HOULIHAN LOKEY

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Independent Valuation Insights

FUND MANAGER VALUATIONS

Cindy Ma • *Managing Director* • Houlihan Lokey
Andrew Proctor • *Director* • Houlihan Lokey
Oscar Aarts • *Director* • Houlihan Lokey

Introduction

Houlihan Lokey is at the forefront of understanding the dynamics of the alternative asset management industry while providing financial and valuation advice and facilitating transactions for our clients.

With regard to financial and valuation advice, we are all familiar with the guidance provided by "SFAS 157" (now known as ASC 820), "fair value measurements," and the need for valuations of the underlying investments of hedge funds and private equity funds. However, a different issue for many alternative asset managers is how to determine the value of the actual management entities that run these funds. This is likely to become a more pressing issue in the future, as the frequency of events driving the need for valuations of managers has increased—events like changes in senior members, succession planning, raising new capital at the manager level, attracting and retaining talent through equity ownership, or the outright sale of an equity stake in the manager. And in these cases, an independent valuation of the manager is critical to understanding the economics of the transaction, to satisfying the fiduciary duties of senior management and the board, as well as to satisfying regulatory and tax requirements.

The valuations of alternative asset managers are far from simple. Complex structures created by managers to incentivize performance while providing for tax efficiency, combined with the unique attributes of comparable public companies and transactions, call for an in-depth understanding of both the manager and the broader industry. The purpose of this paper is to provide insight into the unique and complex issues associated with the valuation of alternative asset managers.

Background

A "typical" alternative asset manager consists of two (or more) separate but related entities—a manager entity and a general partner (GP) entity. The manager entity generally earns revenue from management fees recieved from the respective funds it manages, while the GP generally earns revenue from performance fees

or carried interest in the funds in which it is the general partner. For valuation purposes, these two entities are often (though not always) treated as one entity and valued together. When we refer to the “manager” in this paper, we are inherently referring to both entities unless otherwise noted.

Methodologies

Generally speaking, the valuation methodologies used to value a manager are the standard methodologies used for a variety of other industries, and include capitalization of earnings (generally EBITDA or other earnings metrics discussed below) and a DCF (assuming long-term projections are available). As with other situations, unique company and industry factors should be taken into account in order to ensure appropriate application of these methodologies.

Factors to Consider

In preparing a supportable valuation of managers, there are a number of unique factors that should be considered. These are all generally meant to assess the risk profile and ultimately the directional impact on the value of the manager. Following is a summary of some of these factors and the likely directional impact on value.

Factor	Positive	Negative
Investment Focus	Diversified Portfolio Strategies • Investment strategies • Asset class • Geography • Industry	Single Strategy, Geography, and/or Industry Focus • All eggs in one basket
Revenue Stability	Substantial Management Fees • Limits volatility of revenues and earnings	Heavy Reliance on Incentive Fees • Limits revenue and earnings visibility
Management	Proven Teams of Portfolio Managers • Ability to cultivate and attract talent • Ability to absorb the loss of one person or team • Limits reliance on a single rainmaker	Reliance on One or Two Superstars • Key man risk to performance • Key man departures may trigger LP withdraw rights, or a reluctance to “re-up”
Historical Returns	Stable, Consistent, Attractive Returns	Volatile, Lumpy, or Unpredictable Returns
High-Water Marks	None or Annually Reset	Continuing for the Life of Fund(s)
AUM Growth	Consistent Historic Growth Consistent Returns with Additional AUM History of Successful Funds	Volatile or Declining AUM Limited History of Launching Funds
LP Withdraw Rights	Limitations on Timing, Dollar Amounts, or Percentage Amounts • Lock-up periods • Limitations per LP or in aggregate • GP ability to limit or regulate withdraws	Loose Withdraw Policies = Less Stable AUM
Compensation Structure	Managers’ Comp Through GP/Carried Interest • Directly tied to the performance of management company • Lock-up/vesting provisions	Managers’ Comp as a Cash Cost Paid Out of Management Fees • No long-term vested interest • May not be tied to management company performance

Factor	Positive	Negative
Fund Structure	Hedge Fund Structure • Carried interest is payable at regular intervals without investment liquidation • Underlying funds have unlimited life Private Equity Fund Structure • Locked up AUM until liquidation • Built-in carry on unrealized investments may be significant	Hedge Fund Structure • High-water marks may limit carry payouts • AUM may be volatile and subject to periodic redemption by LP Private Equity Fund Structure • Carried interest only payable upon actual realization of underlying investment and may be volatile and irregular • Limited life of underlying funds • Built-in carry on unrealized investments may be volatile • Clawbacks may be an overhang

In addition to the above operating factors, the rights and privileges of the various stakeholders must be considered. Managers tend to be set up as limited partnerships. The various classes of membership units in the partnerships often have unique rights and privileges that must be considered in the context of valuing such units. This becomes a key consideration when valuing minority interests in a manager. The senior members of the manager may have the power to dictate the operational activities of the manager and financial distribution of the manager's earnings, and the minority stakeholder may have minimal or no influence in the operations or financial performance or distribution of earnings of the manager. The lack of appropriate protections, rights, and privileges for the minority stakeholder may have significant consequences on the value of the minority stake.

Hand-in-hand with the considerations of the rights and privileges of the interest being valued, one must consider the distinction between the compensation expense paid to the managers in their capacity as such and the distributions made to the owners/partners of the manager as the holder of equity interests in the entity. In many management companies, the senior executives of the company also tend to be the majority owners of the equity in the manager, and there may be blurred lines between management compensation and returns to equity holders that need to be carefully considered in determining the appropriate earnings levels of the management company.

Public Market Indications

In the last 10 years or so, a number of large diversified alternative asset managers have publicly listed their equity. These companies often provide valuation benchmarks for privately held managers.

However, there may be material differences between the private manager being valued and the publicly traded alternative asset managers, such as the proportion of revenue and profits from management fees compared to performance fees. This often leads to a need to consider the two income streams separately. In this case, it may be prudent to also consider the publicly traded traditional asset managers that receive only management fees (and no performance fees). It is also important to give appropriate consideration to the volatility of the performance fees reported by the private equity–oriented alternative managers, especially when capitalizing trailing or near-term earnings, or cash flows.

In either case, the factors discussed above must be taken into consideration when comparing these large, diversified public companies to (typically) smaller, less diversified managers.

U.S. GAAP Considerations

Furthermore, when considering the reported earnings and other financial statements of the public alternative asset managers, a number of structural and U.S. GAAP (GAAP) reporting factors must be carefully considered.

GAAP imposes a number of potentially confusing requirements on the financial reporting of alternative asset managers. Some of the critical elements to be aware of include: (i) GAAP may require some of the underlying funds that are run by the manager to be consolidated onto the manager's financial statements, potentially distorting the reported earnings, assets, and liabilities of the manager; (ii) if realized performance fees (carried interest) are subject to clawbacks, GAAP may not allow recognition of those fees until the clawback has expired in a later reporting period (potentially long after the fees have actually been collected by the manager); and (iii) economic interests in the manager held by its founders and other senior personnel may be subject to vesting over time that could result in large non-cash compensation expense items under GAAP during those vesting periods and could distort the operational economics of the manager.

Fortunately, most publicly traded managers provide guidance to its shareholders, and the market in general, regarding the potential distortions of GAAP reporting. The publicly traded managers typically report certain industry-specific, non-GAAP measures, including "economic net income" and/or "distributable earnings," which are meant to reflect the current operational economics by adjusting out most of these GAAP distortions in order to compare financial performance on a relatively consistent basis, both over time for a given manager and between and among different managers. Similarly, these publicly traded managers also report balance sheets that strip out any required consolidation of the underlying funds to provide a more accurate profile of the manager's assets and liabilities.

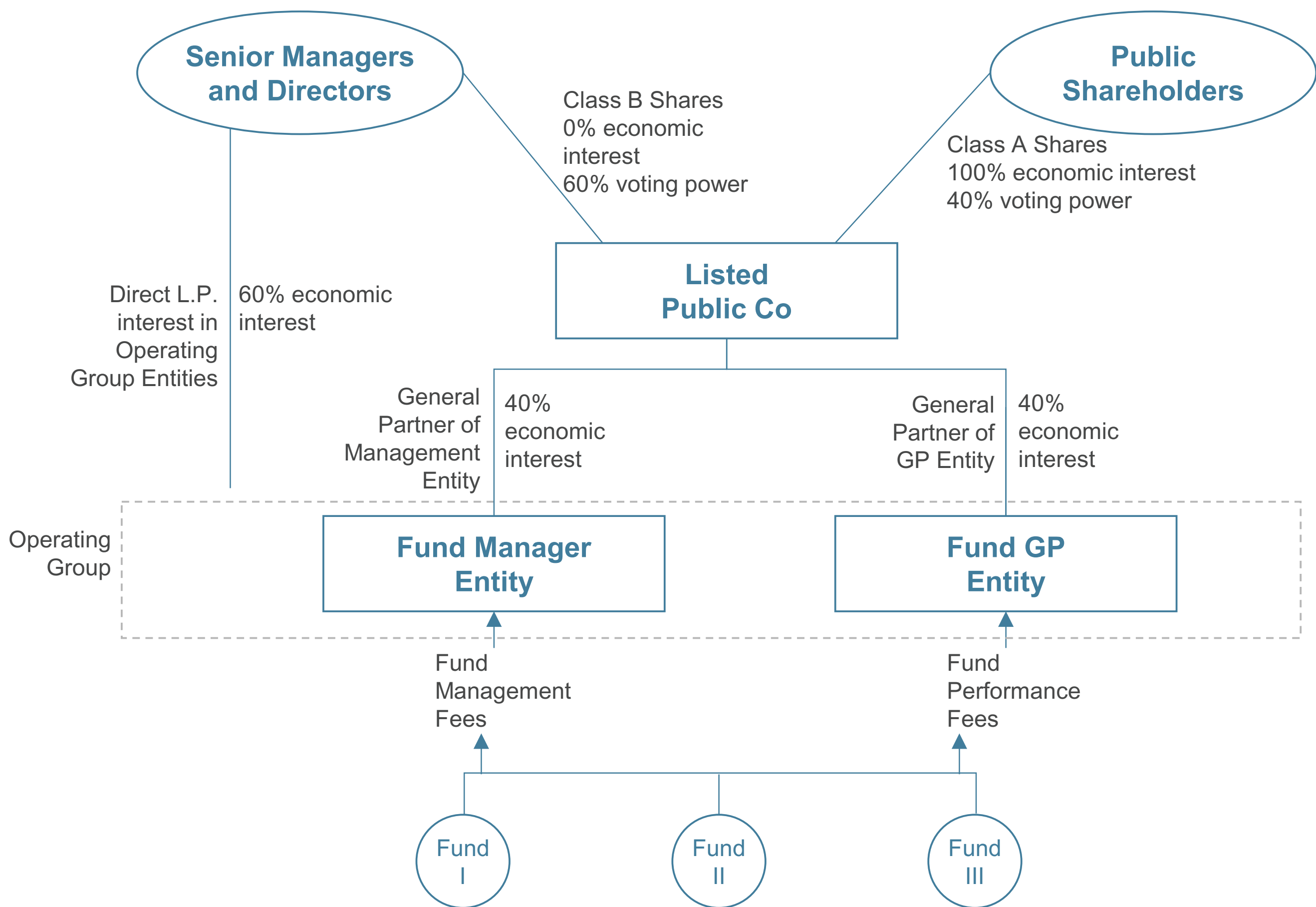
Lastly, the publicly traded managers tend to have unique (but fairly uniform) corporate and ownership structures that may have an impact on GAAP reporting. An example is illustrated below. In this example, there are a few things to pay attention to:

- Listed Public Co is effectively the ultimate general partner of, and runs the Operating Group (substantially all of the operations) of the manager, although it receives only 40% of the economics of the Operating Group of the manager.

- 60% of the economics of the Operating Group is held by the Senior Managers and Directors of the manager through its direct LP interest in the Operating Group. However, that LP interest, per se, does not have any control over the Operating Group. Rather, the Senior Managers and Directors indirectly control the Operating Group through their corresponding Class B share in the Listed Public Co, discussed below.

- Listed Public Co has two classes of shares—Class A, which is held by the Public Shareholders and receives all of the economic interests of Listed Public Co (which itself receives 40% of the economic interests of the Operating Group) and 40% of the voting power of Listed Public Co; and Class B, which is held by the Senior Managers and Directors of the manager and has no economic interest in Listed Public Co but has 60% of the voting power of Listed Public Co.

When reviewing the reported financials of Listed Public Co, keep in mind that the reported GAAP financials often take into account 100% of the financial performance of the Operating Group, and then adjust for that portion of the economic interests that is attributable to the Senior Managers and Directors (in this example, 60%).



This illustration is meant to provide a general framework for analyzing the publicly traded alternative asset managers. However, each one may have other unique attributes critical to appropriately gauging their value. Similarly, it is critical to understand the unique attributes of any privately held asset manager to ensure an appropriate and relevant comparison to the public companies.

Conclusion

There is a growing need for the valuation of alternative asset managers. Although the methodologies employed for these valuations are generally the same as for other industries, certain unique industry attributes can have a significant impact on the valuation outcome—such as the nature of the assets under management, LP withdraw rights, and the relative contribution of management and performance fees. One also needs to consider the rights and privileges of the interest being valued in the context of a complicated capital structure (among other things).

Looking to the markets for comparable indications also introduces further complications. This is particularly true when considering the publicly traded alternative asset managers, rather than the traditional asset managers. Alternative asset managers must comply with a number of potentially confusing GAAP requirements in their financial reporting, so one must look to "distributable earnings" and "economic net income" as well as other adjustments to GAAP so as to compare financial performance on a relatively consistent basis both over time for a given manager and between and among different managers. Also, the degree of diversification of the publicly traded asset managers is generally more extensive than the subject company and therefore must be taken into account when assessing risk factors and capitalization metrics.

Houlihan Lokey has significant experience with the valuation of asset managers and can help with your valuation questions and requirements. This valuation experience is backed by a cross-product industry team that is devoted to this area.

PORTFOLIO VALUATION & ADVISORY SERVICES

Houlihan Lokey's Portfolio Valuation & Advisory Services practice is a leading advisor to many of the world's largest asset managers due to our strong reputation with regulators, auditors and investors; private company, structured product and derivative valuation experience; and independent voice. We have valued illiquid assets on behalf of hundreds hedge funds, private equity firms, financial institutions, corporations and investors.

CONTACTS

Cindy Ma • *Managing Director* • 212.497.7970 • CMa@HL.com

Andrew Proctor • *Director* • 212.497.4156 • AProctor@HL.com

Oscar Aarts • *Director* • 212.497.7869 • OAarts@HL.com

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