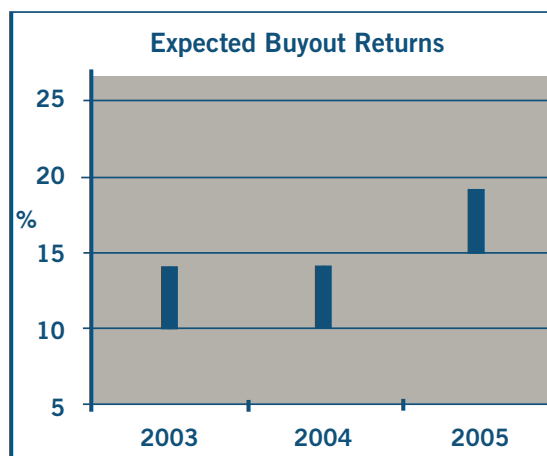
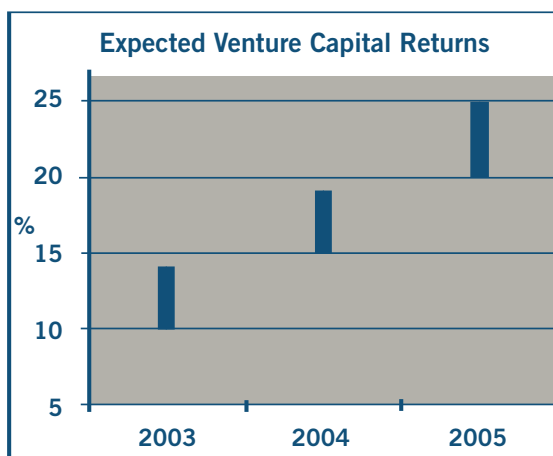


PRIVATE EQUITY INVESTORS FEELING OPTIMISTIC FOR 2006

By Alan Lee

At a time when limited partners (LPs) are increasing their allocations towards private equity investments, expectations for private equity returns are also rising. These expected returns, along with other findings, are contained in the "3rd Annual LP Survey and Report Card" (the "LP Survey") authored by Jerry Borrell and published in the October 2005 edition of Venture Capital Journal (VCJ).

As set out in the below charts, the LP Survey found LPs' expectations for 2006 venture capital and buyout returns to be much more optimistic than previous years expectations. The majority of respondents in the LP survey expect 2006 venture capital returns and buyout returns to be in the range of 20-25% and 15-19% respectively as can be seen from the charts below:



"...POINTS TO A BULLISH PRIVATE EQUITY MARKET FOR 2006"

When asked a general question about LPs' satisfaction with returns that their general partners (GPs) were generating for them, most respondents gave a solid grade at "B" to returns – one of the most positively graded responses in VCJ's entire survey.

Just what exactly were the actual returns? As shown in the below chart, all buyouts and private equity were very solid with 2005 annual returns in the range of 27% and 20% respectively and venture capital has modestly returned to a roughly 8% and very respectable 10-20 year returns:

Venture Economics' US Private Equity Performance ¹						
(Through 6/30/2005)						
	1 Yr	3 Yr	5 Yr	10 Yr	20 Yr	Expected
All Venture Capital	7.8	3	-6.3	25.8	16	20 - 25
All Buyouts	26.9	11	2.9	9	13.8	15 - 19
All Private Equity	20.4	8.2	0.1	12.7	13.8	

Source: Thomson Venture Economics/National Venture Capital Association

¹ Net of management fees and carried interest.

NEW STATUS FOR FAIRNESS OPINIONS?

At Cole & Partners we are biased. We believe independent fairness opinions have a genuine and important role to play in the M&A and governance process. On the other hand, not everyone shares this view.

Says Charles Elson, head of the John L. Weinberg Center for Corporate Governance at the University of Delaware: "In a perfect world we could abandon fairness opinions and let the market pass judgment on whether the deal makes sense. ...fairness opinions are inherently flawed because they can be easily changed by tinkering with any number of the structures the opinion is built on. These are subjective opinions. It's hard to come up with real values. If you change something like interest rates in the formula, the whole model can be thrown off."

The "L" word (liability and litigation), primarily due to conflicts, has Boards and regulators very concerned. One of the key conflict areas is where investment banks are faced with pressure to bless as "fair" deals that enrich clients. Says Ben Howe, a principal at Americas Growth Capital, a substantial American merchant bank and private equity firm, "The conflict-of-interest are clear where the same bank that issues the fairness ruling stands to clear millions of dollars in fees contingent upon the deal closing... I'd like to see an investment bank that had a \$5 million contingency fee riding on a deal come back with an opinion that the deal was unfair... Fairness opinion are often a loss leader because the primary bank on a transaction is willing to let the client negotiate a below-market rate."

In early 2005 when Kohlberg Kravis Roberts & Co. ("KKR"), the New York-based private equity fund, took over Masonite International Corp. ("Masonite"), the investment banking arm of Merrill Lynch was hired by the Board of Directors of Masonite to give the fairness opinion. The good news was that they were trusted and well known to both parties. Merrill Lynch estimated that during the past two years it took in US\$39.6-million in fees from providing debt and equity underwriting and other services to KKR and its affiliates. Merrill had also done meaningful work of Masonite. Their fees however, were roughly as follows: \$1 million; plus, with the deal closing at US\$42.25 a share, Merrill was to get another US\$4.4-million, according to Masonite's regulatory filings; plus up to an other \$1 million at the discretion of the Board. Regardless of the quality of the work, there is the appearance of a conflict. Where is the right balance?

Over the years, critics are vexed over at least three potential conflicts of interest:

- Success Fees – where the provider of the opinion stands to earn a very substantial contingency fee upon completion of the transaction, and that same advisor is also providing the fairness opinion. Critics allege that the success fee provides the advisor with an inappropriate incentive to deem the transaction "fair" regardless of its merits in order to "make the deal happen";
- Beholden to Management – where the relationship of the provider of the fairness opinion to management is such that the provider cannot be independent. This particularly occurs where the opinion provider is hired by the target's management and that management stands to receive big payouts under golden parachutes and other compensation arrangements when the deal is completed;

- Future Business – even if the provider of the fairness opinion is hired by the target board or a special committee of directors, there is often the concern that the provider has an unreasonable incentive to please the directors to obtain other much more lucrative future business.

Exacerbating the above is the fact that there are very few standards against which to judge a fairness opinion, let alone that many shareholders do not understand that fairness opinions are not directed to them and are not intended to be relied on by them.

Where to next? Says Sam Clark, a managing director at Houlihan Lokey Howard & Zukin, a leading U.S. provider of fairness opinions and M&A advisory services, "The buzz out there is that a lot of people want these opinions to be done by secondary sources with a fee structure that isn't contingent upon the deal closing."

Adopting standards such as those set out by the Canadian Institute of Chartered Business Valuators ("CICBV") would go a long way toward managing expectations and enhancing clarity. In June 2004, the NASDAQ® initiated what the Wall Street Journal called a "potentially far-reaching enquiry into the fees, methods, and possible conflicts of interest connected with fairness opinions". However, no definitive findings have been released as of this date.

Plus ça change... or, in the words of Stephen M. Cutler, Director of the SEC's Division of Enforcement when calling on Wall Street firms to do *top-to-bottom* reviews of their business, "shed the blinders of *industry practice* that may have made it possible for you not to see the conflicts that surround you daily. Just because the industry has always done something *that way*, don't assume it's acceptable. It won't be acceptable to your customers when they come to understand the conflicts involved".

So what are Boards doing about the problem? Directors of both acquirors and targets are taking steps such as the following:

- Assignment of the opinion to an expert third-party firm that is not advising either company in the transaction and can be regarded as truly independent;
- Asking for a "second opinion" from another independent expert to support the primary opinion or, at a minimum, a second opinion from a truly independent firm, even if the primary opinion is from one who is not independent;
- Selecting an independent financial advisor having no previous business relationship with management (as recommended in the 1989 court decision *In re Formica Corp. Shareholder Litigation*);
- Applying reasonable selection standards and reasonable care in selecting the fairness opinion provider (which standard is well articulated in the 1999 Chancery Court decision, *Boyer v. Wilmington Materials Inc.*);

Keeping copious records of how a consultant was selected in case there's a court challenge.

1 This article, in summary form, references two articles which are much more detailed and certainly worth reading: "Avoiding the 'L' Word", *Mergers & Acquisitions*, Vol. 39, No. 3 – March 2004 by Brent Shearer; and "The Growing Storm Over Fairness Opinions", *Mergers & Acquisitions*, Vol. 40, No. 3 – March 2005 by Patrick J. Leddy and Randall M. Walters.

CONSIDERING MULTIPLE VALUATION PROCEDURES

Yee, Kenton K., "Combining Value Estimates to Increase Accuracy", *Financial Analysts Journal*, Volume 60, Number 4.

The author states that different valuation procedures applied to the same company often yield disparate answers, and no single procedure is conclusively the most precise and accurate in all situations. Presenting a range of values without commenting on their relative credibility is common practice. On the premise that every value estimate is an incremental piece of information, Yee suggests combining several value estimates together into a superior value estimate.

He considers different methods of achieving this:

1. Delaware Block Method – a valuation technique developed by the Delaware Court of Chancery that, since 1983, has been adopted by virtually all US courts in appraising equity value. This method applies a weighted average of public trading price, net asset value, and a trailing earnings multiple using a multiple derived from comparable companies.

The weighting accorded to each factor varies depending on the nature of the business;

2. A simple average of all known valuation metrics – this technique is derived from Bayesian Theory and considers that each bona fide value estimate provides incremental information. Research into forecasting techniques that found that a simple average performs as well as more complicated techniques;
3. A weighted average – this technique recognizes that some value estimates may have more credibility than others and deserve more weighting.

Back testing and large sample studies to determine appropriate weighting are also discussed but the author cautions that historically appropriate weights may not longer be optimal.

M&A – ACCOUNTING SHIFT AND FASB

Wilson, Arlette and McLelland, Andrew J., "Accounting Shift Proposed for Bargain Deals", *Mergers & Acquisitions: The Deal Maker's Journal*, May 2005.

This article discusses a proposed accounting change by FASB regarding purchase price allocation rules where the purchase price is less than the aggregate value of the identified tangible and intangible assets.

Current GAAP, both in Canada and the U.S., require that the value attributed to the intangible assets is reduced until such time as the shortfall is eliminated.

The FASB proposal, if implemented, will record that difference as a gain in the income statement in the year of acquisition and the values assigned to the identifiable tangible and intangible assets will be the fair value as otherwise determined.

This will have the following effects:

- Until now the Canadian and U.S. purchase price allocation rules were essentially identical. A change of this nature by FASB will result in a difference between Canadian and U.S. rules for bargain purchasers;

- In borderline cases, it would provide an incentive for the acquirer to elect high values for the acquired intangibles in order to trigger an income statement gain; and
- Even if the aggregate value of the business acquired exceeds the sum of the value of the tangible and intangible asset values, the proposed accounting rules will not attribute any value to goodwill. This results from the test being the sum of the identified tangible and intangible asset values taken in isolation, rather than an aggregate value of the business acquired as a whole compared to the purchase price.

With expected returns for 2006 in excess of the historical returns, a signal is being sent by private equity investors that points to a bullish private equity market for 2006.

The findings from the VCJ 2005 LP Survey represent 45 LPs who collectively manage US\$229 billion in private equity investments and more than US\$2 trillion in assets overall. Approximately half of the survey participants were LPs from the US and Canada, while the remaining survey participants were domiciled abroad. The typical LP in the survey managed \$5.4 billion in private equity investments and participated in 80 different managers within 161 different funds. Other topics covered in the VCJ 2005 LP Survey include LP views in portfolio valuations, management fees, capital deployment, succession planning and carry structure.

Other noteworthy findings from the survey include fees, key-man

issues and conflicts of interest. LPs were concerned that GPs should be more concentrated in generating their income from the distributed carry rather than annual management fees and wanted to ensure that the director fees were used to offset its management fees. Regarding the conflict of interest issue, LPs were sensitive towards the director fees that GPs were collecting as directors of portfolio companies.

The LP Survey highlights challenges including:

- Excess amounts of capital to be deployed relative to availability of quality investments may lead to increased competition, which may cause difficulties in obtaining lower pricing;
- Pressure to achieve higher returns will continue to accelerate expansion into markets in India, China and Israel; and
- Relatively thin IPO market as an exit.

NEW STAFF

We have three new professionals whom have recently joined the firm.

Alison Thomas – Alison is a Chartered Accountant and Chartered Business Valuator. Since 1999, she has practiced exclusively in the areas of forensic accounting, litigation support and valuations. Alison has also been involved in preparing numerous business valuation and expert reports. Her focus is on financial litigation support, including commercial and family law matters, and business valuations. Alison currently leads an introductory course on the topic of business valuations for the Canadian Institute of Chartered Business Valuators.

Lorraine Hurding – Lorraine is a Chartered Accountant and Chartered Business Valuator. She has specialised in forensic accounting and business valuation since 2001. Lorraine has experience in business valuation, litigation support, due diligence, forensic accounting and quantifying financial damages. This experience has included preparing reports in respect of business valuation and damage quantification and the provision of financial litigation support pursuant to a variety of commercial litigation, family law, and other dispute matters.

Sid Jaishankar – Sid is a Chartered Accountant. His most recent experience includes a senior associate role with an international accounting firm's financial advisory practice. In this capacity, Sid prepared valuation and due diligence reports which included analyzing financial information, utilizing valuation models, and

auditing clients' financial models. Sid also possesses corporate taxation, internal controls and risk consulting experience with two international accounting firms.

SPEAKING AT THE...

- **7th Annual Due Diligence Conference** on February 1, 2006, presentation by Andrew Harington. Conference is sponsored by Federated Press.
- **3rd Annual Canadian / US Financial Reporting & Accounting Conference** seminar on March 21, 2006, presentation by Andrew Harington and Paula White. Sponsored by The Canadian Institute.

ERRATA Volume 9, No. 2, October 2003

It was recently brought to our attention that the article "Springboard and Early Mover Advantage in Valuation and Damage Calculations" contained a statement that appeared confusing. Specifically, we had said that damages suffered by a plaintiff in a breach of patent or other such right, as a result of lost value beyond the end of the period of breach would not be reflected in an accounting of profits. What we had meant was that this would not be reflected in an accounting of those profits earned during the period of breach. As to whether profits beyond the period of breach are to be disgorged would depend on the specific facts of the case.

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