Locking in value

How can firms ensure their valuation processes meet the needs of their investors while keeping the regulators happy? Claire Wilson gathered six experts to find out

photography by MARK BYRON
Private funds managers have been forced to up their valuations game. The Securities and Exchange Commission first asked whether firms were inflating valuations to attract investors when marketing new funds in 2011, and has kept up enforcement action against firms it believes do not have a robust policy in place.

So how do firms comply with the SEC’s demands, while reporting effectively to their limited partners?

Six years after that initial flare was sent up, the six experts we gathered for our roundtable agree the valuations process is one area of private fund compliance that has been more or less mastered.

“It’s coming up to the five-year anniversary of SEC registration, and we’ve come a long way and arrived at a place where we’re very serious about valuation policy, we have robust models, we talk with the deals guys, sometimes we make adjustments to the models,” Blinn Cirella, chief financial officer at Saw Mill Capital, says.

“Speaking from an auditor’s perspective, we are seeing more detailed written valuation policies and more consistency in following the valuation policy.

“Five years ago that might not have been the case. There is a better understanding by the funds that they need to have a detailed valuation policy and follow it on a consistent basis. This was easier for the larger funds. They had the resources to tackle the issue and were quicker to adopt the new procedures. Smaller funds took longer to implement the necessary policies and procedures,” says Tom Angell, an
audit partner at Withum’s financial services group.

Cirella and fellow roundtable participant Joshua Cherry-Seto are on the Association for Corporate Growth’s private equity regulatory task force. Progress is being made there, too.

“ACG PERT has written a best practices guide, which includes valuations. The process included surveying over 40 PE chief financial officers, circulating a summary of the survey results and seeking feedback from the industry. Initially, there was a lot of writing, but the final output would imply the industry has figured it out because the write-up was two and a half pages,” Cirella says.

“The ACG PERT principles, including guidance around valuations, was circulated for public comment, and the first official version is expected to be released in February at the ACG Middle Market Public Policy Summit in Washington DC,” says Cherry-Seto.

When it comes to methodologies, the participants say there are several a team can use to calculate the worth of their portfolios.

Speaking generally, David Larsen, a managing director for Duff & Phelps, says: “Investing is the GP’s bread and butter. Valuation uses the same inputs that deal teams used to determine the price they paid at entry and the inputs used to monitor the investment during the hold period.”

Angell agrees with Larsen: “Six years ago there were funds that we would audit that ask, ‘what model would you like us to use?’ We would tell them to start with the model they used to determine the price they should pay for the target and follow that consistently year to year. I am seeing a change in the marketplace. Funds are now starting with their deal team inputs at entry.”

Method acting

Cirella says her firm uses three valuation models, because it believes averaging the outcomes is better, and the best way to avoid manipulation.

Lower mid-market firm LLR Partners’ chief financial officer, Noah Becker, says: “We compile a summary of key assumptions for the portfolio quarterly, including such items as multiples, EBITDA margins and revenue compound annual growth rate. The finance team and our internal valuation committee review the summary and find it to be a very helpful part of the process.”

Cherry-Seto says there are some outstanding methodology matters, however: “There are still issues with ignoring the reality of closing costs. Discounted cashflows in any analysis would include these as essential to creating the market for an exit, and four or five years out you can back these costs into the multiple assumption used. When the transaction is near and known, the only place for it to go is to bury it in the execution risk discount with a knowing wink and nod from the auditors.”

While the roundtable participants say they have more or less established

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Lindsay Hill
their valuations process, external experts are being asked for advice.

“We still receive questions on the valuation methods that have to be used or we encounter clients that apply multiple valuation methods because they think they have to. This is not the case. You need to use the valuation methods that will result in the most reliable indication of value,” says Lindsay Hill, director, US valuation services, at RSM.

Larsen outlines what a limited partner is looking for when it comes to valuations. “From an LP entity perspective, they need all assets reported at fair value to determine asset allocations, manage risk and exercise their fiduciary duty. It’s not helpful or appropriate for the LP to hold a portion of their total portfolio at cost, while the rest of their portfolio is

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Tom Angell

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<tr>
<td><strong>Tom Angell</strong> is an audit partner in Withum’s financial services group in the New York office. Angell has more than 25 years’ experience providing audit, tax and consulting services to private equity funds. He advises funds and investment advisors on all aspects of private equity transactions.</td>
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<td><strong>David Larsen</strong> is a managing director in the San Francisco office of Duff &amp; Phelps and part of the portfolio valuation service line. With more than 30 years of transaction and accounting experience, he specializes in valuation, accounting and regulatory issues.</td>
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<td><strong>Joshua Cherry-Seto</strong> is the chief financial officer at Blue Wolf Capital, a mid-market private equity firm focusing on control investments. He is actively involved with multiple mid-market private equity groups and initiatives, including a handful established by the trade body Association for Corporate Growth.</td>
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<td><strong>Blinn Cirella</strong> is the chief financial officer of Saw Mill Capital, a manufacturing, industrial, and commercial services-focused private equity firm which invests in mid-market companies. Cirella manages the financial administration of the firm and its back office.</td>
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<td><strong>Lindsay Hill</strong> is a director at RSM, an audit, tax and consulting practice with a dedicated valuations team. She has 10 years’ experience with the firm, advising companies on valuation and finance-related issues for financial reporting, management planning, and tax planning and reporting.</td>
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<td><strong>Noah Becker</strong> is the chief financial officer at LLR Partners, a lower mid-market private equity firm providing capital and strategic guidance to growth companies in the software, tech-enabled services and healthcare sectors.</td>
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reported at fair value. Pressure is increasing on LPs to demonstrate that they have undertaken procedures to ensure that the GPs’ valuation process is rigorous and robust. One way to save the LP extra effort is when the GPs’ fair value estimates are validated by an experienced third-party valuation specialist.”

As Larsen points out, the SEC is generally more focused on whether a manager follows the procedures they told their LPs they would follow, not necessarily on the conclusion. This means documenting the process is extremely important.

But he adds: “During some examinations, the SEC has asked for all versions of quarterly valuation estimates. Given that valuation requires judgement, interim valuation considerations prior to being finalized, may not be informative.”

Hill sets out what is useful in the documenting of a valuation process: “We don’t need to know about every consideration and every conversation that led to the ultimate value conclusion and neither does the SEC. We need support for the conclusion – how were the methodologies selected and why; what is the support for the key assumptions like discount rates or market multiples; how has the valuation changed over time and why do those changes make sense?” she says.

She adds: “Give enough information for us to recreate the valuation. At the end of the day, we don’t care about how many times you might have gone back and forth on a 5x EBITDA multiple versus a 6x EBITDA multiple, but we need to know why you decided on the 6x EBITDA multiple.”

**Limited vision**

Cirella demonstrated how documenting the process has changed: “Our 2007 fund required the limited partner advisory committee be presented with valuations and allowed 20 days to opine and dispute. The full valuation model, in Excel, is sent to each member for their review. Approval is not required, but we seek it anyway for record-keeping. Under the terms of the new fund’s LPA the LPAC does not disapprove or approve values.”

LLR Partners’ summary is presented to the LPAC every quarter, Becker says: “This supplements the qualitative and quantitative updates given by the partners. We believe that this provides a good way for the limited partner advisory committee to understand our thought process, and assess the reasonableness of the valuations.

“Using the most currently available information from the portfolio companies, you can complete quarterly valuations quickly, usually in 10-15 days or less. Essentially you’re doing the valuations with the same information that a market participant looking to acquire or invest in the portfolio company would use.”

The process is slightly different for growth companies. “We use a rolling
forecast for the discounted cashflow since with each quarter that passes the valuation naturally increases or decreases, based on replacing the just-completed quarter in the DCF, with the quarter five years out. In addition, rolling the date at which the terminal value is calculated impacts the valuations. If we did not use the rolling method, we might end up with very little change in the first to third quarters and then significant change in the fourth quarter which is counter to the purpose of doing quarterly valuations,” he adds.

While confidence in processes has increased, checking it is robust is vital. “Backtesting helps the GP improve their valuation process and helps the LP conclude that their GPs have strong valuation procedures. If there is a ‘pop’ in exit value compared to the prior fair value estimates, the GP should be able to explain why!” Larsen says.

“The general perception is there are problems with pops in the exit value,” Angell adds. “As an auditor I want to know the specific reasons for the pop. Audit backtesting looks at whether there were incorrect unobservable inputs, something strategically in the market place caused the increase or there was a problem with the overall valuation process. We want to learn along with the GPs how they can improve their process.”

LLR Partners takes things back four years, says Becker: “We looked at the schedule for the past four years of exit, and the quarters leading up to the sale. Our marks were fairly reasonable, which helps both us and our LPs gain confidence in the marks and the process behind them. With auditors, backtesting is a two-way process and the auditors use it in a similar manner to the LPs to assess our marks but they also use it to refine their process and their assessment of our current marks.”

Auditors have also changed their approach to calibration. “More and more, we aren’t trying to get our PEG clients to fit their valuations into a black and white model; we’re stepping into their shoes as investors and thinking about how we would transact, how we would buy or sell the investment,” Hill says.

There are also some issues that frequently arise regarding completed valuations, as Hill explains. “Clients will still come to us with ‘conservative’ valuations. They think it’s better to have a conservative value than to overstate value. However, neither a conservative valuation nor an aggressive valuation are fair value. Neither are correct.”

This view is shared by Angell: “Conservative is now considered not right. The emphasis is on evaluation.”

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David Larsen