

# Risks and potential solutions in BSA valuations

By Fay Sanders

**As the French buyout market reaches new heights, management teams are holding increasing sway in deal processes. Yet the sharp rise in deal values has not failed to attract the watchful eye of the tax authorities. Lucrative capital gains made by company managers through BSA stock options are being placed under the spotlight. Further suspicion surrounds the current BSA valuation methods, bringing the threat of heavy penalties at a later date.**

When a buyout occurs it is customary for private equity houses to invite the company's management to acquire a stake in the newco. In France, this can be done either through ordinary shares, ABSAs (Action à Bon de Souscription d'Action or shares with warrants) or convertible bonds. According to Sylvain Cotte of Wagram Corporate Finance, GPs have a double incentive for asking management teams to co-invest. 'Not only do management teams undergo the same kind of investment risks as an institutional investor, but they are motivated by the prospect of equity packages promising greater capital gains when the GP exits.'

Each ABSA comprises one share and several BSAs (Bon de Souscription d'Actions or warrants). In this way, the share can be linked to one or several stock options, allowing the holder to subscribe to a certain number of shares at both a predetermined price and deadline. When the GP exits its shares in a given company, a minimum level of IRR is needed for BSAs to come into effect. If this target is not met, BSAs cannot be exercised and managers suffer losses equivalent to the original amount paid for the stock option.

While French private equity activity reaches record highs, it is becoming increasingly common for management purchases of BSAs to come under close scrutiny from the French tax



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**Sylvain Cotte**  
**Wagram Corporate Finance**

authorities. Judging by the substantial returns generated by exits, it is hardly surprising that state administration has begun looking for loopholes in the system. Suspicion is often aroused by the ambiguous double identity assumed by managers involved in buyouts. As Cotte points out, they can be classed as



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**KPMG**

both wage earners and investors. 'Consequently, problems with tax authorities can arise at the time of a deal exit,' he remarks. A lack of clarity surrounding the manager's status can lead to potential capital gains being harshly taxed at wage earner rates, rather than the more modest rate set for securities investors.

A toughening of approach from the unforgiving tax authorities has prompted a flurry of investors seeking fairness opinions to justify the valuation of BSAs. François Garcin of Carta Diem Private Equity, an investment banking advisory firm focused on private equity secondary assets, alludes to several cases of investors incorrectly valuing BSAs in an attempt to sidestep hefty taxation. However, GPs and lawyers alike remain cagey on the subject and reluctant to disclose specific examples of tax readjustments incurred following incorrect BSA valuations. Cotte stresses the importance of correct valuations in order to dispel any suspicion from tax authorities. BSAs are usually valued according to the common methods used for call options and the value depends mainly on the price and volatility of the underlying share, interest rates and time before the potential exercise. Yet the task of accurately valuing BSAs is far from being foolproof. 'There is no magic formula,' one lawyer remarks. 'Fairness opinions don't guarantee that BSA issuance will be problem free.'

BSA valuation methods have undoubtedly become more sophisticated in recent times, especially where larger buyouts are concerned. Rémi Terrail of BC Partners explains that fairness opinions have become standard procedure for the group. 'Previously, fairness opinions were cobbled together in a very ad hoc manner, but this is insufficient for today's market,' he

asserts. Understandably, many corporate financiers are wary of providing fairness opinions on BSAs. Axel Rebaudières of KPMG explains that fairness opinions require in-depth analyses, which increasingly tend to result in conflicts of interest between the buyer and the seller. KPMG has nevertheless been working on the fairness opinion for BSA holders following Wendel and KKR's recent flotation of Legrand (see page 32). 'Although we have performed such valuations in the past and continue to do so, there is a definite trend towards smaller boutiques taking a larger market share,' notes Rebaudières.

Wagram Corporate Finance has teamed up with Finoptech to test the French waters with an innovative new product designed to value BSAs. Finoptech was founded by Christophe Tymen in 2004 and provides software for investment banks and asset managers to price structured products and exotic derivatives. The new software platform will be managed via a new entity named Fidequity. Already a specialist in pricing quoted groups, Tymen concedes that the same methods cannot be directly applied to unquoted companies owing to the lack of reliable market data on private equity. He affirms that in the case of unquoted groups, comparable pricing algorithms need to be implemented. 'Fairness opinions usually only provide comparable enterprise values, but Fidequity will calculate the value of the stock option according to other parameters such as volatility and default risks.'

To date one of the major shortcomings linked to BSAs is the lack of an irrefutable way to gauge their value. According to Emmanuel Scialom of Willkie Farr & Gallagher, there is no reason why the tax authorities should challenge BSA investments if there is justification that a fair price has been paid.



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**Christophe Tymen**  
Finoptech

Nevertheless he adds: 'In the context of MBOs, the fact that BSAs are so tailor-made makes it difficult to calculate a fair price. Significant discrepancies may appear between any two fairness opinions prepared by different independent experts.' One industry specialist warns of the difficulties inherent in valuing BSAs when deals often involve 70% debt, structurally

senior to equity. On the issue of debt, Tymen is confident that Fidequity is an effective way of accounting for it. Yet explaining how exactly would be giving away trade secrets, he says.

In a private equity market that is more competitive than ever before, management teams are becoming increasingly influential. A decade ago they played a much smaller part in deal processes and were entitled to fairly meagre company



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shareholdings. Nowadays, managers are acquiring stakes closer to the 25% mark and have far more of a say in the way buyouts are conducted. As a private equity lawyer points out: 'The deal won't even take place if the LBO fund can't get on with the management team or agree to its terms.'

As the gap between managers and investors narrows, managers are still targeted by tax authorities for capital gains earned on BSAs. Despite the risk of losing the amount paid for the option, management teams are susceptible to being treated by state administration as wage earners rather than investors. According to Cotte, the risk taken has a just value and should be considered a key element in avoiding tax penalties. Yet concerning BSA valuations, Tymen himself recognises that even the most exhaustive of fairness opinions can only give an indicative value. French fiscal authorities are clearly stepping up the demand for coherent, justifiable analyses of BSAs, which have not been falsified. The move is sending warning signals right through to the lower echelons of the French buyout market.

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