

Private Capital Markets

This book explores the private capital markets, the last major uncharted financial markets. Private markets contain millions of companies, which generate nearly half of the United States' gross national product (GNP). Yet, these markets are largely ignored, partially because of the difficulty obtaining information and because of the lack of a unified structure to approach them. This work offers such an approach. It provides a theoretical and practical framework that enables readers to make sound investment and financing decisions in the private capital markets.

Just what are the private capital markets? They are the venues where debt and private equity investments are made, and private business interests are exchanged. Valuation is a common language uniting the private capital markets. In other words, the language developed in private business valuation enables participants in the private capital markets to communicate and exchange interests.

A premise of this book is that the private capital markets are unique. As such, they require a unique capital market theory to explain and predict behavior of players in the markets. This theory, called private capital markets theory, is an integrated body of knowledge that applies to valuation, capitalization, and transfer of private companies, especially those with annual revenue between \$5 million to \$150 million. Several macro events over the past 20 years have set the stage for the study of private capital markets theory. These are:

- Private business valuation has become a career path. Dr. Shannon Pratt started this movement by publishing his landmark book *Valuing a Business* in 1981. Dr. Pratt was the first to bring structured thought to private business valuation. Partially because of his continued work, private business valuation has become quite sophisticated. There are now more than 5,000 practicing appraisers in the United States.
- Since the early 1990s, the private capital markets have developed many new capital alternatives. Prior to 1990 commercial lenders were the primary source of capital to private companies. In fact, if the local banker could not supply all of the capital needs of the owner-manager, the company probably went without necessary funding. Since that time, asset-based lenders, mezzanine players, private equity groups and others have appeared. The variety of capital purveyors has enabled owner-managers to think in terms of capital structure and the various components of debt and equity that comprise it.
- Techniques to transfer private business interests have proliferated and become institutionalized. Transfer methods such as employee stock ownership plans (ESOPs), family limited partnerships, private auctions, and various other strategies are now available to owner-managers. Whether this transfer happens within the business to employees or a family member, or to an outsider, the owner-manager needs to become more knowledgeable. Owners often view transferring a business interest like grabbing the brass ring on a merry-go-round; increased knowledge in this area definitely improves their chances.

Most owner-managers and their professional advisors do not focus on the breadth of valuation, capital structure, and transfer issues, because they do not spend time dealing with this full body of knowledge. This book provides a resource for these individuals so they can structure and solve difficult financial problems in the private capital markets.

CAPITAL MARKETS

All business is conducted within the broader capital markets. The private markets actually contain numerous marketplaces. For example, there are submarkets for raising debt, equity, and transferring business interests. This book consistently uses the collective term “markets” to describe activity within the private capital markets, rather than attempting to describe particular submarkets with a confusing array of terminology. While there are no definitive size boundaries, Exhibit 1.1 depicts the market segmentation by size of business.

Small businesses with annual sales of less than \$5 million are at the bottom of the ladder. These businesses generally are handled by the business banking group of community or smaller regional banks and are almost always owner-managed. These businesses have limited access to the private capital markets beyond assistance from the Small Business Administration (SBA) and business brokers. Capital access improves as the business moves into the upper segments.

The lower middle market includes companies with annual sales of \$5 million to \$150 million. This is the primary province of the private capital markets as described in this book. As Exhibit 1.2 portrays, companies in this segment have a number of unique characteristics.

The “middle” middle market includes companies with annual sales of \$150 million to \$500 million. They are serviced by regional investment banks and draw the attention of the bank’s top lenders, their corporate bankers. Capital markets access and efficiency improves at this level. Companies with sales over \$150 million begin to have access to nearly all capital markets alternatives.

The upper middle market is comprised of companies with sales of between \$500 million to \$1 billion. They have access to most of the capital markets alternatives available to the largest public companies. This group of companies, which tends to be publicly held, attracts the secondary attention of the largest Wall Street investment banking firms. The

Exhibit 1.1 Segmented Capital Markets

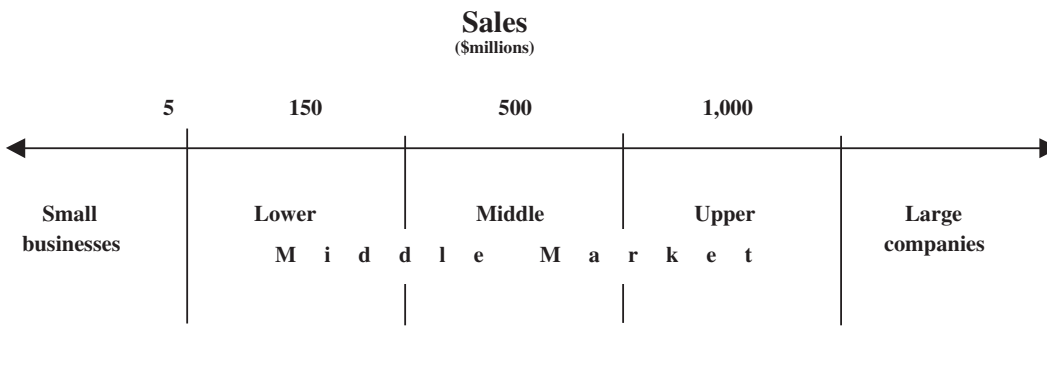


Exhibit 1.2 Characteristics of the Lower Middle Market

- ➔ Owner management
 - ➔ Owner has unlimited liability and personally guarantees debt.
 - ➔ The company employs functional managers.
 - ➔ Company has evolved from bookkeeper to controller or CFO.
 - ➔ Owner typically has more than 80% of personal wealth tied to business.
 - ➔ Owner plans to use the transfer of the business as the main wealth-creation vehicle.
 - ➔ About 70% of the businesses will not transfer to the next generation.
 - ➔ The company has uncertain access to capital.
 - ➔ Owner strongly prefers to manage without equity partners.
 - ➔ Enterprise value of the company can vary widely from year to year.
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largest regional bankers also take notice. In this tier, capital is accessible and priced to reflect the riskiness of the borrower.

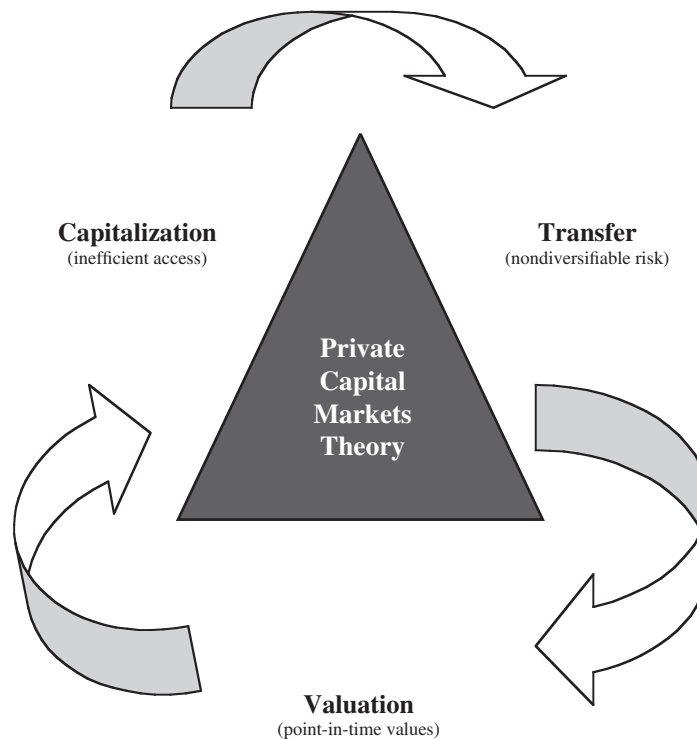
Large companies have the complete arsenal of capital alternatives at their disposal. They use discounted cash-flow techniques to make capital decisions because they can fund projects at their marginal cost of capital. Almost all are public. The few that are private have most of the financial capabilities of public companies. Wall Street bankers focus primarily on these companies. These businesses flourish under the rules of corporate finance theory.

PRIVATE CAPITAL MARKETS THEORY

Private capital markets theory is the integrated capital markets theory unique to private companies, especially those with annual sales of \$5 million to \$150 million. This theory describes the valuation, capitalization, and transfer of private business interests. These three interrelated areas rely on each other in a triangular fashion, as shown in Exhibit 1.3.

Valuation forms the base of the triangle and is the foundation of private capital markets theory. Valuation involves a rigorously defined process that ultimately derives what the company or business interest is worth. Valuation relies on input from the transfer leg of the triangle. The obvious transfer connections are selling multiples and other transactions that help derive values for similar situations. Without this feedback, much of valuation would be done in total isolation from the market and would quickly lead to nonsense. Since private securities do not have access to an active trading market, they rely on point-in-time appraisal or transactional pricing, to determine value.

Capitalization, or capital structure formation, relies on valuation, the base of the triangle. Private capital markets allocate capital according to levels of risk and return. Private companies rely on proper valuations of assets, earnings, and cash flow to raise money. Unlike the public markets, private capital markets are characterized by inefficient access to

Exhibit 1.3 Structure of Private Capital Markets Theory

capital. Private companies cannot determine with any confidence whether they can access the funding they need.

Finally, transfer relies on capitalization. The business transfer spectrum includes a broad range of alternatives. It spans the transfer of business interests to parties within the company to the transfer of interests to external parties. Transfer can only occur if capital is available to support the transaction. Transfer happens at a particular value that is determined using one of the defined valuation processes. Private investors cannot easily diversify their holdings due to the lack of liquidity in the private capital markets. This liquidity limitation increases the riskiness of the private capital markets, making things more difficult for private companies.

Triadic Logic

Triadic logic is a compelling logic holding the three conceptual sides of the triangle together. Unlike most financial logic based on positives and negatives, there is a triadic logic operating here providing powerful cohesion between the moving parts. A system of logic with three bases is dynamic rather than static and serves to bring the three sides of the triangle into a coherent whole. This is the logic of a three-legged stool. The reason for introducing this triadic logical structure is to demonstrate that it is not possible to remove one of the tenets in a dynamic system without destroying the system. Legs can be added, but the logical system is necessary and sufficient on its own to provide coherence to private capital markets theory.

Corresponding Terms

Public

Public capital markets (Wall Street)
 Corporate finance
 Corporate finance theory

Private

Private capital markets (Main Street)
 Private company finance
 Private capital markets theory

For example, consider removing the capitalization side of the triangle and attempting to transfer the business. It is practically impossible. Or try transferring a business without a process of valuation. Again, it makes very little logical sense. Finally an attempt to value a business without considering a possible transfer or how that transfer is capitalized is untenable.

This interrelation of the major areas of the private capital markets not only provides strength to market architecture, but it also requires users of the body of knowledge to understand all three legs of the triangle. Just understanding valuation or capital structure or transfer will not get the job done in the marketplace. Recognizing the triangle acknowledges what the private companies need most—holistic solutions. Typically a private business owner is faced with a financial problem that can only be solved by drawing information from throughout the body of capital knowledge.

Public versus Private Comparison

The public capital markets have long received considerable attention from academics and market observers. Corporate finance theories were created to predict and explain behavior in the public markets. Even though public and private *markets* are quite different, public and private *theories* are related. Both theories emanate from meta-financial theory. This is discussed in the Foreword. Thus, public and private capital markets theories are *siblings*.

But theories are useful only if they are predictive. Corporate finance theory does not predict behavior in private capital markets; likewise, private capital markets theory is not predictive in public markets. The starkness of this contrast is shown by the assumptions behind corporate finance and private company finance listed in Exhibit 1.4.

Exhibit 1.4 Assumptions behind Corporate versus Private Company Finance

Corporate Finance

Use of a C corporation.
 Value is established by a market.
 Ready access to public capital markets.
 Owners have limited liability.
 Owners are well diversified.
 Professional management.
 Company has infinite life.
 Liquid securities efficiently traded.
 Profit maximization as goal.

Private Company Finance

Can be any type entity (S, LLC, etc.).
 Value is established at a point in time.
 No access to public capital markets.
 Owners have unlimited liability.
 Owners have one primary asset.
 Owner management.
 Typical company life of one generation.
 Illiquid securities inefficiently traded.
 Personal wealth creation as goal.

Many underlying assumptions between corporate and private company finance are different and at odds with each other. Several characteristics are particularly noteworthy:

- A market establishes value for public companies, whereas private companies must rely on a point-in-time appraisal or a transaction to determine value. This is a startling contrast. In one case, it is possible to use the Internet to obtain *real time* pricing of a security. In the other case, much work is required to ascertain the value of a security at a particular point in time, probably in the past. If there were no other differences between public and private transfer markets this one issue would suffice to separate them.
- Public companies have ready access to capital, but private companies must create capital solutions one deal at a time, with little certainty of success.¹ Think of it as if public companies have access to a capital cupboard. On shelves within the cupboard lay all of the available capital alternatives. The riskiness of the particular financing determines which shelf the public company can access. Private companies, however, have no access to a capital cupboard. Instead, they must create a shelf each time they need to access capital.
- Shareholders in public companies are able to diversify, because of the high liquidity available in the public capital markets. They do not have all their eggs in one basket. Private owners have nearly all of their wealth tied up in one asset, the stock of their business. Increased risk is the main ramification of this lack of diversification. Both public and private capital markets treat risk similarly: the greater the risk of owning an asset, the greater the return required to compensate for the added risk.

Corporate finance theory was developed in the 1960s to explain the behavior of large companies in public capital markets. Economists never intended these tools to be used to predict other markets' behavior. A complete discussion of corporate finance theories and their application to the private capital markets is contained in Appendix A. Certain corporate finance theories, such as net present value, the capital asset pricing theory, and efficient market theory, either are not used by owners of private companies or do not apply to the private markets. Applying these theories in the private markets is like utilizing the wrong tools in a tool box. Corporate finance tools were specifically designed to "work on" public market mechanisms. This book endeavors to design a set of tools specifically for use in the private capital markets.

Ultimately, to be effective, financial theory must have practical applications. This is the topic of the next section.

PRIVATE CAPITAL MARKETS THEORY IN PRACTICE

Private capital markets theory is the integrated body of capital market theory that describes the valuation, capitalization, and transfer of private business interests. Each of the three sides of the conceptual triangle exhibits a unique framework.

Value Worlds

Private securities do not enjoy access to an active trading market. Either a private valuation must be undertaken, or a transaction must occur to determine the value of a private security *for some purpose at some point in time*. *Purpose* is defined as the intention of the involved party or the reason for the valuation. Purpose leads to the function of an

appraisal. *Function* is described as the intended specific use of an appraisal. Specific functions of a valuation require the use of specific methods or processes, each of which can derive dramatically different value conclusions. The purposes for undertaking an appraisal are referred to herein as giving rise to *value worlds*. Therefore, the premise of value world theory is

A private business value is relative to the value world in which it is viewed.

Every private company, therefore, has a large number of different values at the same time, depending on the purpose and function of the valuation. The purpose of the appraisal governs the selection of a value world. Each value world follows a defined process to determine value under specific rules, based on the function of the appraisal. Each value world may have multiple functions. Each world also has an authority, which is the agent, or agents, that govern the world. The authority decides whether the intentions of the involved party are acceptable for use in that world, as well as prescribes the methods used in that world.

Exhibit 1.5 lists a number of value worlds, with associated purposes, functions, and authorities.

Examples of authority are found in each appraisal world. For instance, the Financial Accounting Standards Board (FASB) is the authority in the world of impaired goodwill. The FASB is responsible for developing criteria and administering methodology used to derive value as well as sanctioning noncompliance.

By understanding the logic, definitions of process, and treatment of facts within each world, it becomes clear that private valuation is only possible within a set of parameters—a value world.

The intention or motive of the involved party leads to a purpose of an appraisal. This is the starting point in the valuation discussion. Purposes for undertaking an appraisal give rise to value worlds. The logical construct of a value world is independent of the experience of individual appraisers and individual assignments. Value, then, is expressed only in terms consistent with that world. Once the project is located in a value world, the function of the appraisal governs the choice of appraisal methods. The responsible authority in each value world prescribes these methods. The choice of appropriate appraisal methods may ultimately lead to a point-in-time singular value. A private business value is relative to the *purpose* and *function* of its appraisal.

Private Capital

Capitalization, or capital structure formation, is the second leg of the private capital markets triangle. Capital structure refers to the composition of the invested capital of the business, typically a mixture of debt and equity financing. For private companies these securities range from placing industrial revenue bonds, to receiving mezzanine capital, to issuing common equity to venture capital firms. The private capital markets are much less efficient than their public counterparts. In fact, due to the lack of an organized market, private capital markets solutions are created one at a time. In other words, private capital is assembled on a deal-by-deal basis, in a ballet this is aptly described as financial hand-to-hand combat.

Exhibit 1.5 Value Worlds Concept Chart

<u>Appraisal Purpose</u>	<u>Value World</u>	<u>Appraisal Functions</u>	<u>Responsible Authority</u>
To find the highest value in the open market	Market value	Sale of a minority or control interest to support a merger	Financial intermediaries
To find a value for tax matters and for some legal reasons	Fair market value	Federal estate and gift taxes, ESOPs, charitable contributions	Federal law, administrative rulings
Shareholder actions	Fair value	To support a minority dissent, oppression claim	Statutory law
Shareholder wealth measurement	Economic value	To create/measure management bonus plans, company performance measurement, capital allocation systems	Academic community and management consulting industry
To determine insurance coverage	Insurable value	To fund buy/sell agreements, business interruption claims	Insurance industry, involved parties
To follow FASB No.142	Impaired goodwill	To determine impaired goodwill	FASB
To value intangible assets	Intangible asset	To value intellectual property, such as patents and copyrights, or to value intellectual capital	Intangible asset laws (patents, etc.)
To value the business from one investor's perspective	Investment value	Value specific to one investor, probably for purchase/investment	Investor
To value the business from an owner's perspective	Owner value	Value specific to owner, probably for sale	Owner
To determine the borrowing capacity of the business	Collateral value	To obtain a secured loan	Secured lending industry
To determine the value of a start-up	Early equity value	To derive the value of a start-up to determine equity splits	Venture capitalists

Yet, there is a structure of capital alternatives in the private markets. Unlike the organized structure that defines the public capital markets, private markets are more ad hoc, which leads to the following statement:

The private markets can be thought of as an outdoor bazaar rather than the public supermarket of securities.

Nearly all capital alternatives are available in the private bazaar, but they are found in separate shops or discrete increments. Financing is more difficult in the private markets because capital providers in the bazaar constantly move around and may or may not rely on prior transactions to make current decisions. Fortunately for those in need of private capital, some organization in this *bizarre* bazaar can be discerned.

There are six broad categories of capital available in the private capital markets. These *capital types* are bank lending, equipment leasing, asset-based lending, factoring, mezzanine, and private equity. Capital types are segmented into various capital access points (CAPs). The CAPs represent specific alternatives that correspond to *institutional* capital offerings in the marketplace. For example, equipment leasing is a capital type and captive/vendor; specialty and venture leasing are examples of capital access points within that type. Exhibit 1.6 shows the capital types with corresponding capital access points. Once all of the capital access points are described, the private capital access line can be graphed. This line represents the expected rates of return required by the major institutional capital providers in the market.

Accessing private capital entails several steps. First, the *credit box* of the particular CAP is described. Credit boxes depict the criteria necessary to access the specific capital. Next, each CAP defines *sample terms*. These are example terms, such as loan/investment amount, loan maturity, interest rate, and other expenses required to close the loan or investment. Finally, by using the sample terms, an expected rate of return can be calculated. This rate is the expected or “all-in” rate of return required by an investor. It is not adequate to consider the stated interest rate on a loan. Other factors, such as origination costs, compensating balances, and monitoring fees add to the cost of the loan.

Exhibit 1.6 Structure of Capitalization

<u>Capital Types</u>	<u>Capital Access Points</u>
Bank lending	Industrial Revenue Bonds SBA 504 loans Business and industry loans SBA 7(a) Loan Guaranty SBA CAPLine credit lines Credit lines Export working capital loans
Equipment leasing	Bank leasing Captive/vendor leasing Specialty leasing Venture leasing
Asset-based lending	Tier 1 asset-based loans Tier 2 asset-based loans Tier 3 asset-based loans
Factoring	Small volume Medium volume High volume
Mezzanine	Debt mezzanine Equity mezzanine
Private equity	Angel financing Venture capital Private equity groups

Exhibit 1.7 plots the expected return percentage of each CAP. The private access line represents portfolios of expected returns that group around a point on the line. An individual investor's experience in the private markets might not fit on the line. Rather, their experience may fit within a larger portfolio of expected returns averaged to a reference point on the line.

The private capital access line concept is helpful to companies that are forming or adding to their capital structure. The financing goal of every company is to minimize its effective borrowing or investment costs. Companies should *walk* the private capital line to achieve this goal. This means borrowers should start at the least expensive lowest part of the line and move up the line only when forced by the market.

Business Transfer

The final section of the book describes the transfer of private business interests. There are a variety of options available to transfer a private business interest. Business interests are any part of a company's equity or ownership interest. *Business transfer* covers the spectrum of transfer possibilities from transferring assets of a company, to transferring partial or enterprise stock interests.

Transfer channels represent the highest level of choice for private owners. Owner motives are the basis for selecting transfer channels. Transfer methods, the actual techniques used to transfer a business interest, are grouped under transfer channels.

An owner has seven transfer channels from which to choose. The channels are employees; charitable trusts; family; co-owners; outside, retire; outside, continue; and public. The choice of channel is manifested by the owner's motives and goals. For instance, owners wishing to transfer the business to children choose the family transfer channel. Owners who desire to transfer the business to an outsider, then retire, choose the outside, retire, channel, and so on. Exhibit 1.8 is a schematic representation of transfer channels and transfer methods in the business transfer spectrum.

Each transfer channel contains numerous transfer methods. A transfer method is the ac-

Exhibit 1.7 Private Capital Access Line

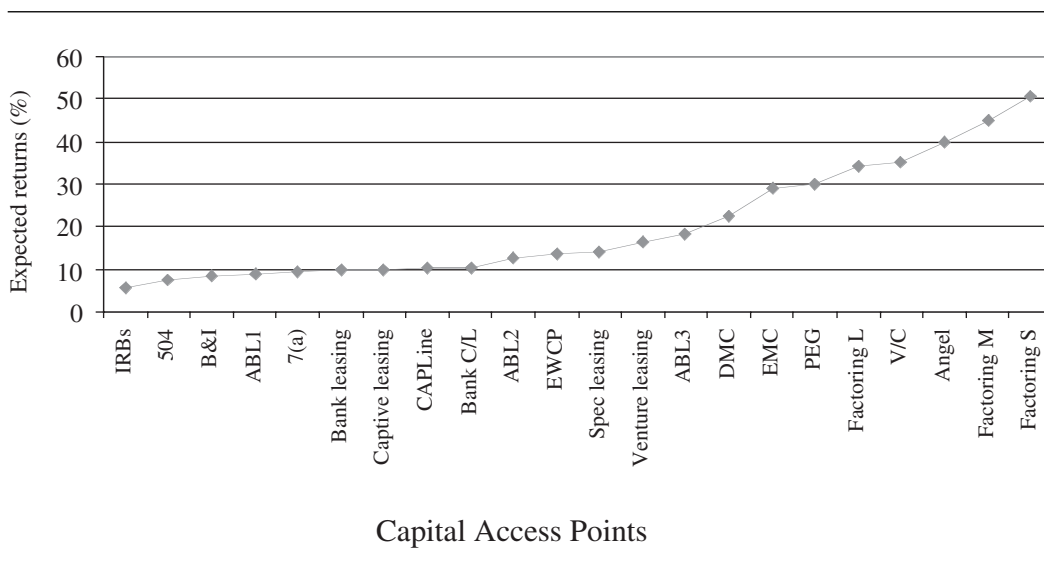
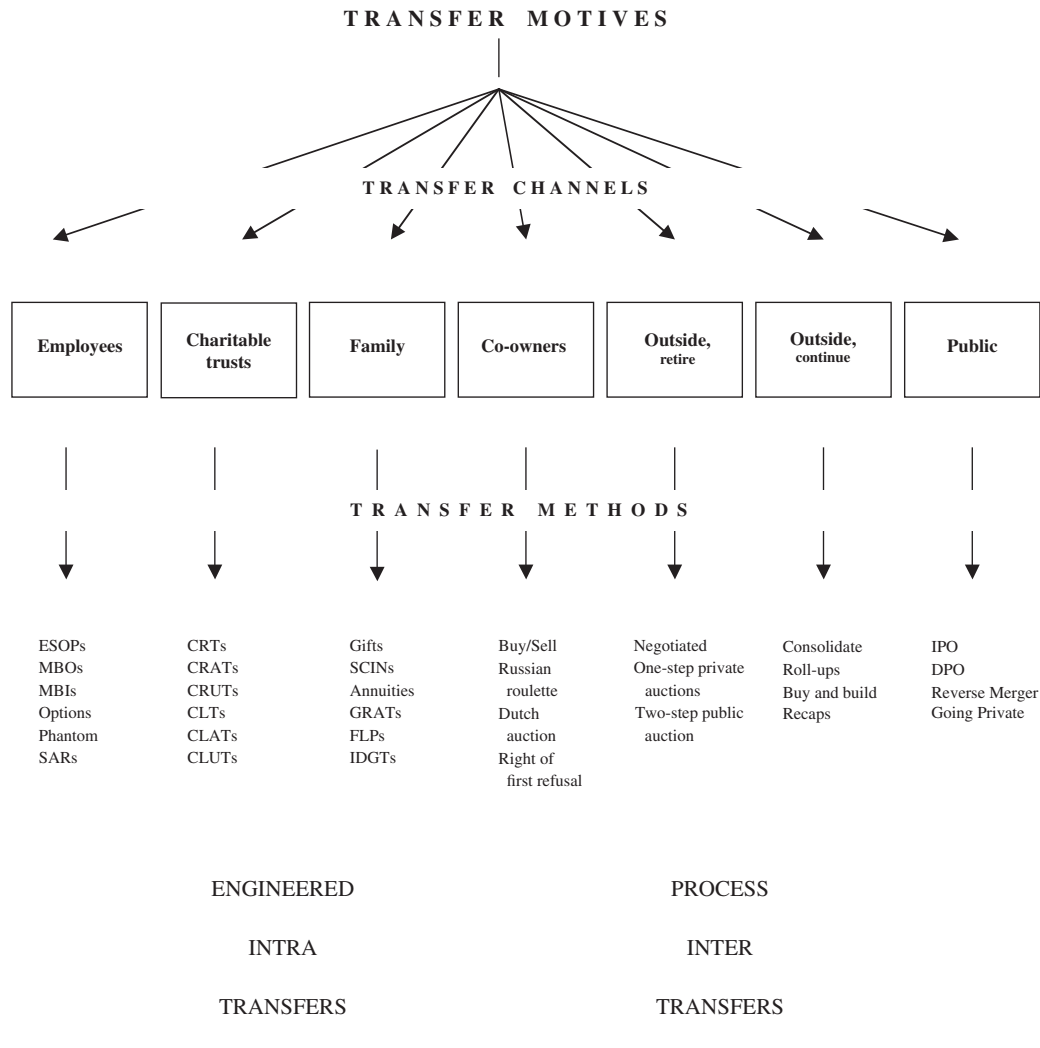


Exhibit 1.8 Business Transfer Spectrum



tual technique used to transfer a business interest. For example, grantor retained annuity trusts, family limited partnerships, and recapitalizations are methods by which an interest is transferred. Certain methods are exclusively aligned with certain channels, such as an ESOP within the employee transfer channel. Other methods can be applied across channels, such as the use of private annuities with either the family or outside channels.

Transfer methods correspond to specific value worlds. For instance, transferring stock into a charitable trust occurs in the world of fair market value. Selling stock via an auction happens in the world of market value, and so on. The connection between transfer methods and value worlds produces a major tenet of private business transfer:

The choice of transfer method yields a business interest’s likely value.

An owner's motive for a transfer leads to the choice of a transfer method, which is linked to a value world. Each value world employs a unique appraisal process that yields a particular value. In other words, owners can *plan* the timing and value of their businesses in a transfer.

When a business interest transfers within the company itself, it is called an *engineered intra transfer*. This is a way to group and discuss the transfer methods that are custom-tailored solutions for use by owners who wish to transfer part or all of the business internally and avoid the uncertainty of finding an outside buyer for the business. Examples of engineered intra transfer methods are management buyouts, charitable remainder trusts, family limited partnerships, and a variety of estate planning techniques.

Business interests that transfer to a party outside the company are called *process inter transfers*. Once again, the term process inter transfers provides a way to discuss transfer methods useful to an investor or buyer outside of the business. As the name implies, process inter transfers employ a process to achieve a successful conclusion. Examples of process inter transfers include negotiated sales, roll-ups, and reverse mergers. As an illustration, if an owner of a medium-sized company wants to sell his business for the highest possible market price, he might employ a private auction process, which should produce the highest possible offers available in the market at that time.

The goal of the business transfer section is to alert private business owners and their professionals to the large number of transfer options that exist. Motives of the owner usually lead to the choice of a transfer channel. Each channel houses numerous transfer methods. The methods enable an owner to convert motives into actions. Due to the technical nature of business transfer, this section is written to give interested players a guide to the various alternatives. Once a road map is conceived, an owner should engage experts to tailor the solution to the need.

OWNER MOTIVES

Motives of private business owners initiate an action. Motives are not like dreams in that dreams do not lead to action. For example, many private business owners dream of going public, yet 99.9% never become public entities because authorities in the market must support the motive and provide it with additional momentum. No positive outcome is possible without this additional support. Authorities control both access and the rules of the game within their spheres of influence. In the case of going public, a private owner must convince a public investment banking firm, the authority, to take the company public.

A motive is a goal that initiates an action. The governing authority must sanction an owner's motive for a goal to be met.

Unintended consequences occur when private business owners act without considering the governing role of authorities. The owner who attempts to give stock to children, without acknowledging Revenue Ruling 59-60, may receive an unwelcome visit from the IRS. Or the owner attempting to raise venture capital money without regard to the venture capitalist's credit box may simply waste time and effort.

Private owners need to understand the mutually exclusive features and functions of the private capital markets. Once the motive initiates action, specific possibilities are opened and closed. This occurs because the owner's motives initiate action from each side of the tri-

angular body of knowledge that forms connections between features and functions. By launching the initial motive without proper information, the owner unknowingly chooses a course of action that narrows future options. For instance, although owner's motives select the appropriate value world, once located in a value world only a limited number of capital access points may be available. Within the value world and preselected capital access points, only a few transfer methods may be available. The available transfer methods, capital access points, and the ultimate price an owner receives triangulate with the value world originally determined by the owner's motives.

For instance, an owner may be motivated to transfer the business to the employees via an ESOP. Since ESOPs are valued in the world of fair market value, the owner's motives cause the company to be valued in this hypothetical world without synergies. Most ESOPs are financed by bank lending. Further, suppose the owner wants to transfer the company to the key managers. Managers live in the world of investment value and are constrained by their ability to finance the purchase price. The managers may access secured lending to finance the deal but may not be able to access private equity without losing control of the company. The owner may be able to increase the purchase price into the world of owner value if the owner is willing to finance the deal through seller notes. Finally, an owner who wishes to sell to a synergistic buyer in a consolidation makes the conscious decision to enter the synergy subworld of market value. An owner's motives drive the price received in a transfer.

Once an owner sets a goal, relevant authorities play a key role in promoting or frustrating the attempt to achieve that goal.

AUTHORITY

Authority refers to agents or agencies with primary responsibility to develop, adopt, promulgate, and administer standards of practice within the private capital markets. Authorities set the rules and processes regarding business valuation, capital structure formation, and business interest transfer in the private markets. Thus, authorities act as *traffic cops* to ensure compliance. The concept of authority helps explain how and why things happen the way they do.

Authority derives its influence or legitimacy mainly from government action, compelling logic, or the utility of its standards. Exhibit 1.9 describes the sources of legitimacy for authority. Authority sanctions its decisions by veto power or denying access to the market.

Each of the three areas of the private capital markets has dozens of authorities. For example, in valuation, the IRS and tax courts are the primary authorities in the world of fair market value. In capital, various capital providers such as banks and venture capitalists are authorities. Finally, in business transfer, authorities may be laws, such as the Employee Retirement Income Security Act (ERISA) laws for ESOPs, or institutions, such as investment banking firms that govern auction sales.

Every authority has a boundary that forms the limit of its influence. The most obvious boundary is the utility of the logic or action that the authority promotes. In other words, if an authority promulgates rules that do not make sense to its constituency, the rules may be ignored or challenged. Even the mighty IRS is countered by the tax courts when members believe the former's rules are misdirected. This has been the case over the past 10 years regarding lack of marketability discounts. Tax courts have consistently ruled against the historic IRS position that private business interests suffer only slightly as compared to public interests.

Exhibit 1.9 Sources of Legitimacy for Authority

<u>Government Action</u>	<u>Compelling Logic</u>	<u>Utility</u>
<p>Many authorities derive their legitimacy through government action. Government action often regulates the valuation process, capital allocation, and the methods by which to transfer business interests. State and federal authorities typically have strong sanctioning power due to the threat of legal action. Government-based authorities are ultimately limited by the consent of the governed.</p>	<p>Authority grounds the language and logic in the community it serves. Membership entails using this language and, when it's deemed useful, following the logic. The membership provides market feedback to the authority when it believes the compelling logic is not useful or could be improved. An example of an authority that fights to win the logic battle are the ERISA laws and the various ESOP service providers.</p>	<p>Authority derives legitimacy from the utility of its logic and actions. Utility is measured by how well it helps the members accomplish their objective. Examples of utility in valuation is the management consultant's espousal of economic value. Unless constituents accept the utility of the authority's argument, economic value will not be adopted.</p>

Authorities have varying degrees of sanctioning power. The most direct sanction is veto power. Capital providers don't have to supply the requested money. Or the IRS can challenge an appraisal in court. Many authorities sanction noncompliance by denying access to information or a market. For instance, financial intermediaries who believe shareholders are overvaluing their company might choose not to represent it in a sale.

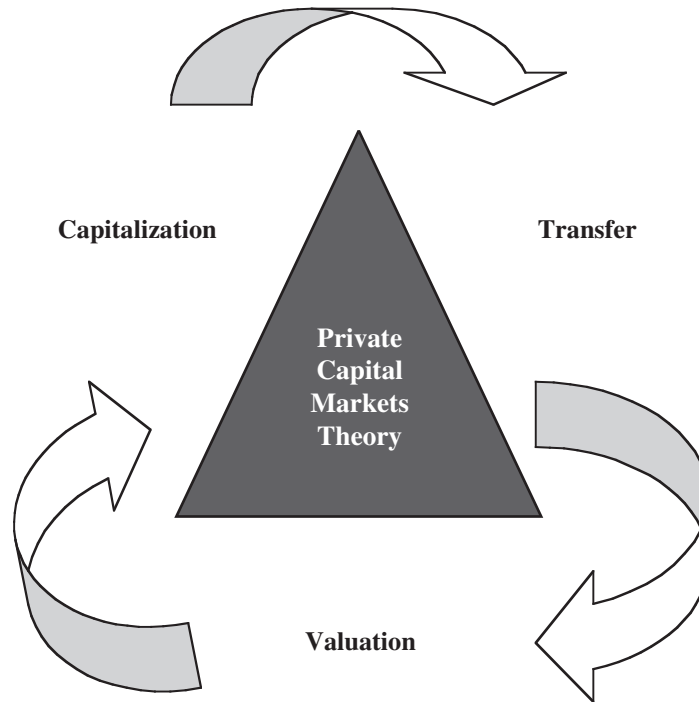
Each chapter in this book discusses authority, especially as it relates to mandated processes and the legitimacy of the authority's position.

TRIANGULATION

The concept of triangulation depicts private capital markets theory as a holistic body of knowledge. It requires an understanding of the entire framework before a specific technique or method can be properly considered and fully understood. That is why this work is consolidated into one book, covering valuation, capitalization, and business transfer as interrelated topics.

Points located on the various sides of the private capital markets theory triangle do not exist in isolation. It is useful to borrow a loosely constructed concept of triangulation from navigation or civil engineering where a point is located only with reference to other points. Once a point is identified and described it can be used as a survey monument or control point to mark its location and relationship with other points. Triangulation, graphically depicted in Exhibit 1.10, refers to the use of two sides of the private capital markets theory triangle to help fully understand a point on the third side. Control networks can then be created using triangulation with various orders of accuracy. In economics, as in surveying, triangulation can help map out unknown territory by establishing relationships with what is known.

Although there is no claim for mathematical accuracy or certainty in applying the concept of triangulation to the private capital markets, its application may bring useful in-

Exhibit 1.10 Triangulation

sights. What is known about two control points on legs of the triangle can be used to locate and understand a third point. The process helps to think about relationships, understand interconnections, and eliminate errors.

On a macro level triangulation can be summarized in three interrelated sentences:

1. Business value is directly affected by the company's access to capital and the transfer methods selected by or available to the owner.
2. Capitalization is dependent on the value world in which the company is viewed and the availability of transfer methods.
3. The ability to transfer a business interest is conditioned by its access to capital and the value world in which the transfer takes place.

Triangulation is a further embodiment of triadic logic, which describes private capital markets theory using a three-legged conceptual stool. In other words, private valuation can only be understood relative to capital/transfer, capitalization must be viewed relative to the impact of valuation/transfer, and transfer is influenced by capitalization/valuation.

Perhaps an example of triangulation will help. Assume Joe Mainstreet, controlling shareholder of PrivateCo, the fictitious company described in this book, wants to diversify his estate and sell the business. This typically calls for an appraisal in the world of market value. Joe has numerous transfer methods from which to choose that will meet his goal. For instance, he may sell to his management team (management buyout), or to an outside

strategic acquirer (private auction), or to a private equity group (recapitalization), and so on. The choice of transfer method dramatically affects the value of PrivateCo. It is likely that PrivateCo is worth far less to his management team than a synergistic acquirer because the former does not bring synergies to the deal. Further, management is limited by its ability to raise capital for the purchase; whereas, the acquirer may not have this problem. Joe may help improve the management's value by financing part of the transaction. While seller financing helps Joe get a higher value for PrivateCo, it also puts him in a riskier position going forward. This is the key to understanding triangulation. Joe Mainstreet cannot view the value of PrivateCo properly without considering the effect that transfer and capital has on the situation. This same triangulated framework of decision making is required no matter which part of the private capital markets triangle triggers the action.

Since owner motives jumpstart the triangulation process in private capital markets theory, nearly every chapter of this book begins with motives of the owner and ends with triangulation. In this way the reader can establish the owner's decision-making process and ascertain the effect all sides of the private capital markets theory triangle have on the decision.

ENDNOTE

1. Unless otherwise stated, public companies are defined herein as those entities that trade on a public exchange and have a float of more than \$500 million.