

Business Transaction Marketplace

Information about Business Valuations, M&A and Corporate Finance December 2010

The Private Equity Group (PEG) Investor

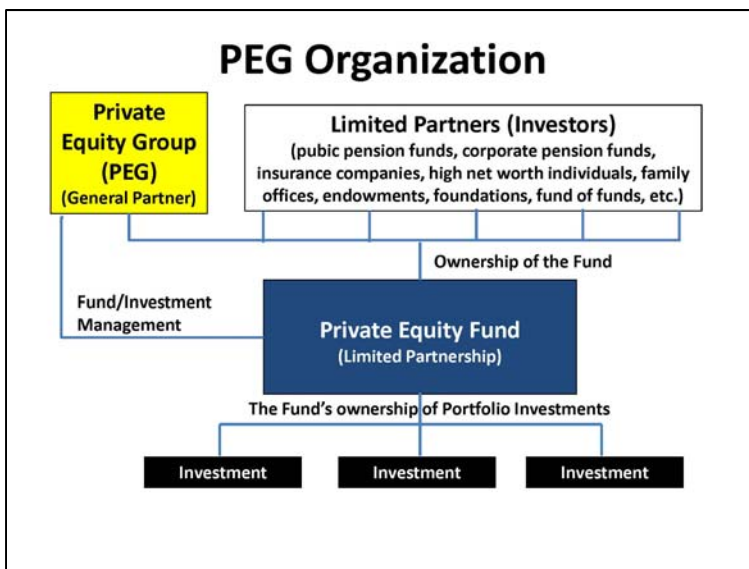
This issue of *Business Transaction Marketplace*SM is devoted to discussing Private Equity Groups (PEGs). Generally, a PEG is considered a *financial buyer*, but not in all cases. A portfolio company within a PEG Fund that makes an add-on acquisition for synergistic reasons would be considered a *strategic buyer*.



We will be discussing how PEGs are organized and the types of portfolio investments they typically make.

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How PEGs are Organized



Life Cycle.

The PEG is typically the General Partner (GP) in a limited partnership with Limited Partner (LP) investors. There are generally five phases to the 3-10 year life cycle of a private equity fund – overseen by the GP: 1) organization/formation; 2) fund raising; 3) deal sourcing and investing; 4) portfolio management; and 5) exiting investments.

Fund Types

There are several types of funds depending upon the level of commitment and the nature of the fund itself: a) committed funds; b) pledged funds; c) fundless funds; d) public company funds; e) family office funds; f) hedge funds; and g) fund of funds.

GP Compensation

The GP is compensated by receiving an annual management fee out of the capital raised – typically 2% of the fund size. In addition, the GP receives a portion of the proceeds from the fund in the form of periodic dividends or from the proceeds upon the sale of portfolio companies. The split is governed by the agreement between the GPs and the LPs. Generally, after the LPs have recovered 100% of their invested capital, the remaining proceeds are split between the GPs and LPs. The portion going to the GP is known as the "carried interest", and is typically in the range of 20% to 25%.

PEG Statistics (Source: GF Data Resources)

- *Number of PEGs in the US.* One measure is *Privateequityinfo.com*, a data base of approximately 1,700 PEGs that have invested in about 34,000 portfolio companies.
- *Fund Raising.* Over the past five years, 2008 was the high point in PEG fund raising where 189 funds were formed raising \$312 billion. In the 1st quarter of 2010, \$17 billion was raised by 20 funds.
- *Deal Size.* Fifty to sixty percent of the capital invested by PEGs since 2003 has been with portfolio companies where the deal size was under \$50 million.
- *Market Multiple.* The average EBITDA market multiple PEGs paid since 2003 to the present – for all industries – ranged from 5.7 to 6.0.

PEG Investment Profile



Investment Size

The size of a PEG investment can range from under \$1 million to over \$500 million. The typical investment ranges from \$2 to \$100 million.

Industries of Interest

PEGs like to invest in mature businesses with a market niche and at least a 10% projected growth in revenue. Manufacturing, distribution and service businesses are common industries of interest, but not exclusively. Unlike venture capitalists (VCs), PEGs don't invest in early stage companies. Nor, are they typically interested in retail, real estate, emerging technology or highly cyclical businesses.

Transaction Structures.

The following are transaction structures that appeal to PEGs:

• 100% buyout (e.g. seller is retiring)	• Sponsoring a management buy-out
• Majority recaps (a second bite of the apple)	• Sponsoring a management buy-in
• Minority recaps (e.g. a dividend distribution)	• Providing growth capital

Advantages and Disadvantages

The following are certain advantages and disadvantages in selling or receiving capital from a PEG:

<u>Advantages</u>	<u>Disadvantages</u>
• Wealth diversification (reduce risk)	• Expensive (time and money)
• Value creation (second bite of the apple)	• Equity dilution
• Remove personal guarantees	• Control issues (operational and at Board level)
• Flexible transaction structures	• Additional debt layers, increasing financial risk

Marketplace Alert – 2010 Tax Bill Now Law



On December 17, 2010, President Obama signed into law the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010". Some key features of the Tax Bill include:

- Individual Tax Rates. The lower tax rates that have been in place since the early 2000s will remain in place through the end of 2012. Those tax brackets being: 10%, 15%, 25%, 28%, 33% and 35%.
- Reduction in Social Security Taxes. For only 2011, individual taxpayers will only pay 4.2% in social security taxes, a 2% reduction from the normal 6.2% rate.
- Capital Gains Rates. The capital gains rate will remain at 15% through 2012 (0% for taxpayers in the 10% and 15% tax brackets).
- Bonus Depreciation. The tax bill will allow taxpayers to deduct 100% of the cost of business property acquired after September 8, 2010 and before January 1, 2012.
- Gift and Estate Taxes. For 2011 and 2012, the gift and estate tax life-time exemption is increased to \$5 million, a top rate of 35%, and a step-up in basis of assets at date of death. When one spouse dies, any unused portion of their \$5 million exemption goes to the surviving spouse. This eliminates the need to establish *credit shelter trusts* in order to maximize the exemption for both spouses.

Upcoming Darrell Arne Seminars

Tax Boot Camp for the Merger & Acquisition Professional
Sponsored by: New England Business Brokers Association
January 20, 2011 – Chelmsford, MA

M&A Taxes – CM&AA Certification Training
Sponsored by: Alliance of M&A Advisors
• February 20, 2011 – Malibu, CA
• April 14, 2011 – Chicago, IL