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BUSINESS OUTLOOK – PRIVATE EQUITY FIRMS GOING PUBLIC

Paul K. Kelly, President and CEO, Knox & Co.

The most fascinating possibilities / consequences of PE firms going public are not, in our opinion, those that have been widely covered in the media, but the following:

1. Valuation – If the public shares traded are essentially the same financial interests as the underlying privately held portfolio investment units, this raises a number of fascinating valuation issues. What happens if significant, and obvious, valuation differences arise between the publicly traded open-market shares and the private portfolio valuations being provided to investors by the PE management company? How will auditors and institutional investors deal with such significant variations? What if an institution holds both underlying illiquid investment units and publicly traded shares in the management company of the portfolio? Can, in effect, the same investment interests, adjusted for liquidity and tax differential considerations, be carried at significantly different values on a "prudent man" basis? How does one justify a significantly higher private valuation of the underlying portfolios by the sponsoring management company if the related publicly traded shares are reflecting a much lower price valuation over a sustained period? If participation in alternative investments become available in a readily tradable securities form, what is an acceptable liquidity price premium for the traded public shares over the underlying private investment interests? Is the tax pass-through of the underlying private partnerships a justification for non-taxable investors, such as pension funds, to favor the underlying private portfolio investment, as opposed to purchasing publicly traded shares, i.e., does the tax advantage offset the liquidity premium of publicly traded shares, on a risk-adjusted basis? These are only a few of many considerations involving potential liabilities that will have to be considered by various interested parties.

2. Derivatives – If there will be a publicly traded stock reflecting an underlying illiquid investment portfolio, numerous arbitrage possibilities against structured derivative investment instruments, representing the performance of the underlying portfolio, are obvious. We expect that this will lead to a variety of new derivative and synthetic instruments to meet the demand. Resultant potential arbitrage activity from the foregoing will cause greater potential volatility of the publicly traded stock price which, in turn, feeds into some of the valuation issues mentioned above.

3. The Goose and the Gander – If the sponsoring PE management company has figured a way to realize liquidity for its portion of the underlying illiquid PE investment portfolio, can anyone imagine that limited partners in the underlying investment fund would not also be interested in a vehicle which would also provide such liquidity? If we were still designing securities, we would be feverishly considering a collateralized security that would pass through the future economic benefits to another investor, without the original investor in the underlying portfolio actually selling its underlying investment unit. In today's overheated market for PE investments, such a collateralized pass through of future economic benefits would likely result in a much better present-value investment return, for the seller, than the expected actual investment return over the life of the underlying PE investment fund.

4. History Repeats – The advent of publicly traded shares sales by PE management funds foretells the reoccurrence of events which we have seen more than once in our business lifetimes. It seems that every time that Wall Street structures a retail publicly traded security to produce a liquidity exit for wealthy, sophisticated investors, Wall Street gets left holding the bag. The first regulatory rule taught to any stock broker is "know your customer". Whenever a relatively sophisticated investment is sold to the public, in relatively small denominations, inevitably, shares will be sold to parties that, if the investment is not successful for them, will claim that the brokerage firm should have known better than to have sold it to them. Such class action, or quasi-class-action, situations have occurred in the retail sale of real estate and natural resource syndications, tax shelters, dot-coms, etc. In a litigious society, with evolving new standards of liability, prospectus language warning investors about investment risks gives little meaningful liability protection to brokerage firms.

   Also, while considering the issue of litigation, in general, institutional underlying portfolio investors may wish to consider how they might fare if, at some future point, both they and the public shareholders asserted claims against the PE management company. At the very least, the possibility of having another potential claimant at the table is something which the underlying portfolio investors never anticipated at the time they made their initial investments.

In any case, we think that a number of new questions and issues have been raised for underlying PE private portfolio investors as a result of the likelihood that other PE management companies may wish to go public in the future. If we were such underlying portfolio investors, we would, for example, want to make sure that the PE managers maintained a meaningful amount of their future override interests in the management company, and could not sell such out completely during the life of the underlying portfolio. A frequently cited merit of private equity investments has been the alignment of interests between the management company sponsors and the underlying portfolio investors. Early sale by the PE managers of their equity interests obviates this alleged mutuality of interests.