BUILDING VALUE

A Business Valuation Newsletter for Business Owners and the Professionals Who Advise Them

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The Changing Face of Private Equity

Over the past few years, practitioners have seen an increase in requests to perform valuation assignments in connection with private equity funds. These requests include the valuation of interests in the companies that raise capital and manage these funds as well as the valuation of partnership interests in these funds. The purpose of these assignments can include estate tax, gift tax, bankruptcy and marital dissolution. In the past few years the dynamics of these funds have changed posing new challenges for the expert. This article will provide an overview of private equity and discuss these new dynamics.

HISTORY AND DEVELOPMENT

The private equity industry is composed of firms that purchase equity interests primarily in non-publicly traded companies. Private equity is a generic term that covers four distinct market strategies: venture capital, leverage buyouts, mezzanine financing, and distressed debt.[1] Over the past several decades, private equity funds, venture capital funds, hedge funds and similar alternative investment vehicles have attracted capital from institutional investors such as pension funds and endowments, as well as from wealthy individual investors.[2]

The first U.S. private equity company is believed to have been American Research and Development. The firm was started in 1946 to fund high-risk technology companies. However, the U.S. private equity industry had been little more than a cottage industry until the late 1970's.[3] Up until this point, investors were mainly wealthy families and extremely high net worth individuals.

This all changed in 1979 when the "prudent man" rule of the Employee Retirement Income Security Act (ERISA) was modified. The prudent man rule was updated to allow pension fund managers to diversify part of their portfolios into riskier assets. Pension funds began to inject capital into private equity funds. Banks and insurance companies also began to invest.

The 1990's saw dramatic growth and excellent returns in almost every part of the private equity industry.[4]

The early part of 2000 was an extremely volatile period for the industry with returns, especially for those firms heavily invested in the technology sector, turning negative. After posting negative returns for three straight years, the private equity market rebounded during 2003. Confidence returned as investors witnessed stronger deal pipelines, rising valuations, and an increase in IPO activity stemming from the strengthening economy and rising stock market. But unlike investors during the go-go years of the late 1990's, it was believed that investors in 2003 were cautiously optimistic and were returning to more realistic valuation and performance expectations.[5] A report by Mercer Consulting goes on to indicate significant attrition, as in the buyout sector, where there were less than half the number of funds that were around at the peak. At the time, Mercer indicated that "fewer funds and smaller fund sizes have become the norm."[6]

Although commitments to private equity slowed down after the technology bubble and three-year bear market, the com-

bination of decreasing interest rates, loosening lending standards, and favorable regulatory changes, resulted in a boom in private equity during the 2004 to 2007 time period wherein commitments regained their momentum resulting in some of the largest buyout deals seen to date.[7] Indeed, companies like Blackstone, Och-Ziff and Fortress viewed 2007 as a propitious time to go public.

The financial crisis that began in late 2007, which was triggered by a decline in housing prices and the subsequent collapsing value of mortgage-backed securities – particularly sub-prime mortgage-backed securities owned by financial institutions – had an adverse affect on most alternative asset management companies including private equity. Since 2008 the global private equity sector has seen a slowdown in economic activity as a result of the 2007-2008 financial crisis. The industry is gradually recovering.[8] According to TheCityUK Private Equity Report:

> Nearly $180 billion of private equity was invested globally in 2010, up 62% from the previous year but still down 55% on the peak in 2007. Activity looks set to build on this recovery and top $200 billion in 2011.[9]

STRUCTURE

Approximately 80 percent of the capital committed to private equity is managed by intermediaries, limited partnerships that collect pools of capital or commitments of capital. Each limited partnership is managed by a general partner, the private equity specialist.[10] Usually, the general partner invests in the fund so as to ensure that their capital would be at risk as well as that of the limited partner. The investors demand a certain return for their risk, then the private equity firm targets a company or a division to acquire.

The intermediary, in the form of the general partner, has broad discretion not only to make investments but also to control the form and the timing of a liquidity event and in pricing the investments at their "fair value" on a periodic basis. The firm is compensated in a few different ways. The two main compensation methods are management fees and carried interest. Management fees are charged annually for identifying the target and managing both the transaction process and participating in the management of the company post acquisition. Management fees are normally 1.5 percent - 2.5 percent of the total assets under management or committed.

Carried interest is the percent of the profits due to the private equity firm as the general partner in the acquisition vehicle. The standard amount for carried interest is 20 percent of the profits, after return of capital to the investors. One significant change since 2008 is that funds that were invested at that time have found it increasingly difficult, if not impossible, to generate any carried interest making valuations of management entities more difficult.

RECENT TRENDS

There are several trends which have characterized the environment in the private equity industry in recent years. One major trend is that there are fewer deals and more competition. Increased competition has prompted an auction process for many deals that increases deal prices through bidding wars between potential suitors. Single-source deals are a thing of the past, and with the current level of competition, there will inevitably be an erosion of returns on invested capital.

The large historical inflow of capital into private equity deals resulted in private equity firms and investors seeking better returns outside the United States. As a result, firms sought investments in foreign markets like India and China where the competition may not have been so keen. That, too, has changed as recently as Bill Conway, a co-founder of the Carlyle Group, indicated that: "I no longer refer to China as an emerging market…. China's emerged."[11]

Another trend is that funds have become much larger. With the growing size of deals, consortiums or "club deals" have become more popular. Some of the larger players are entering into joint ventures in LBOs. A main reason for this is to avoid issues with company charters which prohibit too much capital being invested in a single transaction.

It appears that there are increasing advantages to being a large private equity firm. One advantage is economies of scale. Larger firms have more employees and resources, which allow them to do more deals in a given year. Another advantage is that bigger firms have more standardized procedures. This structure creates more expertise within the organization. Diversification is another advantage. Larger firms are better suited to do deals in multiple sectors of the economy, to do international deals, or to perform other services such as consulting. Another sign of premium paid for size is the return of a number of firms going public including KKR in 2010 and Apollo Global Management in 2011.

OUTLOOK

There are several challenges which face private equity firms in the future, namely increased competition for deals, smaller returns, and more difficult exit strategies. The outlook may be even more problematic for small private equity funds that will not benefit from certain economies of scale, have limited core competencies and a small industry footprint.

A major issue that many private equity firms will have to address is succession of key leadership within their own firms. Many of the founders of private equity companies are still managing the firm and are approaching retirement age. The issue of executive succession is magnified at smaller LBO firms.

IMPACT ON VALUATION

Structural changes in the private equity industry offer new challenges to the valuation practitioner. As indicated, the poor performance since 2008 has made it difficult to predict the timing and amount of future profits from carried interest. In some instances the expert may be confronted with the issue of clawback (money or benefits distributed, then later returned) for those poor performing funds that have distributed carry.

Another issue is continued pressure by investors on management fees. Due to performance issues many fund managers have found it necessary to lower the fees charged to investors.

The combination of these two changes make it difficult, but not impossible, to estimate future revenues for management companies. This also has implications on the amount of compensation managers would be entitled to going forward. A large portion of compensation in this industry is performance-based and with performance lagging, replacement compensation may need to be adjusted to reflect these changes.

Another dynamic is the growth in the secondary market for buying existing limited partner interests. The private equity asset class, by its nature, is illiquid and intended to be a long-term investment for a buy-and-hold limited partner. This poses challenges for the practitioner assigned to determine their fair market value.

What has emerged over the years is a robust secondary market for these interests. Over the last decade the private equity secondary market has grown from a modest beginning comprised of a few investors looking to acquire existing stakes to a full-fledged asset class with upwards of $30 billion of capital available for such transactions.[12]

The practitioner should review these secondary market transactions as one means to estimate the fair market value of these limited partnership interests.

While the last few years have seen dramatic changes in the private equity industry, the future will present more challenges to the practitioner working in this space.

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2 Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issue*, September 2007, page 2.
3 Lerner, Josh; Hardymon, Felda; Leamon, Anne, *Venture Capital & Private Equity: A Casebook*, John Wiley & Sons, third edition, 2005, page 11.
4 Lerner, Josh; Hardymon, Felda, V*enture Capital and Private Equity: A Casebook*, Volume II, John Wiley & Sons, 2002, page 3.
5 "Private Equity Report," Mercer Investment Consulting, June 2004.
6 Mercer Investment Consulting, June 2004.
7 Anson, page 553.
8 "TheCityUK Private Equity Report," August 2011, page 1.
9 Ibid.
10 Anson, page 524.
11 "Admit it, China has Emerged," *Wall Street Journal-China Real Time Report*, August 26, 2011.
12 "Private Equity Secondary Funds: Are They Players or Opportunistic Investors?" Knowledge@Wharton, August 05, 2009.

QUALITY ASSURANCE IN BUSINESS APPRAISAL

Quality assurance is the process of determining whether products meet customers' valid expectations. There is a lot to this simple definition, and business appraisers must carefully evaluate the quality of their own work, work of their subordinates or staff, and, in adversarial proceedings, the quality of the work of the opposing party. Let's first consider the key elements of the definition of quality assurance.

The key words in the definition are:

- Quality
- Assurance
- Process
- Product
- Customer
- Valid expectations

Before determining a comfort level with one's own appraisal or another's appraisal, we must have an understanding of the definitions. Let's discuss each briefly.

Quality can be defined as "fitness for use." *Assurance*, then, is the degree to which one may be comfortable with the fitness of the product. Here, the *product* is typically an opinion of value, expressed in a written appraisal.

Process refers to the procedures and steps undertaken to arrive at a conclusion. In business appraising, the *customer* often refers to a business owner, and may also refer to other consumers, such as the trier of fact, a governmental agency, and others.

Valid expectations refers to responsible, objective, and ethically defined statements of work, that are free of bias, prejudice or other self-serving motivations. The development of a process that fits well with all of these requirements is essential to the credibility of the conclusion of quality.

The appraisal process is typically described as a stepwise series of procedures, beginning with defining the problem and ending with a report of the opinion of value. In my opinion, the process is missing a vital step – that of analyzing and concluding as to the quality of the product, specifically, the opinion of value. How does the business appraiser reasonably judge the quality of the opinion and appraisal report at hand? What are the consequences of not doing so? How is one's practice affected by these considerations?

In my early years as a manufacturing engineer, I was responsible for quality control in a 60-acre manufacturing plant employing 1,500 employees. Quality control was fairly straightforward. The statistics could be arcane and challenging, but the measures were essentially physical, mechanical activities, using devices such as micrometers and vernier calipers. If only measuring business appraisal quality were so simple.

Intellectual work product quality cannot be measured with a micrometer or caliper, but it can be evaluated. When I was at the IRS as the national program manager for engineering and valuation, I implemented a quality review and management system covering all issues for which the program was responsible. I learned how to define and measure credibility. At the Institute of Business Appraisers, along with Frank Rosillo, we implemented major revisions to the business appraisal review accreditation program. We used the body of knowledge from the federal rules of evidence, standards of professional practice from the business appraisal professional associations, and relevant decisions of the U.S. Tax Court and courts of other jurisdictions. We also developed a methodology for reading, reviewing and evaluating business appraisal reports, and developed an interactive educational approach to communicating these methodologies to professionals using facilitated small group sessions.

Credentialed graduates of our program report near-perfect scores on the knowledge gained and practical applications of the processes learned. Students are taught the elements of credibility, how to define and measure reliability, how to integrate standards analysis and the principles of the rules of evidence in a business appraisal review, and how to reach a conclusion and document findings in a professional report. In the process, one's own appraisal and report writing skills are materially enhanced, and business appraisers gain a totally new way to think about quality.

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Expert Tip

Quality assurance is the process of determining whether products meet customers' valid expectations. For business appraisers, it is determining the quality of an opinion of value.