Private equity valuations: Best practices and pitfalls

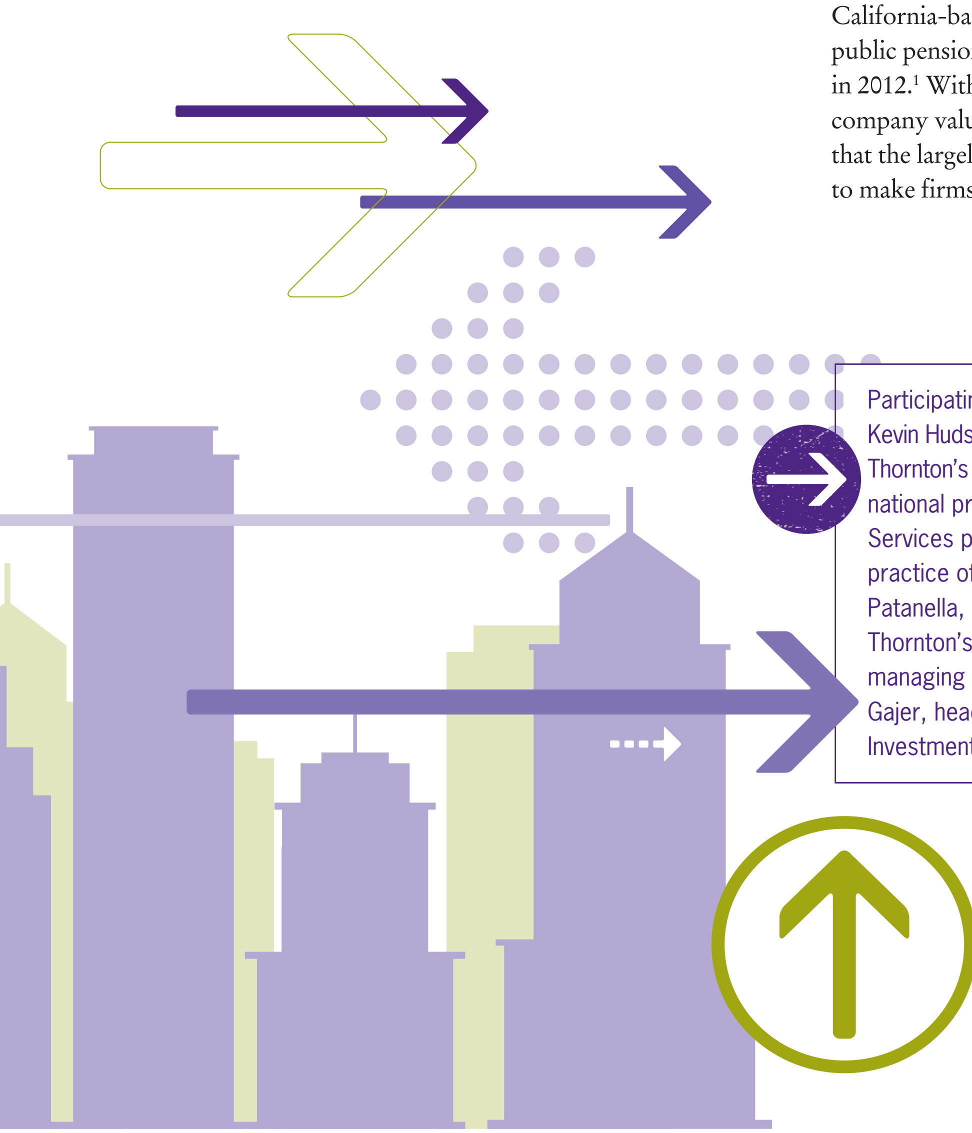
A Grant Thornton LLP 2015 survey

Company valuations are up, and regulators and limited partners (LPs) are taking notice. As a result, the private equity industry will need to provide increasing amounts of transparency regarding valuations, says Grant Thornton's *Survey on Valuations of Portfolio Companies*, conducted in late 2014.

To gain more insight into what private equity firms can do to keep LPs and regulators comfortable with valuation methods, we interviewed Grant Thornton leaders and experienced professionals who evaluate companies on a daily basis. The goal of this discussion is to provide readers with a better understanding of what private equity firms can do to attract less scrutiny and produce valuations that set LPs and regulators at ease.

With leverage levels at a high and private equity firms flush with capital, there's no denying it's a seller's market. These factors, combined with enhanced interest in the private equity space, have been major factors in pushing company valuations up dramatically over the past year. Because a fund's valuation method can have a significant impact on investors' returns and fees, the SEC has increased scrutiny surrounding valuations. Regulators' concerns are twofold: (1) Are firms relying too heavily on prices provided by third-party valuation advisers without fully understanding how they are calculated? (2) Are some managers overly optimistic about the performance or quality of holdings, particularly during fundraising?

As more and more pension funds chase alpha, they are placing capital with private equity firms. According to Cliffwater LLC, a California-based research firm, private equity firms hold 10% of public pension fund assets, or $260 billion, up from $241 billion in 2012.[1] With that much capital flowing into private equity, company valuations are under increased scrutiny. Many believe that the largely self-reported valuation estimates are exaggerated to make firms more attractive to pension managers.



Participating in this white paper's development were Kevin Hudson, managing director and leader of Grant Thornton's Private Equity practice; John Ferro, partner and national practice leader of Grant Thornton's Valuation Services practice and leader of the Fairness Opinions practice of Grant Thornton Financial Advisors LLC. ; Michael Patanella, partner and national sector leader for Grant Thornton's Asset Management practice; David Reiss, managing director at The Riverside Company; and Paul Gajer, head of Dentons U.S. LLP's legacy Private Equity and Investment Funds practices.

[1] Morgenson, Gretchen. "Behind Private Equity's Iron Curtain," *New York Times*, Oct. 18, 2014. See www.nytimes.com for more information.

"Valuations have gotten more attention because virtually all private equity firms are registered with the SEC, and valuations are one of the agency's main areas of focus. They want to see that there is consistency in reporting, especially as funds market their own funds. If all of your portfolio companies' valuations are marked up and you don't have proper documentation, the SEC is going to come down on you," says Paul Gajer. "You don't want to be accused of manipulating your valuations to get LPs interested in your next fund."

The 2008 financial crisis prompted a greater focus on regulatory oversight and due diligence. The Dodd-Frank Wall Street Reform and Consumer Protection Act requires fund managers with assets under management of $150 million or more to register with the SEC as investment advisers, giving the SEC greater responsibility and authority for monitoring fund reporting and controls.

Regardless of whether private equity firms are bullish on valuations, deviations in reporting practices have thrust valuation methods into the spotlight. Although certain methods are widely accepted, the application of these methods varies widely and requires professional judgment. "The fact that there isn't one accepted method always calls valuations into question. To do the job right requires high-level knowledge of finance principles and a deep understanding of capital markets and how transactions are negotiated and executed," said John Ferro. "The best thing private equity firms can do to ward off accusations is to be transparent in how they derived their valuations."

Transparency and consistency are steps in the right direction, but regulators are increasing scrutiny of the private equity industry and its reporting practices in general. Since the Great Recession, the SEC has been taking a closer look at fees, compliance and valuations practices. For example, Nathan Baskerville, a Democratic state representative from Vance County, N.C., supported a bipartisan bill that would have required the state treasurer to disclose all relevant documents involving the state's private equity investments — the $90 billion Teachers' and State Employees' Retirement System pension has almost 6% percent of its funds in private equity deals. The transparency bill did not pass the general assembly before it adjourned for the summer. Baskerville says he intends to revive the bill this year.[2]

"These types of issues seem to keep coming to the forefront," says Kevin Hudson. "Regulators and politicians are unlikely to forget about private equity because so much money is flowing into the sector now."

"Limited partners also want greater transparency," says Michael Patanella. "For a number of years, LPs have felt their alignment with GPs [general partners] has been diverging. To deal with the alignment issues, the Institutional Limited Partners Association (ILPA) put out updated Private Equity Principles, a set of best practices for private equity firms." More than 100 LPs have endorsed the principles, which address three guiding tenets: governance, transparency and alignment of interest.

[2] *Ibid.*

ILPA's Private Equity Principles

In 2011, ILPA updated its Private Equity Principles, a set of standards geared toward improving relations between LPs and GPs. The principles pertaining to valuation methodologies include:

- The auditor should present their view on valuations and answer questions at the fund's annual meeting. "Understanding how the auditor validates valuations and the valuation process can help GPs better understand valuation risks," says Patanella. "The auditor can also share best practices with respect to policies, procedures and controls, which will go a long way in helping assure oversight is effective."
- The auditor should review the capital accounts, paying special attention to management fees, partnership expenses and carried interest calculations in order to provide independent verification of distribution to GPs and LPs.
- LPs should be able to review the methodologies used for portfolio company valuations, and in some cases, approve the valuations themselves.
- Avoid clawback situations: Conduct a net asset value coverage test (generally at least 125%) to ensure a sufficient margin of error on valuations.
- If valuations change from one quarter to the next, GPs should be able to provide an explanation for the fluctuations.
- A fund should provide quarterly reports on each portfolio company, including valuation and methodology information. Each report should include:
  - The initial investment amount (including loans and guarantees)
  - Any additional investments in the portfolio company
  - The fund manager's summary of recent events
  - Selected financial information (by quarter and year), including:
    - Revenue (debt terms and maturity)
    - EBITDA
    - Profits and losses
    - Cash position
    - Cash burn rate

Source: Institutional Limited Partners Association

Best practices

It is important to have procedures in place to mitigate risk. "The industry is moving toward more checks and balances. The top-tier private equity firms are putting valuation methods in place that are easily communicated and can be applied on a consistent basis," says Ferro. "Someone should be able to take the valuation report and recreate your value based on standard valuation methodologies and documentation."

Written valuation policies

The good news is that according to Grant Thornton's valuation survey, 94% of respondents have a written valuation policy, which should make communicating and repeating methodology practices easier.

Consistency is important. While private equity firms may use discretion with regard to their valuation methods, they need to track which approaches they have used and stick with them quarter after quarter. Keeping track of which methods are used will instill confidence and help streamline the valuation process.

"It's very important to use the same approach each quarter and to ensure that the committee is looking at the same underlying materials every single time. Most of the people on the committee have a day job and it's easy to lose sight of what has been done in the past. It is important to be consistent over time," says Paul Gajer.

Private equity firms also need to implement reporting policies that are consistent with regulatory requirements. U.S. GAAP — specifically, ASC 820, *Fair Value Measurements and Disclosures* — requires fair value measurements of disclosures and provides a single framework for measuring fair value and related disclosures. ASC 820 defines various terms, such as the seller's perspective, market participant and orderly transactions, to help private equity operators address fair value issues.

"Riverside follows a well-defined and transparent valuation methodology on a quarterly basis across all fund families. The valuation methodology clearly outlines the protocol and hierarchy that are utilized in order to support a consistent valuation approach from a U.S. GAAP perspective. The valuation methodology uses the most appropriate criteria for valuing an investment, which generally entails a market approach if there are sufficient relevant market comps available, and if not, an income approach," says Dave Reiss.

Standard methodology

When considering the value of a portfolio company, historical financial statements are insufficient; a private equity firm also needs to understand the company's economic, geographic and business conditions. Other important factors include management strategy, operational expertise, competitive landscape, changing technologies and cash on the balance sheet. The price of recent investments, multiples, net assets, future cash flow, earnings predictions and industry benchmarks should also be considered.

"Historical financials are not enough. There are situations where the financial performance of a company didn't really improve, but there was an increase in the valuation because of favorable market dynamics — meaning companies in the space were trading up. It happens," says Gajer.

The price of recent investments is generally the most reliable piece of information. However, that information is not always available, so an alternate valuation methodology may be required. The use of appropriate alternative valuation methods would include consideration of **both** historical performance and future financial performance expectations.

There are certain factors to keep in mind when evaluating a company. According to Grant Thornton's valuation survey, 53% of respondents feel market volatility or liquidity are key risk factors. About 40% of participants worry about the reliability of data provided by outside parties.

"Regardless of risk factors, multiple methods used should result in similar values," says Ferro. "It's crucial to perform the analysis using multiple valuation approaches and financial metrics and then reconcile and explain any differences."

Core competencies

Across the board, survey respondents widely indicated the use of multiple valuation methods. However, the fact that results for the DCF method and the public multiples method differ — and that both values are not closer to 100% — indicates room for improvement. This is not to say that every valuation necessitates multiple approaches; rather, the results underscore the need for clear and consistent documentation, another area where the survey indicates respondents can do better.

Chart A: Multiple methods in play
What valuation methods are typically utilized in your valuation analyses?

Recent transactions in the subject asset	69.2%
Discounted cash flow method	76.9%
Public multiple method	87.2%
M&A transaction method	70.5%
Other	6.4%

N = 78 *Respondents were able to select more than one answer.
Source: Grant Thornton's *Survey on Valuations of Portfolio Companies*

Chart B: Room for improvement
Which of the following do you document and report?

Volatility/change in valuation markets throughout holding period	55.6%
Accuracy of the most recent valuation mark against the exit transaction price	32.1%
Models/methodologies used in the valuation process	81.5%
Divergence from establshed methodologies, with explanation	63.0%
Change in approach or model used from prior valuations	72.8%
Portfolio company information	90.1%
Market comps for asset (e.g., state of development, size, growth and profitability against comparable companies)	85.2%
Independent support of assumptions (e.g., growth, EBITDA margin, capex)	49.4%
Independent support for growth rate	27.2%
Independent support for discount rate	25.9%
Year-over-year change in valuation for specific asset	61.7%
Other	1.2%

N = 81 *Respondents were able to select more than one answer.
Source: Grant Thornton's *Survey on Valuations of Portfolio Companies*

Form a committee and hire experienced professionals

Instituting an advisory board or committee is a good idea. It can provide oversight, transparency and support if conflicts of interest arise. This kind of structure is becoming more common: 34% of survey participants have a fair value committee that is ultimately responsible for the reporting process, and almost 70% rely on an advisory board at some point during the valuation process. Ideally, a valuation committee should be comprised of people both inside and outside of the firm.

Some firms prepare the valuations internally, while others outsource this function. Nearly 35% of survey respondents engage external advisers for asset valuations (see Chart 2). Of those companies, 38% do so on a case-by-case basis, while 48% outsource all of their valuation work (see Chart 3). Those who retain third-party valuation and pricing specialists prefer to stick with the same adviser across valuations (see Chart 4) and prefer to review the qualifications and performance of those advisers at least annually, with 24% performing quarterly assessments (see Chart 5).

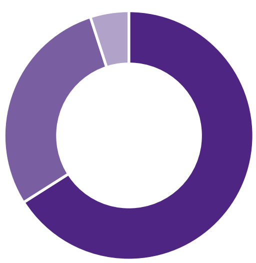
Chart 1: Fair Value Committee participants
What is the composition of the Fair Value Committee?

CFO/controller	72.6%
Portfolio managers/analysts	67.7%
Chief compliance officer	51.6%
Legal	19.4%
Fund administration/fund accounting	16.1%
Audit committee members	14.5%
Chief risk officer	9.7%
Business development strategy executive	6.5%
Other	25.8%

N = 62 *Respondents were able to select more than one answer.

Chart 2: Internal vs. external resources
Do you utilize outside resources for portfolio valuation?

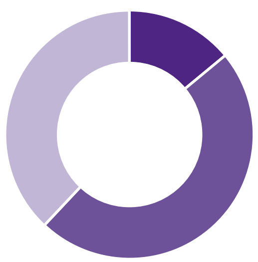
- No, valuation is conducted internally **65.6%**
- Yes, valuation is conducted internally with support from external advisers **28.9%**
- Yes, valuation is conducted by external advisers **5.6%**



N = 90 *Responses may not total 100 due to rounding.
Source: Grant Thornton's *Survey on Valuations of Portfolio Companies*

Chart 3: When are firms retaining external advisers?
Under what circumstances are external valuation advisers retained?

- For the largest and more complex investments **13.6%**
- For all investments **48.3%**
- For foreign investments in territories where we have little experience **0.0%**
- Case by case, as needed **37.9%**



N = 29
Source: Grant Thornton's *Survey on Valuations of Portfolio Companies*

"Having outside members on the valuation committee is crucial," says John Ferro. Yet, two-thirds of survey respondents state that their valuations are prepared internally without external help. "Having the same people who invested in the fund approve the valuations is not a best practice. In addition, an external voice may add a unique industry perspective that can be immensely helpful," says Ferro.

Engaging an independent third-party valuation provider can also benefit private equity firms. While many firms question the reliability of data and information provided by outside parties, working with a reputable appraiser who is familiar with ASC 820 requirements could ease the valuation process and make LPs feel more confident about the information presented.

"Many private equity firms feel that they have a better understanding of their own markets than a third-party valuator that is taking a 30,000 foot view. However, it's still valuable to get outside input and balance that against internal firm knowledge," says Gajer. "Private equity firms must do their homework to make sure they are working with reputable companies — make sure to hire teams with extensive appraisal and capital markets experience," says Ferro. "It's important to note that even if a third-party service provider is used, private equity firms are ultimately responsible for understanding the valuation."

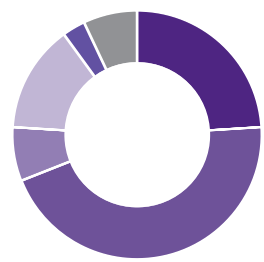
Chart 4: Continuity matters
Under what circumstances are external valuation advisers retained?

- Yes, we typically use the same valuation adviser **65.6%**
- No, we tend to work with multiple valuation advisers **34.5%**

N = 29
Source: Grant Thornton's *Survey on Valuations of Portfolio Companies*

Chart 5: Quality control
How frequently does the firm formally review and approve external valuation adviser qualifications and services?

- Quarterly **24.1%**
- Annually **44.8%**
- Biannually **6.9%**
- No review **13.8%**
- Other **3.4%**
- Not sure **6.9%**



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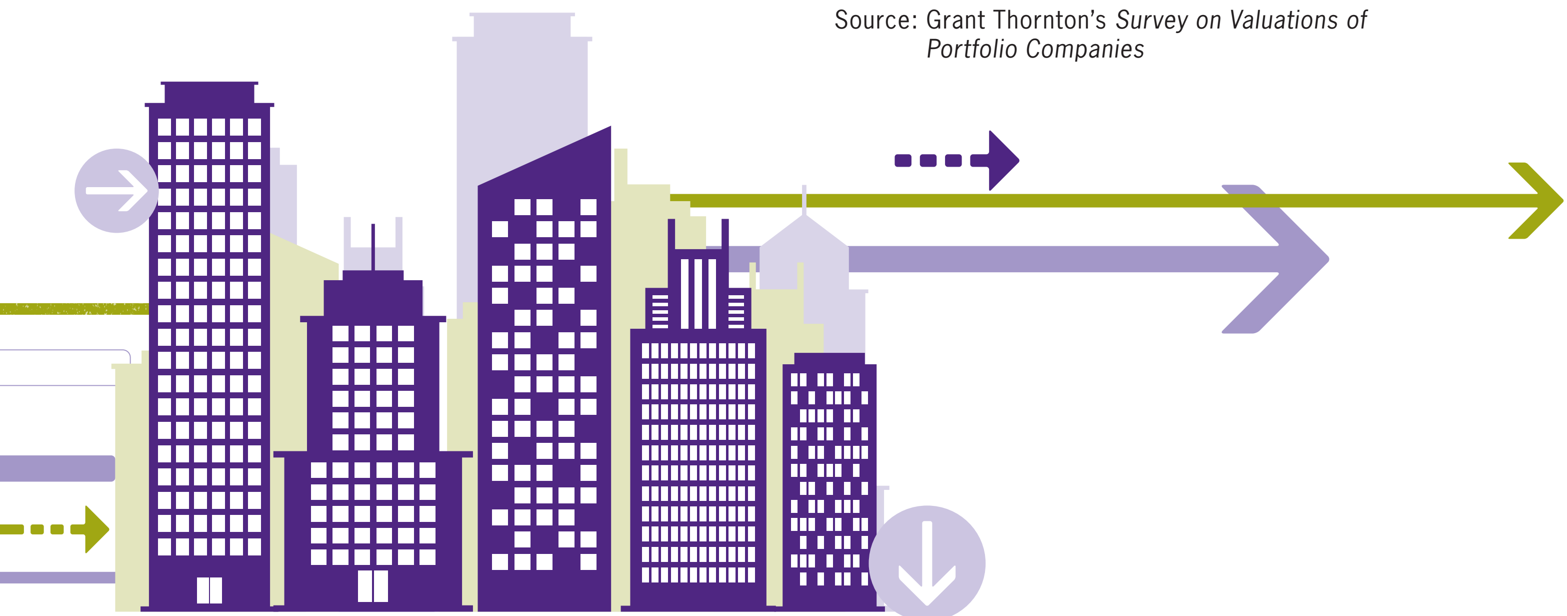


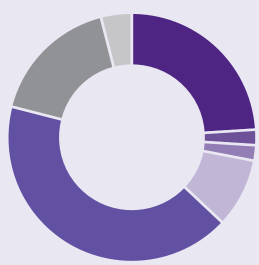
A closer look at valuation policy

Respondents indicate that responsibility for maintaining effective valuation policies and procedures rests largely in the hands of the CFO or controller (42%), with nearly 25% of firms indicating that the buck stops at the chief compliance officer. Just over half of firms cite changes in market trends, asset mix or other fund-related factors as the key contributors driving valuation policy updates.

While facts and circumstances will change with the market, an effective policy hinges on transparency and consistency and implements a tiered approach to reviews and approvals.

Chart A: Taking the lead
Who is primarily responsible for reviewing the valuation policies and procedures to ensure that they are effective?

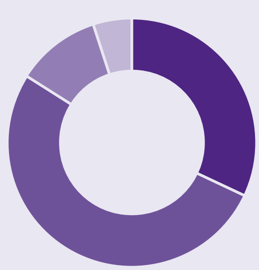
- Chief compliance officer **23.8%**
- CEO **2.4%**
- Board of directors **2.4%**
- Fair value committee **9.5%**
- CFO/controller **41.7%**
- All partners of the firm **16.7%**
- Other **3.6%**



N = 84
Source: Grant Thornton's *Survey on Valuations of Portfolio Companies*

Chart B: Key drivers affecting policy
What key factors drive your valuation policy updates?

- Discussions/comments during audit review **32.1%**
- Changes in market trends, asset mix, other fund-related factors **52.4%**
- Committee's review of PCAOB inspection reports, SEC speeches, SEC comment letters on comparable funds **10.7%**
- Other **4.8%**



N = 84
Source: Grant Thornton's *Survey on Valuations of Portfolio Companies*

Build your own database

It's important for private equity firms to evaluate their historical performance. Looking at sale prices versus estimates can be very helpful. "This data can tell the general partners if their valuations are typically on target, too aggressive or too conservative," says Ferro. "It's still an important data point to assess management's prior track record in developing realistic and supported values." This data can be invaluable in helping firms attract new investors.

In addition to helping firms provide more accurate valuation practices, this data can go a long way with regulators and limited partners. "It can prove your methodology is sound and that you are valuing your portfolio appropriately," says Hudson.

The private equity firms that will fare well going forward are the ones that have a balanced valuation committee, apply uniform valuation standards, solicit outside help when needed and collect data to help them understand their processes. "Transparency will go a long way with investors and regulators," says Ferro. "Most private equity firms are not practicing all of these necessary steps. There are a few that are raising the bar and many more that will hopefully follow."

Best practices checklist

- ✓ Consistent use of a standard methodology
- ✓ Compliance with ASC 820 requirements
- ✓ Strong communication with investor base
- ✓ Balanced valuation committee comprised of internal and external members
- ✓ Data record for future use

Contributors

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