should happen, that make all the economic sense in the world, tend to get stymied. So if anything should be changed, they should go back to the broker vote because, you know, from the point of shareholder populist voting it really doesn't work. But having said that, I'm sorry go ahead Fred.

[Frederic Way]
Yeah, no, and look just very quickly on the last couple of themes, I think we're seeing a lot in the way of minority stakes today. I think there's a lot of capital chasing minority stake opportunities. There's been dedicated pools of capital, dedicated funds which have been raised. To take minority stake in funds, many of which are private equity funds or hedge funds, so that's alternative asset managers again.

[Gregory J. Nowak]
And they're taking the minority stake in the general partner or advisor entity?

[Frederic Way]
Typically in the general partner and they're take a share in the economics of the management fee portion of the company as well as the carry. The share, the percentage that they normally acquire is 20% or below, typically. Again across both sleeves. And then there's the last theme here on the buyer's side is alternative platform deals. And that's again alternative asset management businesses, whether that be private equity firms, hedge firms, real estate infrastructure, real assets more broadly. Selling or finding homes inside of larger, more diversified asset management businesses. Sometimes those asset management businesses sit inside of insurance companies so insurance asset managers of banks and really the genesis and reason they're looking for that is diversification and the opportunity to find yield and yieldy products for ultimately their end clients.

[Gregory J. Nowak]
Okay, we have about 30 seconds. Any concluding comments from the audience here? Paul.

[Paul L. Porretta]
Thanks, Greg. So yes, we've discussed a pretty wide range of certain aspects of exit strategies and ways in which they can actually be integrated. I think ESOP companies that also have forms of equity based compensation for their executives –

[Gregory J. Nowak]
SARs for example.

[Paul L. Porretta]
Yeah, exactly, right, and I would just beware of the traps for the unwary on fiduciary requirements.

[Gregory J. Nowak]
Kaitlyn –

[Katelyn D. Winslow]
Well it sounds like from all the presentations that we've listed offer comprehensive approach to equity compensation, as well as deferring for your retirement, all of that is important, none of the options should be skipped or overlooked.

[Gregory J. Nowak]
And very few of them are mutually exclusive. A lot of them work together. As we showed with Rich who had SARs, who had an ESOP plan and now is part owned by a private equity firm, the operating business, not the ESOP and still generating value all the way across the board. So, again, it can be done. And Rick.

[Frederic Way]
Yeah, sure, I think thematically all of these transcend the drivers of why people are needing to do something or facilitate equity realignment or some form of equity restructuring will continue to be a driver of asset management activity and asset management M&A more broadly.

[Richard Juliano]
I would say Greg that, one of the things for folks listening, you can hear from the folks in the room here, the Pepper folks and Rick, I would urge having a strong team I mean having folks like Pepper on our side through the process that are creative. Having folks like Barclays on your side that are out there doing this work is invaluable and if you're going to do any of these transactions, assemble the best team first and then go because without that team, you're not going to be able to conquer and succeed and Pepper was extremely influential in us being successful and I'm sure Rick you do the same for your clients. But I would strongly urge assembling the best team before you proceed.

[Gregory J. Nowak]
Well thank you Rich, thank you Rick, thank you Paul and thank you Katelyn.
