

Valuations of Interests in Private Equity and Hedge Funds

By Scott M. DeMarco and Michael J. Raymond

The terms “private equity” and “hedge fund” elicit thoughts of complex financial algorithms, high-powered deals, and intricate ownership structures. However, while these financial arrangements are complicated, they are not inscrutable. Ownership interests in these entities can be valued by identifying the components of value (*i.e.*, ownership interests) and then performing the appropriate valuation methodologies for each. What are these components of value, and how can we decipher and work with them in the context of a divorce in the State of New York?

OWNERSHIP STRUCTURE AND COMPONENTS OF VALUE

Private equity and hedge funds can have many different ownership structures. However, the typical ownership structure is illustrated in the chart on the next page.

As the chart shows, an owner will typically have interests in the general partner (where performance fees/carried interests reside); in the management company; and, typically, direct limited partner investments in the fund(s). In this example, the owner has 15% interests in both the general partnership entity and the management company, as well as a direct limited partnership interest in

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the fund. The general partner entity has effectively contributed 5% of the total capital in the investment fund, and the limited partners contributed 95% of the capital. The contributed funds are then invested at the direction of the management company.

The owners (general partners) receive performance fees or carried interests from the limited partners based on certain criteria, and potentially cash flows generated by the management company. Based on the previous chart, the components of value of the ownership interests can be segmented into the following:

- **Capital Value:** The owner's pro-rata share of market value of invested capital (allocated to the general partner entity, as well as the owner's direct limited partnership interest).
- **Performance Fee/Carried Interest Value:** The owner's pro-rata share of the general partner's carried interest or incentive fees.
- **Management Company Value:** The owner's pro-rata share of the value of the management company.
- **Deferred Value:** The owner's deferred and waived fees (this will be discussed in-depth later on in this article).

Allocating value to each owner can be a very complex undertaking, and it is done differently in private equity and hedge funds. For example, a typical private equity fund will have a “waterfall” that determines how a limited partner's total value is allocated among the general partners and limited partners. The waterfall may be updated at various times, such as for quarterly reporting to investors, and each time a portfolio company is exited. Chart 2 on page 3 shows a typical waterfall for a private equity fund that has a market value of \$1,000 (*i.e.*, beginning value of the waterfall).

Each tier of the waterfall will generally be referenced in the limited partnership agreement for the fund. Tier 1 is simply the pro-rata value allocated to the general partner based on his or her contributed capital. The second tier represents the return of each limited partner's invested capital. Tier 3 relates to the return of management fees, organization costs, and other expenses that are credited to the limited partners. The fourth tier represents a preferred return (*i.e.*, hurdle rate) to the limited partners; in our example, it is a non-compounding 8% return on invested capital (over an assumed six-year period in the example). Tier 5 can generally be thought of as the “carried interest” allocation to the general partner. In this last tier, 20% of the remaining value is allocated to the general partner, and 80% is allocated to the limited partners. If a waterfall results in the limited partners not receiving the full amounts that they are entitled to, then any carried interest previously distributed to the general partner may have to be returned to the fund (commonly referred to as a clawback). In this case, the limited partners received their full preferred return in tier 4, so 20% of the surplus value was allocated to the general partners. Even though the general partner only invested 5% of total capital, it was allocated roughly 10% of the total return (due to its carried interest allocation). Note: This example is over-simplified, and each private equity fund can have intricacies that significantly change how value is allocated.

Hedge funds also receive performance fees, but they are generally determined by the “high-water-mark” of each limited partner. For example, if a limited partner contributed \$50 to a hedge fund, and the market value of the contribution increased from \$50 to \$100, the performance fee allocation to the general partners would

be \$10 ($\$100 - \$50 = \$50 \times 20\% = \10), assuming that the performance fee was 20%. The limited partner would not pay another performance fee until the value of its holdings increased above \$100 (*i.e.*, the new high-water-mark).

STANDARD OF VALUE

The Financial Accounting Standards Board (FASB) has adopted the "fair value" standard in determining the value of private equity and hedge fund investments for financial statement purposes. Fair value can generally be defined as the amount that would be paid to sell an asset in an orderly transaction between market participants at the measurement date (*i.e.*, the exit price). Fair value is similar to fair market value, but differences may exist. For example, the focus of fair market value is on hypothetical buyers and sellers, whereas fair value focuses on the price that would be received by the holder of the investment.

The audited financial statements of private equity and hedge funds use the fair value standard in determining not only the value of each investment, but each general and limited partner's capital account statement. If investments are not publicly traded securities, the private equity fund will have valuations performed on its investments. The fair values of the investments will be reflected on the fund's balance sheet (replacing the cost or carrying value); this is necessary for determining the value of each partner's capital account.

PERFORMANCE FEES: CURRENT LIQUIDATION OR GOING CONCERN?

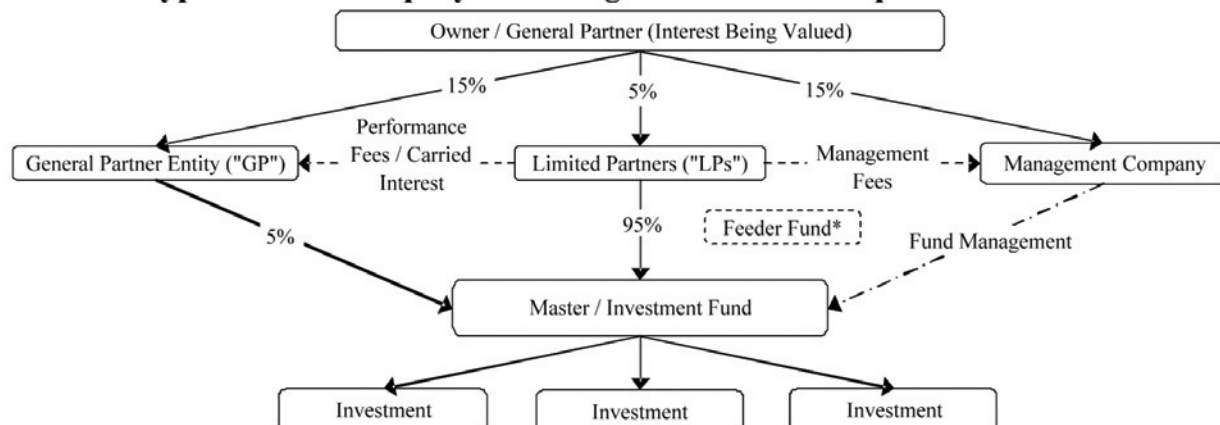
In general, each time that a private equity fund prepares a capital account statement for an owner, the cumulative value of all exited investments and the current fair values of the remaining investments are run through a hypothetical waterfall, as if the fund was liquidated on that date. If the cumulative value of the fund is such that the general partner is entitled to a carried interest, then that carried interest value is included in the capital account of the general partner. The fair value capital account statement for the general partner is stated at the "liquidation" standard of value, since the values of the remaining investments are run through the waterfall on the measurement date (assuming a hypothetical liquidation of the fund on that date). Private equity funds invest in companies and generally hold the portfolio companies for a period of time (typically, three to five years), until the portfolio company is deemed to have reached an optimum value.

The critical factor to consider when valuing a general partnership interest in a private equity fund is that the business appraiser is analyzing the hypothetical sale of the general partner's interest in the fund, not necessarily a hypothetical sale of all of the portfolio companies on the date of valuation. A potential buyer of a general partnership interest is not only interested in the current value of the portfolio companies,

but also in the future value of the portfolio companies and an expected allocation of an incremental carried interest. While it is complex to do, a business appraiser can forecast exit dates and expected rates of return for portfolio companies, run each exit through the waterfall, and then calculate the present value of any carried interest. However, forecasting future portfolio company exits may not be appropriate if a fund is mature and actively seeking to liquidate its holdings. The individual facts and circumstances of the interest being valued may affect valuation assumptions and methodologies.

Hedge Funds also generally report investments and capital account statements at fair value. Stating a hedge fund investment and capital account statement at fair value may be as simple as multiplying the number of shares held by the publicly traded price per share; however, hedge funds may make complex investments that could result in a fair value that is very different than the publicly traded price of the investment. The performance fees for a hedge fund are typically paid annually, so the owners are not subject to "clawbacks" (*i.e.*, previously distributed performance fees that the general partner returns to the fund). Similar to private equity funds, if a general partner's interest in the fund is based upon a fair value capital account statement, then the value is driven by the current fair value of the investments on the date of valuation. However, if the general partnership is to be valued as a going concern, then forecasts can be prepared

Chart 1: Typical Private Equity and Hedge Fund Ownership Structure



***Note:** In many hedge funds, the limited partners invest in feeder funds that invest the capital in a master fund. This is referred to as a master-feeder fund structure.

Chart 2: Waterfall for a Private Equity Fund

Tier	Description	Beginning Value	General Partner	Limited Partner	Ending Value
Tier 1:	GP Market Value of Invested Capital	\$1,000	- \$50	- \$0	= \$950
Tier 2:	Return of LP Invested Capital	950	- 0	- 500	= 450
Tier 3:	Return of Management Fees and Costs	450	- 0	- 100	= 350
Tier 4:	Preferred Return (8%) to LPs	350	- 0	- 240	= 110
Tier 5:	GP 20% and LP 80%	110	- 22	- 88	= 0
Total Value Allocated:			72	928	

that are based on the investment strategies of the general partner and management company. The forecasts are used to determine the present value of any future performance fees.

MANAGEMENT COMPANY

The management company of a private equity or hedge fund receives management fees on a regular basis (typically, monthly or quarterly), which are used to pay for employee compensation and other operating expenses. In certain circumstances, driven primarily by scale, the management company may generate cash flow for the owners. If a fund is nearing its predetermined termination date and there are no plans to raise another fund, then the management company may have little to no value. Also, many smaller private equity and hedge funds may report losses at the management company, due to the lack of scale of assets under management (AUM). Larger funds (in terms of AUM) may be able to leverage work and generate economies of scale that produce cash flows to the owners in the management company, in addition to carried interests or performance fees.

WAIVED AND DEFERRED FEES

Many owners of private equity or hedge funds have the ability to defer management or incentive fees. Under current law, the deferral of fees postpones the payment of taxes, and the deferred fees are generally invested in the private equity or hedge fund, in some form. These deferred fees are locked up for a period of time and the fair value of the fees on a particular date (be-

fore the fees mature) may not be the value that a hypothetical investor would pay (due to restrictions). To account for this, certain methods may be employed to value the deferred fees, such as calculating discounts for marketability and illiquidity.

Many private equity funds also allow the owners to waive management fees, which are instead invested in the private equity fund's investments on behalf of the owner. These waived fees are typically credited to the owner's capital contributions; however, the capital contribution attributed to the waived fees may provide the owner only a profits interest in the funds. This means that the owner receives only his or her pro-rata share of the waiver investment if there are sufficient profits available (*i.e.*, after other components of the waterfall are satisfied). Valuation of the waiver investments require consideration of the specific rights and risks associated with each waiver investment.

PRIVATE EQUITY AND HEDGE FUNDS IN DIVORCE

Various legal issues may affect the valuation method used for interests in private equity and hedge funds, especially if the valuation is for purposes of equitable distribution in connection with a divorce. A legal argument could be made that the future value of a portfolio company or hedge fund investment is at least partially attributable to the active efforts of the ownership interests being valued and should not be subject to equitable distribution — or should at least be subject to a lower equitable distribution percentage. These dynamics will be a matter of law

and may result in the allocation of value for equitable distribution purposes that is different than fair value or fair market value of the subject interest.

In addition, the facts and circumstances of the case will determine if the management company will be valued into perpetuity or assigned a finite existence. For example, due to the fact that private equity funds typically have a finite existence, a new fund must be created to replace the fees generated from the previous fund in order to sustain the management company. Factors such as this could affect the valuation methodologies adopted in a particular case, in addition to the proportions of the marital assets that are distributed.

CONCLUSION

We have provided here only a general overview of the components of value of private equity and hedge funds. In a real-world situation, each component of value should be identified and valued separately. Valuing interests in these funds can be complex, and the facts and circumstances of each interest — in addition to certain legal arguments — can significantly affect the appropriateness of a particular valuation methodology. Understanding some of the basics will help attorneys to better work with the financial experts on their divorce cases and ensure that their clients get the financial settlements they are entitled to.