

Valuation of Hedge and Private Equity Funds

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About The Presenter

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Hedge Funds

What is a Hedge Fund?

- A Hedge Fund is essentially a lightly regulated investment fund open only to a eligible investors
- The Fund is actively managed and employs derivatives, short selling and leverage to increase return on their investments
- Hedge Fund Managers are compensated based on assets under management and, in large part, performance
- First Hedge Fund was established by A.W. Jones in 1949

How they Differ From Mutual Funds

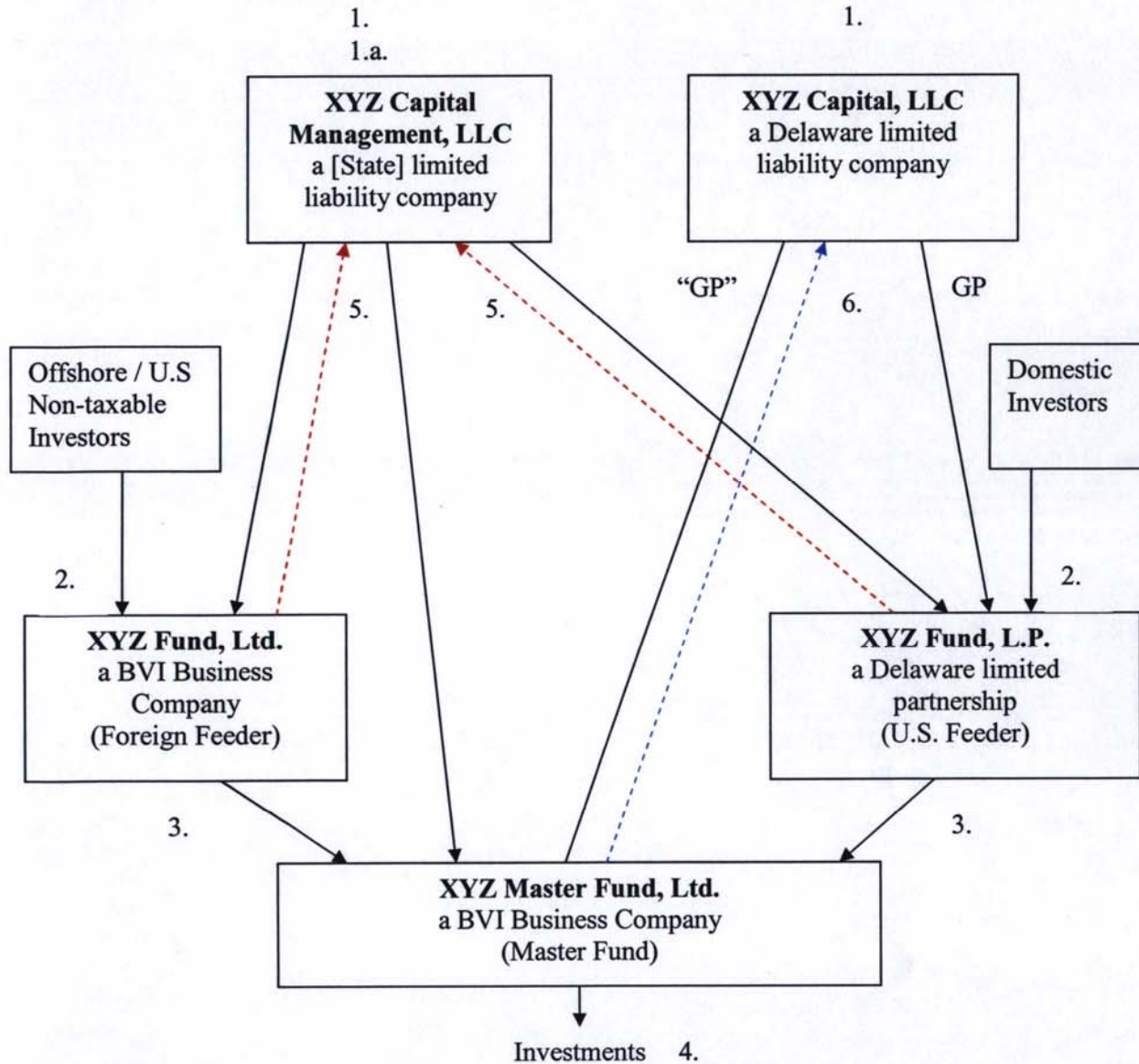
- Hedge Funds:
 - Can employ leverage
 - Can employ hedging techniques such as buying/selling derivatives and selling short
 - Clients can only be “qualified” within the meaning of the Investment Advisers Act of 1940
 - \$750K under investment with the adviser or....
 - \$1.5 million of net worth or...
 - \$200,000 of income in each of past 2 years
 - Can charge performance based fees in addition to basic asset management fees
 - Can provide for restrictions on redemptions
 - Lock up period
 - Periodic redemption rights after lock-up, with notice

How are Hedge Funds Organized?

Master Feeder Structure

Hedge Fund Master Feeder Organizational Chart

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Notes:

- XYZ Capital Management, LLC acts as the GP to the domestic feeder and the IM to the BVI feeder and the MF; XYZ Capital, LLC acts as the "general partner" of the MF.
 - IM agreement between XYZ Capital Management, LLC and MF
- Investors place assets in the domestic/offshore feeders
- Feeders place assets in the MF
- MF makes investments
- Management Fee. At the end of Q1, the BF pays the IM a management fee [Note: the MF does not pay any management fees.]
- Performance Fee. At the end of Y1: the MF allocates BC (the "general partner") a Performance Allocation.

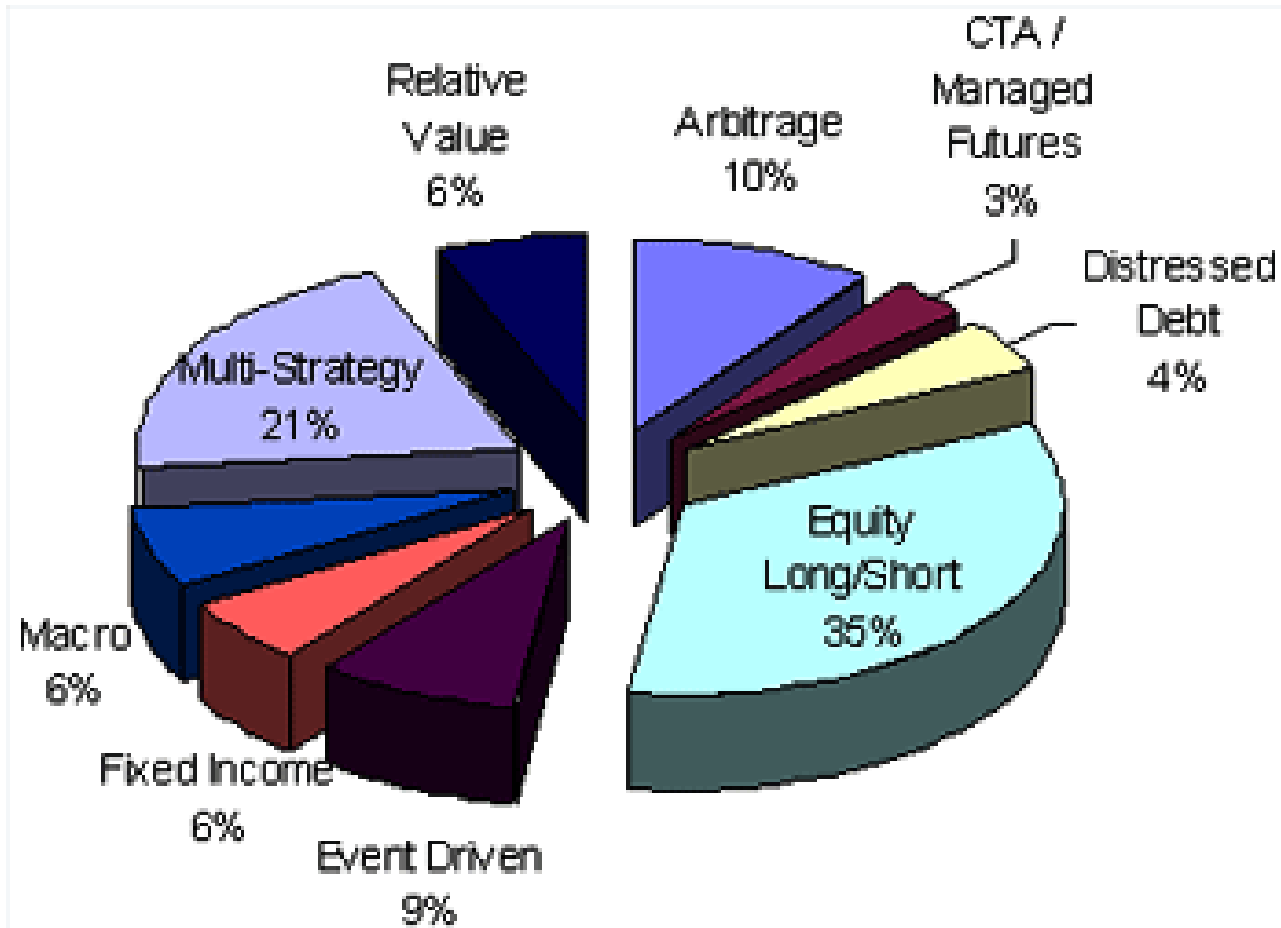
Other Notes:
MF will "check the box" to be taxed as a partnership for US tax purposes

Services or Movements of \$
 Fees
 Allocations

Investment Managers

- Bottom–up Funds
 - Stock Pickers
- Top-down Funds
 - Macro approach
- Proprietary Strategies. Some Using Algorithms
 - Low correlation to the market (market neutral)
 - Arbitrages particular inefficiencies in the market
 - Computer Program trading
- Fund of Funds (increasing popularity)
 - Multiple Strategies
- Many Other Variations on the Theme

Funds of Funds AUM Breakdown by Investment Strategy



Source: EurekaHedge

What Are We Valuing?

- We're not really valuing the Hedge Fund
- What we're valuing is the Hedge Fund **Manager** and the earnings streams that it is expected to generate, as well as other value components attributable to the general partner
 - Management fee income stream
 - Incentive fee income stream
 - G.P. Hedge Fund account consisting of past incentive fee allocations
 - Deferred incentive fees in the offshore fund

How Do Hedge Fund Managers Make Money?

- Management Fees
 - % of Assets Under Management (AUM)
- Performance fees
 - % of Gains over previous “high water mark” and “hurdle rate” or other preferences
 - Hurdle rate can be annual or cumulative
- Typical Fee Structure
 - “1-2 and 20” but there can be many variations of that
 - 1 – 2% of AUM
 - 20% Performance fee
 - “Friends & Family”
 - Managed accounts
- Must run the “waterfall” to determine performance fee
- Fund must achieve critical mass as to AUM in order to survive
 - Can’t rely solely on Performance Fees to meet overhead and salary requirements

How are Performance Fees Calculated “The Waterfall”?

Gain for the Year

Less: Recapture of Loss Carryforwards since last high watermark (last time performance /incentive fees were paid)

Less: Recapture of cumulative hurdle rate
Current hurdle rate

= **Gain eligible for performance/incentive fee**

- Computed for each client
- Computed for each investment of new \$ for each client

How Are Performance Fees Characterized and Paid?

- Is it a performance “fee” or just a special “allocation”?
- Most funds treat it as a special capital allocation at the Master Fund level and not paid and expensed as a “fee”
- This results in capital gain treatment by the fund manager rather than ordinary income
- This treatment is under current attack by the Obama administration and may be legislated as a “fee” subject to self employment taxes and ordinary income tax rates

Can Performance Fees be Deferred?

- The answer is they could be in the past under the Internal Revenue Code, but not after December 31, 2008
- Deferred fees are the obligation of the offshore fund and are essentially reinvested in the Fund. Deferred incentive fees escape current taxation and are only taxable at the end of an elected deferral period.....usually not more than 10 years
- Deferred fees, when paid, are taxed at ordinary income tax rates
- Repealed by the Emergency Economic Stabilization Act of 2008 -- New Code Section 457A for **post** 2008 fees
- Previous deferrals are grandfathered

Lock-ups and Withdrawal Rights

- Most Hedge Funds have “lock-up” provisions that prohibit redemptions for a specific period of time---could be a matter of years
- Once the “lock-up” period expires, a Fund can limit redemptions to certain times of the year (generally quarterly) and only after written notice
- These provisions guard against the need to liquidate investments at bad times in the market and let the Fund Managers plan for levels of needed liquidity and implement their investment strategies
- Some Fund agreements give the Manager the right to prohibit any redemptions in certain situations even after “lock-up” periods have expired. Rarely used, but many Managers invoked such right in the recent market collapse

Know The Jargon!

- You won't get a valuation engagement if you can't speak the language
- Terms Commonly Used in the Hedge Fund World (see glossary from *HedgeFund.net* and Definitions of Hedge Fund Strategies attached)

Know The Jargon!

- A few examples.....
 - Alpha
 - Bottom up
 - Equity Long/Short
 - High Water Mark
 - Hurdle
 - Waterfall

Overall Valuation Considerations

- Two distinct earnings streams with significantly different risks
- Management Fees
 - Based on AUM regardless of performance
 - Covers basic overhead and salaries
- Performance (Incentive) Fees
 - Based on gains above previous high water mark and preferential returns and hurdle rates
 - Source of Bonuses
 - Previous losses (“loss carryforward”) and current/cumulative hurdle(s) (preferential returns) have to be recouped before any new performance fees can be earned

Valuation Approaches/Methods

➤ **Asset Approach**

- Doesn't capture the expected future cash flows
- Acceptable for
 - Capital Account Balance of the GP in the Fund
 - Deferred Incentive Fees in the Offshore Fund

➤ **Market Approach**

- Very few publicly traded comparables, especially for smaller Hedge Funds
- Limited information on completed deals by public companies
- Only anecdotal info is usually available on private deals
- Some would argue that valuation multiples of public mutual fund managers are acceptable for the management fee portion

Valuation Approaches/Methods

- **Income Approach**
 - Preferred method is DCF
 - Especially given economic downturn
 - Multiples of EBITDA used in M & A
 - Mature Fund
 - Stable Market environment
 - Bifurcation/Valuation of two distinct earnings streams
 - Management Fees
 - Performance Fees

Public Guideline Companies?????

- A Sample of Publicly Traded Hedge Fund Managers
 - Fortress (FIG)** [Hedge & PE Funds—AUM \$32 billion]
 - Blackstone (BX)** [Hedge & PE Funds—AUM \$24 billion]
 - Man Group (UK:EMG)** [\$39 billion in AUM down from \$80 billion at peak]
 - Cypress Sharpridge Investments (CYS)** [Recent IPO]
 - KKR Financial Holdings LLC (KFN)**
 - Och-Ziff Capital Management (OZM)** [\$23.1 billion at 12/31/09 down from \$27 billion at 12/31/08]
 - RAB Capital (UK:RAB)** [AUM fell 74% to \$1.9 billion in 2008]
- Very large and diverse. Care must be taken when using as guideline companies

Deutsche Bank Global Hedge Fund Survey

- Top 5% of Fund Managers control 85%-90% of all invested hedge fund capital (9,000+ hedge funds)
- On average the industry loses 700-900 funds annually
- Lost twice that amount annually during the 2007 – 2009 meltdown (1,471 fund liquidations in 2008)
- Invested funds were \$1.6 trillion at 12/31/09
 - Up from \$1.4 trillion at end of 2008
 - Down from \$1.9 trillion at 2007 peak
- 2010 expectation----\$100 million in positive net funds flow

Deutsche Bank Global Hedge Fund Survey

- Currently most popular strategies
 - Equity—Long/short
 - Distressed Debt/Equity (cyclical)
 - Macro
 - Event Driven

Valuation Approaches and Methods

- What about rules of thumb?
 - e.g., % of AUM

- Unreliable!

Excerpt from BONY Mellon 10Q 9/30/09

Acquisition of Insight Investment Management

In November 2009, we acquired Insight Investment Management Limited (“Insight Investment”) from Lloyds Banking Group plc for £235 million (**\$377 million of cash and stock**). Based in London, Insight Investment specializes in liability-driven investment solutions, active fixed income and alternative investments. Its clients include some of the UK's largest pension schemes, corporates, insurance companies and local authorities, along with a growing number of non-UK clients and some of the best-known financial services and intermediary companies. Insight Investment has approximately £83 billion (**\$133 billion**) in assets under management. Insight Investment will join the other investment boutiques at BNY Mellon Asset Management.

Critical Facts/Assumptions in DCF

- Expected Funds Flows
 - Review monthly trends prior to valuation date
 - Research industry funds flow expectations
- Anticipated Investment Returns
 - Review historical performance
 - Consider hurdle rates
- Position of the Fund Manager relative to high watermarks as of the valuation date
- Existing Funds subject to lock-up
- Anticipated bonuses to Fund Managers
- Near term growth curve for newer funds much steeper than larger, more mature funds

Difficulties in Valuation

- Past performance is no guarantee of future performance
- Difficulty in predicting funds flows and investment performance
- Example:
 - In valuing a hedge fund at 6/30/07, could anyone have predicted what would happen over the ensuing 2 years?
- Valuing future performance fees very difficult

Private Equity Funds

Long term Investors in Private Equity Funds

- 3 – 5 year investment period
- Followed by 5 to 7 year holding period
- Typical investors are long term investors and generally include institutions, endowments and pension plans who are looking to increase their returns through alternative investments

Different Stages of PE Investment

- Venture capital for start-ups
- Capital for growth and expansion
- Capital to facilitate acquisitions and/or buy-outs
- Mezzanine financing
- Distressed Equity

Private Equity Alive & Well

Private Equity Fundraising - Last 12 Months



Source: PitchBook



Growth in Value

- How do PE management companies help portfolio companies grow EBITDA?
 - Capital to fund organic revenue growth
 - Capital to fund acquisitions
 - Expertise
 - Assist management in cost reduction/restructuring
 - Provide expertise in strategic planning
 - Facilitate exit strategy

Three types of fees are paid by the Fund

➤ Management Fee

- Typically annual fees equal to 1.5% to 2.5% of a combination of committed capital and the marked-to-market value of the portfolio companies
- May be paid to the GP if it is the Manager, or
- May be paid to an Affiliate of the GP if the Affiliate is the Manager

Three types of fees are paid by the Fund

➤ Acquisition Fee

- Usually a % of the Acquisition Price
- Usually Converted to an Equity Stake
- Becomes the “skin in the game”

Three types of fees are paid by the Fund

➤ Incentive Fee, or Carried Interest (the “Carry”)

- Typically 20% interest in the gains and other income realized by the fund
- In some funds, a hurdle return to the investors must be achieved before the GP receives any payment on the profits interest
- Agreement also may include a “claw-back” provision in case later investments do poorly
- Although incentive fees may be distributed when a portfolio company is monetized, the overall carry is based on the performance of the entire fund
- Carry generally “paid” as an allocation of profits on a deal and is, therefore, taxed at long term capital gain rates

Game Changer?

- During July, after much publicity about the extraordinary levels of income of managers of certain investment funds, Congress held hearings that addressed the lower long-term capital gains rate that accompanies the payouts on the profits interests held by the limited partners in private equity funds.
- **Legislation** has been introduced in the House of Representatives for the purpose of amending the Internal Revenue Code:
 - Treat as ordinary income the gains allocated to partners under profits interests granted to them as compensation for performing investment management services.

Game Changer?

- The **debate** currently taking place over the taxation of gains attributable to profits interests is between those who:
 - Urge that income tax rates be consistently applied to individuals earning personal service income regardless of how they earn it and
 - Argue that taxation of gains attributable to profits interests as ordinary income would discourage risk-taking by the individuals who are at the center of private equity fund enterprises.

Deferred Carried Interests

- Private Equity Fund Managers
 - Generally organized as partnerships for federal income tax purposes
 - Take the position that their “carried interest” constitutes an interest in “investment profits” rather than “compensation” for federal income tax purposes
 - Under this view, deferring receipt of the carried interest should not be subject to new Code Section 457A. But.....the debate goes on

PE Funds of Funds

- These are funds that invest in other private equity funds similar to Hedge Funds of Funds. Their purpose is to:
 - Give their investors greater diversity than can be achieved by investing in just one private equity fund and
 - To provide investors with the expertise of the managers of the funds of funds in choosing among private equity funds.
- Multiple layers of fees are charged by fund managers
 - At the Fund level
 - At the Fund of Funds level
- A typical fund of funds fee arrangement with its general partner might be a;
 - 1% management fee and a 10% profits interest
 - These percentages may vary.

Valuation Complexities/Considerations of PE Companies

- Projecting fees for DCF
 - Asset management fees/carried interest are based on changing portfolio company valuations
 - Predicting the timing of future investments of committed but uninvested capital
 - Different fee structure for each class of capital
 - Timing and nature of exit strategy for each portfolio company
- Difficulty in assessing the level of risk in achieving projected results

Issues Unique to Matrimonial Litigation

- Differing standards of value in and between jurisdictions
- Even though all valuations are forward looking, due to “separate property” constructs, some courts are hesitant to capture income from post divorce active efforts
 - Poses difficulty in using DCF methodology and projecting incentive/performance fees and carried interests
- Dealing with interim valuation dates when incentive fees are generally earned at year end dates
- Valuing carried interests that are not earned until an exit event that may not happen for years
- Use of “as, if and when” and constructive trusts in lieu of valuation

Issues Unique to Matrimonial Litigation

- Appropriate valuation date given what has transpired over the last two years---significant motion practice in this area
- Inherent difficulty of retrospective valuations when hindsight is always 20/20, especially in these times
 - “Known or knowable” vs subsequent events
- Treatment of Clawbacks-----Contingent liability?
- Madoff Fallout (i.e., Bernard “Bernie” Madoff, Allen Stanford, et. al.) – *Simkin v. Blank*; Supreme Court, State of New York, First Judicial Department

Thank you for your attention!