

Tiered Partnerships

It seems lately that there has been quite a bit of attention being paid to tiered entities. This is an interest in an entity is held by another entity, and the interest in that entity is the one that is being valued. The issue at hand most often is the type and magnitude of discounts that are appropriate for such an interest. On the one hand, each “layer” exhibits characteristics that are not desirable for any investor – and these are generally characterized along the control and marketability axes. Restrictions on transfer, lack of control over assets and distributions, lack of control in corporate governance, etc etc. When you have an entity that holds an interest in another entity, surely these characteristics must come into play to some degree, but what degree is that? Is a combined discount of, say, 70 percent ok? Meaning the hypothetical buyer would only pay 30 percent of the face value of the investment as a result of these multiple restrictions? Many experts would argue there is a returns constraint – i.e. the valuation associated with the interest is ultimately a function of the anticipated cash flows and the risk associated with them.

I tend to agree with this constraint theoretically, but the challenge is – what is the required rate of return for this incremental risk? In reality, there is no market for interests like this. By that I mean, good luck finding a buyer. I think the closest we come to a market benchmark for this sort of thing is the limited partner interests in private equity vehicles trading on the secondary market. From what I understand many of these interests are trading at 40 to 60 percent discounts to their estimated face value (often the same thing as basis, i.e. invested capital).

Regardless, how does one calibrate the appropriate return for this sort of thing given there is not a robust pool of buyers readily willing to share their views on target returns? Let’s just guess for a second. Certainly an investment of this nature is riskier than a private equity investment, right? Typically private equity investors purchase controlling interests in cash flow positive companies. They have say over basically everything – management, dividends, exit, strategy, etc. Most industry sources will cite target returns in the 20 to 30 percent range for this asset class. What about a private holding company that owns minority interests in other privately held companies? 30 to 40 percent? 40 to 50 percent? Higher? I would argue higher. So what does that translate to in terms of combined discounts? Let’s say I invest in an entity that holds a risk free investment that compounds a rate of return of 5 percent over five years, at which time I get my money back with interest. If my target rate of return is 25 percent, I need to discount the face value by 58 percent. If it’s a 50 percent rate of return, I need to discount it 83 percent. So at a minimum, combined discounts should be 58 percent. That’s still way low. That’s a risk free investment! A 50 percent return for an interest in a private company that holds interests in minority stakes in other private companies doesn’t sound unreasonable, and a five year holding period with no dividends or distributions for that time period is also reasonable. So, by nature, an 83 percent discount should be acceptable. Wow. That’s huge! I understand this is overly simplified, but the reality of it is – it’s not too far from the truth, either.

Now the problem lies in the fact that while this is theoretically sound, it is also the very thing that leads attorneys to create vehicles strictly for their tax advantages – i.e. the interests were never meant to trade, but rather serve as tax advantaged vehicles for use in wealth transfer. I can understand why this upsets the IRS. However, they themselves supported the practice in my opinion with Revenue Ruling 93-12 – the treatise on discounts and intrafamily transfers. I also know there have been some recent cases, the Astleford case, for example, that have started the movement in the greater discount direction. It certainly is interesting, given the increasing pressure on the IRS to generate incremental tax revenues given all the unfunded liabilities and entitlement programs (nevermind the current deficits). Interesting times indeed.

