Grant Thornton

PrivateEquityStrategist

August 2008

Investing in a family-owned business

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The family business owner is looking to sell. The private equity firm is looking to buy and wants to get a foot in the door. They need to tread carefully. While family-owned businesses are fertile ground for dealmaking, land mines abound. One false step and...

Family-owned businesses and private equity. The two are hardly strangers. Over the years there have been very many private equity investments, of all types and across myriad industries, in family-owned entities.

That said, thanks to retiring baby boomers, such investments might become a larger part of private equity portfolios in the coming years. Given the demographics of this large and entrepreneurial generation — 78 million Americans born between 1946 and 1964, according to the U.S. Census Bureau — we are just entering an era where increasing numbers of family business owners will be looking to partially or fully divest their ownership in firms they or a family member founded. In fact, a 2007 Grant Thornton International study found that four in 10 businesses will change hands in the coming decade.

For these reasons, more private equity firms may decide to explore investments in family-owned businesses. In doing so, it is helpful to keep in mind that these types of deals are often extremely personal. The individual sitting across the negotiating table may be there reluctantly, compelled to sell for family or other personal reasons, and about to cede control of a thriving entity that may have been in the family for decades. Long-time employees may be the business owner's relatives or close friends. Their welfare will be of primary concern. And the owner may be unfamiliar with, and leery of, private equity.

Approaching a family business owner, therefore, calls for a nuance and finesse that might not be necessary in other types of dealmaking.

Continued on page 2 >

Investing in a family-owned business (continued from page 1)

As an illustration, a Grant Thornton client, the founder and CEO of a successful manufacturing firm, recently decided the time was right to diversify his wealth. He wanted to realize some liquidity and pursue philanthropic and other interests. While he was ready to relinquish majority ownership, he wanted to continue running the company, at least for several years.

As a business owner, and not a dealmaker, the client was unfamiliar with the finer points of a recapitalization and had many questions. To help allay his concerns and educate him on the finer points of private equity, a series of meetings were held with several private equity firms. Armed with a list of questions, the client quizzed each of the firm's representatives on his investment process, plans for running the company, the likely exit, and the history of the private equity firm itself. The marathon sessions, which took place over three days, illustrate the concerns central to family business owners looking to sell.

Control

The idea of giving up control is not easy. The person at the helm wants to leave a legacy, for himself and the family.

Some private equity firms of course insist on full control, while others are flexible. The key is to match a fund to the desires of the business owner. Of paramount importance is to make clear to the owner the difference between economic and operational control. There is often a misperception among owners that a private equity firm will constantly be looking over their shoulder, involved in every decision concerning the operation of the business. Of course, in most cases, the investor does not want or need to play such a role. The investor most often wants the person who has so successfully built and run the business day-to-day to continue doing so. A private equity firm needs to present itself as a partner and the investment as a true collaboration designed to further grow the company and benefit investor and owner alike.

Leverage

Business owners fear it. Private equity firms can't do a deal without it.

Many business owners have never operated with leverage. The idea of placing significant debt on the business is, at the very least, troubling. A primary concern will be the possibility of default, and what it may mean for the business and for the owner personally. Will the private equity firm show him the door, or use its influence with the lender to help remedy the situation? Education here is all-important, helping the owner understand the necessity and benefit of leverage. While the owner may understand the downside, or think he does, he may not fully grasp the possible significant future gains made possible by leverage.

Deal Structure/Fees

A deal must be equitable to both sides. In addition to leverage, there are certain elements of a deal structure that particularly resonate with owners and that need to be addressed up front and clearly explained.

Private equity firms often prefer to use a different type of financial instrument than what a business owner will receive to guarantee downside protection. This could be a deal breaker. Private equity firms should be willing to share in the same risks and rewards as the business owner. And if there are incentives for the owner to get a greater piece of the upside upon exit, such as a clawback, private equity firms should ensure the owner fully understands them.

A closing fee is often very unpalatable to family business owners. If the private equity firm plans to take a payment at closing, this must be clearly stated and a cogent argument provided for doing so.

Value Add

This may be the Achilles heel of private equity firms when pitching family business owners. They may not perceive it as a weakness, and in fact they often view it as a strength. However, it could hobble or cripple the chances of closing a deal.

Private equity firms often believe they bring significant added value to a prospective portfolio company. That may not always be the case. It is critical that the firm know its audience. If the firm is negotiating with an unsophisticated company with only the most rudimentary processes and controls, it is easy to demonstrate the expertise it can bring to bear on the business. For the owners of such companies, formal budgeting or a comprehensive MIS system may truly be novel.

Grant Thornton in the news

"Small and mid-size companies are faring better because there's plenty of private equity in the marketplace. Buyers are being more selective, but there are fewer deals around, so valuations for many small companies are holding up."

Harris Smith
Managing Partner,
Private Equity
Chicago Tribune
August 4, 2008

When pitching more advanced companies, the private equity firm will have to work harder. It can be difficult to convince a business owner with a career's worth of industry expertise, leading a sophisticated enterprise, that an investor can provide meaningful know-how and skills to further grow his business. It won't be budgeting expertise these firms need. Product sourcing, acquisitions, international expansion, strengthening the executive team or board — these and similar issues could be the needs of a mature business and of which the private equity firm will have to demonstrate particular expertise and skill.

Chemistry

The baby boomer generation is as diverse as its numbers. Boomers' ages, education levels and backgrounds vary enormously. The owner with whom a private equity firm representative is negotiating could be significantly older or younger, or vastly different in outlook and temperament. An owner of this generation can be an urbane, sophisticated 40-something with Ivy League credentials, or from rural America with little formal education, nearing retirement age.

Regardless, it is of the utmost importance to establish a true rapport from the start. Again, family business investments are highly personal.

A private equity firm needs to be thoroughly versed in the company and its history, and garner as much intelligence on the owner as possible. The firm representative must clearly communicate an understanding of the business and a respect for the business owner and what he has accomplished.

Ultimately the business owner must be convinced the private equity firm is providing a fair valuation and equitable deal structure, and will be a true, hopefully value-added, partner that shares the owner's vision for the long-term, continued success of the company. •

FASB Statement 157: Fair value measurement and private equity

By Mark Scoles, Grant Thornton Accounting Principles Partner and **Frank Raffaele,** Grant Thornton Audit Partner

It's not as simple as buy and sell. The concept of fair value greatly impacts the way funds measure assets and liabilities. There are significant issues that private equity firms need to be aware of in implementing FASB Statement 157.

Overview

FASB Statement 157 was designed to provide investors with expanded information about the extent to which entities measure investments at fair value, the information used to measure fair value, and the effect of fair value measurements on related income and performance. This Statement is effective for financial statements issued for fiscal years beginning after Nov. 15, 2007.

Statement 157 emphasizes an exit price versus an entry price in determining fair value. It assumes an orderly transaction, which presumes that an asset has been exposed to the market for a sufficient period of time prior to the measurement date. For investments such as a private equity firm's portfolio company, it presumes that the necessary time to sell the interest in that investment would have elapsed. It emphasizes market participants versus the notion of "willing parties" that was prevalent in other areas of GAAP.

Association for Corporate Growth Boston Growth Conference

Once again, Grant Thornton was a platinum sponsor of the Association for Corporate Growth Boston Growth Conference. Grant Thornton participants in the June event included Dan Reid, National Managing Principal, Transaction Advisory Services, and Paul Beecy, recently promoted to Partner-in-Charge, Boston office Transaction Advisory Services.

Mr. Reid participated in a panel discussion on the state of the M&A market. He was joined by panelists John Goodwin, Managing Director, GE Antares, Dave Powers, Partner, Goodwin Procter, and Bill Roman, Managing Director, Harris Williams & Co. Jay Jester, Managing Director, Audax Group, served as moderator.

During the luncheon, Mr. Beecy spoke about the worldwide trend in the volume of middle-market deals as compared to large transactions. He noted that data on disclosed transactions indicate that middle-market deals outnumber large transactions.

Several other Grant Thornton executives attended the conference, including Fred Astrauskas, who recently joined the Boston team as Executive Director of Transaction Advisory Services.

It emphasizes the use of market-based information over entity-specific information. And it emphasizes the price in the principal market from the seller's perspective, or in some cases, the most advantageous market.

What is the primary purpose of the fair value hierarchy? That's open to interpretation. It could be argued that it is to prioritize the use of observable inputs over unobservable inputs in determining fair value measurement. It is important to remember that the hierarchy does not relate only to disclosures, which are a byproduct of prioritizing the inputs.

Implementation

The first step in implementing Statement 157 is to identify assets and liabilities measured at fair value. For private equity firms, that would include their investment portfolio. The next step is to identify assets and liabilities disclosed at fair value. Management should then assign assets and liabilities to clearly discernible groups and then determine the principal, or most advantageous, market to sell the assets or transfer the liabilities. Once the items have been appropriately grouped, the use of market-based inputs is prioritized to determine the value. The final step is to determine the hierarchy of those inputs, and classify within the hierarchy for disclosure purposes as required under Statement 157.

With regards to market participants, or using market-based inputs, there is no requirement to identify specific participants in arriving at fair value. That said, it often helps to do so if there is difficulty determining who the market participants are or what they would look like.

When using an outside valuation specialist to provide fair value measurement, it's important to understand that management is responsible for the amounts and disclosures in its financial statements. In relying upon specialists to provide a value, it is necessary to understand the processes and controls they employed in deriving the value.

Regarding the fair value measurement three-level hierarchy, one would expect most investments in private portfolio companies to be classified as Level 3. There will be times, however, when private equity firms will have securities classified as Level 1 or Level 2. An example of Level 1 is an identical security traded on an active market, including exchange-traded securities such as stocks, bonds, futures and options. An active market is defined as having sufficient frequency and volume of transactions to provide pricing on a continuous basis. The presumption is that an exchange represents an active market, and the burden of proof would be to show trading volume is not sufficient to consider it active.

As for Level 2, in general, restricted stock of a public company would fall within this category. Other examples are debt securities traded on an active market but for which matrix pricing is used, and debt securities traded on a market that is not active. Additionally, many derivatives would be Level 2.

Restrictions and Fair Value

Certain restrictions on the sale of a security can affect fair value. This will be of interest to private equity firms as their investments, the portfolio companies, conduct IPOs.

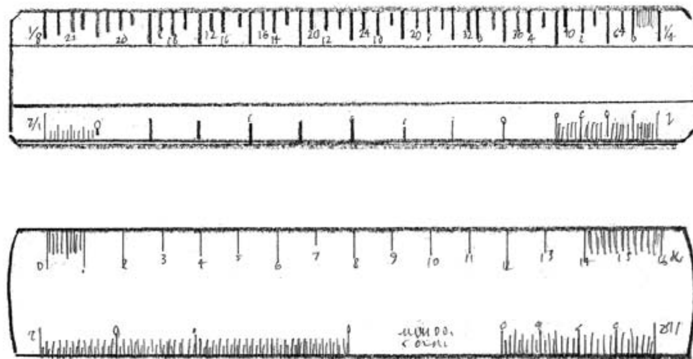
Very simply, a restriction specific to a security would result in an adjustment to the quoted price, while a restriction specific to the holder would not. For example, if your portfolio company has gone public and is trading on an exchange, the securities you own may be restricted under Rule 144. Because this restriction is specific to the security, there would be some discount to the price.

Continued on page 6 >

Now, assume you've got a portfolio company that has executed an IPO, and you are subject to an underwriter's lockup agreement. That agreement is an attribute of the holder of the security, not of the security itself. While you are restricted from selling the security, the value would be simply price times the quantity, with no adjustment. It is important to remember there could be a restriction associated with the security, such as under Rule 144, in addition to the lockup agreement. In that case, the restriction under Rule 144 would cause an adjustment to the transaction price, or the quoted price, in the active market, while the restriction associated with the underwriting would not.

In calculating the discount to an actively traded, restricted security, one should consider the company's trading characteristics, the investor's ability to sell when the restriction lapses, and the length of the restriction. Valuation specialists use a variety of methods, depending on the facts specific to the situation, to calculate the discount. Regardless of the method used, the discount should decline as the remaining length of the restriction decreases.

Such restrictions will of course impact disclosure. For common stock of a public company restricted under Rule 144, for example, the amount of the adjustment from the quoted price would likely bring that investment down to Level 2. Occasionally, it's also feasible that the amount of the adjustment, or the subjectivity of that adjustment, could bring it to Level 3. Restricted stock of a public company that is subject only to an underwriter's lockup agreement, or some type of contractual relationship between the holder and the company, would be a Level 1 for disclosure purposes. There would not be any adjustment.



Market Approach/Income Approach

There are several factors that should be considered when determining the fair value of an investment in a portfolio company. Most important is determining the principal market to sell the investment in the portfolio company, and whether a secondary market exists.

If no market can be identified, or there's a market with little transparency, it is necessary to identify the inputs that hypothetical market participants would use to price the investment. Again, there is no requirement to identify specific market participants, but it can be helpful to think of it in that context. Generally, most market participants considering the purchase of an investment in a portfolio company are going to use some type of valuation model, employing a market approach or an income approach.

For an equity security, examples of a market approach are multiple of earnings or multiple of EBITDA. As for an income approach, discounted cash flows would be appropriate for a debt security. For derivatives, options, or warrants, an option-pricing model would be the appropriate income approach. For a hybrid security, some combination of market and income approaches would be used.

In the past, many investment companies, BDCs in particular, may have used a technique where the value of a debt security would not change as long as there was sufficient enterprise value to support the payoff of the liability. This method will probably not work under Statement 157, since it does not take into account market participant assumptions that would be relevant to a prospective buyer. If it doesn't consider all the information that a market participant would look at to price the investment — changes in the issuer's credit, credit spreads in the industry, interest rates, the economy — it's not going to work under Statement 157.

Since many firms will use a market approach to determine a value for the equity, a valuation technique that determines the enterprise value of an entity would also need to go through an allocation process, allocating the value among the equity classes, and, in some cases, the debt classes as well. In the past, some companies might have used a liquidation approach. If there was sufficient enterprise value or if the preferred might consume all the enterprise value, then nothing would be allocated to the common. This is likely not the proper method.

There are several factors that should be considered when determining the fair value of an investment in a portfolio company. Most important is determining the principal market to sell the investment in the portfolio company, and whether a secondary market exists.

The American Institute of Certified Public Accountants published a practice aid entitled "Valuation of Privately-Held-Company Equity Securities Issued as Compensation" that provides useful guidance on methodologies to allocate value among equity classes. Companies will want to look to this guidance. Not only will it be necessary to come up with the enterprise value or the value of the equity, you'll also need to have a rational methodology to allocate that value among the equity classes.

Recent transactions involving a portfolio company need to be factored into the valuation. For private equity investors, there has been a true paradigm shift in thinking in how to do so. In the past there may have been a greater reliance upon recent transactions or even not-so-recent transactions in determining fair value. However, the new rules require that investments be valued as if they were to be sold today. That said, transactions provide some valuable information in coming up with the fair value of a portfolio company. So depending upon how recent the transaction, it will likely be given a fair amount of weight in determining fair value.

How would a transaction involving a portfolio company be factored into the level within the hierarchy for disclosure? Generally, we believe the transaction price would not be considered observable and thus, not a level 2 input for purposes of disclosure within the hierarchy under the definitions of Statement 157. That said, there could be certain situations in which it would be observable. If it is, any adjustments to the transaction price due to the different rights and obligations in the reference securities that were sold in that transaction compared to the securities that are held by you or any adjustments due to the staleness of the transaction data, would be Level 3 inputs. And again, a Level 3 input or any combination of Level 3 inputs that are significant to the overall valuation would result in the investment being Level 3 overall.

Regarding a subsequent round of financing, how much weight to give to that financing is going to be somewhat dependent upon who the investors are. If they're all the current investors in the portfolio company, investing in the same proportion as their ownership, then the transaction price may not provide much useful information. On the other hand, if they are new third parties making an investment decision, that provides much more relevant information in determining fair value. It is important to look beyond just the fact that there has been a subsequent round of financing.

Now, consider the situation where you have a controlling interest in an actively traded public company. That raises the question of whether a control premium is appropriate or whether fair value should be based solely on the product of the quoted price times the quantity held. One view is that Statement 157 requires the use of the quoted price times the quantity. Another school of thought is that if the unit of valuation is a controlling interest, the highest and best use might indicate the principal market is a transaction with a strategic buyer that would potentially pay a premium for the benefits associated with controlling the entity. Those who hold the former view say the principal market cannot be based upon management intent. They assert the principal market is that which has the greatest volume and level of activity, the public market, and the notion of which market is the most advantageous are irrelevant if there is a principal market. Companies should be aware that further guidance or clarification on this issue could be given in the future. In the meantime, if a company is of the belief that Statement 157 allows for a control premium in certain circumstances, the firm needs to have adequate documentation and evidence to support that their intended exit strategy is to sell in a single transaction to a buyer that would pay a control premium and have support for the amount of the control premium that would be paid.

Continued on page 8 >

FASB Statement 157: Fair value measurement and private equity
(continued from page 7)

There is some question as to whether transaction costs incurred in the purchase of an investment should be expensed based on the guidance of Statement 157. We believe they should not. The *AICPA Audit and Accounting Guide for Investment Companies* indicates that transaction costs are an element of the cost of the investment. Some may argue that such costs are not an element of fair value, and since an investment company is required to account for items at fair value, perhaps there should be a change in accounting so these costs would now be expensed. Our view is that the guide is still applicable and that transaction costs should be an element of the cost of the investment. However, these costs do not represent an element of fair value, and thus would generally result in an unrealized loss when marking the investment to fair value on day one.

Any limited partner investment in a fund of any kind must determine the principal market to sell that investment, and whether there is a secondary market. If no market is identified, or there is no transparency into that market, it is necessary to consider the types of inputs that the hypothetical market participant would use to price that investment. For instance, are there restrictions on the sale of the investment, and are those restrictions an attribute of the security, or are they an attribute of the holder of the security? Interestingly, the answer may differ from fund to fund. One should also consider transfer restrictions, and in the case of a hedge fund, redemption and similar provisions.

What about an investment in a private equity fund of funds? Again, one needs to determine if there is a secondary market. In the case of private equity funds, there would be. And a private equity fund of funds has probably transacted in that market in the past or otherwise has insight into that market. When transactions have occurred in that secondary market, it is necessary to examine whether those transaction prices are at net asset value, at a discount to net asset value or even at a premium to net asset value. In general, they are at a discount to net asset value, and the discounts can vary considerably based on the nature of the investment. One will want to examine what type of factors about this particular limited partnership investment would influence the amount of discount or, in rare cases, premium to net asset value that a market participant would be willing to pay today. We would expect that these investments generally would be Level 3 within the fair value hierarchy although there may be instances in which transaction prices are observable that could lead to Level 2 within the fair value hierarchy.

Conclusion

Statement 157 addresses past differences in determining fair value of illiquid investments. It provides greater consistency and much-needed guidance in the implementation of fair value measurements. For private equity firms it is likely to significantly impact how they calculate the value of an investment in a portfolio company, and there are particular issues that firms need to be aware of as those companies go public. •

Questions?
Grant Thornton LLP professionals understand the unique needs and strategies of private equity firms and their professionals. Throughout the life cycle of a fund, we deliver timely value through our audit, tax, transaction and other specialty services. For more information on how you can benefit from Grant Thornton's private equity services, contact:

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