Privcap/ Briefing

Context for Private Capital Investment

Q2 2014

Valuation Methods for Private Equity Assets

An Executive Summary of the Privcap Thought Leadership Series
Valuations in Private Equity

Sponsored by

RSM

Valuation Methods for Private Equity Assets

Key Findings

1. Most firms use three methods of valuation: public market comparisons, comparable sales transactions, and discounted cash flow
2. Firms must use hard and soft measures to establish the fair value of private equity assets
3. Auditors increasingly expect firms to calibrate their valuations
4. Energy asset valuation requires a nuanced approach using discounted cash flow
5. The options pricing model of valuation can be complicated and expensive, and is rarely useful

The Panelists

Mitchell Coddington
Partner, Chief Financial Officer
Energy Investors Funds

John Lambrech
Chief Financial Officer,
Chief Compliance Officer
W Capital Partners

Kevin Vannucci
Partner, National Practice
Leader for Business Valuation
RSM

1. Most firms use three methods of valuation: public market comparisons, comparable sales transactions, and discounted cash flow.

Firms tend to use a blend of three valuation methods when valuing a portfolio company. Of the three, public market comparison is often the most straightforward: A firm finds a statistically significant number of public companies similar to the portfolio company and uses them as proxies to establish a valuation. However, this method is not without its complexities.

"There are a number of challenges around using public comps," said John Lambrech of W Capital Partners. "Are you measuring the public comps at one particular point in time? Are you looking at how they trade over a period of time, whether it be the last 12 months or a longer history? Do you look at how cyclical they are over time? What's the volatility of these companies? If they're highly volatile, you rely a little less on a comp being an accurate measure."

The two other primary methods of valuation—discounted cash flow and comparable sales transactions—are added to the mix and weighted accordingly, based on how a firm feels about the results. These methods can also be thorny.

"With the comparable sales transaction method,


Kevin Vannucci, RSM

On the Mark

Private equity firms can't simply assign a value to a portfolio company and expect to be taken at their word. They need to clearly explain how they arrived at the number and provide solid documentation for the valuation.

"Without a doubt, all audit firm clients are asking for more documentation, because there is increased scrutiny on the marks right now, and there will be continued scrutiny," Vannucci said. "I know the American Institute of CPAs is coming out with guidelines that will help funds become better at following what the auditors are asking for, because right now there are no real guidelines related to how to mark to market certain investments."

Vannucci expects the AICPA to release a practice aid within the next few years, similar to the guidance it has given for goodwill impairment and purchase-price allocation. Prior to that guidance in those two areas, there was some confusion, with different accounting firms recommending different approaches.

Now the AICPA is targeting the topic of valuation. "It has formed a task force around this to really provide some better guidance, so there won't be the gray area and so everyone will be marching to the same beat," Vannucci said. "That should help all the clients and all the funds eventually."

that information isn't publicly known," said Kevin Van-nucci of RSM. "There's not a lot of information out there to help you adjust some multiples down on those market participants to fit the subject company."

Some firms keep track in an internal database of those portfolio companies they sell, which they can use when searching comparable transactions for a current portfolio company. Then they just have to make sure the audit firm is comfortable with this approach.

2. Firms must use hard and soft measures to establish the fair value of private equity assets.

In addition to the hard measures firms use to value portfolio companies—revenue, EBIDA, running cash flow, and others—they should also use soft measures, which can carry a lot of weight. Soft measures include the quality of the management team, the depth of intellectual property and the strength of a company's defensive position or competitive advantage in the market. All can make a significant difference in a company's value.

"We always talk about the art and the science," Lambrech said. "The science part, with comps, is a lot easier. The other part—saying, 'Well, I've got to be ahead of that comp' or 'I should be at a discount to that comp'— that's the one that usually involves more artful thinking, and the one that we typically will spend more time getting the auditors comfortable with."

When using comparable sales transactions, firms should be careful to assess whether there are synergies baked into the sales price. "Under fair value, it's marketplace-participant assumptions and not synergistic value," Vannucci said. "If you're using comparable sales transactions, you have to be careful that synergies aren't embedded in there. If they are, then that's really not fair value, unless a market participant would pay for those synergies."

3. Auditors increasingly expect firms to calibrate their valuations.

Calibration is a hot topic in the world of PE valuation. Most firms are doing it already, and those that are not soon will be, because audit firms are demanding it.

What is calibration? Say a firm buys a company at five times EBIDA and identifies several equivalent market participants trading at eight times EBIDA. That means the just-purchased company has a three-times term difference, and all things remaining equal, that should stay the same over time, unless the company sees more growth or different margins than those other market participants. Essentially, calibration is a way for a firm to tell when investment is not following the market-participant assumptions the firm identified when it made the investment.

"As you start to move further away from that initial investment, looking back and calibrating where it was in the initial model is less relevant," Lambrech said. "But it's something we absolutely consider. We're always looking back and saying, 'What did we think this company was going to do, and what's changed over time?'"

"Investments are going to change," Vannucci added. "So as you're coming toward your exit event, the initial acquisition is going to change. But what auditors are looking for is the color around that and why it's changed."

For instance, if you buy a company at five times EBIDA and market participants are trading at eight times, and then three years down the road the market participants are trading at six times but you've marked your company at nine times, that calibration is going to tell you either that you hit a home run or that something else is going on.

"You have to give that color to the auditors and your LPs to explain what is going on and help them get comfortable," Vannucci said. "That's what calibration is all about."

4. Energy asset valuation requires a nuanced approach using discounted cash flow.

Different types of assets require different types of valuation processes. Energy Investors Funds, for instance, invests primarily in power plants and transmission lines that typically have a long-term contract with a local utility. "So our valuation technique falls into what's considered the level-three category in a fair-value world," said Mitchell Coddington of Energy Investors. "We don't have market activity or public markets to look to, so we use discounted cash flow analysis."

Mitchell Coddington, Energy Investors Funds

Reality Check

Before assigning a value to any portfolio company, Energy Investors Funds first takes a reality check.

"We look at other transactions in the marketplace to determine if the exit value we're using for that particular asset is in fact reasonable," Coddington said. "Generally there aren't public market comps, but in the trade rags and other industry publications you can find sales transactions where actual sales have taken place, and we use some of that information as a comparable for a portion of our valuation analysis."

This analysis is also crucial for the firm's auditors so they feel comfortable that the exit value assigned to an asset is appropriate and supported by market activity.

"We have newer funds that are acquiring assets, and of course older funds that are liquidating," Coddington said. "What's important is that the valuation technique we use when we're buying assets is the same analysis that other buyers are using when they acquire assets from us."

The valuation is based largely on the power-purchase agreement with the local utility. Other inputs range from fuel-supply agreements to project-finance structured debt to equipment operation and maintenance agreements.

John Lambrech, W Capital Partners

Fair Comparison

Should private equity firms use public market comparables when assigning a value to their privately held portfolio companies?

Lambrech thinks that's a rational approach, at least under certain circumstances. "If you have a company in your portfolio that under a reasonable set of circumstances could be a public company and has enough similar aspects and metrics that you can build a case, then it's reasonable to think that it ought to trade like a public company," he said.

Lambrech added a caveat, though. Firms should make sure they aren't comparing their company to a single company but have a meaningful number of comparables—somewhere between five and eight—to serve as proxies for where an asset should trade.

He pointed out a variety of other challenges that may come up when firms use public comps. "Are you measuring the public comps at one particular point in time? Are you looking at how they trade over a period of time? What's the volatility of these companies?" he asked. "If they're highly volatile companies, you start to rely a little less on a comp being an accurate measure. So a number of factors need to be considered."

"You have a range of assumptions you make for certain of the inputs—then you have to determine a discount rate to discount all those cash flows back to a current valuation," he explained. An important component at the end of the contract is to determine a "terminal value."

"Let's say you have a 15-year contract," he said. "At the end of year 15, you'll input a terminal value—what you believe that asset would sell for. We can look to other transactions that we've been involved in or we see in industry publications to get a sense and to give our auditors some comfort that the valuation we're using for our terminal value, as a component of our discounted cash flow model, is reasonable and supportable."

5. The options pricing model of valuation can be complicated and expensive, and is rarely useful.

Occasionally debates break out in the field of valuations. A current discussion is the option pricing model versus current value method. Some accounting firms are pushing OPM, others are not.

"The option pricing model is typically relevant if you have a cap structure where there are a lot of levels of securities," Lambrech said. "It comes into play when you have more of a distressed sale, where the proceeds for the sale of the business won't cover all the preferences and will not flow through the waterfall or else you'll have people out of the money. The idea behind the OPM is to say, 'Well, even though this common stock by that method may have zero value, there's probably some optionality to it. There probably is a market.' It's a very limited set of circumstances where you might use it."

The American Institute of CPAs has formed a task force that is going to issue a practice aid that likely will discuss the relevance of option pricing models versus the current value method. Many private equity professionals can't wait.

"Hopefully the practice aid will solve some of the issues, because some accounting firms really push their clients for OPMs for all investments; other accounting firms don't," Vannucci said. "A lot of clients have heartburn because typically option pricing models could have multiple tranches, and some funds aren't set up to do that. Then it can be a long process and an additional cost to pay a third-party provider to come in and set these OPMs." ◆

Expert Q&A

with Kevin Vannucci
Partner, National Practice Leader
for Business Valuation RSM

What sets RSM apart in the way the irm works with private equity irms?

"We provide audit, taxing and consulting services. One of our core services is valuations.

What really sets us apart from a valuation boutique firm is how we help our auditors assess our audit clients' marks and whether they're reasonable. We work seamlessly with our audit teams to make that process efficient and as smooth and painless as possible for our clients and still maintain our independence.

One service we provide that sets us apart is our external marks. Given our unique position we can really understand the full scheme of valuations for our client companies."

RSM

Please contact Kevin Vannucci at **Kevin.Vannucci@RSM.com**
www.RSM.com

Privcap/ Thought Leadership for the Private Capital Markets

Series / Valuation Methods for Private Equity Assets

Watch the series in its entirety at Privcap.com

- Do You 'Calibrate' Your Valuations?
- Using 'Comps' The Right Way
- Valuing Energy Assets
- PE Valuations: Why Options Pricing Doesn't Cut It

This thought-leadership series is sponsored by RSM.

About Privcap

Privcap produces and distributes high-quality digital content for participants in the global private capital markets. Our members gain access to our first-person thought-leadership videos, transcripts, podcasts, articles, and supporting material without the expense and hassle of traveling to industry conferences. The valuable context we provide allows investors to make better decisions and achieve greater success across private capital access classes.

To join, visit Privcap.com

Contacts

Editorial
David Snow / dsnow@privcap.com
Matthew Malone / mmalone@privcap.com

Sponsorships and Sales
Gill Torren / gtorren@privcap.com

Privcap.com