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The Up-C IPO: a structure that keeps on giving

By John LeClaire, Brad Weber

In 2006, **Hellman & Friedman** acquired a minority interest in **Artisan Partners**, a Wisconsin-based investment management firm. Artisan was organized as a partnership at the time of the investment. Hellman & Friedman and Artisan opted to leave Artisan's partnership structure in place following the investment rather than converting the company to a C corporation.

Almost seven years later, in 2013, Artisan went public at an aggregate equity value of approximately \$2 billion. The IPO utilized an "Up-C" structure in which Artisan again retained its partnership form. This structure will allow H&F and other pre-IPO owners to receive aggregate cash payments from the public company over subsequent years that were estimated at \$855 million at the time of the IPO. These payments will be in addition to the owners' gains from sales of their equity stakes. Had Artisan's partnership form been jettisoned at any point, the ability to capture these additional cash returns would have been lost.

Up-C IPOs have not been broadly utilized as a means of exit by sponsor-backed companies to date, but have become somewhat more common in recent years. In 2013 and 2014, respectively, 12 and 17 IPOs were filed using the Up-C structure, all but one of which closed or remained pending at year-end 2014. The issuers in these offerings had an average market capitalization of \$1.1 billion at IPO and two-thirds had private equity owners. The number of Up-C IPO filings in 2013 and 2014 represented an increase compared to the five-year period from 2008 to 2012, when a total of 18 Up-C IPOs were filed, with only 11 even-



John LeClaire



Brad Weber

tually closing (see accompanying table). Prominent Up-C IPOs that are currently pending include the **Go Daddy** and **Shake Shack** IPOs.

Fairly simple in concept but complex in detail and implementation, an Up-C IPO requires a profitable business in tax pass-through form. The business assets remain owned and operated by the pass-through entity (an LLC or LP) through and after IPO rather than converting the business to a C corporation at the time of the IPO. The offering is effected by forming a new C corporation to issue stock to the public, with the C corporation using the IPO proceeds to acquire an interest in the operating partnership. Pre-IPO owners who hold direct partnership interests continue to hold these interests until they want liquidity, which they obtain by exchanging the partnership interests for public company shares and selling the shares in the market.

Tax Windfall

The taxable nature of the exchange of the partnership interests for public company shares drives the Up-C structure.

Applicable tax rules provide that these exchanges enable the public company to write up the tax basis of the assets of the operating partnership that the public company is deemed to acquire each time it receives exchanged units. The amounts of these write ups are based on the value of the public company stock at the time of each exchange. Tax rules further provide that the public company can amortize these tax write ups over 15 years, with the resulting deductions sheltering future income. The higher the stock price at the time of each exchange, the greater the amount of the write up for the public company.

The public company in an Up-C IPO agrees to make cash payments to the pre-IPO owners under "Tax Receivable Agreements" to compensate them for the benefits the partnership interest exchanges create and (in some cases) for tax benefits associated with contributions of other tax assets by certain pre-IPO owners at the time of the IPO. These payments are taxed as capital gains. Pre-IPO owners typically receive 85 percent of the value of the tax benefits and the

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public company typically keeps 15 percent, with payments made by the public company as the benefits are realized. The payments themselves generate additional tax benefits and therefore additional payments to pre-IPO owners on an iterative basis.

The relatively small number of Up-C IPOs to date has occurred in an environment in which private equity investors, especially in the middle market, tend to favor exiting by sale over IPO. Yet the potential magnitude of the cash payments that an Up-C IPO can generate, as well as the other potential benefits of operating in pass-through form, should cause an increased level of focus on the pass-through alternative at each stage of company growth. Historically, many entrepreneurs have organized new businesses in C corporation form or converted them to C corporation form in order

to avoid perceived complexity, accommodate institutional investors or go public. But as entrepreneurs and investors give increasing weight to the potential benefits a pass-through structure can provide in relation to potential detriments, and as investors have gained greater flexibility to invest in pass-through entities directly or via “alternative investment vehicles” and the like, familiarity and expertise in addressing pass-through challenges and opportunities have become essential skills in winning and structuring deals.

Will the Up-C IPO become ubiquitous, particularly for companies in the middle market? That is unclear. While the overall level of awareness is rising, some investors and many entrepreneurs are not even aware of the possibility of an Up-C IPO exit. By choosing a structure that negates the possibility of such an

exit (let alone the other potential benefits a pass-through structure can provide), these investors and entrepreneurs reduce optionality, sometimes unwittingly.

In the near term, it is likely that the Up-C IPO structure will remain the province of larger companies with strong cash flows and sophisticated sponsors. Over time, broader use, or at least broader consideration, may result, especially if successes using the Up-C IPO structure become more widely known. For that to happen in any individual case, the foundation must be laid well in advance. The owners of Artisan knew that and are profiting from their knowledge yet.

John LeClaire is partner, co-founder and co-chair of the private equity group at law firm Goodwin Procter LLP, while Brad Weber is a partner in the firm's business law department.

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Select Up-C IPO Filings, 2010-2014

Company Name	First Public Filed Date	Lead UW	Status	PE Backed?	Total Market Cap at IPO
Shake Shack Inc.	12/29/14	J.P. Morgan	Pending	Yes - Leonard Green, SEG Partners	n/a
Black Knight Financial Services, Inc.	12/23/14	Pending	Pending	Yes - T.H. Lee Partners, FNF	n/a
Summit Materials, Inc.	12/18/14	Citigroup	Pending	Yes - Blackstone	n/a
J. Alexander's Holdings, Inc.	10/28/14	Stephens, Inc.	Pending	Yes - Newport, Fidelity National	n/a
The Habit Restaurants, Inc.	10/16/14	Piper Jaffray	Closed	Yes - KarpReilly	\$454,549,572
Fifth Street Asset Management Inc.	9/8/14	Morgan Stanley	Closed	No	\$830,567,079
Neff Corporation	9/3/14	Morgan Stanley	Closed	Yes - Wayzata	\$381,417,225
Enovation Controls, Inc.	8/29/14	Morgan Stanley	Pending	No	n/a
Medley Management Inc.	8/18/14	Goldman Sachs	Closed	No	\$527,999,994
Woodside Homes, Inc.	6/25/14	Credit Suisse	Pending	Yes - Oaktree, Stonehill	n/a
GoDaddy Inc.	6/9/14	Morgan Stanley	Pending	Yes - KKR, Silver Lake, TCV	n/a
Spark Energy, Inc.	5/29/14	Baird	Closed	No	\$247,500,000
Adeptus Health Inc.	5/21/14	Deutsche Bank Securities	Closed	Yes - Sterling Partners	\$451,821,920
Parsley Energy, Inc.	4/11/14	Credit Suisse	Closed	No	\$2,318,300,657
Mercury Payment Systems, Inc.	3/28/14	J.P. Morgan	Withdrawn	Yes - Silver Lake	n/a
Virtu Financial, Inc.	3/10/14	Goldman Sachs	Pending	Yes - Silver Lake	n/a
Moelis & Co	3/4/14	Goldman Sachs	Closed	No	\$1,333,288,875
Ladder Capital Corp	12/24/13	Deutsche Bank Securities	Closed	Yes - GI Partners, TowerBrook	\$1,651,575,789
Malibu Boats, Inc.	12/13/13	Raymond James	Closed	Yes - Black Canyon	\$313,999,938
Norcraft Companies, Inc.	10/7/13	Citigroup	Closed	Yes - SKM, Trimaran Capital	\$300,470,816
JGWPT Holdings Inc.	10/7/13	Barclays	Closed	Yes - JLL	\$393,680,896
Premier, Inc.	8/26/13	J.P. Morgan	Closed	No	\$3,800,514,330
RE/MAX Holdings, Inc.	8/19/13	Morgan Stanley	Closed	Yes - Weston Presidio	\$645,536,562
Athlon Energy Inc.	6/5/13	Citigroup	Closed	Yes - Apollo Funds	\$1,679,693,040
Jones Energy, Inc.	5/28/13	J.P. Morgan	Closed	Yes - Metalmark Capital	\$740,044,995
Frank's International N.V.	5/10/13	Barclays	Closed	No	\$4,444,000,000
Silvercrest Asset Management Group Inc.	4/19/13	Sandler O'Neill	Closed	Yes - Vulcan Capital	\$123,750,110
Truett-Hurst, Inc.	3/11/13	WR Hambrecht	Closed	No	\$40,815,864
PennyMac Financial Services, Inc.	2/7/13	Citigroup	Closed	Yes - Highfields and BlackRock	\$1,335,999,996
Health Insurance Innovations, Inc.	12/20/12	Credit Suisse	Closed	No	\$186,666,676
Artisan Partners Asset Management Inc.	11/1/12	Citigroup	Closed	Yes - H&F	\$2,050,001,460
Chesapeake Oilfield Services Inc.	4/16/12	Goldman Sachs	Did not close	No	n/a
Edgen Group Inc.	12/29/11	Jefferies	Closed	Yes - Jefferies Capital Partners	\$465,619,473
Cantor Entertainment Technology, Inc.	12/22/11	Cantor Fitzgerald	Did not close	Yes - Cantor Fitzgerald	n/a
PBF Energy Inc.	11/14/11	Citigroup	Closed	Yes - Blackstone	\$2,510,035,216
Vantiv, Inc.	11/10/11	JP Morgan	Closed	Yes - Advent International	\$3,627,769,672
Manning & Napier, Inc.	7/1/11	BAML	Closed	No	\$1,066,800,000
Convergex Inc.	5/5/11	JP Morgan	Did not close	Yes - GTCR	n/a
FXCM Inc.	9/3/10	Credit Suisse	Closed	Yes - Lehman Brothers	\$1,054,200,000
Aurora Diagnostics, Inc.	4/30/10	Morgan Stanley	Did not close	Yes - Summit, KRG Capital	n/a
DynaVox Inc.	1/5/10	Piper Jaffray	Closed	Yes - Vestar Capital Partners	\$447,399,720

Source: Goodwin Procter LLP, data as of Jan. 23, 2015