

# IIR Venture Capital Private Equity Tax Practices West October 25, 2006

**New Issues on the Horizon**

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Where is the Market Today?

“It was the best of times . . .”

# U.S. Private Equity Performance Index (PEPI)

(Investment Horizon Performance as of 3/31/2006)

Fund Type	1 Year	3 Year	5 Year	10 Year	20 Year
Early/Seed VC	9.7	5.0	-8.6	41.4	20.5
Balanced VC	31.0	13.5	-1.0	18.0	14.6
Later Stage VC	17.4	10.7	-1.8	10.7	13.8
All Venture	19.8	9.4	-4.4	22.7	16.5
All Buyouts	25.5	17.6	6.3	8.9	13.3
Mezzanine	11.9	6.1	3.1	6.6	9.1
All Private Equity	22.8	14.7	3.0	11.8	14.3
NASDAQ	17.0	20.4	4.9	7.8	10.1

\*The Private Equity Performance Index (PEPI) is based on the latest quarterly statistics from Thomson Venture Economics' Private Equity Performance Database analyzing the cashflows and returns for over 1814 US venture capital and private equity partnerships with a capitalization of \$657 billion. Sources are financial documents and schedules from Limited Partners investors and General Partners. All returns are calculated by Thomson Venture Economics from the underlying financial cashflows. Returns are net to investors after management fees and carried interest.

Source: Thomson Financial

# “It was the worst of times . . .”

[« Song of The Day | Main | Search By Salary »](#)

## Is The "Traditional Venture Capital Model" Broken?

[According to The New York Times](#) (Oct 7, 2006), Sevin Rosen has decided not to raise Fund X (ie their tenth fund) because:

*“The traditional venture model seems to us to be broken,” Steve Dow, a general partner at Sevin Rosen Funds, said in an interview.*

That is an opinion not to be taken lightly. Sevin Rosen is a quality firm with a ton of experience doing venture deals over almost 30 years.

But it reminds me a bit of the analysis that [Paul Ferri](#) and [Howard Anderson](#) have put forward in recent years. The model that worked for the past 30 years isn't going to work as well for the next 30 years, that's for sure.



“It was the age of wisdom, it was the age of foolishness . . . .”

**The Mercury News**  
MercuryNews.com

**Sunday, October 8, 2006 (MercuryNews.com)**

[1. VCs are still spending \\$2 billion a year on chips](#)

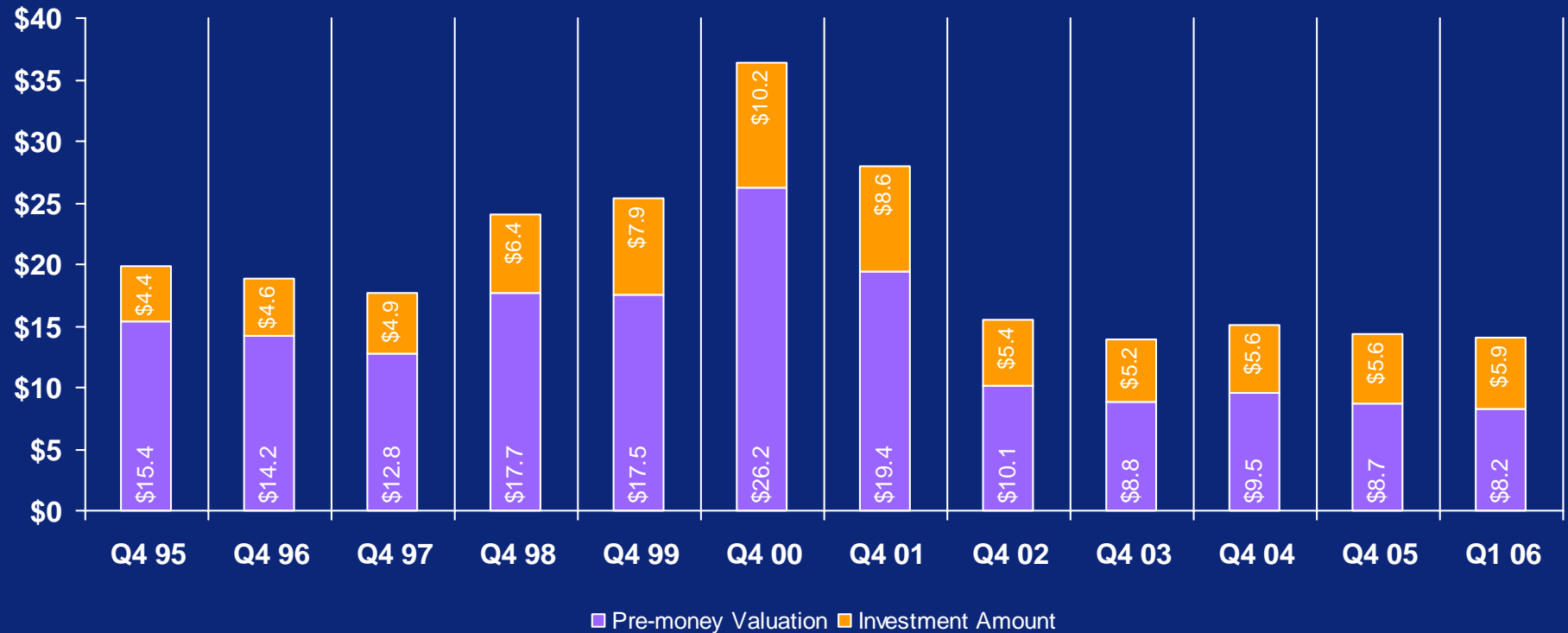
## **VCs are still spending \$2 billion a year on chips**

It's getting harder to start chip companies, but venture capitalists are still making bets on seasoned entrepreneurs in the industry that is the bedrock of Silicon Valley. ... can still get funding. New start-ups such as *Optosecurity*, Nextreme Thermal Solutions, Imsys, ...

# Are we buying high?

## Post-Money Valuations – Early Stage Companies. 1995 to Q1 2006

12 Month Average



Q4 Year	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	Q1 2006
Total	\$19.83	\$18.73	\$17.61	\$24.14	\$25.44	\$36.45	\$27.95	\$15.54	\$14.00	\$15.13	\$14.37	\$14.06

# New Fund Formation is accelerating . . .

Year	Venture Capital		Buyouts & Mezzanine**	
	Number of Funds	VC Raised (\$M)	Number of Funds	Buyout & Mezzanine (\$M)
2002	171	3,847.7	88	25,731.1
2003	144	10,680.2	92	29,310.4
2004	201	18,253.3	134	50,953.1
2005	202	26,530.8	175	94,669.7
2006 YTD	105	17,972.6	73	54,383.7
Quarter				
Q2 '05	56	7,676.0	63	26,446.0
Q3 '05	62	5,608.1	60	21,677.4
Q4 '05	70	8,083.8	50	32,491.0
Q1 '06	64	6,762.5	46	23,575.0
Q2 '06	50	11,210	35	30,808.7

Source: Thomson Venture Economics/National Venture Capital Association

\*These figures take into account the subtractive effect of downsized funds

\*\* This category includes LBO, Mezzanine, Turnaround and Recapitalization-focused funds

\*\*\*Date current as of 7/17/06

# Deals continue at a healthy pace

## Q2 2006 – Most Active Venture Investors

Venture Capital Firm	Location	Total Deals
Draper Fisher Jurvetson	Menlo Park, CA	26
New Enterprise Associates	Baltimore, MD	22
Kleiner Perkins Caufield & Byers	Menlo Park, CA	20
Intel Capital	Santa Clara, CA	20
Austin Ventures, L.P.	Austin, TX	17
Polaris Venture Partners	Waltham, MA	17
Oak Investment Partners	Westport, CT	16
Sequoia Capital	Menlo Park, CA	16

# Exits continue at a steady pace

## Analysis of Venture-Backed IPO and M&A Activity

Date	Number of IPOs**	Total Venture-Backed Offering Size (\$M)	Average Venture-Backed Offering Size (\$M)	Number of Venture-backed M&A deals	Average M&A deal size***
2001	41	3,489.9	85.1	353	101.8
2002	24	2,473.5	103.1	318	52.1
2003	29	2,022.7	69.7	293	62.8
2004	93	11,014.9	118.4	340	83.0
2005 Q1	10	720.7	72.1	82	94.9
2005 Q2	10	714.1	71.5	80	133.1
2005 Q3	19	1,458.1	76.7	98	93.1
2005 Q4	17	1,568.1	92.2	86	65.7
2005	56	4,461.0	79.7	346	95.8
2006 Q1	10	540.8	54.1	101	114.5
2006 Q2	19	2,011.0	105.8	86	95.4

\*\*Includes all companies with at least one U.S. VC investor that trade on U.S. exchanges, regardless of domicile

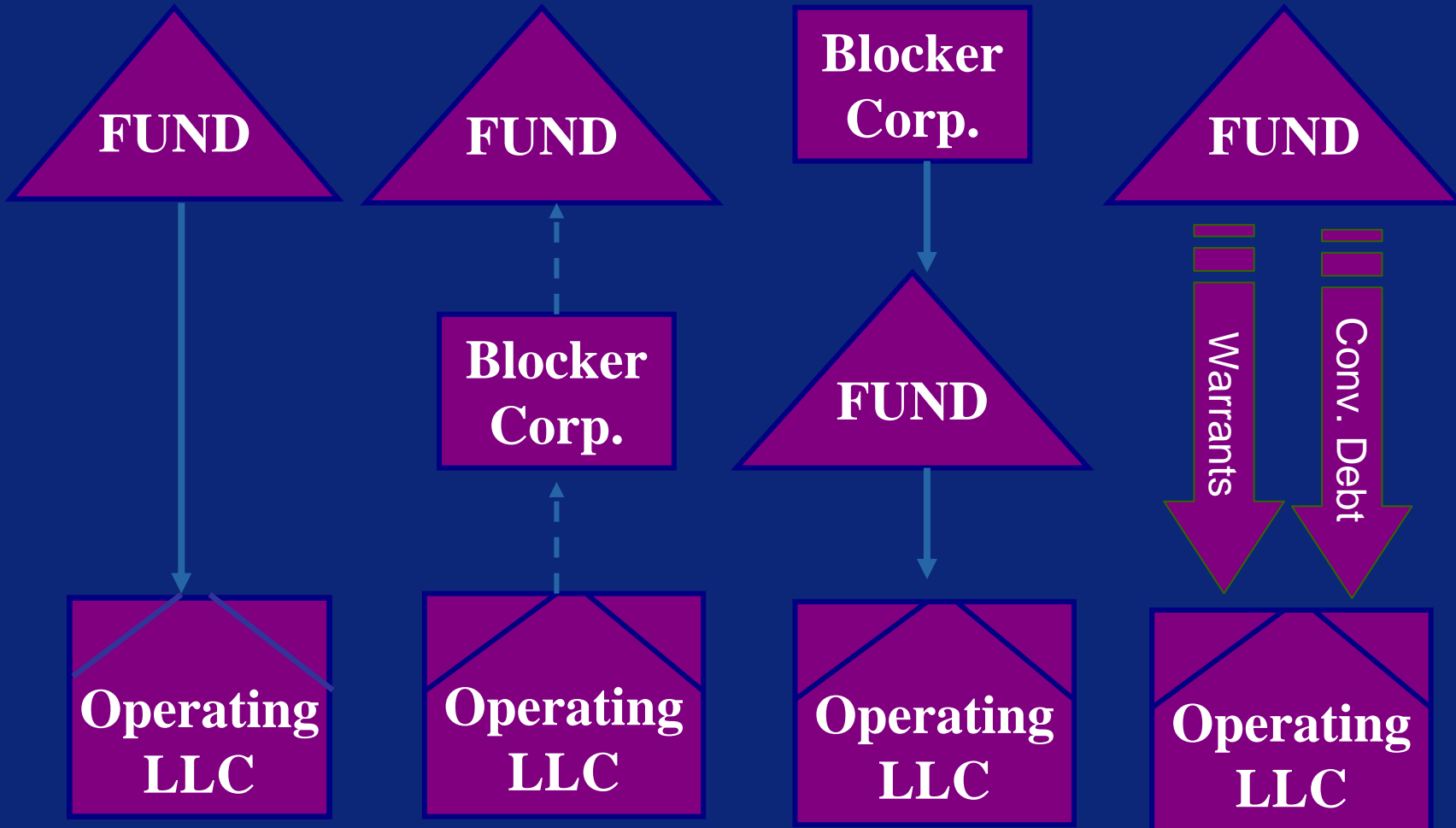
\*\*\*Only accounts for deals with disclosed values

Source: Thomson Venture Economics/National Venture Capital Association

Will Funds Continue To Be UBTI  
Sensitive?

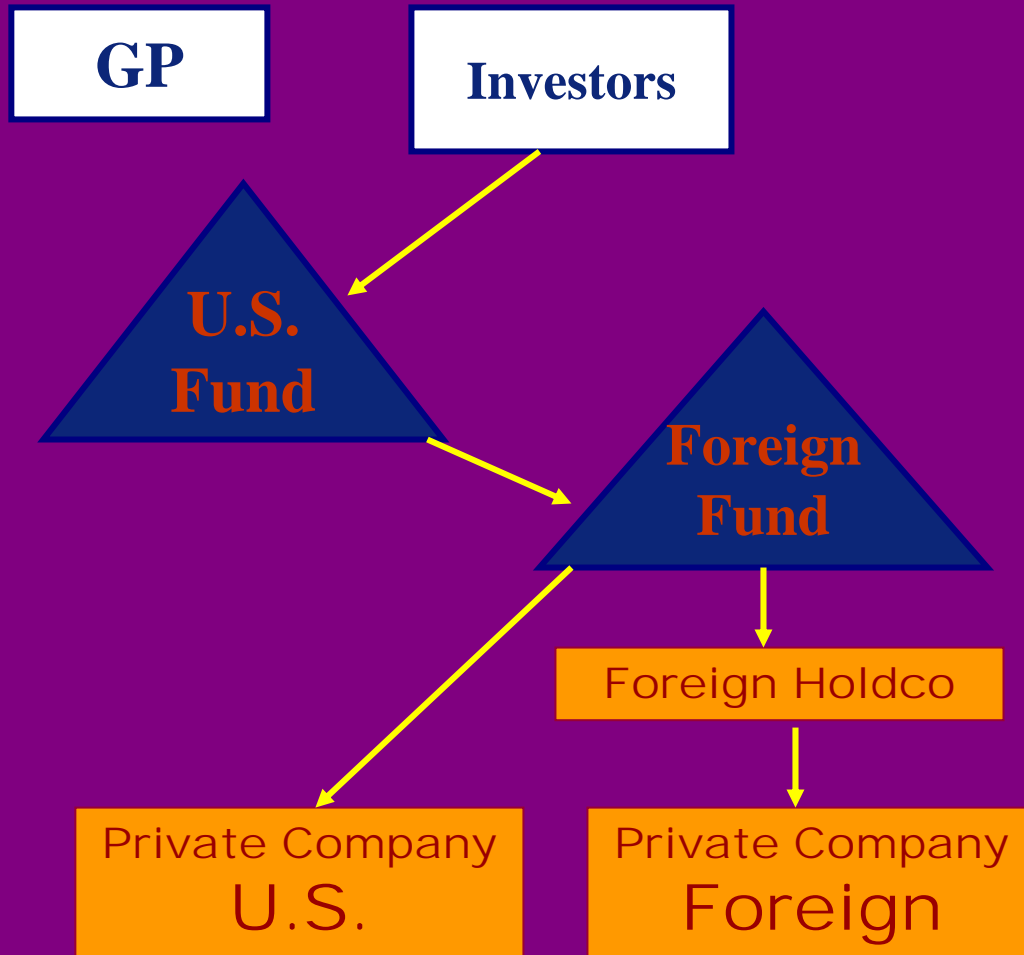
# Will Funds lose their fear of business income?

Vanilla    Lower Tier Blocker    Upper Tier Blocker    Next Generation?



# Will Funds Continue to Move Offshore?

# Will Funds increasingly move across borders?



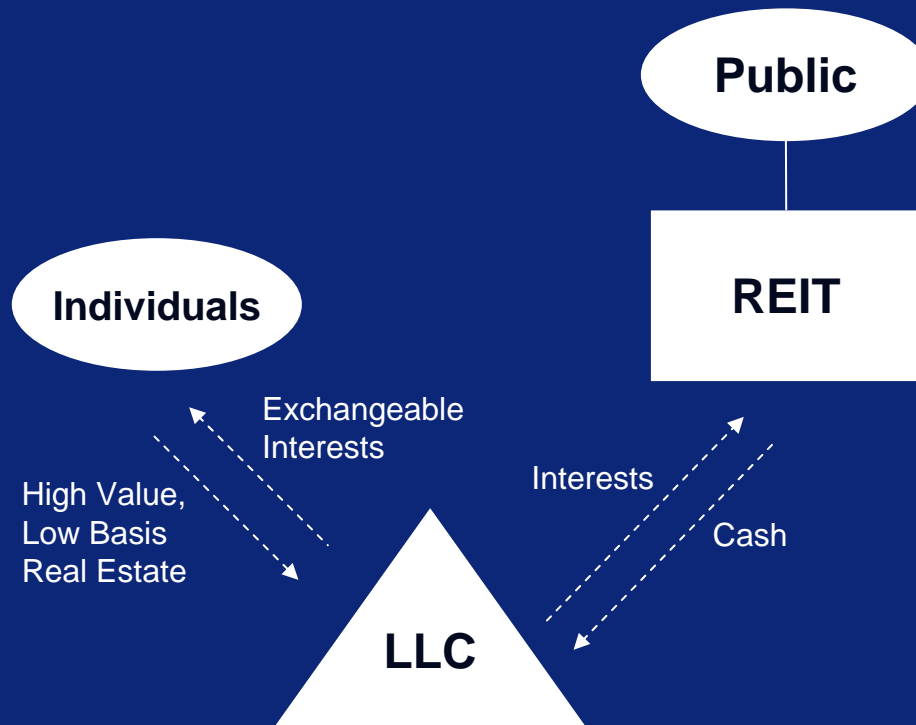
## Feeder Fund Structure

- Dedicated fund may qualify for tax benefits in foreign country.
- Feeder structure reduces foreign tax exposure for US fund
- Local Investors may choose to invest directly into foreign fund.
- Investors may choose to invest through an intermediary entity.

Will a New IPO Model Gain  
Traction?

# Public LLC – Predecessor Transaction

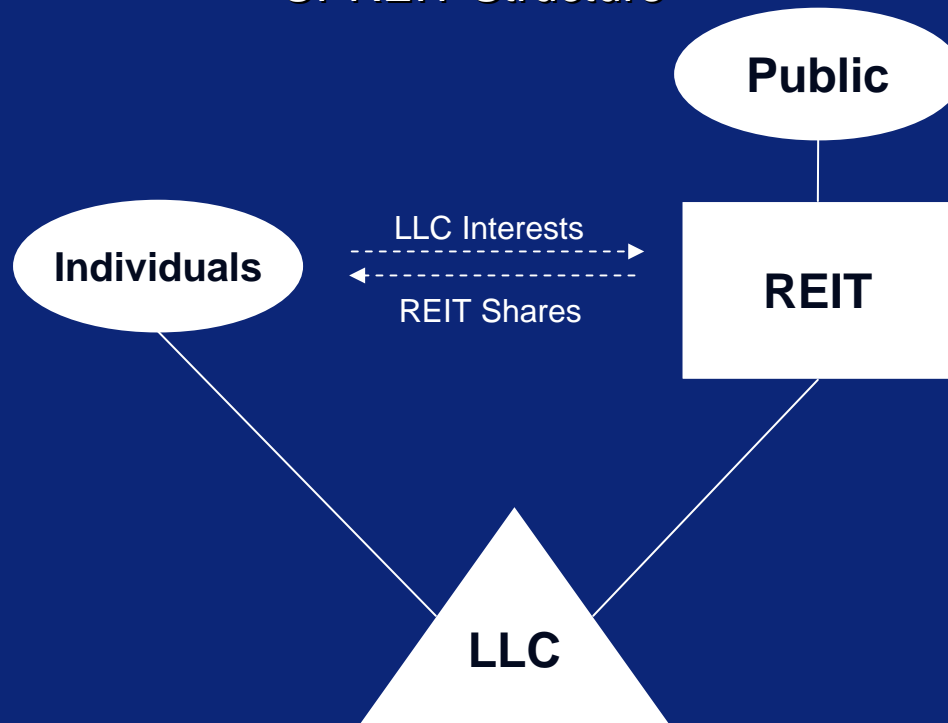
## UPREIT Structure



- Individuals contribute real estate to LLC in exchange for interests that are exchangeable for REIT shares. REIT contributes cash to LLC in exchange for interests.

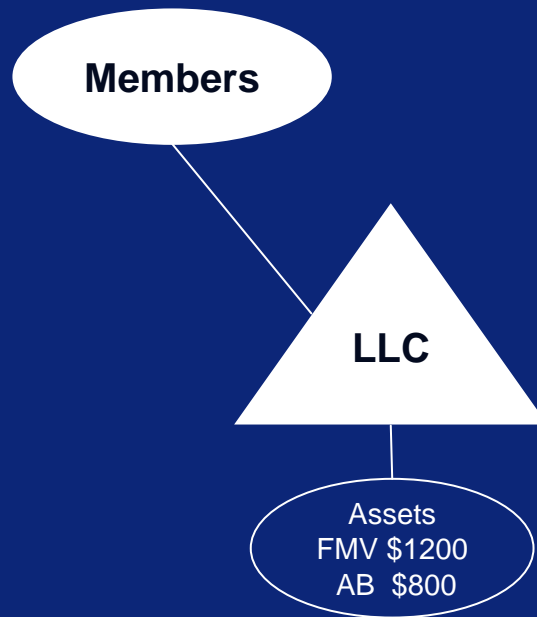
# Public LLC – Predecessor Transaction

## UPREIT Structure

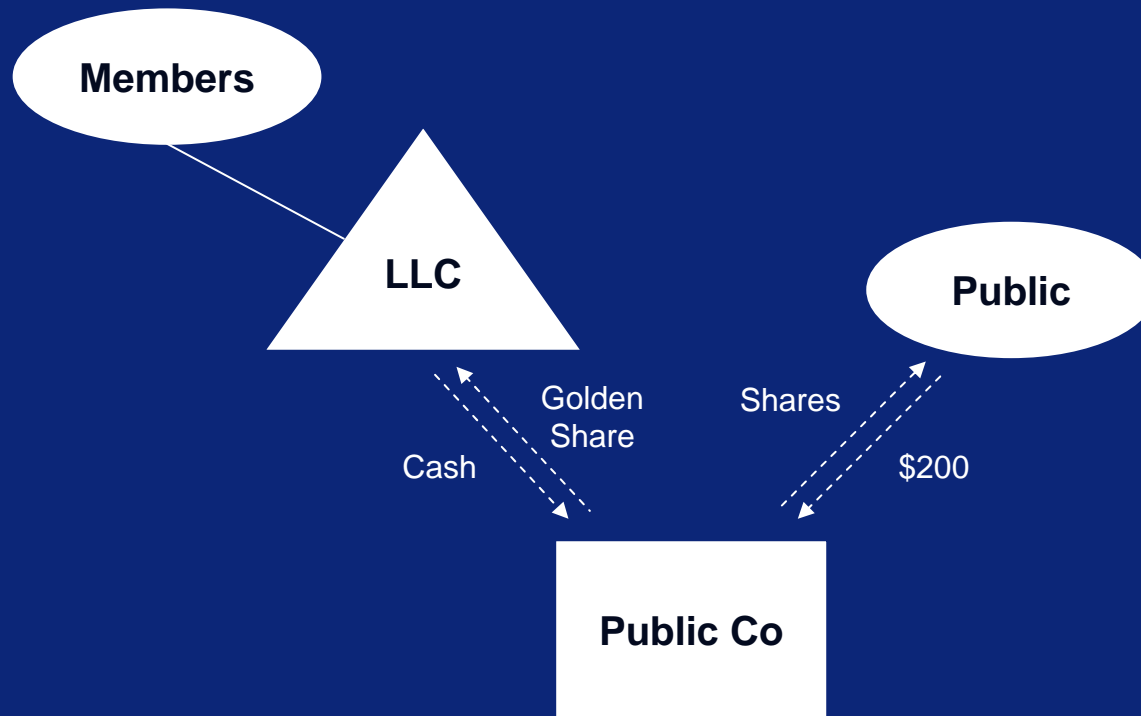


- Individuals exchange LLC interests for REIT shares in taxable transactions.

# Public LLC – Structure

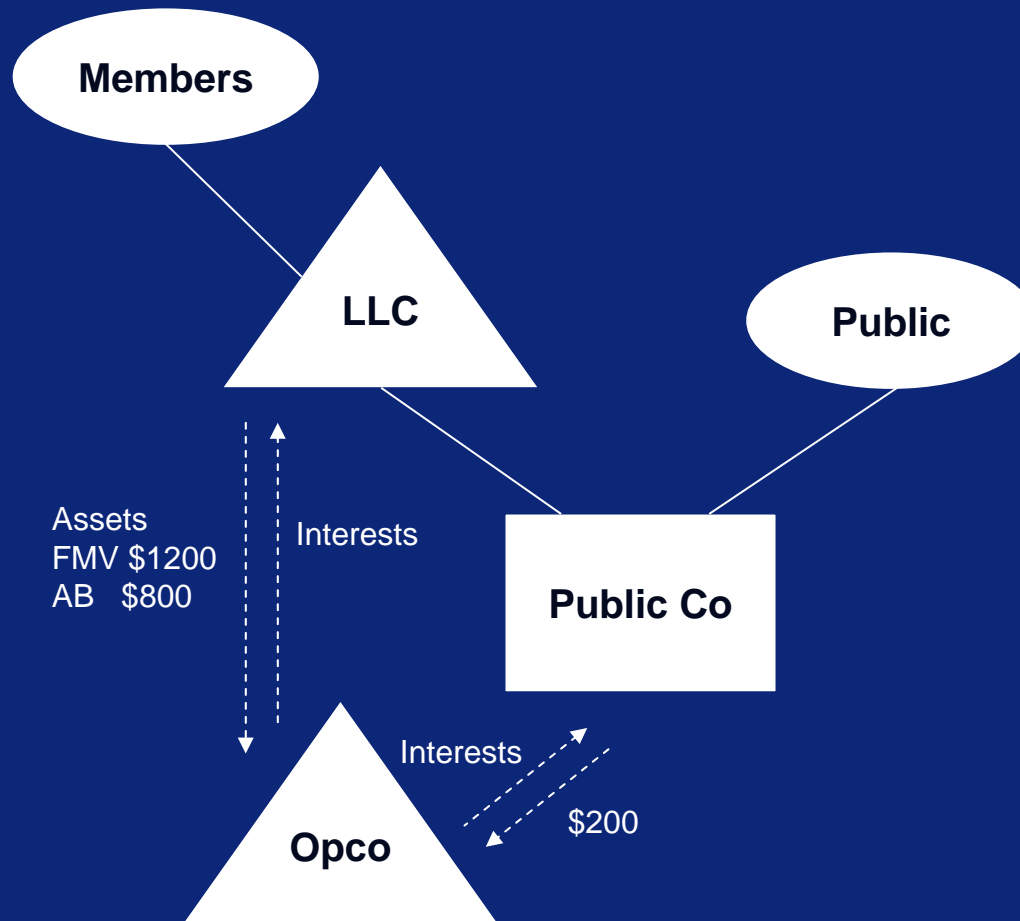


# Public LLC – Structure



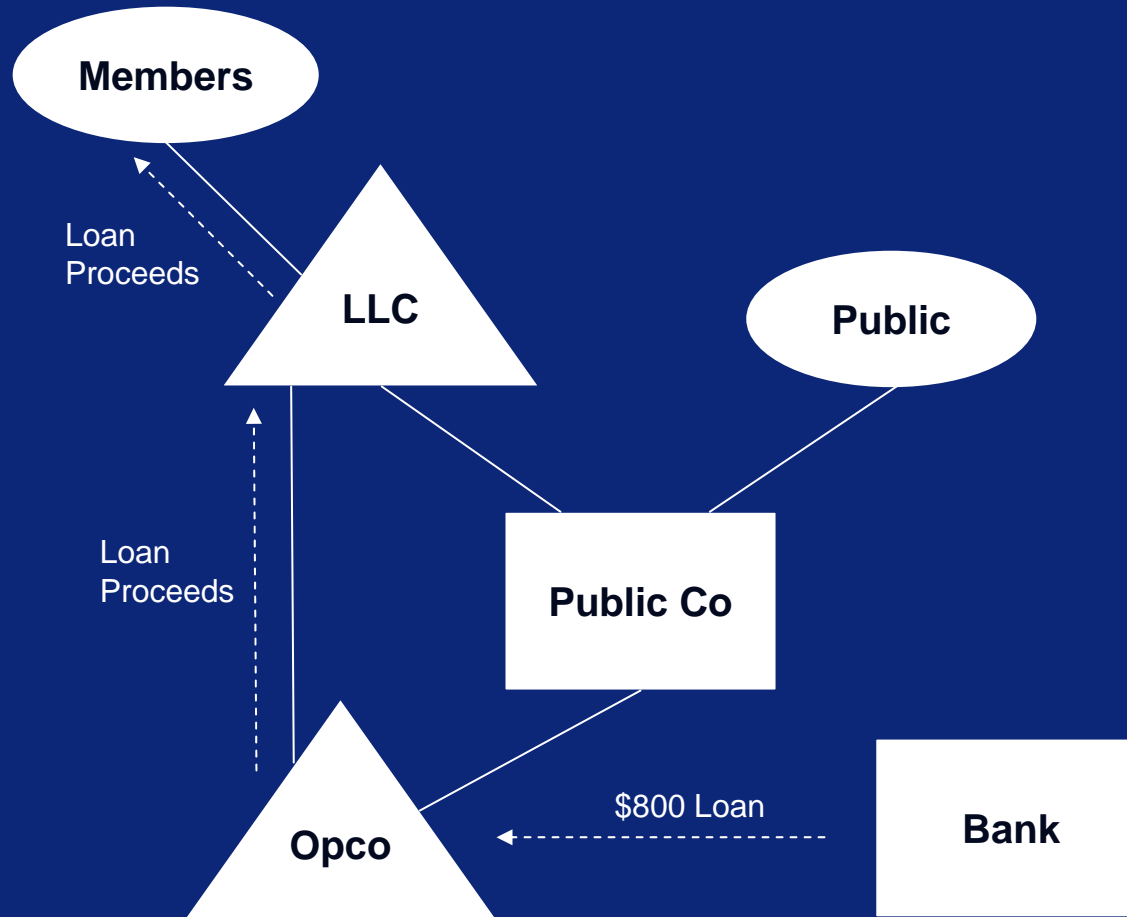
- LLC contributes cash to Public Co for a share of “high vote” stock. Public contributes cash to Public Co for regular common stock.

# Public LLC – Structure



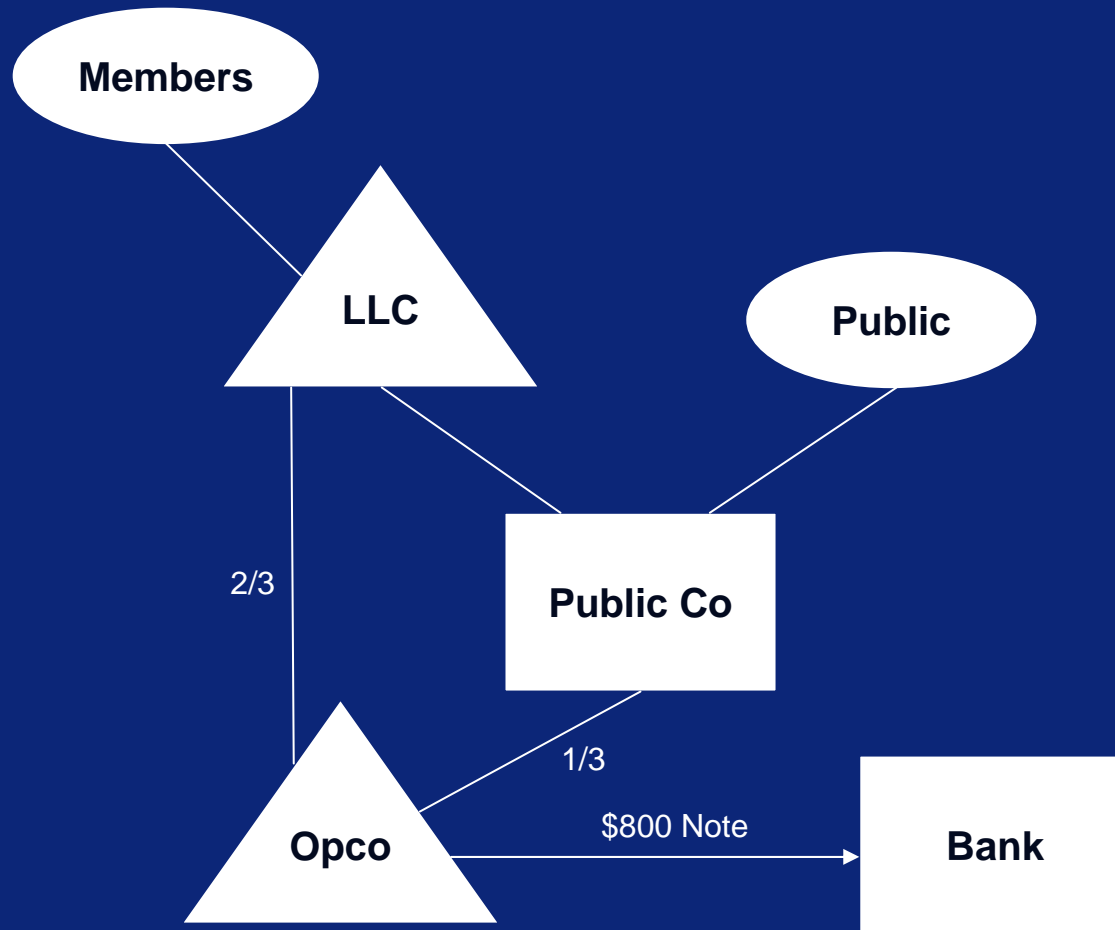
- LLC contributes assets to Opco for Opco interests that are exchangeable for Public Co stock. Public Co contributes cash to Opco in exchange for Opco interests.

# Public LLC – Structure



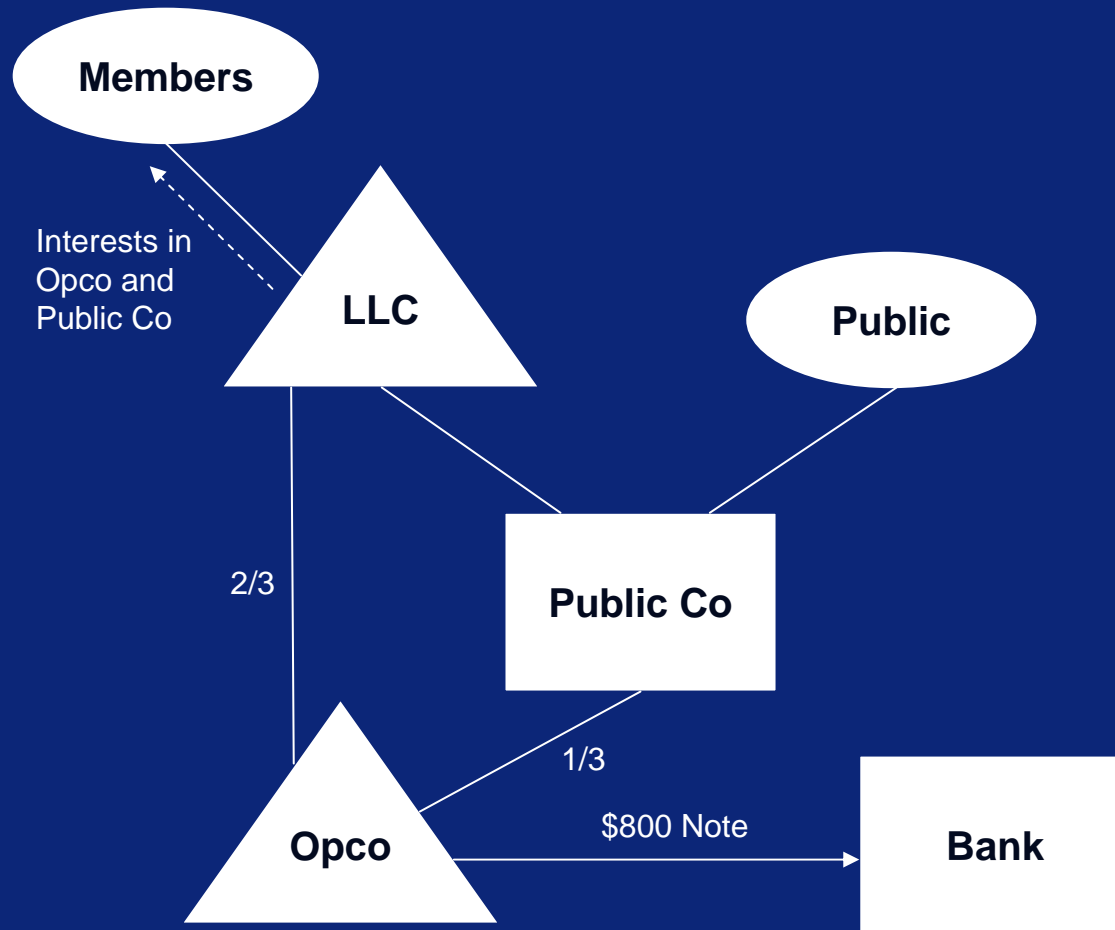
- Opco borrows money from Bank. (The loan is recourse only to Opco and its assets.) Opco distributes to LLC the loan proceeds in partial redemption of LLC's Opco interest. LLC distributes the cash to its members.

# Public LLC – Structure



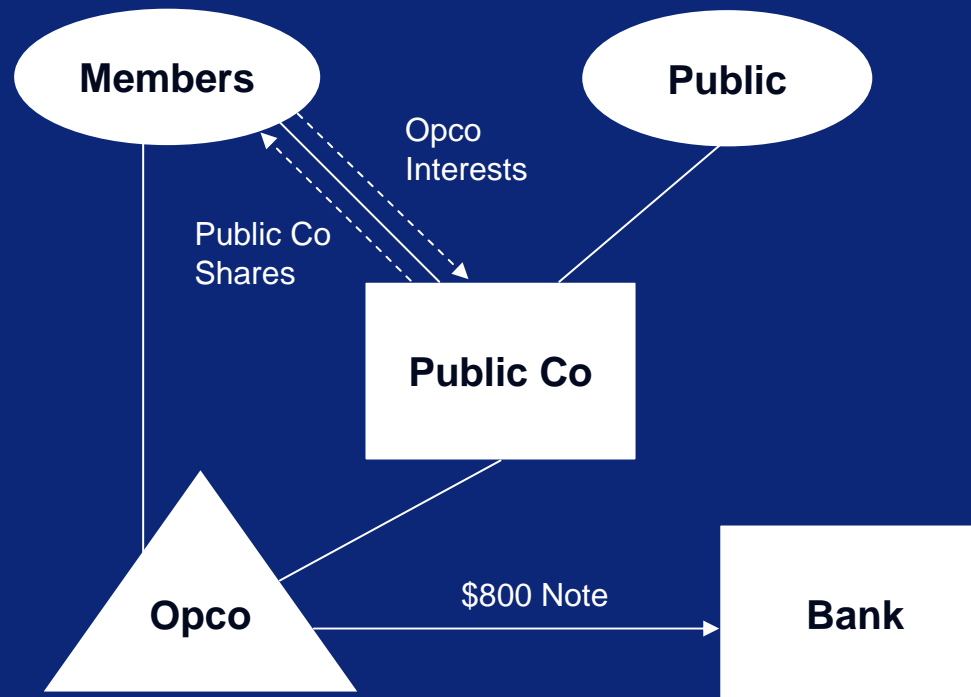
- This is the post-IPO “interim look.”

# Public LLC – Structure



- To accommodate differing objectives of its members and to address regulatory concerns, LLC liquidates, distributing its Opco interests and Public Co shares to its members.

# Public LLC – Structure



- When Opco interests are exchanged in taxable transactions for Public Co shares, Public Co receives § 743(b) adjustments, and exchanging members receive ITRs.

# Public LLC

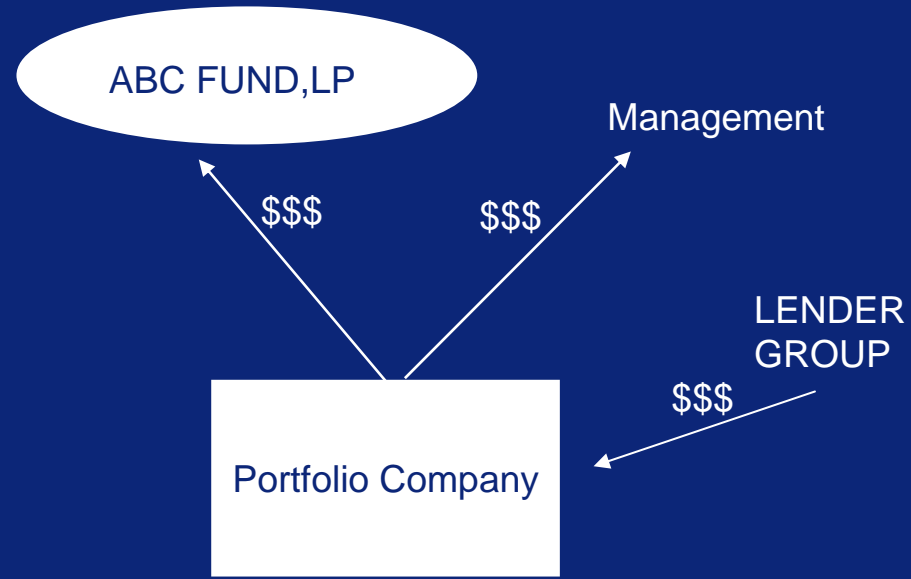
For IPOs using a variation of this structure, see:

- [barnesandnoble.com](http://barnesandnoble.com)
- Charter Communications, Inc.
- Accenture
- Calamos
- Texas Genco (filed but not executed)
- Lazard
- Evercore

Will Funds Continue To Do  
Dividend Recaps?

# DIVIDEND RECAP

- E&P
- Valuations
- Leverage
- Effect on GP/LP Economics
- IIR
- Reinvestment
- Tax distributions
- Risk Shifting



Will Funds Continue To See  
“Convergence”?

# OVERHANG

- From 1998-2004, the total “overhang” was \$237.5 billion, with \$234.5 billion of that in US funds
- In the first half of 2005, \$88.9 billion was raised and only \$34 billion invested, adding to the overhang
- Buy-out firms continue to raise more money than they invest, signaling a potential reduction in fund raising
- VC firms are investing more than they are raising and there is still a \$60+ billion “overhang”, signaling a potential reduction in investing and/or increased fund raising

# Convergence

- Fund types
  - Hedge
  - Venture
  - Growth
  - Buyout
  - Mezzanine
  - Distressed
  - Fund of funds
- Private Equity vs. Hedge Fund
  - Contributions
  - Withdrawals
  - Portfolio securities
  - Valuations
  - GP remuneration
- Drives behavior
  - Liquidity
  - Risk tolerance
  - Driving IIR

What will the publicity do?

# Spotlight on the Industry

- Retail-ization: consumer protection
- Profits interests & 409A regulations
- Rate changes
- PPA effects
- Securities regulation & examination
- Audits

# BusinessWeek Online – Cover Story

“GLUTTONS AT THE GATE.

Private Equity Are Using Slick New Tricks to Gorge  
on Corporate Assets. A story of Excess.”

October 30, 2006