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Excellence in Private Equity Valuations

Based on the Privcap Thought Leadership Series,
"Best Practices in Private Equity Valuations"

Plus:
Expert Q&A with Colin Sanderson, Partner at RSM

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Excellence in PE Valuations

Key Findings

1. Institutional investors expect a robust valuation methodology
2. Big gaps in exit value and the last valuation mean room for improvement
3. Improving a valuation methodology often takes an outside expert
4. Minority ownership in portfolio companies presents unique challenges
5. The definition of "control" is not uniform

Darren Friedman
Partner
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1. Institutional investors expect a robust valuation methodology

Valuing a portfolio company is as much an art as science, but investors don't really want to hear it. They want to see evidence that their private equity partners maintain a rigorous methodology.

"As auditors, we always try to look retrospectively at how the position was marked, up until the exit," said Colin Sanderson of RSM. "We also look at forecasts and actual audited and unaudited numbers over the life of the portfolio company. We want to get a sense of whether that data is being accurately reflected. How have they been providing that to management? Is it considering real-world scenarios? Why did we get an exit above the value we were carrying on the books?"

As more firms recognize that investors want solid valuation methodologies in place, they're providing proof that they have them. "We see GPs releasing to LPs a lot more of their underlying data and methodologies," said Darren Friedman of StepStone. "Some firms are completely open-book." Not only are they providing the financials, but also the comp sets they used to determine those numbers. In some cases, firms are even disclosing the three different methods they used to get to that valuation, Friedman noted.

If its methods are not producing accurate valuations, a firm should revamp them, Sanderson added. "Auditors love consistency. However, it's very important that the GP has

Darren Friedman

Valuation Challenge: How Should a Firm Deal with Downward-Facing Debt?

Here's an issue that most private equity professionals at one time or another (whether they admit it or not): Their firm has an interest in a portfolio company with publicly traded debt and that debt is trading below par. How does that affect the value of their equity in the company?

Believe it or not, it can actually increase the value of the equity. "If the company is worth a dollar and you have 50 cents of debt and 50 cents of equity, now you're saying the debt is worth 45 cents. But the company is still worth a dollar, so I just gained 5 cents of equity," explains Darren Friedman, a partner at StepStone. "Today that's how big banks do the accounting every quarter. If their debt trades down, their equity value goes up."

This may seem like voodoo economics at its finest but Kevin Vannucci, a partner at RSM, notes that one plus one doesn't always equal two in the world of high finance. "I think some people could say, 'Hey, if your debt actually goes down then your equity should go up because the sum parts should always equal the same.' But I don't necessarily think that's true all the time."

a process in place and evaluates its models based on new information," he said. "If you're not using multiple models, maybe you should. If you're relying too much on an averaging of various methods, maybe you should tweak it."

2. Big gaps in exit value and prior valuation mean room for improvement

Firms should monitor their valuation processes for signs that they're underperforming. One of the most telling indications is a consistent discrepancy between the last valuation and the exit.

"...If you're consistently off by more than 25%, I think you may want to think about looking at some new methods, maybe sharpening the pencil a little bit and availing yourself of some of the help out there," noted John Lambrech of W Capital Partners.

Friedman said 25% is the threshold for him, too. "If we consistently see, among our own portfolio or among GPs we invest with, exits 30% above or below their marks, that's a red flag."

Still, Friedman added that exit valuations above last valuation are not a huge surprise, given the nature of private equity. "GPs try to exit at the most opportune time," he said. "That's what we pay them to do. You're trying to exit to maximize your valuation. From an accounting perspective, most of the time you're valuing at some type of average valuation—whether you're using public comparable, average multiples, precedent transactions, or averaged multiples—and private equity's job is to try and sell above that average."

Friedman also noted that different investors place varying emphasis on valuation. To an individual, the important numbers are the amount of cash that went in and the amount that came out. "But for certain types of investors, such as pension funds, valuation matters, because they're looking at their assets," he said. "How much over- or underfunded is that plan? That entity may have to make additional contributions based on the value of those assets."

3. Improving a valuation methodology often takes an outside expert

The people who created the firm's methodology are not necessarily the best people to fix it. And the increasing importance of valuation methodologies has generated an industry that specializes in accurate valuations. These experts are often the best option when a methodology needs revision.

"We've seen firms outsourcing as much as they can of their quarterly valuation work," Friedman said. "It takes the biases of individuals out of the equation. The GP can say, 'Look, I have a third-party expert who's doing the valuation. So if I sell companies for higher or I have to mark them down significantly, [it's not because] I'm trying to game the system.'"

4. Minority ownership in portfolio companies presents unique challenges

Valuing a company is a complex process, and it gets even more vexing with minority positions. A lot depends on the amount of information available. If a firm owns a small percentage of a company and does not have a place on the board, it may have blind spots.

"Another aspect in minority situations is that you often have a syndicate of different investors that each may own 10% or 15% percent of the company," Lambrech said. "It's very important to understand their mindset. Did one investor get in at the sub-A round? Their timeframe is going to be very different than someone who came in at the B or C round. Understanding the nature and composition of the investor base is very important."

Different positions often require that different valuation methodologies be used. For instance, if a minority-interest shareholder can't change the cash flow stream, "you're stuck with that cash flow stream, versus a controlling-interest shareholder that can make changes," Sanderson said. "That's going to impact the underlying value for a minority."

Another difference between control and minority positions would be a discount for lack of marketability, observed Sanderson. "On a minority-interest basis some would say you apply a discount for lack of marketability to get down to your ultimate mark. On a control basis, some would say you don't," he said.

John Lambrech

Valuation Challenge: What Should a Firm Do When There Is Doubt about the Last Round?

As investors know, valuations for early-stage companies can be highly subjective. So what happens when you're planning to invest in a young company but you have serious doubts about the valuation that was set in the previous round?

"Personally, I don't put a lot of credence in the last round," says John Lambrech, the CFO at W Capital Partners. "I think it's OK to hold the valuation there for a quarter but then I think you ought to be employing your own models to build a bottom-up analysis on what the company is worth."

Colin Sanderson, a partner at RSM, says that when valuation gaps do exist, it's impor-tant to consider the circumstances that led to the earlier round. "Was it a forced sale? Was it a rescue package? Were there strategic investors involved? Because they may be making decisions for strategic reasons and not necessarily for those of other market participants. In determining the fair value you need to consider all that."

5. The definition of "control" isn't uniform

The fact that firms in minority and control positions arrive at different valuations of the same company raises the question: Is the definition of control a moving target?

"Control or minority—what does that really mean?" Sanderson said. "Does it mean if you're a private equity group and have multiple funds you define control as greater than 51% across all funds? And on the flip side do you look at control or minority if you're involved in club deals?"

In the end, it usually boils down to the degree to which a firm can influence company operations. "How much influence do you have over management to sell a company now versus make a strategic change in the business and grow it over several years?" Lambrech said. "I've heard a lot of minority investors talk about, 'Well, we're on the board and we exert our influence, we control our own destiny.' But the reality is that, unless you have perfect alignment among all minority investors…you're probably not going to have that much influence on the outcome." ◆

Expert Q&A

with Colin Sanderson
Partner
RSM

What is unique in the way that RSM works with private equity funds?

RSM is the leading U.S. professional services firm focused on the middle market, and has significant global capabilities. We work with 1,200 private equity firms globally. We are able to serve private equity firms from an audit, tax and consulting perspective, both at the fund and at the portfolio level, as well as over the lifecycle of the investment.

What services does RSM offer private-equity firms through the investment life-cycle?

Our financial services groups work with firms in terms of structuring their fund, from a tax perspective as well as working with their counsel.

Also, we're able to serve the firm post deal, and from an assurance tax, as well as a consulting perspective, whether that be merger integration, or they're looking at technology process improvements at that company.

Our 75 offices allow us to work with private-equity firms in any geographic location to mobilize a team quickly, to that location or from that location, to serve them.

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- Valuing a Minority Stake: It's Complicated
- Valuation Challenge: Downward Facing Debt
- Expert Q&A with Colin Sanderson

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