Fundless Sponsors & Qualified Small Business Stock:

An Incredible IRR Boost

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Definition of Fundless Sponsor

Before explaining the advantages of Qualified Small Business Stock, I thought a definition of a fundless sponsor would be helpful. An article in The Economist provided an excellent example: "The typical search-fund principals are MBA graduates from an elite American university, who raise $400,000 or so of "walking around money" from investors, who purchase a stake in the fund for about $40,000 a share. The fund searches for a high-growth, high-margin target, valued at $5m-20m. The fledgling businessmen then hold a second round of acquisition financing, as well as raising debt. Their tenure as bosses lasts until they sell out." [1]

The article itself is concise and worth the read. Even the title is appropriate here: "Seek and We Shall Fund: Private Equity for Absolute Beginners." The only point I would argue is that I have met many fundless sponsors that had very different backgrounds from the MBA graduate background described.

Purpose

The purpose of this installment is to highlight Section 1202 of the Internal Revenue Code which permits excluding capital gains from federal tax payments so long as the securities held qualify as Qualified Small Business Stock (QSBS).

The reason that Section 1202 is so frequently overlooked by the private equity community is that it only applies to smaller transactions. It is therefore not an industry practice. To qualify as QSBS the transaction in question must have gross assets equal to or less than $50 million, which is limited to the lower end of what is known as the lower-middle-market of private equity.

Sidenote: I also believe it is overlooked because returns to investors are measured pre-tax. In my opinion, if one private equity group consistently had to subtract 15% of the gains achieved when reporting results while the competition did not, they would quickly evaluate this option.

Application

As stated above, if shares held qualify as QSBS, then shareholders can exclude a portion of the proceeds received for federal tax purposes.

The amount that can be excluded varies accordingly:

- For QSB stock acquired on or before Feb, 17th 2009, 50% of the qualified gain can be excluded.
- For QSB stock acquired after Feb, 17th 2009 and before Sept, 28th 2010, 75% of the qualified gain can be excluded.
- For QSB stock acquired after Sept, 27th 2010, **100% of the qualified gain can be excluded.**

The amount to be excluded is capped at the greater of $10 million or 10 times the taxpayer's basis in the stock (*without getting into too much detail, if you are unfamiliar with taxpayer basis, think about this sum as the dollar amount invested*).

Without providing all of the details, and at a very superficial level, the principal requirements are threefold:

1. The entity must be a domestic (U.S.) C corporation.
2. Total gross assets cannot exceed $50 million at the time the shares were issued.
3. The shares must be held for more than 5 years.

NOTE: *There are many additional qualifications, and this is a superficial definition. Please review Section 1202 of the tax code for a more thorough explanation. If you are contemplating a transaction, seek legal counsel (ASimpleModel.com does not provide investment or tax advice).*

Structure:

One potential structure follows: A sponsor creates of a new entity in the form of a C corporation ("HoldCo"), which serves as a holding company to acquire all of the stock of the target company. Instead of raising capital through a limited partnership agreement (as discussed in LBO video series), the sponsor and investors purchase shares in HoldCo directly.

As a reminder, carried interest generally works out to 20% of the potential gains. To achieve this level of compensation by purchasing shares, the sponsor would have to purchase 20% of the common stock, which could require a large sum of money. A solution is to offer investors the opportunity to invest in the form of redeemable preferred stock with warrants (common stock without voting rights would be another option).

As we learned in the video titled LBO: Common + Preferred, preferred stock can have the effect of making the common stock "cheaper." Cheaper here means that the same dollar value purchases a greater ownership position on account of the senior equity leverage.

This structure is typically outlined in what is known as the Certificate of Incorporation. What follows is a truncated version of an entirely hypothetical example of such a certificate:

Certificate of Incorporation of HoldCo, Inc.

ARTICLE ONE
Name
The name of the corporation is Company Holdings, Inc. (the "Corporation")
[More Language]

ARTICLE TWO
Purpose
[More Language]

ARTICLE THREE
Capital Stock
The Corporation shall be authorized to issue two classes of stock designated as "Common Stock" and "Preferred Stock." The total number of shares of Common Stock which the Corporation is authorized to issue is 1,250,000 shares, par value of $0.01 per share, to be issued in one or more sub-classes or series, of which (a) 250,000 shares of Common Stock shall be, and hereby are, designated as Class A Common Stock ("Class A Stock"), and (b) 1,000,000 shares of Common Stock shall be, and hereby are, designated as Class B Common Stock ("Class B Stock"). The number of shares of Preferred Stock the Corporation is authorized to issue is 125,000 shares, par

value $0.01 per share, of which 125,000 are hereby designated as “Preferred Stock” (the “Preferred Stock”).

Common Stock
Each holder of Class A Stock is entitled to one vote for each share of Class A Stock held by such holder at all meetings of stockholders. The shares of Class B Stock shall have no voting power.

Preferred Stock

Corporation Redemption Rights:
At any time, the Corporation may, in the sole discretion of the Board of Directors, elect to redeem all (but not less than all) of the issued and outstanding shares of the Series A Preferred Stock at a price per share equal to the original Series A Issue Price per share, plus all accrued but unpaid dividends.

Dividends:
The holders of record of Preferred Stock shall be entitled to receive dividends at the rate of eight percent (8%) of the Series A Original Issue Price per fiscal year, compounded annually, payable in preference and priority to any payment of any dividend on shares of any other class or series of capital stock of the Corporation for such fiscal year.

Distributions upon Triggering Events (*distribution waterfall with no catch up)*:

Preferred Distributions: First to the holders of Series A Preferred Stock, pro rata, until such holders have received cumulative distributions equal to any accrued but unpaid Series A Dividends plus the Series A Original Issue Price for each share of Series A Preferred Stock outstanding.

Distributions to Common Stockholders: Following the distributions pursuant to Section (*the section above*), any remaining Distributable Proceeds shall be distributed among the holders of Common Stock pro rata.

Ownership Structure

Finally we have the ownership structure. To make sense of the share counts provided in our hypothetical example above and the structure that follows, we first need to review a simple concept:

Number of Authorized Shares >= Number of Issued Shares >= Number of Outstanding Shares

The Certificate of Incorporation lists the number of shares that Holdco is *authorized* to issue (“authorized shares”). This is generally a number greater than the number of shares that the board intends to issue because it provides the ability to issue more shares in the future should there be any need to do so. Finally, if a company issues shares and then repurchases them (treasury shares), the number of outstanding shares is reduced by the treasury shares:

Outstanding Shares = Issued Shares – Treasury Shares

With that knowledge in mind, let’s look at a hypothetical equity structure for HoldCo. Per the Certificate of Incorporation, we have two classes of stock, one with voting rights (Class A) and one without (Class

B). This permits the fundless sponsor to maintain control. The investors (or Limited Partners) are then offered redeemable preferred stock with warrants attached (Preferred Stock with Class B Warrant Shares).

Shares Issued:

Shares of Class A Common Stock Issued: 200,000

Shares of Class B Common Stock Issued: 800,000

Shares of Preferred Stock Issued: 100,000

Sponsor

1. Shares of Class A Common Stock (Voting)

Limited Partners

1. Preferred Stock
2. Class B Warrant Shares (Non-Voting)

Management

1. Shares of Class B Common Incentive Stock (Non-Voting)

Whatever the value of the equity required to finance the transaction, the majority of the value would be allocated to the Preferred Stock. For example, if total equity raised was $20 million, the capitalization table might resemble the following:

Limited Partners	Preferred Stock with Warrants: $19,800,000	70%
General Partner	Class A Common: $200,000	20%
Mgmt. Team	Class B Common: $0	10%

The warrants are issued with the preferred stock, and when exercised provide 70% of the ownership of HoldCo. In a future sale of HoldCo the warrants will be sold for the value per share of the common stock less the exercise price (in a normal transaction this difference would be taxed as a capital gain, but if the shares qualify as QSBS per the conditions listed under Section 1202, this gain can be excluded).

This structure provides a 20% ownership position and full control of the business to the fundless sponsor for $200,000 when the total equity raised is $20 million. (Note: If the fundless sponsor does not have $200,000, they could require a closing fee equivalent to this sum, and use that balance to purchase the Class A common stock.)

The management team's shares would be issued post close, and therefore the position is listed under fully diluted ownership with no dollar value assigned.

In the event of a successful sale, the Limited Partners and the fundless sponsor would not pay capital gains taxes. For the management team, whether or not they enjoy this privilege depends on how the incentive equity is structured (e.g. options are generally taxed as ordinary income – if the shares were purchased they would enjoy the same benefit realized by the other parties).

For more information about QSBS please visit the IRS website: LINK

[1] http://www.economist.com/news/finance-and-economics/21706334-private-equity-absolute-beginners-seek-and-we-shall-fund