Reality Check: Valuing ERISA Plan Investments In PE Funds

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Many ERISA retirement or pension plan managers have plan money invested in limited partnership positions in private equity firms. The plan manager has a fiduciary duty to the employees whose funds are included in the plan to ensure that the plan's money is prudently invested. It is increasingly common for ERISA plan managers to be sued based on the nature of and the due diligence performed with regard to the assets in the plan's portfolio. This is especially true if the plan has taken a significant loss on an investment.

In recent years, nearly every securities class action related to failed investments or activities of a company has been accompanied by a similar ERISA class action against both the designated plan fiduciary and corporate executives as fiduciaries. These are based on any number of theories and related to the economic disaster driven by the sub-prime mortgage mess.

In light of seemingly solvent investments overseen by Maddoff and Stanford, which turned out to be completely fictitious, pension and retirement fund managers should be especially conscientious when it comes to their investments in private equity and other similarly elusive investment vehicles. It is well documented that in the middle of this decade financial buyers, such as private equity firms, purchased businesses at extraordinarily high prices. Given the "five years in and five years out" private-equity cycle, as the terms of these funds reach their conclusions and companies purchased in the last five years must be sold, dramatic losses will be realized.

The Bubble Created

Private equity firms buy companies, improve them and intend to sell them in the future for significant gains. These firms purchase businesses with a combination of debt and equity capital from investors and are typically limited partnerships formed by or sold to institutional investors, including retirement and pension plans. For tax and other reasons, retirement and pension plans often invest through separate partnerships than those used by individual investors, although the two types of partnerships often invest side-by-side in the same investment pools. The general partner makes money on management fees (often based on the value of the assets held by the PE firm) and takes a disproportionate share (a "carried interest") of the ultimate profits when the businesses are sold.

In the middle of this decade, the terms and availability of debt financing reached all-time lows. The Federal Reserve lowered its fed funds rate below three percent for the first time in over 40 years, and below one percent for the first time in history of the rate. These rates remained around one percent for an unprecedented 12 months and below three percent for over three and a half years. LIBOR (the London Inter-Bank Offered Rate, the rate most commonly used in private equity deals) followed this same trend, as it typically mirrors the fed funds rate. As rates could not go much lower, competitive lenders loosened their terms and "covenant-lite" loans emerged. The result was essentially free money.

These low rates drove prices for nearly any leveraged investment sky-high, including mortgages, real estate, and businesses. According to Standard & Poors, loans for leveraged acquisitions were around $20 billion in 2003. By 2007, debt investment in leveraged private equity deals had exceeded $189 billion. Private equity firms paid a great deal more for companies and relied more on leverage for purchases of very large companies. If a PE firm could not raise enough investor cash to make a payment, it could just borrow more.

Investors sought out these high-opportunity investments. Values were rising almost exponentially for a period of four to five years. Most investors had no idea how unusual the monetary policy was, but even those who did would have looked to history and made the educated guess that the Fed would raise rates slowly over eight years as it did in the late 1950s through mid-'60s. Most investors saw no end in sight to the rising markets, and retirement funds were no different.

The Bubble Bursts

Times have certainly changed, arguably due in large part to a rapid 4.25 percent increase in the fed funds interest rate with LIBOR in lock step. This historically unforeseeable action following historically low rates over a historically long period of time destroyed these leveraged arrangements more rapidly than PE Managers could effectively react. Private equity firms' general partners attempted to save overleveraged holdings by renegotiating debt and equity relationships, but this did not improve the value of the firm's assets.

Politicians, regulators, and plaintiffs' attorneys are on the warpath. Historically, hedge fund and private equity fund managers have escaped litigation and regulation. Recent events and scrutiny indicate that increased regulation is inevitable and lawsuits against hedge fund and private equity fund managers are on the rise.

Trade groups have attempted to head them off with internally generated protections for investors. Private equity and hedge fund managers operate within the terms of certain agreements which include provisions for valuation and presentation of the assets of the funds. Asset values have historically been based on GAAP rules and reported at original cost until they are sold. This has allowed fund managers to maintain inflated asset values and stronger balance sheets.

Under FAS 157 and similar rules passed by the Private Equity Industry Guidelines Group ("PEIGG"), however, by the end of a firm's 2009 fiscal year all portfolio assets must be valued at their "fair value." The International Private Equity and Venture Capital Valuation Guidelines also support this requirement.

> The International Private Equity and Venture Capital Valuation Guidelines (IPEV Guidelines) were launched in March 2005 to reflect the need for greater comparability across the industry and for consistency with IFRS and US GAAP accounting principles. Valuation guidelines are used by the private equity and venture capital industry for valuing private equity investments and provide a framework for fund managers and investors to monitor the value of existing investments. The IPEV Guidelines are based on the overall principle of "fair value" in order to be consistent with IFRS and US GAAP.

From the Exposure Draft Of The 2009 Edition Of The IPEV Guidelines, Brussels, 22 May 2009.

The IPEV recognizes the need and importance for uniform international guidelines for valuing private equity investments and provide a framework for fund managers and investors to monitor the value of existing investments. The objective is to create best practices for the private equity industry.

Apparently this is not enough as the House Financial Services Committee passed H.R. 3818, the Private Fund Investment Advisers Registration Act, introduced by Congressman Paul E. Kanjorski (D-PA). Chairman Kanjorski states:

> The past year has shown that the deregulation or in many cases, lack of regulation, of financial firms is an idea of the past. Advisors to financial firms must receive government oversight and we must understand the assets of financial firms, including for hedge funds, private equity firms, and other private pools of capital.

Overall performance will also be impacted to the extent investors' auditors force even greater discounts from reported net asset values to comply with FAS 157-new fair value reporting standards.

Who Should Perform These Re-Valuations?

General partners overseeing the portfolio of the private equity firm prefer and are permitted to value the companies and interests they hold. These same general partners, however, are often compensated through management fees based on the value or increase in value of the portfolio assets. They also were often the architects of the ill-advised acquisitions of the over-valued and over-leveraged assets held by the firm.

Given overpayments during the wild years of the middle of this decade and recent economic problems, it is very likely that assets held by private equity firms are now worth less than original cost, perhaps much less. If the fair value determinations are made by other than the general partner, these weaknesses will be revealed, the fund's value will be seriously injured, and balance sheets will have to be heavily discounted. In addition, the general partner may have to return compensation that was not earned, due to "clawback" provisions in their partnership agreements. This creates an inherent and obvious conflict of interest.

Fund general partners also negotiate debt and investment infusions based on maintenance of certain ratios, often based on asset value. Debts also include covenants based on portfolio value. Everyone has been aware that when the termination dates arrive and assets must be sold, serious losses will be realized (unless, by luck, the market recovers enough). A sudden decrease in value to fair value now could topple the house of cards even earlier than anyone predicted. Nonetheless, this revaluation is clearly advised by oversight groups today and will be required by law in the near future.

As fund managers tend to be risk takers, they will be tempted to perform these valuations themselves (as long as they are permitted to do so), and then try to sell their valuations to the investing public. Valuing intangible privately held investment assets, however, is highly complex and requires an expert with a deep understanding of the required methodologies and experience to make the proper judgments.

By comparison, a third party valuation reduces liability exposure, provides accountability, and increases the ability to communicate changes effectively to investors, regulators and bankers to avoid problems, especially under the current economic environment. In the wake of Maddoff and Stanford, a manager of a retirement plan with investments in private equity funds has a fiduciary obligation to the plan members to validate the prudence of these investments.

1. Are the gains or stability that appear on the face of the financials presented real?
2. Are the valuations prepared by the general partner reasonable?
3. Were they prepared using recognized methodologies?

Conclusion

An outside professional valuation expert provides the plan manager an additional layer of third-party justification and accountability for his investment decisions. At a minimum, the manager of an investing retirement fund should demand an independent valuation be secured by the general partner of the private equity fund. This could be critical in defending litigation challenging the prudence of the investment based solely on the valuation of the portfolio presented by the general partner. If the general partner of the PE Fund refuses or fails to provide investors with an independent determination of the fair value of the fund's holdings, the manager of an investing plan should consider divesting or paying for a valuation to justify continued investment in the fund.

Litigation is on the rise. Fiduciary liability has been assessed against corporate executives as well as plan managers. Given the delicacy of the situations facing private equity firms, an ERISA plan manager should consider additional protections before continuing an investment in or investing in a private equity fund.

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