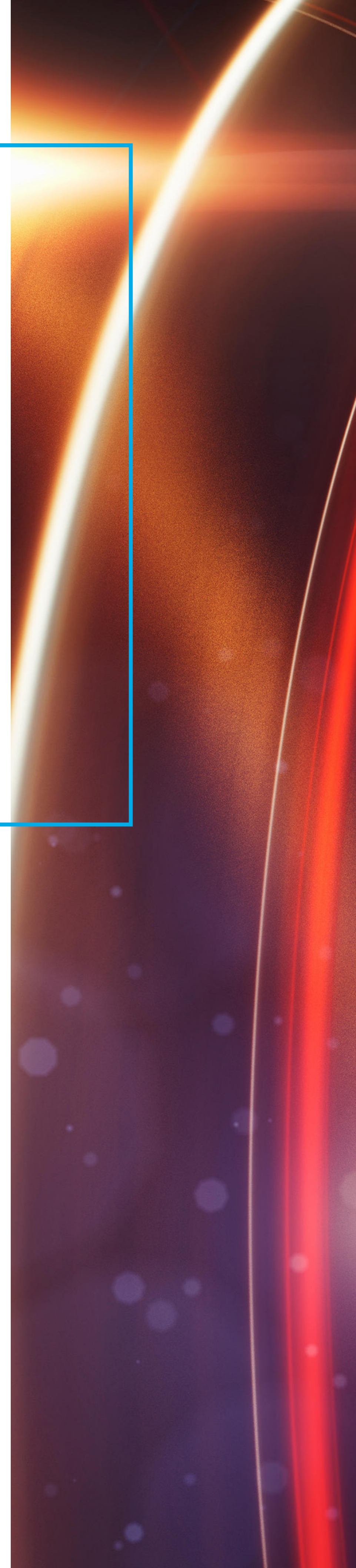
Valuation and PE firms:
Ready for growing scrutiny



Valuation and PE firms: Ready for growing scrutiny?

Recent attention from several quarters has cast a bright light on the private equity (PE) business. From accounting treatments to returns to political rumblings for industry overhaul, PE firms have faced scrutiny of their performance and practices.

Beyond the headlines, private equity's role across the financial landscape continues to grow. PE deal activity has more than doubled in the past 10 years. Meanwhile, the number of companies listed on US stock exchanges has fallen by 50 percent over two decades.

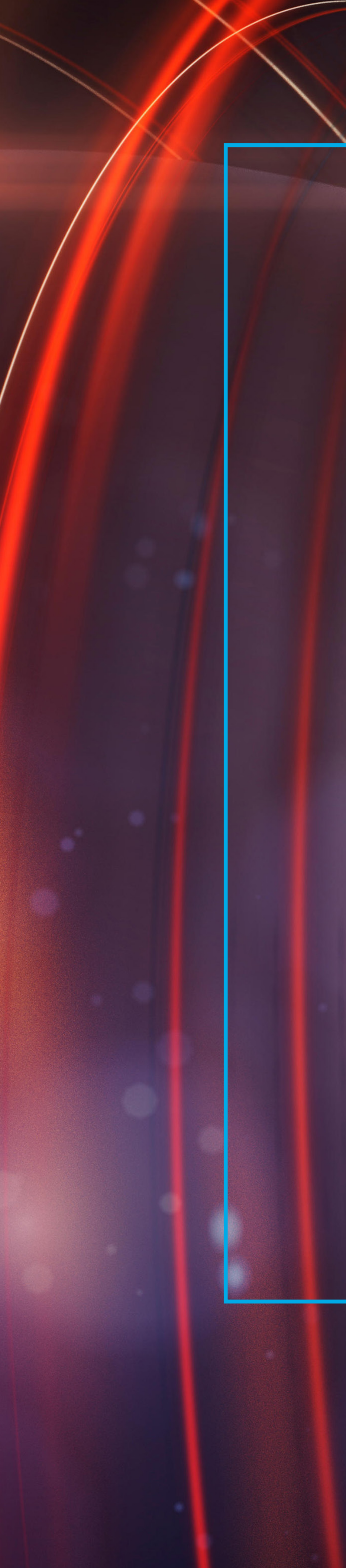
As PE activity expands, so too does investor and regulator interest in how firms establish the value of their portfolio companies. Valuation—what a company is worth today—is arguably the single most important component of PE financial reporting, and it will remain preeminent as the longest US economic expansion in history continues or, sooner or later, wanes. Transparency into how fund managers establish, govern, and carry out their valuation process will be increasingly important to the spectrum of PE stakeholders for the next several years.

Valuation comes to the fore

As an alternative to public listing, a PE firm provides portfolio companies with needed capital, ownership opportunities, and, importantly, the firm's business experience, insights, and guidance to help those businesses pursue growth.

Further fueling interest in the PE world, the Securities and Exchange Commission has signaled it will seek public comment on whether to lower the $200,000 annual income and $1 million net worth requirements for investors in PE funds. While these changes "would likely be years off, if they happen at all," such consideration acknowledges PE firms' interest in greater access to retail investors.

Whatever the arc of such a shift, if it were to occur, firms would face new disclosure, inspection, and review requirements. And whether or not the investor base expands in this manner, over the next three to five years valuations will likely continue to be the most important metrics of PE performance. How will leading firms be setting them? Here are three considerations.



A range of valuation approaches

"We have a process." "We know what it's worth." "It's more art than science." Through the years, these have been familiar responses to queries regarding the modeling of PE investments for valuation purposes. While audit reports for publicly traded companies must comply with standards set by the Public Company Accounting Oversight Board, no such strictures exist for private company valuation.

Absent such requirements, PE firms value their investments in various ways. One accepted approach is the guideline public company (GPC) method, which values similar companies using financial metrics such as price-to-earnings and price-to-book ratios.

Another common methodology, discounted cash flow (DCF), takes a more forward-looking, subjective view. Valuation is assigned based on the company's expectations for business growth.

A third method, comparable transaction, is commonly used to value companies that are M&A targets. This approach examines transactions that involve companies with similar business models to that of the target. Firms can also employ a combination of these and/or other methods. For example, GPC, DCF, and comparable transaction could be calculated, with each assigned a 33-percent weighted value.

An overarching consideration for firms in setting valuations is the need and stakeholder expectation for firms to apply a consistent process period after period. This approach presumes that the outcome should not be a predetermined number. Instead, if the process is solid, the number is simply the number.

For PE firms wanting to strengthen their value processes, help is on the way. In August 2019, the American Institute of Certified Public Accountants announced the release of its new guide, *Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies.* The working draft of the guide and accompanying case studies were released in 2018. Although this is a nonauthoritative document, the guide does provide a framework of acceptable practices for valuing PE investments. Adherence to these protocols could serve a company well when, for example, a fund's limited partner seeks assurance that valuations are well-founded rather than the product of a cursory, "drive-by" analysis.

Benefits of and barriers to third-party valuation

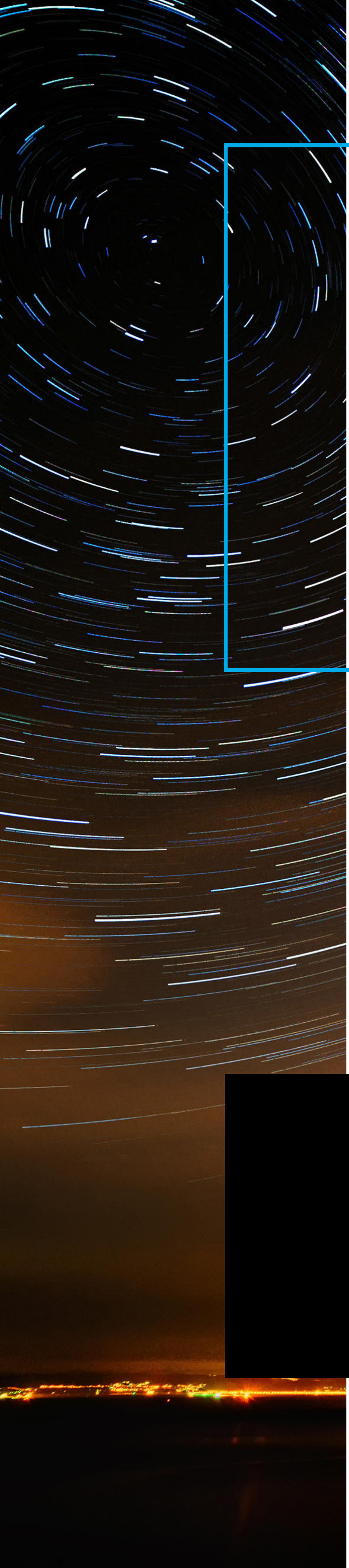
Publicly traded companies are hyperaware of the need to accurately value their third-level assets—assets that are illiquid and difficult to assess, including PE investments. Because Level 3 assets can be major balance sheet items, income generators, and carried interest sources, public companies want to avoid any suggestion or appearance to investors that valuations are being manipulated. For that reason, they routinely outsource valuation to a third party, in some cases alternating the work between multiple providers to strengthen confidence in the numbers.

PE firms, in contrast, rarely seek such outside support. The contrast is somewhat ironic, in that public companies are compelled to keep valuations in line because of regulatory requirements, while private firms, which face no such demands, might benefit from the third-party view. That said, the typically high percentage of PE investors that stay with a firm as it rotates from fund to fund reduces the urgency for fresh valuations.

The importance of operational due diligence

Potential and current limited partners could pose several operational questions in the course of conducting their due diligence on a potential PE investment. What are the firm's valuation policies? Does it conform to industry practice and literature? Does it employ a third-party administrator for accounting services? Does it hire an outside firm to help conduct valuations?

How PE firm leaders answer these questions can be a key factor in earning and maintaining the confidence of limited partners and portfolio company operators over the life of a fund.



Valuation: A cornerstone of PE performance

PE firms can expect increased scrutiny as they expand their portfolios, pursue returns, and cultivate new investors. Valuation provides a clear measure of how well a firm identifies investment opportunities, recruits investors, elevates portfolio company performance, and, ultimately, delivers value. The methods a PE firm employs to arrive at its valuation, the objectivity and transparency of its approach, and the ability to stand up to rigorous operational due diligence will become increasingly important in the next two to three years.

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