

# Investment Management and Hedge Funds: What's Happening Now

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# Valuation Issues for Private Equity and Hedge Funds

# Introduction

- ▶ Purposes of valuations – tax and financial reporting
- ▶ Standards of value for tax and financial reporting valuations;
- ▶ Valuation approaches and methodologies
- ▶ Valuations of hard to value assets (Level 3);
- ▶ Typical valuation methodologies applied in valuations of Carried Interests;
- ▶ Discussion of valuation discounts.

# Standards of Value

## Tax Valuations – Fair Market Value

The price at which the subject asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.

## Financial Reporting Valuations – Fair Value

The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

***The valuation approaches and methodologies for tax and financial reporting are not significantly different.***

# Valuation Approaches

## Market Approach

A general way of determining a value indication of a business, business ownership interest or security using one or more methods that compare the subject to similar businesses, business ownership interests or securities that have been sold.

## Income Approach

A general way of determining a value indication of a business, business ownership interest or security using one or more methods wherein a value is determined by converting anticipated future benefits to a present value.

## Asset-based or Cost Approach

A general way of determining a value indication of a business' assets and/or equity interest using one or more methods based directly on the value of the assets of the business less liabilities.

# Hard to Value Assets – Level 3

## Example – Bankruptcy Trade Claims

### Market Approach

There may be a bond of the bankrupt company trading which has similar rights as the trade claim. That price can be adjusted for the relative lack of marketability of the trade claim, not usually a large adjustment.

### Income Approach

Based on bankruptcy filings and disclosure statements, timing of the realization of proceeds from the trade claim can be estimated and the estimated amount discounted to present value. Discount rates tend to range from junk bond to equity rates depending on the risks associated with realization and timing of the estimated amount.

### Asset-based or Cost Approach

A liquidation analysis can be performed on the bankrupt company's balance sheet and an estimated amount available for the trade claims can be derived.

# Valuation of GP Interests in Private Equity and Hedge Funds

Also referred to as Carried Interests or Incentive Fees

A private equity fund manager's incentive fee is the share of private equity fund's profits that the fund manager is due once the fund has returned the outside investors' capital and perhaps a preferred return.

A hedge fund manager's incentive fee is a share profits with no provision for a return of outside investors' capital first, but is also subject to high water marks and clawbacks.

Incentive fees may vary, but are commonly 20% of investment returns.

Carried interests for private equity and hedge funds generally valued using an income approach. Expected fees are estimated based on assets under management and expected returns. Methodologies include discounted cash flow or DCF, or income capitalization.

Expected returns can be estimated by appraiser or using Monte Carlo techniques.

# Example of Private Equity Carried Interest Valuation Using DCF Methodology

Year	0	1	2	3	4	5	LP Capital & Preferred Return	Profit Subject to Carry	Carry
LP Capital	100	112	125	140	157	176	128	49	9.72
Assumed Fund Average Return	12.0%	12.0%	12.0%	12.0%	12.0%	12.0%	Present Value Factor		<u>0.328</u>
Preferred Return to LPs	5.0%								<u><u>3.19</u></u>
Carried Interest Percentage	20.0%								
Discount Rate	25.0%								

# Example of Income Capitalization Valuation Methodology for Hedge Fund

LP Capital	100
Assumed Fund Average Return	12.0%
Profits Subject to Carry	12
Carried Interest @ 20%	2.4
Capitalized @ 25%	9.6

# Discussion of Valuation Discounts

**Tax Reduction via Valuation Discounts.** Must be justified in relation to the particular entity being valued. Examples:

- ▶ Marketability/Liquidity
- ▶ Minority (Lack of Control)
- ▶ Built-In Capital Gains
- ▶ Voting vs. Non-Voting

For more information, visit

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# Valuation: An Audit Perspective

# Objectives

- ▶ Provide a better understanding of the objective around auditing valuations
- ▶ Discuss appropriate valuation methodologies for different asset classes
- ▶ Identify what we deem to be adequate audit support for valuations
- ▶ Highlight valuation best practices
- ▶ Highlight common areas for improvement we see in audits

# Audit Objective

- ▶ Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
- ▶ To determine whether valuations appear to be within a reasonable range of fair value
  - Different investments may have different ranges that appear reasonable

# Valuation Methodologies

- ▶ Exchange-traded prices
- ▶ Broker quotes
- ▶ Pricing services
- ▶ Valuation approaches and techniques
  - Income approach
    - DCF
  - Market approach
    - Market comparables
  - Cost approach
- ▶ NAV as a practical expedient

# Audit Support

- ▶ Exchange-traded prices
  - Auditors will verify to independent source
- ▶ Broker quotes
  - Single vs. multiple
  - Independent vs. counterparty
  - Insight into how quotes determined
  - Back-testing
- ▶ Pricing services
  - Insight into how prices determined

# Audit Support (continued)

- ▶ Valuation models
  - Approach/technique
  - Key inputs
  - Key assumptions
  - Calculations
  - Back-testing / recalibrated
- ▶ NAV as a practical expedient
  - Audited financial statements of underlying fund
  - Fiscal year end

# Best Practices

- ▶ Policies and procedures
  - By asset class
- ▶ Governance, independent price verification, and front office's role
- ▶ Due diligence / back-testing on broker quotes
- ▶ Oversight of third party pricing services and valuation firms
- ▶ Validate and recalibrate models
- ▶ Documentation
  - Approach/technique
  - Key input and assumptions
  - Analysis

# Common Areas for Improvement

- ▶ Analysis of the subject investment
- ▶ Documentation explaining valuation methodology/approach
- ▶ Support for key inputs and assumptions, including changes
- ▶ Using cost as fair value without any support
- ▶ Single broker quotes
- ▶ Outdated appraisals / events
- ▶ Failure to identify esoteric investments requiring unique valuation approach relative to rest of portfolio
- ▶ Piecemeal support/process

For more information, visit  
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- ▶ Concentrates his practice in securities law, particularly in representing investment management companies and other clients on matters arising under the Investment Company Act of 1940 and the related Investment Advisers Act of 1940, and broker dealers and commodity futures traders and pool operators
- ▶ Represents many hedge funds and other alternative investment funds in fund formation, investment and compliance matters, including compliance audits and preparation work
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- ▶ Supports Rockport's growth and business development and provides oversight of the firm's execution of valuation and M&A engagements
- ▶ Has over 35 years of experience in valuations, mergers and acquisitions, litigation support and other financial consulting matters
- ▶ Experience covers a full spectrum of industries from hospitality to manufacturing technology
- ▶ Experience includes involvement in several major litigation support projects as an expert witness before Federal and state courts and arbitration panels. The results of Mr. Kerr's valuation projects have been used for financial and tax reporting; litigation and expert testimony; fairness and solvency opinions; M&A transactions and reorganizations; strategic planning and ownership succession; and buy/sell agreements.



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- ▶ Leads EisnerAmper's investment performance reporting initiative
- ▶ Provides audit and advisory services primarily to hedge funds, private equity funds, funds of funds and banks
- ▶ Has 20 years of experience in the financial services industry, including 15 years in public accounting at EisnerAmper and a Big 4 firm.
- ▶ Has provided consulting services to registered investment advisors, including regulatory compliance. His work on SOX 404 and SSAE 16 engagements provides him valuable insight to reviewing, evaluating, and recommending internal controls



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