Privcap/ Video Series Briefing

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# Valuation Trends in Private Equity

An executive summary of the Privcap thought-leadership series on company valuation

**Richard Brekka**
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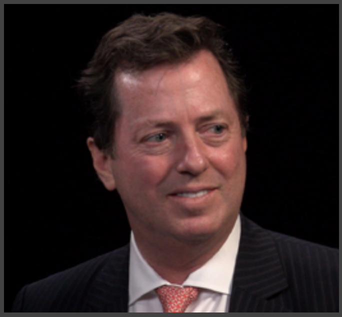
# Valuation Trends in Private Equity

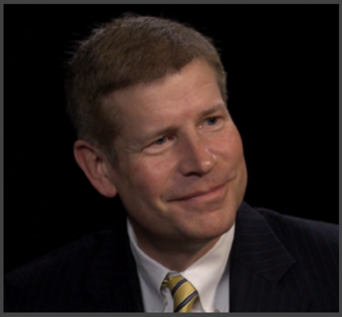
## *Key Findings*

1. *With valuation policies, the more robust and transparent, the better*
2. *A robust strategy helps GPs defend against second-guessing*
3. *"Calibration" is increasingly important in valuation methodologies*
4. *When valuing a "unicorn," GPs should focus on fundamentals*
5. *GPs should beware conflicts of interests in early-stage valuations*

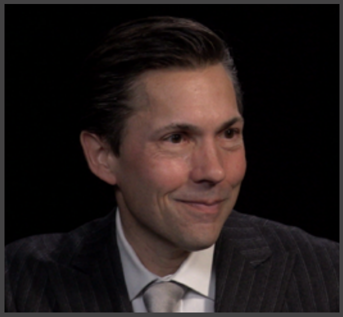
## *The Panelists*



**Richard Brekka**
Managing Partner,
Co-founder,
Second Alpha Partners



**Chris LaDue**
Principal,
RSM US LLP



**Kevin Vannucci**
Partner,
RSM US LLP

**Max Wolff**
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# 1 With valuation policies, the more robust and transparent, the better

Valuation is an art and a science—and GPs who fudge the math could be history. The SEC is looking hard at valuations, as are limited partners and audit firms, and GPs who are tainted with any implication of fraud or misdirection might soon be looking for a new career. This is why valuation policies must be robust and transparent.

"For us, the more robust, the better; the more transparent, the better," says Kevin Vannucci, a partner at RSM US LLP. "And we're seeing that limited partners want that kind of valuation policy as well. If they're going to invest in your firm, they're going to ask to see that valuation policy, because limited partners are out in the forefront of trying to understand how you're marking to market. Obviously they have their money to allocate, and they look at asset allocations. So that's why fair value is so important to limited partners—because of that asset allocation."

And although a rigorous valuation policy may be more work up front for GPs, it pays in the long run. "It does a couple of things," says Richard Brekka, a managing partner at Second Alpha Partners. "It saves us a lot of time later on when we're doing the audit. And it saves us money at the end of the day, because the less time we have to spend with our auditors, the less they get to charge."

# 2 A robust strategy helps GPs defend against second-guessing

An important factor at play in the valuation space these days is the increasing amount of negative information that's available. A tough valuation policy provides GPs with an effective

The Art of the Deal

**Max Wolff**
**Manhattan Venture Partners**

Determining the valuation of an early-stage company with a limited track record is practically all art and no science. "Selecting comps at the early stage is very hard, and it's controversial," says Wolff. "When you sit down and talk to management teams, comps that we think are ingenious they often find marginally, or more than marginally, offensive."

The problem, Wolff says, is that an A-round story is so different from a C-round story. Plus, startup prices have spiked dramatically over the last several years, seemingly in defiance of common sense, and this makes it even harder to apply fundamentals to the early-stage valuation process.

"The story of venture is grossly exaggerating real or perceived differences from whoever else is in the market, which intrinsically makes the comps selection far more fraught than you'd get in your accounting classes," says Wolff.

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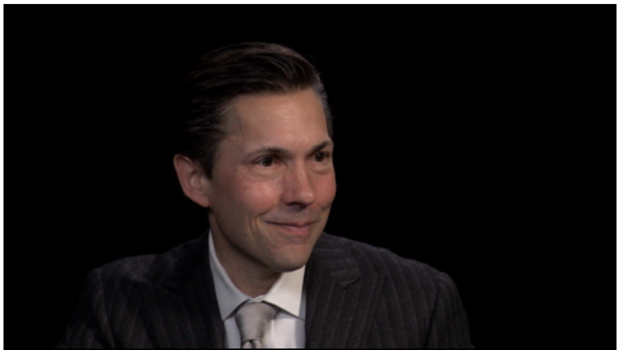

The Value of Culture

**Kevin Vannucci**
**RSM US LLP**

Logic dictates that two private equity firms of roughly the same size and operating in the same space would have similar valuation policies. But when it comes to the valuation game, logic often languishes on the sideline, while other factors control the game.

"Without a doubt, the culture of the firm can very much influence valuation policies," says Vannucci. "If firm X develops a valuation policy and you compare it to firm Y's, it is probably different, based on how the people in each of those firms think."

He says valuation policies often depend on the individual within a particular firm who's leading the drive on the audit committee or valuation committee. "Some people are very detail-oriented, so they want to cover every single point in the valuation policy, which could bring more exposure to them," he explains. "And other people want to keep it more generic, so they, in theory, don't have that exposure."

means of defending their decisions against second-guessing by armchair quarterbacks.

"There are a lot of outside forces pushing on a valuation that historically weren't there," says Max Wolff, a managing partner at Manhattan Venture Partners. "There are newspaper articles; there is a lot of active trading in the secondary market. It floods you with data points, many of which are bad. We need to have a robust strategy, because we need to defend why we're not necessarily pushing toward the latest news story or the most recently quoted—or not publicly quoted—prices in the secondary trade."

## 3 "Calibration" is increasingly important in valuation methodologies

A buzzword that comes up now in a lot of conversations about valuation is "calibration." It's not a new term, but many in the PE industry still are not familiar with it.

Brekka explains it this way. "If you buy a company at eight times EBITDA at acquisition, at that time you should identify the comparable public companies and look at their unadjusted multiple—say it's 10x. Therefore, you have an 8-to-10 ratio or 80 percent calibration ratio." It's also important to look at the gross size of risk of those public companies versus the private company, he says, adding that, all things being equal, on the next measurement date the exact same thing would be done.

Calibration is useful in many ways. It takes uncertainty out of the picture. It benchmarks a company at date of acquisition and provides benchmarks going forward. It assures an audit firm and investors that a GP is looking at the true, fair value and specific market participants. It mitigates the concept of discounts for lack of marketability if a GP holds a minority interest versus a controlling position. "It takes away

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another level of subjectivity," Brekka says.

But calibration can be difficult in the case of early-stage companies, which often have a constantly evolving story. "The big issue is the pivot," Wolff says. "It's not infrequent to see a fundamental shift in business focus in the early stage or even midstage. And that changes the entire comps set. If you started out as a social media company and you're now an ad-tech company, there's no recalibration I can do. I've got to cut down the old forest and find a new forest to compare you to."

## 4 In "unicorn" valuations, GPs should focus on fundamentals

Unicorns were once a rare, almost mythical beast. Now they're everywhere, and investors are taking a much closer look at their over-the-rainbow valuations. "Some of these horses are going to be glue in the next year or two," Wolff says. "Valuations got very aggressive. Part of what happened is that there is an inefficient price-discovery process in private markets. Part of what happened is these companies got hot and there was a lot of FOMO—fear of missing out—on investing. And part of what happened is people lost sight of valuation."

The challenge for accounting firms is negotiating the gap between a unicorn's market value and the value a manager must report to investors. The solution is to focus on fundamentals, although there is still balancing to be done.

"We go back to income-based approaches, discounted cash flow, market-based approaches, with guideline public company or transactions to try to substantiate the valuations that we see," says Chris LaDue, a principal at RSM US LLP. "But with regard to some of these unicorns and the anticipation of those valuations, we're trying to bridge where we sit relative to funda-mentals and things that we can point to that the accounting firms, and their auditors, are going to be looking at for substantiation—but

Three Different Approaches

**Richard Brekka**
**Second Alpha Partners**

Early-stage valuations are a tricky business. But from an audit standpoint, those valuations are initially dictated by the venture capitalists who invest in the business.

"When a venture capitalist makes an investment, from an accounting and review standpoint, we tend to take as gospel that the indication made by the institutional smart money is correct," he says. The real challenge, adds LaDue, is when you are called upon to perform valuations that are not tied to a recent funding event, or what he calls an "off round" valuation.

"Being on the outside looking in, we're asking ourselves, what was the process to come up with those initial valuations? Was there some horse trading going on between valuation and investment terms?" he asks. "Since many of these companies don't have revenue, and in many cases are not profitable yet, we find ourselves making the same types of assumptions investors make. So what does the exit event look like? How big do these companies get? How much funding will be needed? What returns should be assumed? And do those assumptions make sense? Are they reasonable to any pragmatic investor? These are the challenges we face when performing these valuations off-round and being able to support them and substantiate them."

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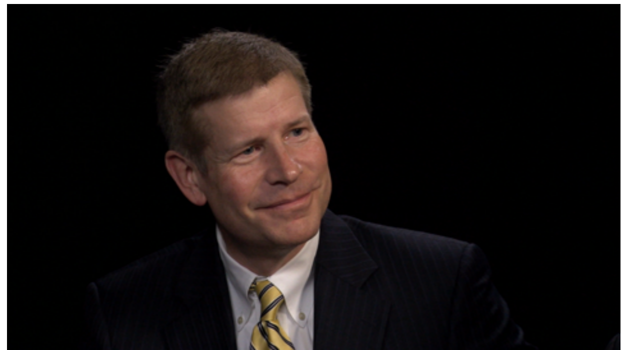
being cognizant of the fact that the market is dictating the pricing of some of these companies, and they don't always make sense relative to fundamentals."

## 5 GPs should beware conflicts of interests in early-stage valuations

When early-stage investments don't do well, the spotlight turns to managers and the valuation stories they told leading up to the tragic ending. If the story turns out to be a fairy tale, the manager can get burned.

"There's a huge conflict of interest for the general partner, because GPs want to be able to show returns," Brekka says. "When they're making these investments, they're not getting cash out, so the only thing they can show is current market value of their portfolio and be able to reflect that to the institutional investors that are backing them. They also want to raise their subsequent fund—and since they're not delivering cash back in the near term, it's all about valuation."

But when a unicorn investment is marked up and eventually written down to almost zero—like, say, flash-sale companies Fab and Gilt Groupe—it can mean game over for the GP. "That can end it for a general partner in terms of being able to raise future funds," Brekka says. It's not entirely the GP's fault, of course. Today's managers have fewer tools to bring to bear in the valuation process. "We've relied historically on a robust IPO market to help us back value," Wolff says. "And now our IPO market is gone, so we have a vacuum. Obviously we can see how last year's IPO crop is trading—although that's not terribly inspirational right now—but we don't have any new flow. That gap has not been great for price discovery." ■



The Valuation Game

**Chris LaDue**
**RSM US LLP**

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"Being on the outside looking in, we're asking ourselves, what was the process to come up with those valuations? Was there some horse trading going on?" he asks. "What is assumed is many of these companies don't have revenue, certainly in many cases are not profitable yet. So what does the exit event look like? How big do these companies get? And do those assumptions make sense? Are they reasonable to any pragmatic investor? That is the biggest challenge that we face when we have to do these valuations off-round and be able to support them and substantiate them."

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# Expert Q&A



**What does RSM do?**

**Kevin Vannucci:** RSM is the fifth-largest accounting firm in the country. We're the sixth- largest globally. RSM is an accounting firm that does assurance, tax and consulting work and I head up the national valuation group. And within that, we do mark-to-market work. We do purchase-price allocation. We do fair market value work. We do litigation work, and I have with me Chris LaDue, a partner in our Boston office. He heads up our go-to-market, early-stage VC valuation team.

**Chris LaDue:** In Boston we have a team of eight people that, essentially specialize in what I call "under the technology umbrella." We spend about a third of our time valuing technology-related companies—software, hardware, electronics to some extent. And then another third is roughly life sciences company, both biotech, traditional pharma, and medical devices.

**Vannucci:** RSM serves 1,300 private equity and VC relationships across the country. So the private equity space is what we do very well. We are one of the largest providers to private equity, whether it's at the fund level or the portfolio company level.

**What are the advantages of a working with your team as a private equity firm?**

**Vannucci:** The big advantage from RSM's standpoint, is that we are an audit firm. So not only do we do external valuations for clients, but we also review valuations performed by our competitors every day to help assist the audit teams. So we're reviewing our competitor's work products as well as producing work products. So we see the good, bad and the ugly all the time. And we see what every other firm is doing out there.

**What is the cost advantage of working with RSM?**

**Vannucci:** Because RSM is the fifth-largest [accounting firm] in the nation, and we're not in the Big Four, we're going to have the same depth of service but yet we're going to be a lower-cost provider in bringing you that same expertise that you need. ■

RSM

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Privcap is a digital media company that produces events and thought-leadership content for the global private capital markets. Privcap Media offers communications services to market participants.

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- **How Detailed Should Your Valuation Policy Be?**
- **The Use of 'Calibration' in Valuations**
- **Valuations and the 'Unicorn' Phenomenon**
- **Expert Q&A: With Chris LaDue and Kevin Vannucci**

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