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by Andrew K. Gibbs, CFA, CPA/ABV

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Capital Raising Alternatives for Community Banks

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This article originally appeared in the May 2008 issue of Mercer Capital's *Bank Watch,* Mercer Capital's complimentary monthly newsletter. For more information on *Bank Watch,* see page 11.

Capital raising efforts among financial institutions began in earnest in late 2007, primarily among money center banks and investment banks suffering under the weight of mark-to-market adjustments on various asset types. Banks with fewer assets marked to fair value through the income statement largely maintained sufficient capital to manage the initial wave of industry problems. However, the capital pressures intensified in 2008 as past-due levels and losses increased across a spectrum of loans tied to real estate, causing a number of banks to reassess their capital positions and, in some cases, to capitulate under the weight of the external environment and seek out additional capital.

This article provides a summary of capital raising transactions that have occurred in 2008 and offers insight into the financial considerations present in evaluating each capital alternative. These considerations are relevant whether a bank is in the position of raising capital to buttress the balance sheet or, alternatively, has an opportunity to make an investment in another bank facing a capital shortfall.

COMMON STOCK

The surest way to shore-up capital ratios is through the issuance of common stock, which places no pressure on the company's cash flow if no dividends are declared. The primary disadvantage of common stock offerings is the dilution that current shareholders may experience to their ownership positions and future earnings per share.

Figure One indicates recent common stock offerings. Most of the issuances have occurred at discounts to the issuer's stock price prior to the transaction. In one-half of the issuances, the offering price for the common stock was less than pro forma tangible book value per share (existing tangible book value, plus the equity raised in the offering). One recent article noted that investors were potentially willing to purchase stock at tangible book value per share, as adjusted to reflect the investors' estimate of expected losses in the loan portfolio.[1]

In considering a common stock issuance, important questions for community banks to consider include:

» How should the transaction be structured? Should the bank conduct a subscription rights offering to existing shareholders? Should the bank attempt to sell stock to a small number of new investors who may bring additional expertise to the bank?

» What perquisites of control, such as board seats, should the new investors possess?

» What share price balances the need to raise capital with the goal of minimizing dilution to the existing shareholders? In setting the price, how does the bank bridge any gap between the investor's assumptions about potential losses inherent in the portfolio with bank management's estimates of such losses?

» Should other incentives, such as warrants, be included in the "package" offered to investors?

PREFERRED STOCK

Depending on its structure, preferred stock can bear a resemblance to either long-term debt or equity. In its simplest form, "straight" preferred stock economically resembles long-term debt with either fixed or floating rate payments. Convertible preferred stock is a hybrid instrument that combines elements of both debt and equity. Generally, convertible preferred stock has a lower dividend rate than straight preferred stock, but a higher yield than common stock. To compensate investors for accepting the lower current return, the investors receive the right to participate in the appreciation of the common stock. Further, preferred stock dividends can be either cumulative (meaning that dividends are accrued in the intent of paying such dividends later) or noncumulative.

Issuer	Closing Date	Offering Size ($000s)	Offering Price	Premium / (Discount) to Issuer's Stock Price	Shares in Offering / Pro Forma Shares O/S	Offering Price / Pro Forma Tangible Book Value
Citigroup Inc.	4/30/2008	$4,910,662	$25.27	-5.7%	3.7%	194%
Colonial BancGroup, Inc.	4/21/2008	$349,600	$8.00	-19.4%	21.7%	104%
First Horizon National Corporation	4/29/2008	$690,000	$10.00	-7.0%	35.3%	76%
Harrington West Financial Group, Inc.	3/25/2008	$2,178	$7.75	1.6%	4.8%	89%
Harrington West Financial Group, Inc.	4/23/2008	$2,085	$7.75	1.6%	4.6%	89%
National City Corporation	5/2/2008	$631,000	$5.00	-40.0%	16.6%	48%
Provident Bankshares Corporation	4/9/2008	$13,510	$9.50	-9.1%	4.3%	102%
Security Bank Corporation	3/14/2008	$28,369	$6.58	-10.6%	18.6%	75%
Sovereign Bancorp, Inc.	5/12/2008	$1,250,000	$8.00	1.8%	24.5%	120%
Wachovia Corporation	4/14/2008	$4,025,000	$24.00	-13.7%	7.9%	154%
Washington Mutual, Inc.	4/7/2008	$1,535,750	$8.75	-23.4%	16.8%	59%
MEDIAN				**-9.1%**	**16.6%**	**88.7%**
Buyer Received Further Consideration						
TIB Financial Corp.	3/11/2008	$10,080	$8.40	39.8%	8.6%	119%
Buyer received 1.2 million common shares and warrants to purchase an additional 1.2 million common shares (with a strike price of $8.40 per share exercisable before 3/7/11) in exchange for $10.1 million						
Pending Deals: Federal Trust Corporation, Guaranty Financial Group, Inc.						

Source: SNL Financial; Mercer Capital Research

FIGURE ONE: 2008 COMMON STOCK OFFERINGS

From a bank's perspective the advantages of preferred stock include:

» Tier 1 capital treatment of the proceeds. No formal limits exist on the amount of non-cumulative preferred stock that a bank may include in Tier 1 capital, although certain informal limits exist on a bank's reliance on non-voting equity, such as preferred stock. Cumulative preferred stock is includible in Tier 1 capital, subject to certain limits;

» For straight preferred stock, the avoidance of dilution caused by issuing common stock; and,

» For convertible preferred stock, a potentially lower dividend rate than obtainable by issuing straight preferred stock or subordinated debt.

Potential disadvantages from a bank's perspective include:

» The cash flow requirements to service the dividend payments; and,

» The lack of tax deductibility of the dividend payments.

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Our banking clients range from new bank charters to multi-billion dollar (assets) bank holding companies. We have worked for numerous governmental agencies, including the IRS, the FDIC the SBA, the U.S. Attorney General's Office, and the Attorney General of the State of Tennessee. Our work has been reviewed and accepted by the major agencies of the federal government, including the SEC, the FDIC, the Federal Reserve, the Office of Thrift Supervision, and the OCC. Our work has also been reviewed by the largest accounting firms in the nation in connection with transactions involving their clients.

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» Core Deposit and Other Intangible Asset Appraisals
» Employee Stock Ownership Plans
» Tax Compliance
» Strategic Analysis of Alternatives to Enhance Shareholder Value
» Financial Advisor to Independent Board Committees

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From an investor's perspective, preferred stock can be an attractive alternative to common stock. For convertible preferred stock, the investor may receive a dividend in excess of the common stock's dividend, plus the right to enjoy appreciation in the underlying common stock. Thus, the higher dividend protects the investor's downside (to the extent the issuer actually pays the dividend). Further, if the investor is a corporation, the tax deduction for dividends received may be available.

Preferred stocks have been a popular capital raising tool in the present environment, owing to their flexibility and the downside protection afforded to investors. Figure Two indicates issuances announced during 2008.

When structuring a preferred stock issuance, important considerations include:

» What is the appropriate dividend rate? This depends, in part, on the type of preferred stock (straight or convertible). In addition, the perceived credit quality of the issuer is of paramount importance – compare the 9.88% rate on National City's issuance to the 7.88% rate on U.S. Bancorp's offering.

Ordinarily, dividend rates on convertible preferred stocks are lower than straight issuances. While this is true for individual issuers (note, for instance, the difference in the dividend rates on Citigroup's straight and convertible issuances), it is not true for the group of recent issuances as a whole. Several convertible issues contain dividend rates of 10% – higher than any straight issuances. This likely reflects the perceived financial condition of the issuers and the resulting difficulty in accessing the capital markets.

Issuer	Closing Date	Amount Offered ($000s)	Convertible?	Callable?	Dividend Rate	Conversion Premium
Straight Preferred Stock						
1st United Bancorp, Inc.	5/2/2008	$6,500	No	No	7.65%	nm
Bank of America Corporation	1/24/2008	$6,000,000	No	Yes	8.00%	nm
Bank of America Corporation	4/24/2008	$4,000,000	No	Yes	8.13%	nm
Citigroup Inc.	1/18/2008	$3,715,000	No	Yes	8.13%	nm
Citigroup Inc.	4/21/2008	$6,000,000	No	Yes	8.40%	nm
Citigroup Inc.	5/6/2008	$2,000,000	No	Yes	8.50%	nm
First Merchants Corporation	3/31/2008	NA	No	No	na	nm
JPMorgan Chase & Co.	4/16/2008	$6,000,000	No	Yes	7.90%	nm
National City Corporation	1/24/2008	$150,000	No	Yes	9.88%	nm
Popular, Inc.	Pending	$350,000	No	Yes	na	nm
QCR Holdings, Inc.	12/28/2007	$7,500	No	Yes	9.50%	nm
U.S. Bancorp	3/10/2008	$500,000	No	Yes	7.88%	nm
Wachovia Corporation	2/5/2008	$3,500,000	No	Yes	7.98%	nm
MEDIAN					**8.13%**	
Convertible Preferred Stock						
Bank of America Corporation	1/24/2008	$6,900,000	Yes	No	7.25%	33.7%
Citigroup Inc.	1/15/2008	$12,500,000	Yes	Yes	7.00%	8.8%
Citigroup Inc.	1/17/2008	$3,168,650	Yes	Yes	6.50%	16.1%
East West Bancorp, Inc.	4/23/2008	$200,000	Yes	No	8.00%	17.2%
Huntington Bancshares Incorporated	4/16/2008	$569,000	Yes	No	8.50%	32.9%
National City Corporation	4/20/2008	$6,369,000	Yes	Yes	na	-40.0%
Provident Bankshares Corporation	4/9/2008	$51,215	Yes	No	10.00%	0.5%
South Financial Group, Inc.	5/1/2008	$55,562	Yes	No	10.00%	0.3%
South Financial Group, Inc.	5/1/2008	$184,718	Yes	No	10.00%	0.3%
South Financial Group, Inc.	5/1/2008	$2,248	Yes	No	10.00%	0.3%
South Financial Group, Inc.	5/1/2008	$7,472	Yes	No	10.00%	0.3%
Wachovia Corporation	4/14/2008	$4,025,000	Yes	No	7.50%	12.2%
Washington Mutual, Inc.	4/7/2008	$1,992,800	Yes	No	na	-23.4%
Washington Mutual, Inc.	4/7/2008	$3,664,200	Yes	No	na	-23.4%
MEDIAN					**8.50%**	**0.4%**

The conversion premium measures the extent to which the value of the preferred stock at issuance exceeds the value of the common stock that the preferred shares may be converted into (also as of the issuance date)

FIGURE TWO: 2008 PREFERRED STOCK OFFERINGS

» For convertible issues, what is the appropriate conversion premium? At the date the preferred stock is issued, the conversion premium measures the extent to which the issuance price of the preferred stock (generally its par value) exceeds the value of the common stock into which the investor may convert the preferred shares. For instance, consider a preferred stock with a par value of $1,000 that can be converted into 20 shares. This implies that the conversion price is $50 ($1,000 / 20 shares). If the value of the common stock on that date was $50 as well, then the conversion premium is 0%. Generally, conversion premiums are greater than 0%, meaning that the common stock must appreciate before conversion becomes financially attractive.

Issuing banks prefer higher conversion premiums, because fewer shares will be issued upon conversion. Continuing the preceding example, if the conversion premium is 20%, the conversion price would be $60 ($50 common stock price x 1.20). Then, upon conversion, the bank would issue only 16.7

shares ($1,000 par value / $60 conversion price). Conversely, investors prefer lower conversion premiums.

From an issuer's perspective, the most unattractive terms include a high dividend rate and a low conversion premium. As an example, consider South Financial Group's May offering of 10% preferred stock with a 0.3% conversion premium.

» Should the preferred stock investors receive voting rights? Of the issues analyzed, only the National City issuance granted voting rights to investors.

» Are the dividends cumulative? This affects the capital treatment of the proceeds, as well as the potential return required by an investor.

» Do the terms of the issuance meet applicable regulatory guidance for consideration in Tier 1 capital? Regulatory capital guidance contains a number of considerations that can affect the capital treatment of the offering. For instance, structures that create an incentive for the bank to redeem the preferred stock for cash, particularly in times of financial distress, may not be includible in capital.

Issuer	Closing Date	Amount Offered ($000s)	Maturity Date	Interest / Distribution Rate	Floating Rate Pricing
Trust Preferred Securities					
Bank of the Carolinas Corporation	3/26/2008	$5,000	2038	na	3-mo. LIBOR + 300 bp
IBERIABANK Corporation	3/28/2008	$7,000	2038	na	3-mo. LIBOR + 350 bp
First Interstate BancSystem, Inc.	1/8/2008	$10,000	2038	6.78%	na
First Interstate BancSystem, Inc.	1/8/2008	$10,000	2038	na	LIBOR + 275 bp
Washington Trust Bancorp, Inc.	4/7/2008	$10,000	2038	6.23%	3-mo. LIBOR + 350 bp
First Interstate BancSystem, Inc.	12/19/2007	$15,000	2038	na	na
PNC Financial Services Group, Inc.	Pending	$15,000	2030	9.50%	na
City Holding Company	3/27/2008	$16,000	2038	na	3-mo. LIBOR + 350 bp
S&T Bancorp, Inc.	3/31/2008	$20,000	2038	6.44%	na
Smithtown Bancorp, Inc.	3/4/2008	$20,000		na	3-mo. LIBOR + 375 bp
National City Corporation	1/24/2008	$100,000	2043	12.00%	na
PrivateBancorp, Inc.	5/15/2008	$125,000	2068	10.00%	na
Regions Financial Corporation	4/25/2008	$345,000	2078	8.88%	na
M&T Bank Corporation	1/24/2008	$350,000	2068	8.50%	na
PNC Financial Services Group, Inc.	2/11/2008	$375,000		8.70%	na
Fifth Third Bancorp	4/29/2008	$400,000	2068	8.88%	na
National City Corporation	1/23/2008	$400,000	2043	12.00%	na
PNC Financial Services Group, Inc.	2/6/2008	$450,000	2068	7.75%	na
SunTrust Banks, Inc.	2/26/2008	$685,000	2068	7.88%	na
KeyCorp	2/20/2008	$740,000	2068	8.00%	na
Wells Fargo & Company	3/5/2008	$1,575,000	2068	7.88%	na
JPMorgan Chase & Co.	5/7/2008	$1,815,000	2078	8.00%	na
Wells Fargo & Company	5/12/2008	$2,500,000	2044	7.70%	na
MEDIAN				**8.00%**	

Source: SNL Financial; Mercer Capital Research

FIGURE THREE: 2008 TRUST PREFERRED SECURITIES OFFERINGS

TRUST PREFERRED SECURITIES

Trust preferred securities are a hybrid instrument, combining the tax treatment of debt and the Tier 1 capital treatment of equity. From a bank's perspective, the favorable after-tax cost of capital represents one of the primary advantages. Prior to late 2007, another significant advantage of trust preferred securities was that community banks could easily access the capital markets by participating in one of the pooled offerings underwritten by investment banks. As conditions in the credit markets deteriorated, this advantage disappeared, as the pooled offerings have largely vanished from the marketplace, although they may eventually return if investor demand improves.

Figure Three indicates data on trust preferred securities offerings announced in 2008 by publicly traded banks. While pooled offerings have not occurred in 2008, several smaller publicly traded banks have placed trust preferred securities with institutional investors. The pricing in these offerings has increased since the last pooled offerings, which often contained spreads in the range of 150 basis points over LIBOR. The variable rate offerings indicated in the table contain spreads in the range of 350 basis points over LIBOR.

While the availability of trust preferred securities through pooled offerings is currently uncertain, other investors may exist. Alternatively, banks can consider issuing trust preferred securities to local investors or shareholders. Although this type of offering may require more time and professional fees than a pooled offering, the bank will still enjoy the significant tax and capital benefits of trust preferred securities. Questions to consider for banks include:

» If the bank issues securities to local investors, what is an appropriate rate? This would involve, among other considerations, the structure of the offering (e.g., fixed versus floating rate payments), credit quality (e.g., the capital ratios and loan quality of the issuer), the interest rate environment, and market pricing of comparable instruments.

» What are the capital implications? While current capital rules permit a bank to include trust preferred securities in Tier 1 capital, these rules will eventually be tightened. Currently, the capital rules limit trust preferred securities to 25% of "core capital elements." Eventually, "core capital elements" will exclude goodwill, thus reducing the amount of qualifying trust preferred securities for institutions with goodwill.

SUBORDINATED DEBENTURES

In the event that the bank needs to raise Tier 2 capital, instead of Tier 1 capital, subordinated debentures may be desirable. Subordinated debentures may be included in Tier 2 capital, subject to a limitation equal to 50% of Tier 1 capital. Like trust preferred securities, interest payments on subordinated debentures are tax deductible. Subordinated debentures can be issued at the subsidiary bank level, which may decrease their credit risk for investors, relative to instruments that require the holding company to maintain sufficient liquidity from bank dividends or other sources of funds.

Figure Four indicates the pricing of subordinated debenture offerings in 2008. While few community banks are included in this group of offerings, subordinated debentures may remain an attractive alternative to curing a Tier 2 capital need. Transactions announced in April and May have occurred at interest rates ranging from 8.75% to 9.50%. All of the issuances have involved either ten or thirty year terms.

For community banks where subordinated debentures may solve a problem, the following questions should be considered:

» What is the interest rate? Similar to trust preferred securities, an analysis should consider market interest rates, rates on similar subordinated debentures, and the credit quality of the issuer.

» What is the capital treatment? Subordinated debentures have various capital limits and phase-outs. Over the last five years of the debenture's maturity, the amount includible in Tier 2 capital declines by 20% per year. In addition, the amount of subordinated debentures includible in Tier 2 capital is limited to 50% of Tier 1 capital. To the extent that the new capital guidelines limit the amount of trust preferred securities includible in Tier 1 capital, banks may find a portion of their trust preferred securities now included in Tier 2 capital. In that case, the trust preferred securities and subordinated debentures would collectively be subject to the 50% limit.

Subordinated Debt	Closing Date	Amount Offered ($000s)	Maturity Date	Interest/ Distribution Rate
Bank of America Corporation	3/3/2008	$31,666	2038	6.15%
Bank of America Corporation	3/10/2008	$24,024	2038	6.00%
Colonial BancGroup, Inc.	2/28/2008	$250,000	2038	8.88%
Fifth Third Bancorp	2/26/2008	$1,000,000	2038	8.25%
Provident Bankshares Corporation	4/25/2008	$50,000	2018	9.50%
Security Bank Corporation	4/29/2008	$40,000	2018	9.50%
Sovereign Bank	Pending	$500,000	Pending	8.75%
SunTrust Bank	3/17/2008	$500,000	2018	7.25%
Wilmington Trust Corporation	3/27/2008	$200,000	2018	8.50%
MEDIAN				**8.50%**

Source: SNL Financial; Mercer Capital Research

FIGURE FOUR: 2008 SUBORDINATED DEBENTURE OFFERINGS

CONCLUSION

For community banks needing capital, the alternatives possess substantially different impacts on existing shareholders and the bank's future returns, not to mention divergent capital treatments. For potential investors in community banks, downside protection is important in the present environment. As a result, recent capital raises have included common stock issued at discounts to the issuer's market price and convertible preferred stock issuances with relatively high dividend rates and low conversion premiums.

Mercer Capital can assist community banks and investors with considering the advantages and disadvantages of the spectrum of capital instruments available to a particular bank, focusing on their effects on existing shareholders and future shareholder returns, as well as evaluating the pro forma capital impact of different instruments and offering amounts. We can also assist banks and investors in determining an appropriate stock price or interest rate in offerings sold to local investors, analyzing, from an investor's standpoint, the advantages and disadvantages of different proposed investment structures, and providing fairness opinions that the capital offering is fair to a specified group of shareholders. To discuss any of the structures mentioned in this article, please feel free to contact us.

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For a copy of our "Capital Instrument Comparison Chart," that summarizes the advantages and disadvantages of the instruments considered in this article, visit our website at www.mercercapital.com.

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VALUATION BEST PRACTICES

Hedge Fund Investment Portfolios

by Sujan Rajbhandary

Two private-sector committees established by the President's Working Group on Financial Markets ("PWG") released best-practices guidance for the hedge fund industry on April 15, 2008.[1] The Report of the Asset Managers' Committee (the "AMC report") is targeted at hedge fund managers, while the Report of the Investors' Committee (the "IC report") offers recommendations to hedge fund investors.[2] The AMC and IC reports establish a set of key frameworks that aim to reduce systemic risk and promote transparency and protection for investors. This article will briefly discuss the motivation for a robust valuation framework as it applies to hedge funds before delving into the implementation of the valuation framework prescribed by the AMC and IC reports.

MOTIVATION

The global hedge fund industry has exhibited impressive growth in the last two decades. Assets under management have grown from $39 billion in 1990 to around $2 trillion by mid-2008.[3] Unlike other investment vehicles, there is a substantial diversity in investment strategies adopted by individual firms within the hedge fund industry. Common hedge fund strategies may be classified as directional (e.g., equity long/short, managed futures, global macro, etc.), event driven (e.g., merger arbitrage, distressed security, etc.) or arbitrage (e.g., convertible arbitrage, fixed-income arbitrage, etc.). Regardless of the specific strategy employed, many hedge funds invest in securities and instruments that are difficult to value, either because they do not have an easily-identifiable market prices, or they are (temporarily) illiquid, or both.

Typically, a significant share of hedge fund manager compensation is tied to fund performance based on the ultimately realized value of the investment positions held by the fund. These compensation (incentive fee) arrangements align investor and manager interests and provide the requisite motivation for superlative manager performance. However, incentive fees can create conflicts of interest between managers and funds in the valuation of fund investments and presentation of fund performance. The conflicts are especially apparent for classes of investments that do not have easily-identifiable market prices. Further, liquidity of most classes of investments may be (temporarily) impaired by inclement market developments, which adds to the difficulty in valuing these investments.

Hedge fund managers need to dispel (the appearance of) conflicts of interest in the valuation of fund investments to gain investor confidence. Appropriate separation between fund management and investment valuation responsibilities, oversight of the entire valuation process, and a special focus on difficult-to-value investments are critical elements of a well-formulated valuation framework. In addition, a robust valuation framework is best complemented by adequate disclosures that discuss the critical elements of the valuation framework.

IMPLEMENTATION OF THE VALUATION FRAMEWORK

The Asset Managers' Committee report calls for an integrated valuation framework providing for clear and consistent valuations of fund investments while minimizing potential conflicts that may arise in the valuation process. The recommended framework includes three specific components: 1) Valuation Policies and Procedures; 2) Governance Mechanism (Valuation Committee); and 3) Valuation Personnel.

1. **Valuation Policies and Procedures**

   A set of written policies and procedures addressing each class of investment held by a fund is fundamental to a functional valuation framework. An effective valuation framework should require consistent application of the policies and procedures adopted by a hedge fund. In addition, valuation frameworks should include appropriate disclosures about the limitations of these policies and procedures.

   The AMC report recommends the adoption of valuation policies that, at a minimum, identify the personnel or group(s) involved in the valuation processes, establish valuation methodologies relevant to each class of investment, and provide procedures to effectively alleviate potential conflicts.

The valuation policies should adequately define the roles and responsibilities of internal and/or external parties engaged in the valuation processes. A discussion of the valuation methodologies should include potential pricing and informational sources for the various classes of investments. The valuation policies should also address internal documentation procedures and mechanisms for recording material deviations from the adopted valuation procedures.

The best valuation policies include further guidance for the treatment of investments that do not have easily-identifiable market value and "side pocket" investments. In particular, formulating valuation policies that govern difficult-to-value investment positions can be tricky because of the inherently greater potential for conflicts of interest. The AMC report suggests that, in the absence of satisfactory external (third-party) valuations, the valuation policies should adequately identify the circumstances under which use of internal valuation models is acceptable. A valuation committee should review any material deviation from the application of internal valuation models as prescribed by the valuation policies.

Likewise, valuation of side pocket investments requires extra care. Side pockets consist of fund investments deemed to be (temporarily) illiquid, thus having no easily-identifiable market value. Many funds elect not to transact side pocket investments until their liquidity is restored. Usually, funds do not assess incentive fees on side pocket investments and prohibit new investors from acquiring stakes in these investments. While the absence of incentive fees substantially removes valuation conflicts associated with side pocket investments, the AMC report emphasizes the need for detailed valuation policies that oversee the use of side pockets. Funds should pay close attention to the specification of the criteria for moving investments into and out of side pockets, and to the valuation of investments held in side pockets.

In general, valuation conflicts can be mitigated by the use of qualified and independent third parties to either review or generate valuations of fund investments. This is especially true for difficult-to-value investments, particularly if reasonable external valuations of such investments are available.

2. Governance Mechanism (Valuation Committee)

A suitable governance mechanism, usually a valuation committee that oversees the entire valuation process is the second component of the valuation framework recommended by the AMC report. While it is desirable for valuation committees to include key management individuals, a significant degree of independence from portfolio managers and trading personnel is necessary to ensure the valuation committee is reasonably free from potential conflicts of interest.

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The responsibilities of valuation committees include:

- Developing valuation policies and procedures;
- Periodically reviewing and amending valuation policies, as necessary;
- Establishing mechanisms to assess the fairness of the valuation policies and their consistent application; and,
- Conducting regular consultations with independent auditors, third-party administrators, third-party valuation firms, and legal advisors to examine the ramifications of fair value accounting requirements on fund valuation policies and investments.

The AMC report establishes SFAS 157 as a benchmark for disclosures related to fund investments.[4] SFAS 157 institutes a fair value hierarchy based on the quality of inputs used in the valuation of specific investments. Levels 1 and 2 include investments that are valued using observable inputs (of differing quality), while valuations of Level 3 investments require the use of unobservable inputs. Side pocket investments, for example, would virtually always be Level 3 assets.

SFAS 157 requires companies to disclose the amount of investments held at each Level, and imposes supplemental disclosure requirements on Level 3 investments including information on realized and unrealized gains and losses, transfers of investments in and out of Level 3, and a description of inputs used in the valuation processes.

In addition to the responsibilities enumerated earlier, the AMC report recommends valuation committees monitor fund disclosures, which (at a minimum) should be compliant with disclosure requirements set forth in SFAS 157. The AMC report suggests funds make supplemental disclosures for Level 2 investments in addition to Level 3 investments. Valuation committees should periodically review the guidelines and policies for classification of fund assets within the fair value hierarchy prescribed by SFAS 157. In addition, the AMC report also calls for valuation committees to undertake periodic back-testing of sample valuations with a particular focus on Level 2 and Level 3 investments.

3. **Valuation Personnel**

The third component of the valuation framework prescribed by the AMC report provides for personnel who oversee the implementation of valuation policies. In general, qualified individuals from within a fund or a qualified external party (or a combination of the two) could execute the valuation function of the fund. Two considerations are paramount with respect to the valuation personnel. First, they must conduct valuations based on procedures and information sources detailed in the valuation policies adopted by the fund. Second, the valuation function should be reasonably separated from the portfolio management and trading functions of the fund to avoid potential conflicts of interest.

VALUATION BEST PRACTICES: THE HEDGE FUND INVESTOR PERSPECTIVE

Reliable valuations of hedge fund investments are crucial to the entire investment process, from inception (choosing to invest in a/any hedge fund) to end (exiting investment through either redemption or liquidation). The Investors' Committee report recommends that investors (and/or fiduciaries representing investors) in hedge funds exercise special care in studying the documentation and disclosures provided by funds prior to, and for the duration of, investments in hedge funds. In particular, the IC report emphasizes the variety and dynamic nature of portfolio strategies and associated risks, which require continual monitoring of not only the fund investments, but also valuation policies and procedures, and any deviation from such policies.

Like the Asset Managers' Committee report, the Investors' Committee report states that funds should maintain written valuation policies that, at a minimum, identify the classes of investments expected to be held as well as the valuation methodologies and sources for each class. The IC report recommends that investors verify the existence and consistent application of the valuation policies and procedures governing fund investments, as well as an appropriate governance mechanism that oversees the valuation processes. In particular, investors should examine whether valuations of the investments in the fund portfolio are consistent with GAAP fair value standards, including SFAS 157.

Investors need to be more vigilant in monitoring funds whose holdings include difficult-to-value investments, whether or not they are deemed side pocket investments. The IC report suggests that investors seek independent valuations of funds with significant holdings of difficult-to-value investments on a semi-annual basis. The report also recommends investors confirm appropriate separation between the portfolio management and valuation functions of the fund, and reasonable valuation treatment of illiquid and side pocket investments.

CONCLUSION

This discussion has focused on developing and implementing valuation best practices to foster productive relationships between fund managers and investors.

In summary, the valuation of hedge fund investment portfolios can be fraught with potential conflicts of interests because of incentive fees. These fees, designed to provide adequate motivation to the fund managers, can create perceived or real conflicts, in the context of investments that are difficult to value. This is true whether the difficulties arise due to a dearth of market (pricing) information for similar investments, or due to (temporary) illiquidity, or both. However, a well-executed valuation framework that includes appropriate valuation policies and procedures, an adequate governance mechanism, and an able team of valuation personnel (internal and external) can successfully minimize investors', and indeed, systemic, risk. While external valuation expertise is not a substitute for a sound valuation framework, incorporating such expertise can considerably improve the efficacy of the valuation framework in assuaging investor concerns related to the valuation of fund investments.

Mercer Capital provides independent valuation services to individuals and corporations of all sizes for portfolio valuation, financial reporting, corporate planning and tax compliance purposes. Our professionals are well-versed with the increasingly complex fair value reporting standards. Mercer Capital has valued many liquid and illiquid securities and instruments to auditor, regulatory, and client satisfaction for more than 25 years. Contact us to explore how we can assist you in formulating and implementing your hedge fund valuation framework.

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Endnotes

1 President's Working Group on Financial Markets Best Practices Guidance, released April 15, 2008

From page x of the Report of the Asset Managers' Committee:

> The PWG was established by Executive Order in 1988. The PWG was given the mandate to enhance the integrity, efficiency, orderliness, and competitiveness of U.S. financial markets and to maintain investor confidence. The PWG includes the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Securities and Exchange Commission, and the Chairman of the Commodity Futures Trading Commission, or their designees.

2 President's Working Group on Financial Markets Best Practices Guidance, released April 15, 2008

From page i of the Report of the Asset Managers' Committee:

> The [Asset Managers' Committee], which comprises institutional alternative asset managers representing diverse strategies and perspectives, was formed as a private sector committee by the PWG in September 2007.

From page 4 of the Report of the Investors' Committee:

> The Investors' Committee comprises senior representatives from major classes of institutional investors including public and private pension funds, foundations, endowments, organized labor, non-Us institutions, funds of hedge funds, and the consulting community. Each of the members has reached out broadly to other institutional investors as well as to professional associations and financial services professionals to gain an informed perspective on the best practices for hedge fund investments.

3 "The Lo Down." *The Economist*, June 14th – 20th, 2008, pg.102.

4 For more on SFAS 157, see "A Primer to SFAS No. 157 Fair Value Measurements" in the Article Library at www.mercercapital.com.

CASE REVIEW

Jane Z. Astleford v. Commissioner

by B. Tyler Beckman

The case of *Astleford v. Commissioner*[1] is noteworthy for a number of reasons. For instance, the Court's ruling provides further support for applying tiered discounts in asset holding entities, and not only were the discounts tiered but they were also significant on each level applied, resulting in total blended discounts of approximately 55% with respect to certain assets. Additionally, in the determination of the appropriate lack of control (i.e., minority interest) discounts, the Court made use of data pertaining to both REITs that were publicly traded and RELPs that were traded on secondary markets. The Court also made use of studies cited in an expert's report to justify discounts that were more than twice those applied by the expert.

FACTS AND CIRCUMSTANCES

After M.G. Astleford, a real estate investor, passed away in 1995, his wife, Jane Z. Astleford (Taxpayer), created the Astleford Family Limited Partnership (AFLP) in 1996. After transferring property to the AFLP, she gifted a 30% limited partnership (LP) interest to each of her three children (the 1996 AFLP interests), and retained a 10% general partnership (GP) interest. In 1997, Taxpayer transferred additional properties to the AFLP including a 50% GP interest in Pine Bend Development Co. (Pine Bend). As a result of this transfer, Taxpayer's GP interest in AFLP increased significantly. In order to return Taxpayer's GP interest to 10% of AFLP, Taxpayer gifted to each of the three children additional LP interests (the 1997 AFLP interests) necessary to return the ownership structure to the initial 30/30/30/10 allocation.

The Court outlined three general issues to be addressed in its ruling:

1. The value of 1,187 acres of Minnesota farmland

2. Whether a particular interest in a general partnership held by the AFLP should be valued as a partnership interest or an assignee interest, and

3. The lack of control and lack of marketability discounts that should apply to the limited and GP interests.

This article will summarize the first two issues briefly, and then address the third issue, which deals with valuation discounts, in greater detail.

Issue #1 – Determine the value of 1,187 acres of Minnesota farmland (Rosemount Property)

The Taxpayer's expert and the IRS expert each used a market approach by reviewing sales of similar properties.

According to the Court, the IRS expert was "particularly credible, highly experienced and possessed a unique knowledge of farm property located in the county in which the subject property was located." The court used his initial value of $3,500 per acre.

However, the IRS appraiser did not apply an absorption discount to this value. The Court determined that an absorption discount was appropriate, but not to the extent applied by the Taxpayer's appraiser. Using present value mechanics and making assumptions with respect to the holding period, discount rate, and appreciation rates, the Court applied an effective absorption discount of about 20%. The discounted price per acre was $2,786.

Rosemount Property	Taxpayer	IRS	Court
Initial Value per Acre	$3,100	$3,500	$3,500
Less, Absorption Discount[2]	($1,283)	($0)	($714)
Discounted Value per Acre	$1,817	$3,500	$2,786
Value of 1,187.51 Acres	**$2.16 million**	**$4.16 million**	**$3.31 million**

FIGURE ONE

Issue #2 – Determine whether 50% GP interest in Pine Bend (held by the FLP) should be valued as a GP interest or an assignee interest.

The Taxpayer's appraiser argued that it should be valued as an assignee interest. As such, he discounted the interest because under Minnesota law a holder of an assignee interest would have an interest only in the profits of the partnership and would have no influence on management.

The IRS appraiser argued that the "substance over form doctrine" should apply, and therefore, the interest should be valued as a GP interest.

The court adopted the "substance over form doctrine" and rejected the Taxpayer's argument; however, as discussed below, the Court applied a combined lack of control and lack of marketability discount of 30% to the Pine Bend interest, consistent with the Taxpayer's appraiser's methodology.

Issue #3 – Determine the lack of control and the lack of marketability discounts that should apply to the limited and GP interests.

Figure Two summarizes the discounts applied by the Taxpayer, the IRS, and the Court.

Lack of Control Discounts Applied to AFLP Interests

The Taxpayer. The Taxpayer's expert relied upon RELP secondary market data to determine that the lack of control discounts applicable to the 1996 and 1997 gifts of AFLP Interests were 45% and 40%, respectively. The RELP data, which reflected a group of four selected RELPs, provided a range of discounts of 40% to 47%. It is unclear how the Taxpayer's expert determined that the lack of control discount applicable to the 1996 interests was greater than that applicable to the 1997 interests.

The Court noted that two of the four selected RELPs were more leveraged than AFLP. In addition, AFLP's distribution yield of 10% was greater than the 6.7% average yield of the RELP group. The Court considered these two factors to be indicative of a lack of control discount less than that reflected in the RELP pricing. Due to these differences, among others, the Court concluded that the RELPs selected were "too dissimilar to AFLP to warrant the amount of reliance [the Taxpayer's] expert placed on them" and the discounts for lack of control were excessive.

The IRS. The IRS expert relied upon REIT data to derive discounts for lack of control. The REIT data, which included approximately 75 REITs, indicated that the selected group traded at a median premium of 0.1% in 1996 and a median discount of 1.2% in 1997.

The Court explained that REIT prices are "in part affected by two factors, one positive (the liquidity premium) and one negative (lack of control)." The Court went on to say that liquidity premiums should be reversed out of the trading prices so as to determine the embedded discount for lack of control.[3]

Valuation Discounts	Taxpayer's Expert	IRS Expert	The Court
General Source for Data Supporting Discounts	Secondary Market RELP Data	Publicly Traded REIT Data	Does not consider either RELP or REIT data superior to the other. RELPs more closely resemble AFLP, but lack the trading volume of REITs
1996 AFLP Interests Lack of Control Disc.	**45%**	**7.14%**	**16.17%** (Used REIT Data, with adjustments, in tandem with restricted stock data)
1996 AFLP Interests Lack of Mktbility Disc.	**15%**	**21.23%**	**21.23%**
Implied Blended Discount Applied to '96 AFLP Interests	**53.3%**	**26.9%**	**34.0%**
Pine Bend GP Interest	**40%** Combined Lack of Control and Lack of Mktability Disc. (range: 22%-46%)	**None** A discount was not applicable at this level, but rather, at the AFLP level only	**30%** Combined Lack of Control and Lack of Marketability Discount (Used RELP Data, with adjustments)
1997 AFLP Interests Lack of Control Disc.	**40%**	**8.34%**	**17.47%** (Used REIT Data, with adjustments, in tandem with restricted stock data)
1997 AFLP Interests Lack of Mktbility Disc.	**22%**	**22%**	**22%**
Implied Blended Discount Applied to Pine Bend GP Interest	**71.9%**	**28.5%**	**54.9%**
Implied Blended Discount Applie0d to '97 AFLP Interests	**53.2%**	**28.5%**	**35.6%**

FIGURE TWO

RELATED SERVICES

Valuations are a critical element of successful tax planning strategies. Consequently, objective third-party valuation opinions are vital. Mercer Capital has over twenty years of experience providing objective valuations for tax compliance.

Mercer Capital's opinions of value are well-reasoned and well-documented which provide critical support for any potential challenge, although the consequence of our thorough, well-reasoned and well-documented work has resulted, in the overwhelming majority of the time, in quiet acceptance by the IRS and state and local taxing authorities.

Mercer Capital provides the following services related to tax compliance:

- Closely held stock valuations for family wealth planning and estate tax compliance
- Business valuations for corporate restructurings and related tax planning
- Executive stock option valuations for tax planning
- Business & intangible asset valuations in connection with Subchapter S tax status
- Intellectual property valuations
- Restricted stock valuations for family wealth planning and estate tax compliance
- Valuation of covenants not to compete
- 409a compliance

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The IRS expert used a regression analysis to determine that REITs traded at a liquidity premium of 7.79% relative to closely held partnership interests. Based upon this liquidity premium and the 1996 REIT group median premium of 0.1% and the 1997 REIT group median discount of 1.2%, the IRS expert calculated discounts for lack of control of 7.14% and 8.34% in 1996 and 1997, respectively.[4]

The Court. The Court ultimately decided to use the REIT data presented by the IRS expert to determine the appropriate lack of control discount, but the Court deemed the 7.79% liquidity premium offered by the IRS expert to be "unreasonably low." Accordingly, the Court sought to calculate a more reasonable liquidity premium by calculating the difference in "average discounts observed in the private placements of registered and unregistered stock." The Court considered any such difference as representative of "pure liquidity concerns." Using this methodology, the Court referenced two studies cited by the IRS expert which indicated that a general premium for liquidity in publicly traded assets was on the order of 16.27%. Based upon this observed premium and the REIT group premium of 0.1% in 1996 and discount of 1.2% premium in 1997, the Court concluded that the discounts for lack of control in 1996 and 1997 should be 16.17% and 17.47%, respectively.[5]

Lack of Marketability Discounts Applied to AFLP Interests

Little explanation was provided with respect to the marketability discounts applicable to the gifts of AFLP interests.

The following relates to the 1996 AFLP interests:

> *[The Taxpayer's] expert estimated a discount of 15%, and [the IRS] expert estimated a discount of 21.23%. We perceive no reason not to use [the IRS's] higher marketability discount of 21.23% without further discussion, which we do.*

The following relates to the 1997 AFLP interests:

> *Because both parties advocate a lack of marketability discount of approximately 22%, we apply a lack of marketability discount of 22%.*

Combined Lack of Control and Lack of Marketability Discounts Applied to Pine Bend GP Interest

The Taxpayer's expert relied upon data regarding 17 RELPs to determine a range of discounts of 22% to 46%, and he then selected a 40% discount without fully explaining the selection of that measure over the midpoint of the range or some other measure. The IRS appraiser did not apply any discount, as he claimed that any such discounts should be applied at the AFLP level only.

The Court rejected the position of each appraiser and performed its own analysis of RELP data. The Court concluded that a 30% combined discount for lack of control and lack of marketability was appropriate at the Pine Bend level, providing further support for applying tiered discounts in asset holding entities.

SUMMARY AND CONCLUSIONS

Figure Three summarizes the valuation conclusions reached by the Taxpayer's expert, the IRS's expert, and the Court.

As shown, the Court's opinion fell within the range defined by the conclusions of the experts representing the Taxpayer and the IRS, with a slight overall bias towards the Taxpayer's expert.

OBSERVATIONS

The Court's application of an absorption discount appears to be well-grounded in present value mechanics using seemingly reasonable assumptions. Further, the general application of valuation discounts to not only the FLP interests but also the GP interest held by the FLP seems to be supported by valuation theory. However, the Court's reliance on RELP and REIT data to determine the lack of control discount to be applied to AFLP interests is questionable.

In general, the price-to-NAV ratios observed in the REIT and RELP marketplace often reflect a numerator (price) which is current and a denominator (NAV) which is more dated. A REIT's NAV may be determined once per year (usually at year-end) while market prices are determined by trading activity throughout the year. Under this system, some properties held by a REIT may experience rapid and unexpected appreciation in June, but NAV would still reflect the appraised values as of the preceding December, resulting in an understated NAV measure, all else equal. In this case, the price-to-NAV ratio may indicate the REIT is trading at a substantial premium to NAV due to the understated measure used in the denominator.

More meaningful valuation discounts may be derived using investment classes that have NAV measures which are updated throughout the year. One example is closed-end funds. In our experience, closed-end funds (equities and bonds) frequently trade at a discount to NAV between 0% and 15%. These discounts may be interpreted to represent a discount for lack of control.

Finally, the Court relied upon two studies (cited in the IRS expert's report) in the determination of a liquidity premium. We note that these studies make use of equity market data (registered and unregistered stock information). The Court selects the liquidity premium implied in the equity markets and applies it to a FLP holding real estate. In a sense, the Court seems to have assumed there is only one liquidity premium for all asset classes in the marketplace. The Court uses this liquidity premium in tandem with the price-to-NAV ratios of REITs to calculate the resulting discount for lack of control for the AFLP interests. Intuitively, there appears to be a disconnect between REIT market pricing and the premiums paid for registered versus unregistered equity interests.

YEAR OF GIFT	1996	1997
Description of Gift	Three 30% LP Interests in AFLP	After transfer of 50% GP interest in Pine Bend and additional properties to AFLP, gifts of LP Interests in AFLP necessary to return ownership structure to 30/30/30/10
Value of Gift per Taxpayer	$277 thousand	$4.0 million
Gift Taxes per Taxpayer	$80 thousand	$2.0 million
Value of Gift per IRS	$627 thousand	$10.9 million
Gift Taxes per IRS	$128 thousand	$4.0 million
Value of Gift per Court	$518 thousand	$6.6 million

FIGURE THREE

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Endnotes

1 *Jane Z. Astleford v. Commissioner,* T.C. Memo 2008-128, filed May 5, 2008

2 The Court's absorption discount was based upon assumed market absorption over a four-year period, a discount rate of 10%, appreciation of 7% per annum, sales expenses of 7.25%, and property taxes of 60 bp. Taxpayer's expert made similar assumptions, but applied a discount rate of 25% (rather than 10%).

3 With respect to REIT data, discounts and premiums are based upon the ratio of price to NAV.

4 The relevant formula is: (1 + Liquidity Prem.) x (1 – LOC Discount) = (1 + Disc. or Prem. to NAV)

Using 1997 as an example: (1.0779) x (1 – LOC Discount) = 0.988
(1 – LOC Discount) = 0.9166
Lack of Control Discount = 8.34%

5 For 1996: 16.27% - 0.1% = 16.17%
For 1997: 16.27% + 1.2% = 17.47%

Ask the ESOP Valuation Experts

Mercer Capital values scores of employee benefit plans for both financial institutions and corporate clients across the nation. We present the first in a series of "Ask the ESOP Valuation Experts" in this issue of *Value Added*™. Tim and Wendy begin by asking and answering a few fairly basic questions. In subsequent issues, they will tackle more specific valuation-related questions. To view those questions and answers, you can visit our website at www.mercercapital.com. If you have an ESOP valuation need, contact Tim or Wendy.

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What is an ESOP?

An Employee Stock Ownership Plan (ESOP) is a qualified retirement plan created in the form of a trust which is designed to own the capital stock of the sponsoring (employer) company. Eligible employees of a company become the participants (i.e. employee owners) in the ESOP by way of contributions made by the employer on the employees' behalf. Most ESOPs are created by way of leveraged transactions whereby an ESOP borrows funds to purchase newly issued stock or stock sold by shareholders of the sponsoring company.

Are ESOPs regulated?

As qualified retirement plans, ESOPs must adhere to the Employee Retirement Income Security Act of 1974 (ERISA), which provides legal guidelines for private pension plan administration and investment practices. These plans are overseen and regulated by the Department of Labor (DOL). We would be remiss not to mention that the Internal Revenue Service is also a stakeholder in the ESOP universe as their interests extend to both the shareholder and corporate domains. Prospective ESOP companies must understand that an ESOP is a shareholder and a retirement plan beneficiary, thus the fiduciary responsibilities should not be taken lightly.

What are some of the incentives underlying an ESOP?

ESOPs can provide multi-faceted benefits for stakeholders. Sellers of stock to an ESOP can use the plan to achieve liquidity while in certain instances, deferring taxes on gains resulting from the sale. Employees can receive a potentially valuable retirement asset, which through their collective efforts can support the perpetuation of the company and the growth in value of the stock. Such ownership for many participants is likely the only way they would ever enjoy a capital ownership stake in their employer. Strategically, many well-run, viable businesses are better candidates for this form of internal ownership transfer than they may be for a transaction in the open marketplace. In many cases, an ESOP can provide sellers the opportunity to diversify shareholders' wealth while providing enhanced liquidity and retain for selling shareholders the ability to direct the destiny of the company.

For more information on Mercer Capital's ESOP Valuation Services contact Tim or Wendy, or visit www.mercercapital.com

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BV Resources Teleseminar
Andrew K. Gibbs, CFA, CPA/ABV
co-presenting with William J. Wilhelm, Crowe, Chizek and Company, LLP

August 22, 2008
"Valuing a Bank"
Clifton Gunderson Annual Valuation Conference
Andrew K. Gibbs, CFA, CPA/ABV

September 16-17, 2008
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September 18, 2008
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MERCER CAPITAL
HIGHLIGHTS

Mercer Capital's professionals are actively engaged in thought leadership through various speaking engagements and published articles.

Z. Christopher Mercer, ASA, CFA, wrote a series of articles titled "Your Client's Buy-Sell Agreement : Ticking Time Bomb or Reasonable Resolution?" that appeared in the April 2008 and June 2008 issues of ***Southeast Wealth Management*** magazine.

Mercer also presented the "Integrated Theory of Business Valuation" in a webcast sponsored by the **National Association of Certified Valuation Analysts (NACVA)** on July 16, 2008. "The Integrated Theory of Business Valuation," the topic of Mercer's latest book, helps business appraisers understand and correctly apply fundamental valuation concepts.

Matthew R. Crow, ASA, CFA, and **Travis W. Harms, CFA, CPA/ABV**, led a webcast on July 31, 2008, titled "Getting Ready for SFAS 141R: *Business Combinations*," offered in conjunction with ***Compliance Week*** magazine. The webcast provided an overview of SFAS 141R and explored the valuation implications of key provisions of the new standard. To view a recording of the webcast, visit www.mercercapital.com.

Barbara Walters Price wrote an article titled "Marketing in a Slowing Economy," which appeared in the June 4, 2008 edition of the ***American Society of Appraiser's BV E-Letter***

Andrew K. Gibbs, CFA. CPA/ABV was quoted in the article titled "Banking Workforce Reduction Ahead," that appeared in the April 23, 2008 issue of the ***Memphis Daily News,*** as well as in the article titled "Tennessee Banks Wrestle with Housing Decline," that appeared in the April 1, 2008 issue of ***The Tennessean.***

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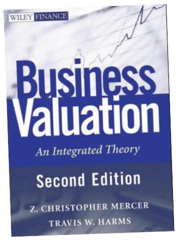

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