



INSIGHT

What is the Cost of Private Equity?

Given the changes in today's economic environment, what return should a private equity investment generate?

For many years, we have heard the comment, "A private equity investment should generate a 30% return". This comment has come from investment fund managers, investment bankers, and owners of privately or closely held businesses. But, is this single equity return benchmark still

.....

As a result of these experiences, and because of the perceived risk associated with these investments, the industry became comfortable with the notion that a return in the 30% range was proper compensation.

.....

relevant in today's business climate? It doesn't make sense to us that this investment hurdle continues to be valid, given the changes in the economic environment. Two readily observable economic factors lead us to conclude that a fundamental shift in equity return expectations must have occurred; lower interest rates and the reduced leverage (and risk) of target investments.

CORPORATE FINANCE MATH

Private equity funds dramatically expanded in the mid-1980s in the onset of the leveraged buyout era. During that time, private equity investors were investing relatively small amounts of equity capital (around 10-20%), coupled with large amounts of debt (80-90%), to complete transactions. As these transactions matured and the portfolio companies were sold, private equity funds realized large returns. As a result of these experiences, and because of the perceived risk associated with these investments, the industry became comfortable with the notion that a return in the 30% range was proper compensation.

It is a much different environment today.

IS MEZZANINE EXPENSIVE?

Given the conclusions summarized in the adjoining article about the reduced cost of equity and weighted cost of capital in today's marketplace, there's no escaping the follow on conclusion that mezzanine capital (or subordinated debt) is currently quite expensive.

Mezzanine capital is that middle layer of capital oftentimes used in leveraged buyouts and growth financings. Mezzanine is provided in the form of notes that are subordinated to the senior bank lender. The market rate of interest on these notes is in the range of 12-13% with the provider expecting to earn an additional 8-10% from warrants. This implies an after tax weighted cost of capital from mezzanine providers in the range of 17-18%, almost the same return expected by equity investors.

It makes us wonder why buyout funds would use mezzanine in market priced deals because it means paying an equity level return on the capital without the mezzanine provider taking the same level of risk.

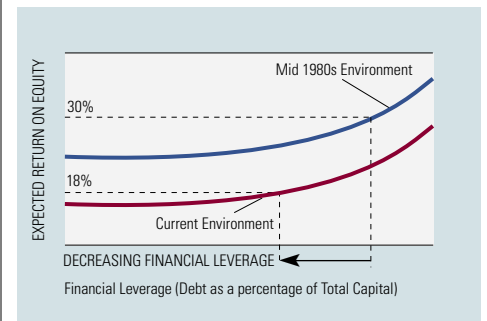
Companies experiencing rapid growth and requiring capital in excess of what they can borrow from senior lenders may find mezzanine the ticket in order to preserve control. Although expensive, it represents a form of bridge capital that can be retired when the business performs and can afford to pay it off. ♦

Interest rates are significantly lower. This factor alone should cause all return expectations to decrease because the benchmark against which all investments are ultimately measured, the risk-free rate, has declined. In

comparison, a 10-year treasury bond in the mid-1980s yielded around 10.5%. Bonds with the same maturity in today's market yield approximately 3.3%. The reality is that a 3.3% return today and a 10.5% return in the 1980s are equivalent in terms of the risk-reward payoff.

Additionally, the ability and willingness to use leverage to finance a transaction today is significantly reduced from the early days of the LBO. Current private equity transactions only support debt in the range of 50% of enterprise value. The result is a greater equity investment and a significantly reduced level of financial leverage and risk.

The following graph illustrates the corporate finance theory of return and risk as measured by financial leverage. The downward shift of the curve represents the effect of lower interest rates and the leftward movement along the curve shows the impact of less risk on the return requirement.



After adjusting for these factors, our calculations lead us to believe that the required return on equity for similar businesses should be much lower. A 15-20% return on equity sounds much more reasonable than 30% in today's market.

WHAT DOES THE MARKET THINK?

Discussing this issue with private equity managers yields agreement on the intellectual concept of less risk requiring less return. Yet, many private equity fund managers say that the private equity industry experience with private company investments has proven that the business risk is far greater than was previously thought and that fact justifies continuing high return hurdles. Some equity managers indicate that their investors have

started to adjust to the lower return environment. Investments in the low yielding corporate bond market (5-6%), the low return stock market (7-9% expectations), and less

.....
The cost of equity is a significant factor in the determination of the WACC. Equally important components are the cost of debt and the amount of financial risk, measured as the relative amount of debt and equity in the capital structure.

than promised venture capital and private equity returns have lowered institutional investors' expectations.

Investment advisors to institutional investors in private fund investments provide additional evidence to the thesis that equity returns have dropped. Our sense from these discussions is that a fund manager who could generate returns to investors in the range of 15% would have little trouble generating an institutional following. Grossing up this return for management costs implies a cost of equity in the range of 18% for a private equity investment.

THE RELATIONSHIP BETWEEN THE COST OF EQUITY AND VALUE

Value is a function of the projected operating cash flow stream discounted by the weighted average cost of capital ("WACC"). The cost of equity is a significant factor in the determination of the WACC. Equally important components are the cost of debt and the amount of financial risk, measured as the relative amount of debt and equity in the capital structure. The table below illustrates the change in values of the different components between the mid-1980s and today, and the effect on the WACC and business value.

If the underlying fundamentals of the business remain equal, changes in the WACC should imply higher values. This may help to explain the relatively high transaction values being assigned to very good companies showing long term market stability and

Lender's Underwriting Analysis		
Cost of Debt	13%	6%
Cost of Equity	30%	18%
Financial Leverage*	80%	50%
WACC*	12.8%	11.0%
Implied Value/EBIT Ratio*	5.09	5.94
* Defined as Debt/Total Capital Invested		
** Tax rate is held constant for both periods		
*** Assume no growth cash flow stream		

growth. The high degree of competition for these opportunities has shown that investors are willing to accept a lower rate of return for a high quality, low risk business.

But, not all transactions are generating these values. Institutional investors have learned more about the risk of private equity investing and are showing greater selectivity. In the last few years, we have observed a much narrower focus on acquisition candi-

.....
A more sophisticated assessment of risk seems to be evolving, with very good private companies being valued at higher levels and less mature or riskier market position businesses being more harshly assessed.

dates by potential acquirers. In short, they are sticking close to what they know. A more sophisticated assessment of risk seems to be evolving, with very good private companies being valued at higher levels and less mature or riskier market position businesses being more harshly assessed. ♦

Shareholders Agreements: The Buy/Sell Provision

Buy-sell agreements provide investors in private businesses an escape mechanism, but are these agreements counter-productive?

Individuals investing in private businesses should give careful thought to the potential future need for liquidity. The "buy-sell" agreement is typically the document that provides for an escape mechanism. Although crafted by well-intentioned business people and their attorneys, in many cases, the buy-sell procedures can economically disadvantage the buyer, seller, or both and can be counter-productive to achieving the intended objective.

A buy-sell agreement attempts to provide a process to accommodate the departing shareholder while allowing the remaining shareholders to retain control of the business without being economically disadvantaged. The task is to balance the needs of the selling shareholder to obtain liquidity in a reasonable time frame and at a fair value with the desires of the remaining shareholders to not have their investment objectives, horizon, or risk be compromised. The buy-sell agreement establishes the procedure to determine the specific compromise. In reality, these objectives are in conflict. Efforts to resolve

the conflicts are usually contentious and, invariably, one or all of the shareholders are disadvantaged in the process.

Although there are as many variations of agreements as there are imaginations,

.....
A buy-sell agreement attempts to provide a process to accommodate the departing shareholder while allowing the remaining shareholders to retain control of the business without being economically disadvantaged.

most standard forms of agreement outline a process to determine and realize fair value. Three commonly used mechanisms are:

1. Right of First Refusal: The agreement allows the selling shareholder to find a buyer, but gives the corporation and remaining shareholders a right of first refusal, once

a bona fide offer is obtained. This process requires the shares to be offered first to the corporation, then to individual shareholders under the same terms offered by the third party buyer. If neither the corporation nor the shareholders elect to purchase the shares, the shareholder is free to complete the transaction with the third party.

There are a number of problems with this approach, the foremost being that it is practically impossible to accomplish a sale. Prospective buyers must be willing to invest the effort and expense to evaluate the purchase, often without access to critical information or management's views on the business, only to wait 90-120 days to see if existing shareholders will match the offer. Even if a buyer is found, the value is likely to be meaningfully discounted because of the inability to sell "control" and the requirement of the buyer to enter into the same buy-sell arrangement.

2. Selling Shareholder "Put" Right: This mechanism allows the selling shareholder to force the Company to buy back the shareholder's interest. If the parties cannot

Credit Markets Update: The Pendulum Swings

Banks are becoming more interested in new financing opportunities.

After a period of rapid credit expansion in the latter part of the 1990's, the needle on the commercial credit appetite pendulum swung sharply in early 2000 from the "greed" zone far into "fear" territory, where it has been firmly planted for the better part of three years. According to the National Bureau of Economic Research, the recession officially ended in November of 2001. Nevertheless, the rebound in economic growth has been extraordinarily slow as the economy has struggled to deal with massive over investment, terrorism concerns, and intense competition from foreign competitors. At the same time, the productivity of workers has been unusually strong, meaning that business can meet sluggish demand for products without adding new jobs and activating idle capacity. The result has been a recovery in the eyes of economists that doesn't feel like one to many business owners, managers and workers. In fact, this downturn has produced a landslide of defaults and a record level of bankruptcies (more than 100,000 companies over the past 30 months). In this environment, commercial banks have taken a lot of hits, evidenced by the fact that loan recovery rates plummeted as the supply of distressed assets mushroomed. Collateral always seems to be worth the least when it's needed the most.

In such circumstances, bankers tend to turn inward putting marketing efforts on

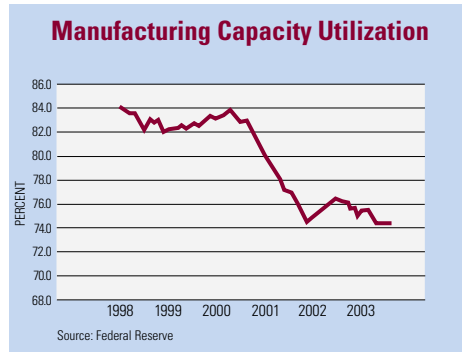
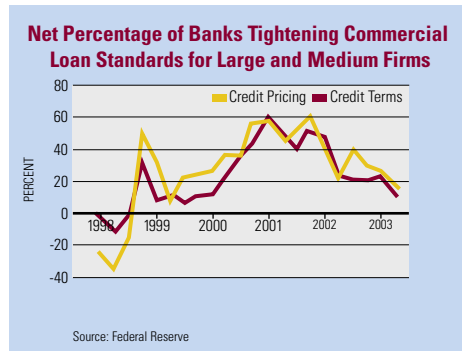
.....

Commercial banks have taken a lot of hits, evidenced by the fact that loan recovery rates plummeted as the supply of distressed assets mushroomed.

.....

hold. Invariably, this means tighter credit accommodations for middle-market firms. This time around was no different. Many borrowers suffered stricter terms, reduced availability and higher pricing as bankers grappled with their problems. Aggressive efforts were undertaken to purge weak credit relationships from commercial loan portfolios. In 2001, BofA publicly announced a decision to reduce commercial credit commitments by some \$30 billion. They were stunningly successful. Within a year they managed to run off more than \$100 billion in commercial relationships.

Now, this process has largely run its course. Delinquency rates have stabilized



and exposures are, for the most part, well reserved. This economic downturn is notable for the lack of major bank failures or bailouts. Banks have emerged with their capital positions intact. Problem deals are being worked down through a combination of restructurings, refinancing, liquidations, loan sales and charge offs. The process of portfolio rationalization has been sped along by extraordinarily low interest rates that have allowed borrowers to lower debt service costs and work down or refinance debt. Even though a massive investment bubble burst.

When you talk to local bankers, you hear concerns about the runoff of assets (loans) and the need to grow. Bankers at B of A, Wells Fargo, US Bank and all of the asset based lenders are now saying that their organizations have a renewed appetite for credit and are beginning to shift from an internal credit focus into a marketing mode. Apparently, banks can't turn away new lending opportunities and meet Wall Street's revenue and earnings growth expectations. This shift in lending posture is borne out in the Federal Reserve's April, 2003 Senior Loan Officer Opinion Survey, which indicated that the proportion of banks tightening standards for commercial and industrial loans to large and middle-market companies fell to nine-percent, the lowest measure since November, 1999.

While no one is handing out cash quite like they were in the "easy money" 1990's, there has been a noticeable pick up in com-

petitive interest in new financing opportunities. There is some evidence of more aggressive underwriting parameters. Selected leveraged financings have been getting done in the 3.5X debt to EBITDA range, as compared to the 2-2.5X range that prevailed over the past couple of years.

While money is available, demand remains soft. According to the Federal Reserve, banks are generally reporting weak demand for new commercial loans by middle-market and large companies since the first of the year. Now that banks are in the mood to lend, it seems no one is clamoring for the money. Much of the current lending activity seems to be focused on refinancings that simply move existing credit from one lender to another in exchange for more liberal pricing and terms. Business investment has not yet begun to rebound. Capital-intensive manufacturers are generally not adding or revamping capacity and few seem to be building inventories. Annual growth in U.S. industrial capacity has declined to a near record low of almost one-percent. At the same time, middle-market M&A activity remains soft, although the overall level of activity has been bolstered by a handful of very large deals.

The world is awash in excess capacity in a host of industries (automobiles, telecom,

.....

As long as weak demand and excess capacity prevail, it is difficult to see a strong pick up in commercial credit needs.

.....

consumer electronics and durables, airlines, hotels, apparel and banking services). Global supplies of goods and services exceed demand as the result of over investment in new capacity, particularly in China. The impacts of higher productivity and excess capacity are aggravated by a slump in demand brought about by weak consumer confidence. Manufacturers and retailers in many sectors have found it necessary to cut prices over and over in the effort to stimulate consumer demand.

As long as weak demand and excess capacity prevail, it is difficult to see a strong pick up in commercial credit needs. The pressure on lenders to generate new loan assets won't evaporate anytime soon as the pendulum swings back toward the "greed" zone. It is fair to expect that lenders will compete vigorously to handle companies' financing needs as the economic rebound gains steam. ❖

Shareholders Agreements *continued from p.3*

agree on value, an independent valuation expert is employed to determine “fair value”. This introduces the risk of “valuation roulette” with the conclusions left to an academic exercise which often does not reflect market value. Financing share purchases to buyout a shareholder is often a challenge; so the seller may be obliged to accept a note that is subordinate to the company’s bank. As a result, the seller may receive little or no liquidity and the company is saddled with additional leverage, possibly at a time that is detrimental to the business.

3. “Texas Auction”: This mechanism presents an interesting way to determine fairness in that the initiating shareholder sets a price for his or her interest and agrees to be either the buyer or seller in a transaction. The problem is that a shareholder wishing to gain liquidity may instead have to buy the rest of the business in order to have sufficient control to sell. If neither party can complete the transaction, the penalty is often a forced sale of the business.

Each of these mechanisms, or variants thereof, has its drawbacks and shareholders should understand the implications before entering into a long-term agreement that will affect their investment. The pros and cons of each approach are summarized in the table below.

Buy-Sell Mechanisms: Implication to Shareholders		
	SELLER	BUYER
1. Right of First Refusal	<ul style="list-style-type: none"> ■ Difficult to attract buyers ■ Can’t force cooperation of company management ■ No strategic value ■ Cash? 	<ul style="list-style-type: none"> ■ Lose control of information ■ Potentially gain unwanted partner ■ Increased financial leverage
2. “Put” Right	<ul style="list-style-type: none"> ■ Valuation roulette ■ No strategic value ■ Cash? 	<ul style="list-style-type: none"> ■ Valuation roulette ■ Forced increase in leverage ■ Damage to future business value?
3. Texas Auction	<ul style="list-style-type: none"> ■ May not be able to sell ■ No strategic value 	<ul style="list-style-type: none"> ■ May end up as seller ■ No strategic value

The inescapable outcome of each of these mechanisms is that all parties are to some degree disadvantaged.

A SUGGESTED APPROACH

An alternative approach to consider is a set of guiding principles to maximize value for all shareholders. Instead of modifying the investment to meet investors’ changing circumstances, the integrity of the investment would be first.

The integrity of the investment objectives and strategy would be protected by guaranteeing ownership continuity for an agreed upon investment horizon unless overruled by a super majority.

Following the investment horizon, the majority (or, as otherwise agreed) would control liquidity decisions.

Assuming the majority elects to obtain liquidity, it would be accomplished through a process designed to obtain the highest return while leaving the minority shareholders with an equal opportunity to retain the business.

Investors should recognize that investments in privately held businesses are illiquid. The best protection against disappointment is to know the other investors and agree on the purpose of the investment.

.....

Investors should recognize that investments in privately held businesses are illiquid. The best protection against disappointment is to know the other investors and agree on the purpose of the investment.

.....

An investment theme and a reasonable period of time to achieve the investment objectives should be agreed in advance. Most institutional private equity investors expect returns to them to occur over a three to ten-year timeframe with a final liquidity date of no later than 12 years. Expectations for an individual investment are in the range of 5-7 years, but there is no obligation to adjust the investment horizon for individual investors due to individual circumstances. To force a liquidity event, a super majority is typically required. The intent is to allow the business to have a reasonable period to perform and accomplish its business plan without interference related to changing investor circumstances.

Following the investment period, a lesser standard should be set to allow liquidity to be pursued. When a group of investors are involved, probably a simple majority should rule. In the case of two investors, maybe either should be able to force action. However, all investors should be held to a standard of confidentiality and non-disclosure to protect the interests of all shareholders.

A suggested mechanism to obtain liquidity is as follows:

1. The shareholder (or group of shareholders) who elects to force a liquidity event should give notice, whereupon the company and/or remaining owners should be allowed a right of first offer. If accepted, the problem is solved.

2. If the first offer is not accepted, the selling shareholders could force the Board to pursue a managed sale of the entire company designed to achieve the highest possible value for all shareholders. Any offer that results in a value that is greater than the first offer would be accepted and all shareholders must participate. If the best offer is less than the first offer, the non-selling shareholders would have the right to complete a transaction at the lower value.

3. During the sale process, any shareholder should be accorded the same opportunity to bid for the business as outside buyers.

This process makes it very clear that investors are signing up for an illiquid investment. These rules are designed to preserve the integrity of the investment objectives over the personal situation of individual shareholders. All shareholders would be treated equally based on the initial objectives established at the time of the investment. Bad feelings may erupt based on business judgment, diverging objectives, and changing personal circumstances, but the fear of being economically disadvantaged by an investor initiated event would be avoided. ♦

ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to ZacharyScott.com.

Mark Working
206.224.7382
mworking@zacharyscott.com

Frank S. Buhler
206.224.7383
fbuhler@zacharyscott.com

Ray D. Rezab
206.224.7386
rezab@zacharyscott.com

William S. Hanneman
206.224.7381
bhanneman@zacharyscott.com

Michael T. Newsome
206.224.7387
mnewsome@zacharyscott.com

Doug Cooper
206.224.7388
dcooper@zacharyscott.com



Zachary Scott
INVESTMENT BANKERS

500 Union Street, Suite 1000
Seattle, Washington 98101