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CloserLook

Positioning for success in private equity: The UP-C advantage

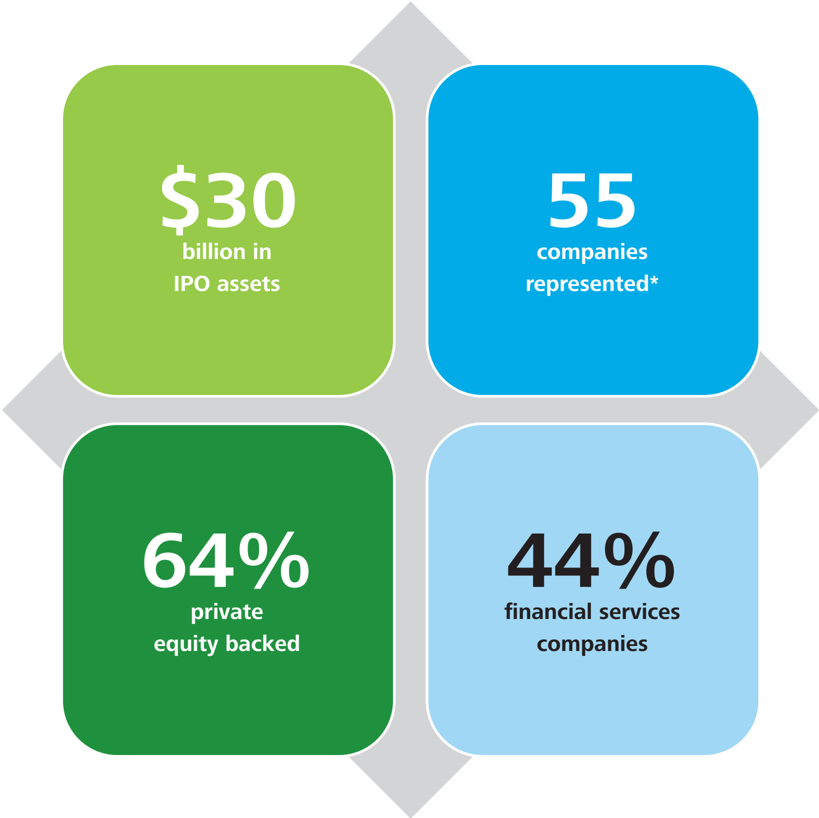
Introduction

Private equity firms are taking a closer look at an exit strategy that is growing in popularity. Known as an UP-C, the umbrella partnership corporation structure may provide a favorable tax posture to owners and investors. Five years ago, UP-Cs were not commonly used, but that is now changing. Based on the benefits this structure may provide, it is increasingly important for private equity firms and their portfolio companies to consider an UP-C during strategic exits, transaction structuring, and succession planning.

Understanding UP-Cs and IPOs

The UP-C structure, modeled after the UP-REIT, has been utilized for some time.[1] Over the past decade, 55 companies have gone public using either an UP-C or the closely related adviser publicly traded partnership (PTP) structure.[2] The aggregate deal value of these initial public offerings (IPOs) totals $30 billion, as depicted in Figure 1.

Figure 1: UP-Cs and adviser PTPs (2005–2015)



Source: Deloitte Center for Financial Services. Based on analysis of Thomson Reuters IPO data, January 2005–June 2015.

*Includes 47 companies with an UP-C structure, and eight using an adviser PTP.

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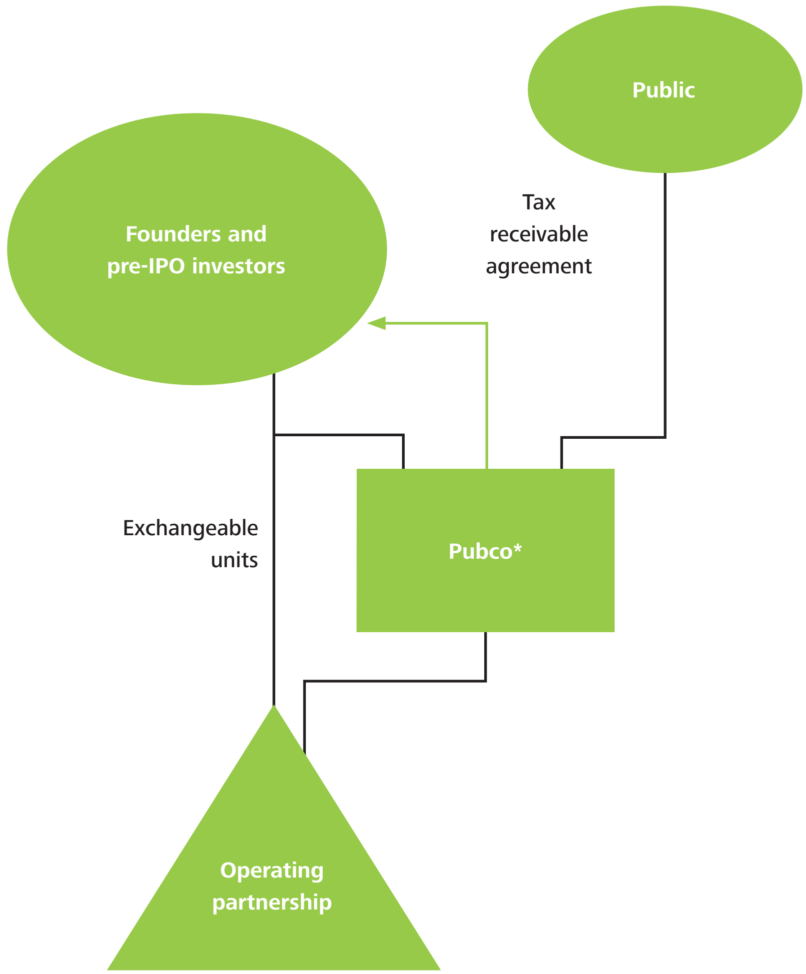
Private equity firms may find UP-Cs particularly attractive: 64 percent of the IPO assets raised using this structure to date have been private equity backed. Financial services companies tend to use UP-Cs more than other industries, representing 44 percent of companies originating UP-Cs.

A significant benefit of the UP-C is in its ability for historical owners to receive a premium on the value of their partnership units equivalent to the present value of a percentage of the tax savings to the "Pubco" on its acquisition of the partnership units in exchange for Pubco shares. This process is detailed in Figure 2, as it relates to IPO exits. As illustrated, when a company prepares for an IPO, the company creates a partnership, if one does not already exist. The company then forms the new entity, Pubco, a corporation, the shares of which are publicly traded.

A tax receivable agreement is set up (of which the Pubco is part), with this new structure reflecting the amortization of goodwill and intangible assets resulting from favorable partnership basis adjustment provisions.[3] The economic benefit that results from these tax deductions is generally split on an 85/15-percent basis between the historic owners of the partnership and the Pubco.

Figure 2: UP-C simplified ending structure



Source: Deloitte Tax LLP.

*Pubco issued stock to the Public in IPO as part of the UP-C IPO.

Beyond the IPO

The potential tax benefits of UP-Cs may be valuable to private equity firms and their portfolio companies during two other important events:

Transaction structuring: The ability to use an UP-C may enhance the competitive positioning of private equity firms and portfolio companies during transaction structuring. The goal of the UP-C structure is to enable existing partners in a business operated through a partnership or limited liability company to access the public markets through a corporation, while still holding their interests using a pass-through structure (which is generally more tax efficient for the partners) until the historic partners are ready to sell their interests. As such, private equity firms may leave portfolio companies in the form of a partnership or limited liability company, allowing them to benefit from operating through this structure. Then, when the owners are looking to exit their investment, the owners may:

1. Sell the partnership interest to a buyer, or
2. Access the capital markets through the UP-C structure.

In the first option, the sale of a partnership interest generally will result in a step-up in the tax basis of the company's assets to the buyer, resulting in potentially additional tax amortization or depreciation (which may offset future taxes) for the buyer. Consequently, a buyer may increase its purchase price for the present value of this tax benefit.

In an UP-C structure, the sellers deliver a step-up to the tax basis of the company's assets for the Pubco, and the tax benefit derived from this step-up is split 85/15, as noted above. Thus, the UP-C structure allows a private equity company to operate in a pass-through structure, and still access the capital markets when it is ready to exit or grow the business.

Succession planning: According to the NACD Private Company Governance Survey, only one-third of companies have a formal CEO succession plan.[4] Our related experience shows that private equity firms are inquiring more frequently about the value of an UP-C during this same succession planning process, signaling a growing wave of interest in the topic. As the ultimate goal of succession planning is to understand the value of the business, to preserve its value and future growth potential, and to pass it forward intact,[5] the organization may want to consider the potential flow-through tax benefits of the UP-C during this process. Significantly, leadership transitions are expected to become more top of mind in the private equity industry as company founders prepare for retirement.

Looking forward

Increased transaction activity may create more opportunity for private equity companies to consider using an UP-C. Deloitte's 2015 M&A Trends Report reveals that 63 percent of private equity executives polled expect transaction activity to be "high" or "very high" in the ensuing 12 months, up from 52 percent a year earlier.[6] More than 60 percent of these respondents said they expect a strategic sale will be the primary form of portfolio exit. There was also a slight uptick among those who expect to turn to an IPO, with 38 percent of respondents looking to the IPO market, up from 36 percent a year earlier.[7]

Other aspects of the environment also appear favorable for UP-C expansion. On the regulatory side, accounting rules and tax laws allow use of the structure. Word-of-mouth marketing by dealmakers in the private equity space has promoted its growing use. Publicity around a number of recent IPOs has also turned a brighter spotlight on the UP-C.

These positive signs—combined with the growing adoption rates discussed above—indicate that the time may be right for companies to consider the potential benefits of an UP-C structure. This IPO alternative may be a structure a private equity firm or portfolio company needs to consider when it comes to planning for the future of the business and evaluating potential tax efficiencies.

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Endnotes

1 An UP-REIT, or Umbrella Partnership Real Estate Investment Trust, enables the exchange of real estate properties into an interest, which can be converted to a public or private security.

2 Deloitte defines an adviser PTP as the publicly traded partnership structure employed by select alternative asset managers in which the public's interest in assets that give rise to "qualifying income" under the tax rules is held through tax transparent entities and the public's interest in the management company (which earns income that is not "qualifying income") is held indirectly through a corporation. An adviser PTP may also be called an UP-PTP.

3 A tax receivable agreement requires a new corporation to pay the original owners a percentage of present and future realized tax benefits.

4 "2014-2015 NACD Private Company Governance Survey," National Association of Corporate Directors, 2015.

5 "Business succession planning: Cultivating enduring value," Deloitte LLC, 2015.

6 "M&A Trends Report, 2015," Deloitte Development, LLC, 2015.

7 Ibid.

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