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Long Ideas: Grantor Retained Annuity Trusts Update

3DAdvisors, LLC Special Update Report

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This *Special Report* is an update to a report done on 08/02/06 that explored a relatively rare transaction that insiders enter into called Grantor Retained Annuity Trusts (GRAT), which are designed to minimize estate and gift taxes. Because the insiders that enter into these transactions and file their details on a Form 4 tend to have very large positions and exert significant influence on a company's management and direction, under certain circumstances, the appearance of a GRAT can be highly significant behavior that is not normally picked up by the data services and other analysts. This report focuses on a recent example of a GRAT that we uncovered where there is also other bullish - and relatively rare - behavior, which we think makes this one particularly worthy of investigation by our clients that are interested in potential long ideas.

Special Reports are published periodically on topics of general interest to 3DAdvisors, LLC subscribers.

Companies Highlighted in this Special Report

- J. Crew Group Inc. (NYSE:JCG) ⬆
- Epoch Holding Corp. (NASDAQ: EPHC) ⬆

Discussion of 3DAdvisors Findings

Over the years, few situations have intrigued us like those that emit very subtle bullish trading signals that are unlikely to be mere hype on the part of insiders. With regards to hype, we are always acutely sensitive to certain buying by corporate insiders that proves to be no more than a PR effort. Indeed, when analyzing such activity, we subscribe to the theory that subtle is better. There is hardly a more subtle signal than that which comes from the creation of a Grantor Retained Annuity Trust (GRAT) by a significant insider/stakeholder who is in a position to influence significant strategic corporate decisions. Such moves are rare but highly correlated with upside performance in the shares of the company involved.

We first covered this rare phenomenon in a 3DA Special Report on 08/02/06 (search by ticker symbol SRPT). Our first experience with a GRAT formation occurred back in November of 2005 when EchoStar's (NASDAQ:DISH) Chairman **Charles Ergen** distributed 50 million shares among four GRAT trusts for the benefit of his family members. DISH shares were $22 at the time but were about to start a long uptrend which would ultimately take them as high as $50 over the next 18 months. We are currently seeing similar activity in J. Crew Corp. (NYSE:JCG). Allow us first, however, to offer a brief refresher on why GRAT-related behavior is worth monitoring.

GRATs are used to pass along a maximum amount of wealth to heirs while minimizing gift and estate taxes. Unlike outright gifts, the GRAT delivers its benefits without any potential transfer tax disadvantage to the grantor or family members designated as beneficiaries. Afterwards, beneficiaries of a GRAT receive the tax-free appreciation of the assets accumulated in that trust, above and beyond the initial value of the assets deposited plus an annual "hurdle rate" established by the IRS. Currently, this "hurdle rate" is at 4.2%, the lowest it has been since December 2004. This means that assets deposited in the GRAT must appreciate more than that annual rate in order for the GRAT to generate any tax advantages for the beneficiaries of the trust.

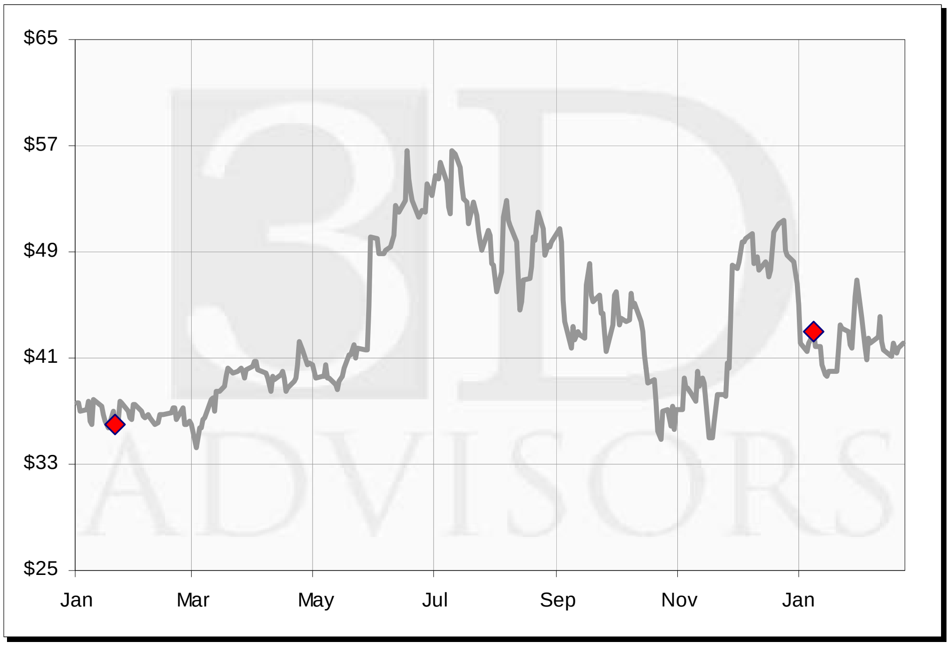
A GRAT that underperforms in its initial years is unlikely to be profitable since the underperformance in those early years must be compensated for by better than average gains in the later years of the trust. Because of this, it makes sense for an insider who is funding a GRAT with shares of company stock to do so at the lowest possible price level and with no negative news on the horizon. This motivation becomes quite interesting when an insider such as J. Crew CEO **Millard S. Drexler** (63), who owns a significant amount of the stock, is in a position to influence strategic corporate decisions. We have highlighted a number of GRAT situations in the past year, but one we passed on due to its small market cap and bleak fundamentals was candy and nut distributor John B. Sanfilippo & Son Inc. (NASDAQ: JBSS). The controlling Sanfilippo family transferred 95% of its holdings into GRATs in December, just before the shares spiked 35% when the Company reported a 160% earnings increase in the fiscal second quarter. While not all GRAT situations work out this favorably, more often than not they have presaged steady share price appreciation.

J. Crew Group Inc. (NYSE:JCG)

J. Crew shares have held up well compared to its industry peers, outpacing the DJ US Apparel Retailers index by 12% in 2008 and 40% over the past 52 weeks. The issue, which traded lower throughout the second half of 2007, was aided by surprise third quarter earnings which boosted the shares nearly 20%. The issue gave back most of the gains a month later, which is when (January 10th) Chairman, Chief Executive Millard "Mickey" Drexler (63) contributed 1 million shares to a new Grantor Retained Annuity Trust. Millard, who controls 14% of the outstanding shares, now has 2.5 million shares, equal to 30% of his holdings, in two such GRATs. His last GRAT contribution of 1 million shares occurred in January 2007, after which the issue gained 25% by year-end despite unfavorable industry conditions.

But there is more here in the form of another subtle but bullish insider behavior. This surfaced with a non-qualified option exercise by Director **Josh Weston** (78). Weston, a board member since 1998, served as the chief executive of Automatic Data Processing (NYSE:ADP) in the early 1990s and was an ADP board member until 2004. Over the years he was a very timely acquirer and seller of ADP shares, which is

Figure 1. JCG Daily Closing Price, 01/03/07 through 02/25/08. Red diamonds are the dates that Mickey Drexler contributed shares to a GRAT. Source: Reuters and JCG SEC Filings.



why we place great importance on his January 23rd acquisition of J. Crew stock. Weston exercised a non-qualified option series not set to expire for eight more years and retained the underlying 38,715 shares at a personal cost of $250,000. Non-qualified options, unlike their performance or incentive counterparts, cause the insider involved to incur a personal income tax liability reflecting the difference between the option strike price and the price of the underlying shares at the time of the exercise. In other words, they incur the tax liability whether they actually take the profit (i.e. sell the shares) or not. If the shares drop lower, they are still responsible for taxes on gains never taken. By exercising the options (and incurring the tax liability) but still holding on to the shares, Weston is betting that they will not trade lower in the future. Weston is J. Crew's audit committee chairman.

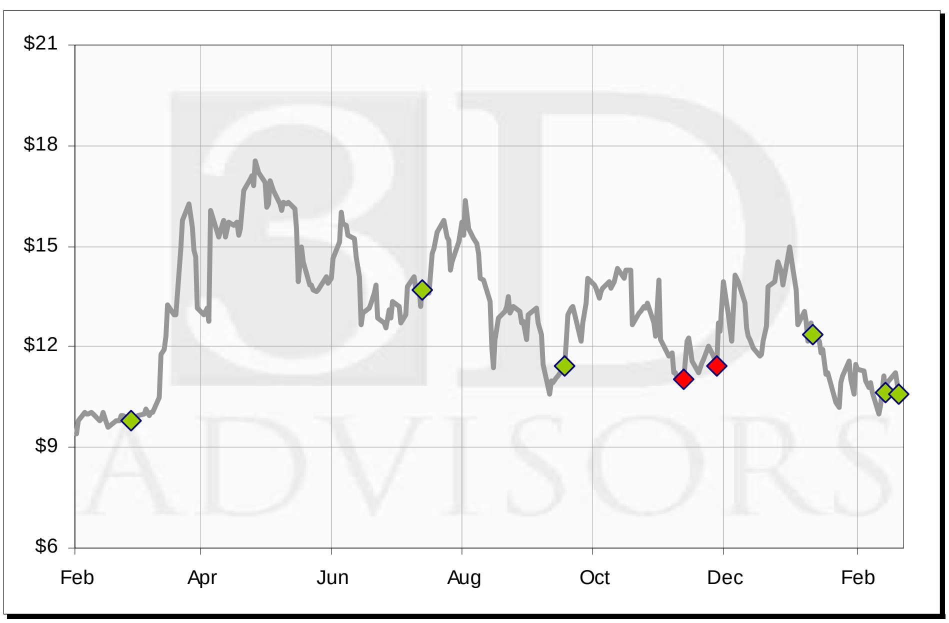
On a final note, we recognize there is some uncertainty surrounding the unexpected January 22nd announcement that President **Jeffrey Pfeifle** (49), a long-time Drexler sidekick, was leaving the Company effective February 1st. Very little is yet known and J. Crew has been tight lipped on his departure. But we also cannot help but notice a certain money flow moving into J. Crew shares, including T. Rowe Price which increased its ownership from 323,000 shares to 4.1 million (7%) in the fourth quarter and Lord, Abbett & Co. which boosted its position from 4.8 million shares to 7.7 million (13%), to name a few. Combined with the raised fiscal 2007 guidance and encouraging transactions of Drexler and Weston, we think it a good bet that the prognosis is good for JCG shares.

Epoch Holding Corp. (NASDAQ: EPHC)

Investment management and advisory firm Epoch Holding has been growing revenue and assets under management at a striking clip over the past year and currently has no debt on the books. With its return on equity increasing 30% in the fourth quarter year-over-year, there are few in its peer group with fundamentals that are as impressive. EPHC shares have not benefited from the Company's performance, trading in line with the NASDAQ (-8.0%) over the past three months, but certain high-level insiders have quietly taken steps to take advantage of momentum they apparently believe will occur in the near future.

On November 12th Chief Executive, Director **William Priest** (66), Epoch's largest shareholder with 15% of the outstanding stock (30% of the float), transferred one-third of his shares (1 million) into a two-year Grantor Retained Annuity Trust for the benefit of his family. Those familiar with the Company might be aware that this transaction occurred in between two of Priest's 10b5-1 sales in October and December, covering a total of 100,000 shares or 3% of his position. Priest entered into the plan back in July after having sold 150,000 shares between June 19th and July 10th, marking his first sales since the issue began trading in 2004. Obviously the sales seem to negate somewhat the implications of his GRAT contribution, but he would not have established the trust unless he anticipated EPHC outpacing the hurdle rate over the ensuing two years. In addition, we must note that he is not the only EPHC insider to set up a recent GRAT trust.

Figure 2. EPHC Daily Closing Price, 02/01/07 through 02/22/08. Green diamonds indicate dates of purchases by Director **Enrique Arzac**; Red diamonds indicate dates CEO William Priest and COO **Tim Taussig** funded their GRATs.



Shortly after Priest's move, Chief Operating Officer **Tim Taussig** (50), holder of 6% of the outstanding stock, transferred 40% of his holdings (500,000 shares) into a two-year GRAT of his own on November 27th, with a family trust as the beneficiary. Taussig sold last June and July but has not done so since. Between these two insiders, they have collectively transferred 15% of the float into trusts. Epoch Holdings is one of the few GRAT situations we have seen that is not centered on just one individual, but has a second insider substantiating the underlying motivation (price upside) behind the GRAT strategy. We also have some open market activity to report, as Director **Enrique Arzac** (66), a board member since August 2006, has spent $100,000 to buy stock since February 2007, including the 3,700 shares purchased this quarter. Arzac, a Finance professor at Columbia University, sits on the boards of two other publicly traded firms (Petroleum & Resources Corp. and Adams Express Co.), but has only been a buyer of EPHC shares.

Though it seems contradictory to our GRAT strategy that Priest would have sold under a 10b5-1 plan at year-end, his sales seem trumped by the additional GRAT creation by Taussig's and Arzac's accumulation. Even though Priest may sense a bottom in EPHC shares or, at the very least, no negative news on the horizon, it would seem that his December sales may have been a result of a need to raise funds.