

Valuing A Hedge Fund

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VALUING A HEDGE FUND

What is a Hedge Fund?

Hedge funds are privately held entities formed for the purpose of pooling investment dollars into a single fund and investing in a variety of securities. Hedge funds are typically organized as limited partnerships (LP) or limited liability companies (LLC). When a hedge fund operates as a LP the investors are classified as either general partners or limited partners. When the fund operates as a LLC the investors are classified as either managers or members.

The manager (or general partner) is responsible for the trading activity and day-to-day operations of the fund. Often the manager has his or her own capital at risk within the fund. By contrast, the members (or limited partners) supply capital but do not participate in the securities trading or day-to-day decision making of the fund.

How Hedge Fund Managers are Compensated

The manager of the fund normally receives compensation in the form of management fees and incentive compensation. Management fees are usually calculated as one percent of the net assets under management. Management fees are typically paid quarterly and may be insufficient to cover the overhead expenses of the fund.

Incentive compensation is calculated by multiplying the “net profits” of the fund by some percentage (typically 20 percent). Generally speaking, net profits are defined as the capital appreciation of the assets (i.e., securities) plus any dividends or distributions less the expenses incurred in operating the fund.

Incentive compensation is typically limited by a “high water mark” provision. This provision protects members from being charged incentive compensation in a

favorable year when the cumulative return for the fund is a net loss. For example, if the fund earns a net profit during its first year of operation, the manager is entitled to receive 20% of the net profit as incentive compensation. If the fund subsequently experiences a net loss, the manager will not be entitled to any incentive compensation until such time that the cumulative prior period losses are recovered.

This high water provision has negative consequences for the manager when the fund is significantly “under water” (i.e., reports cumulative losses). Since the management fees may not be sufficient to cover the operating expenses of the fund, the manager may be stuck in the position of having to operate an unprofitable business until such time that the fund increases in value to the point of permitting the payment of incentive compensation.

Business Valuation Approaches

There are three basic approaches to valuing an interest in any business enterprise: (1) the market approach, (2) the income approach, and (3) the asset approach.

The market approach is comprised of two methods: (1) publicly traded company method and (2) merged or acquired company method. The publicly traded company method uses price/earnings multiples of publicly traded companies to value a private company. The merged or acquired company method uses the price paid in mergers or acquisitions to value the private company. In the case of hedge funds, the market approach is rarely useful. There are few, if any, publicly traded companies or mergers or acquisitions involving hedge funds. Consequently, relevant data necessary to use a market approach is typically not existent.

The income approach is often based on a discounted cash flow method. The discounted cash flow method may be useful if the following conditions are present: (1) the fund is either near or above the high water mark and (2) the fund has a history of profitable operations.

Indications of value provided by the income approach generally include intangible value in the nature of (1) personal goodwill of the manager and (2) the investing ability of the manager. Depending upon jurisdiction, it may or may not be appropriate to include this component of intangible value if the analysis is conducted for marital dissolution purposes. Hedge funds rarely, if ever, have any enterprise or institutional goodwill.

The asset approach is conducted by estimating the discrete value of the individual assets contained within the fund. These assets may include publicly traded or privately held securities. In order to properly conduct the asset approach, it is necessary for the analyst to assess the economic characteristics of each of the individual securities contained within the fund.

Selection of Valuation Method

When valuing the ownership interest of the manager of the fund, it is important to determine whether the fund is above or below the high water mark. If the fund is near or above the high water mark has a good track record of profitable operations, the use of the income approach may be appropriate. However, if the fund is significantly under water and the management fees are inadequate to cover the fund operating expenses, the asset approach may be the most appropriate valuation method.

Since members do not receive management fees or incentive compensation, the asset approach is generally the most relevant approach to value a member's interest.

When conducting the asset approach, it is important to remember that financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP) are not stated at fair market value. Consequently, it is recommended that the analyst not rely on the indications of value provided by the financial statements and consider the economic characteristics of the individual assets contained within the fund.

Value of Assets Contained in the Hedge Fund

Generally, the assets of a hedge fund are publicly traded or closely held debt or equity securities of companies or real estate. If the security is (1) publicly traded and (2) the number of shares held by the fund (i.e., the block of stock) is small relative to the trading volume of the stock, then the most reasonable indication of value is the publicly traded price as listed on the pertinent stock market exchange on the valuation date.

If the security is publicly traded and the block of stock held by the fund is large relative to the trading volume, then the analyst should consider whether to apply a blockage discount.

If the security is privately held, it may be appropriate to apply discounts for lack of liquidity or lack of control to the indicated value as provided on the funds' financial statements.

The income stream of the security may also provide an indication of value or it may mitigate the discounts the analyst would otherwise apply in the analysis.

Blockage Discounts for Publicly Traded Securities

When a fund owns a substantial block of stock of a publicly traded company relative to the trading volume, it may be appropriate to apply a "blockage discount." To assess whether a blockage discount is appropriate, the number of shares owned by the

fund is compared to the average weekly trading volume in the subject security. For instance, if the fund owns 100,000 shares and the average weekly trading volume is 5,000 shares, the entire block may be difficult to liquidate without substantially depressing the stock price. Consequently, the application of a blockage discount may be appropriate.

There are several methods to quantify blockage discounts. One method often used is referred to as the “trickle-out” method. The trickle-out method is based on volume restriction guidelines for unregistered securities of publicly traded companies as defined in the Securities and Exchange Commission (SEC) Rule 144.

To quantify a blockage discount using Rule 144 guidelines, it is necessary to perform the following analysis: (1) determine how many quarterly periods will be necessary to liquidate the entire block of stock, (2) determine how many shares can be sold during each quarterly period, (3) multiply the current stock price by the number of shares to quantify the future sale proceeds during each quarterly period, and (4) apply a present value discount rate to the future proceeds to quantify the present value. The present value discount rate used may be an equity rate of return or based on some other reasonable measurement.

Summary and Conclusion

Hedge funds are complicated investment vehicles that often contain a variety of publicly traded and closely held securities. Consequently, one should not assume that financial statements of the fund prepared in accordance with GAAP provide reasonable indications of the fair market value of the assets. Asset values provided on financial statements are typically based on the historical cost of the asset or the most recent trading activity of the subject securities. Neither of these numbers may have any relationship to

fair market value of the assets of the fund. The investment characteristics of each individual asset or security should be analyzed and considered in order to properly estimate the fair market value of a hedge fund.

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