ROUNDTABLE

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# How the secondaries market changed valuation

*Valuing a private equity investment is still more an art than a science, but the artists feel they are increasingly being watched, five experts tell Marine Cole*

When ride-sharing company Uber Technologies announced its intention to go public in the spring of 2019, the company, which was worth $76 billion based on the private investments it had received over the years, was seeking a valuation of up to $100 billion. It therefore came as a surprise to many when its May initial public offering ended up valuing Uber at $82.4 billion, well below the $120 billion some bankers had suggested at one point. It also reminded financial markets of the subjective nature of companies' valuations.

As the private equity market continues to expand, the focus on valuations has become front and center, impacting the work of chief financial officers, valuation specialists, auditors and accountants.

In January, five valuation experts gathered in New York to discuss recent developments affecting the way they value private equity portfolio companies. They were Tom Angell, a partner at WithumSmith+Brown; Douglas Burrill, a principal and the head of valuations at Apollo Global Management; Blinn Cirella, CFO at Saw Mill Capital; April Evans, a partner and CFO at Monitor Clipper; and Mark McMahon, a managing director at Alvarez & Marsal.

They agree that trends as varied as the growth of the secondaries market, LP demands for greater transparency and over-valued companies, particularly pre-IPO unicorns, have all influenced work around valuations, the way valuations are calculated and best practices.

In less than a decade and due to its rapid growth, the secondaries market has emerged as one area valuation professionals have been paying close attention to, as this new source of liquidity has placed private equity valuations under the microscope.

The volume of secondaries transactions grew to $88 billion in 2018, an all-time high, and up from $28 billion only six years

PHOTOGRAPHY: **BRIAN SHUMWAY**

**Mark McMahon**

Managing director at Alvarez & Marsal

McMahon is the global practice leader of Alvarez & Marsal valuations services and also leads the alternative investment services group. He specializes in the valuation of illiquid securities and interests across various strategies and alternative asset classes. He previously served as managing director in the alternative asset advisory practice of Duff & Phelps.

**Blinn Cirella**

CFO at Saw Mill Capital

Cirella is CFO at Saw Mill Capital, which was founded in 1997 and invests in lower mid-market companies. She manages the financial administration of the firm and its back office, including LP reporting, accounting, and audit and tax preparation. She previously served as director of BISYS Private Equity Services and controller at Commonfund Capital.

**Tom Angell**

Partner at WithumSmith+Brown

Angell is the practice leader of Withum's Financial Services Group based out of the firm's New York office. He has more than 35 years' experience serving a diverse client base including private equity, venture capital, hedge funds, fund of funds, investment advisors and regulated funds. He is known as a thought leader in the private equity industry and has presented at many industry events.

**April Evans**

Partner and CFO at Monitor Clipper Partners

Evans joined lower mid-market firm Monitor Clipper Partners in 2005. She oversees finance, accounting and tax work, among other areas, at the firm. She previously served as the CFO of Advanced Technology Ventures. Previously, she was also a founding partner at accounting firm Squillace & Evans.

**Douglas Burrill**

Principal and head of valuations at Apollo Global Management

Burrill joined Apollo Global Management in 2011. The alternative asset management firm invests in private equity, credit and real assets and has $331 billion in assets under management. Burrill previously worked in merchant banking at Goldman Sachs and research equity at Merrill Lynch.

prior in 2013, according to data from advisory firm Greenhill & Co. Along with that growth, more mid-market funds and even lower mid-market funds are the subject of secondaries transactions.

One of the effects of the growth of that market on valuations comes from the fact secondaries buyers price their investments based on the net-asset value of a fund and its underlying portfolio companies, typically at a premium or at a discount.

## Secondaries' weight

"The maturation of the secondaries market is huge," says Evans. "It gives LPs a liquidity option and a rebalancing tool. It is very different from a decade ago. The demands on my team are large in this regard."

She explains that an LP in one fund was pursuing a secondaries transaction at the time of the roundtable and had recently submitted a four-page questionnaire to complete with detailed questions concerning tax position issues. "This after already completing extensive diligence requests regarding the selling LP's capital account activity and value, as well as full fund history," she says.

*"There is an inherent conflict of interest when the GP is both the seller and buyer in the transaction"*

**TOM ANGELL**
**WithumSmith+Brown**

"A challenge I often hear that CFOs face is the continued expansion of the secondaries market," adds McMahon. "This process often introduces a whole new level of due diligence that taxes many of the finance function's resources."

With the growth in secondaries volume, valuations are also being scrutinized more frequently than they used to be, that in turn has created new responsibilities for auditors and valuation specialists who are being called to assess investments in funds being transferred in secondaries transactions and to provide fairness opinions.

"Managers are often concerned about secondaries transacting at value that implies a large premium or a discount to their stated marks," says McMahon. "These concerns will sometimes necessitate the advice of a valuation firm to help ensure policies and procedures are appropriate, implemented properly, and ultimately effective."

Evans elaborates on GPs' views regarding pricing levels at which fund stakes trade.

"GPs are increasingly interested in

seeing their positions not trade at either a premium or a discount, which is, I would think, virtually impossible because the seller has a whole raft of reasons for pursuing the sale. And if it's normal course, they're not going to take a discount, but if they have a liquidity need, then they are going to take a discount just to generate cash in their portfolio," she says. "That has nothing to do with the value of the portfolio." She adds that different secondaries buyers will have different hold period plans and return expectations.

The bulk of secondaries transactions consist of the sales of LP fund stakes, but GP-led secondaries also represent an increasing part of that market and managers need to tread carefully when it comes to valuing their assets to avoid conflicts of interest.

Angell mentions that the Securities and Exchange Commission has issued several enforcement actions in recent years on that very topic and continues to pay close attention to the matter. "There is an inherent conflict of interest when the GP is both the seller and buyer in the transaction," he says.

Cirella notes that her firm conducted a secondaries transaction concerning a distressed asset in an old fund that was eventually bought out by her newer fund. "The transaction took a long time to close as every single co-investor in the holding company had a say and there were over 60 co-investors," she adds.

### More scrutiny, less responsibility

The pressure on valuation specialists is also coming from limited partners, who for several years now have increasingly been wanting to know and understand the valuation process, guidelines and best practices GPs follow.

However, LPs are also making clear that they don't want to have any responsibility regarding final valuations. "They want to

*"Increasingly, LPs are less comfortable ratifying valuations"*

**APRIL EVANS**
**Monitor Clipper**

be on the LP advisory committee for the transparency this gives them," Angell says. "It seems to be a trend lately that they will no longer sign off on valuations as they had in the past. It appears they just don't want to be on the hook."

The CFOs around the table confirmed that trend. Monitor Clipper, for example, holds a valuation call once a year with the advisory board to ratify valuations. Its LPs also ratify the firm's valuation policy at the beginning of the fund's life and anytime there are changes. "There's always a good discussion, but increasingly, LPs are less comfortable ratifying valuations," Evans says.

Cirella adds: "In our new fund, the only role for the advisory committee is just to approve the policy and they don't want to have anything to do with looking at the valuations." She notes that in contrast, concerning Saw Mill's previous fund, which was raised in 2006 and 2007, she sends valuation models annually and LPs have 20 days to disapprove the valuations.

"The appetite amongst LPs is still very high," says Burrill. "I think LPs in general are getting more sophisticated around valuation, understanding what their role is, deciding what their involvement needs to be and their individual requirements. More and more, we hear of auditors asking LPs how they get comfortable with the valuations provided by GP's. All in all, the attention level is increasing."

Cirella explains that she tends to avoid one-off reporting practices and special treatment of LPs. Instead, in the instance that an LP is making an unusual request and she agrees to it, she then grants it to all the fund's LPs to avoid constant one-off reporting or being seen as giving preferential treatment to any one LP.

"I usually try to take the highest best practice and spread that," she says. "If someone is asking for something special, then you incorporate it in your reporting, and it becomes a best practice."

*"Analysis often involves reconciling the metrics implied by the most recent financing with comparable observations and getting comfortable with those differences"*

**MARK McMAHON**
**Alvarez & Marsal**

### Reconciliation

Although valuations are inherently subjective in nature, at times the discrepancy between the valuation of a privately held company and what investors would actually pay for that company in a secondary

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>
> **DOUG BURRILL**
> **Apollo Global Management**

## A common language for valuations

**Six months after the American Institute of CPAs issued the final version of its accounting and valuation guidance, participants to the roundtable applauded the outcome of years of discussion around how to best fair value portfolio companies.**

Released in August, the guide, titled *Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies*, is intended to harmonize the industry's views on valuation work among investors, auditors and valuation specialists.

The goal of the AICPA guide, which is not compulsory, was to provide professionals with a common language – and it seems to have reached it. In particular, the guide was successful in taking into account the subjective nature of valuation work and refrained from issuing a simple single formula.

"Now valuation practitioners are all talking the same language and we have a common set of guidelines to point to," says Burrill. "I think the best thing the guide did was, through the examples, demonstrate adequately that there's no right answer and that different views and perspectives pertaining to individual situations matter. I think it did a really good job of building that case, that practitioners can look at things through the different lenses of their individual holding and exit strategy and come up with different yet appropriate conclusions."

This is a reminder that valuation work doesn't equal price making, but instead consists mainly of values and judgments based on specific circumstances. As such, after several years of comments and hundreds of pages of guidance, the AICPA guide has emerged as a tool that GPs, LPs and practitioners can use to point to in support of their conclusions.

"We don't see people quoting pages out of this guidance at every opportunity," says McMahon.

"I look at it thematically in that it achieved some important goals. It introduced a healthy dose of realism to valuation in response to situations where people can get bogged down in mechanical processes that look great on paper but don't necessarily give you a realistic answer. In my view, this guidance tries to steer practitioners more toward what ultimately makes sense by balancing valuation techniques and conclusions with the reality of what managers invest in and why."

### Wide acceptance

The guide tackles accounting and valuation issues that have emerged in recent years, including transaction costs, backtesting and the impact of control and marketability, to assist investment companies in addressing the challenges in estimating fair value of their investments. It also includes 16 case studies that can help investment fund managers, valuation specialists and auditors to reason through real situations.

Burrill concludes that after several months of getting acquainted with the guide, it has almost fallen out of the conversation thanks to its wide acceptance.

"The guide was released, everyone did a gap analysis to see where they should be versus where they are today and how much they're going to move closer to the ideal, and that was the bulk of the conversation that needed to take place," he says.

"It's not something we're talking about every single quarter on every single investment anymore. It's a roadmap that if we need it, we can pull it out of the cupboard and use it to inform us on best practice for particular issues as they arise. Otherwise, we all see the road ahead of us now and we are all talking around the same guiding principles."

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**BLINN CIRELLA**
**Saw Mill Capital**

sale or a public offering can be wide. It has been the case with pre-IPO venture capital-backed companies such as Uber. Another well-publicized unicorn, WeWork, had a private valuation of $47 billion at the beginning of 2019. When it filed to go public in the summer, the regulatory filing revealed questionable corporate governance practices and that the company was burning through cash quickly. It was targeting a valuation between $20 billion and $30 billion for its IPO. Following further revelations of problems at the company, it delayed its IPO indefinitely.

Meanwhile, as emerging market private equity firm Abraaj Group was accused of misappropriating money, it was also alleged that the firm had reported inflated valuations of its investments to help the firm raise fresh capital.

Although the roundtable participants were not investors in these companies and these instances didn't have a direct impact on the valuation of their portfolio companies, they and their LPs certainly took note.

"In light of the attention unicorns and other high-profile IPOs have been getting, LPs have asked to understand how third-party providers treat situations where they have multiple clients invested in the same security," says Burrill. "Do they allow clients to have different values for the same investment? The short answer is, 'Yes, within reason,' and the guidance supports why that makes sense. But I encourage people to speak with their valuation providers directly if this issue impacts them."

These situations are reminders that there are no right answers when it comes to valuation.

"We have different clients that invest in the same entity and they come up with different valuations," says Angell. "Valuation is an art not a science. If they are using an average of multiple methods maybe some firms are putting more weight on one method versus another, or maybe they are using different comps compared to others. Those issues happen. You're never going to get to an exact number. From an auditor perspective, we want to make sure they are using correct and consistent methodologies. If they change methodologies or companies used in their comp set, why was there a change? There needs to be an explanation."

Angell adds that valuations will often differ in the private market from the public market because investors look at companies through a different lens, usually focusing on growth for late-stage private startups and on profitability for publicly traded ones.

"This illustrates the unique challenges facing any valuation analysis of early-stage and pre-IPO companies," McMahon says. "In these instances, the analysis often involves reconciling the metrics implied by the most recent financing with comparable observations and getting comfortable with those differences based on those facts and circumstances. In some instances where synergies or highly strategic factors influence a transaction, that level of comfort may be difficult to achieve. This may result in some form of an adjustment that can be just as qualitative and judgmental as reliance on the financing itself, all of which highlights the subjectivity inherent in these situations." ■

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