Making your mark

Valuing a portfolio company in a way that's fair, accurate and suits investors is easier than it was 10 years ago. *pfm*'s roundtable discuss the changes in the industry

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photography by LEA RUBIN

From left: Tom Angell, WithumSmith+Brown; **David Larsen,** Duff & Phelps; **Blinn Cirella,** Saw Mill Capital; **Mark McMahon**, Alvarez & Marsal; **April Evans**, Monitor Clipper Partners; **Noah Becker**, LLR Partners

With one voice, our panel of portfolio company valuation experts agrees that in the decade since the global financial crisis, best practice in valuations has undergone a significant shift resulting in more consistency and transparency. "Our main concern is to be thorough and thoughtful as we value companies, and remember there is no right answer," says April Evans, chief financial officer at Boston-based mid-market firm Monitor Clipper Partners.

"The assumptions that go into an evaluation are by definition subjective. So [our goal is] being clear about what they are and consistent – period to period – and identifying the best method of valuation for each of our companies."

"The industry has come a long way," says Mark McMahon, a New York-based managing director and head of valuation services at professional services Alvarez & Marsal, "and it continues to evolve. Transparency has become institutionalized. We often forget how things were 10 years ago. I remember when fair value as we know it today was gaining traction. Conversations with the deal teams were really challenging due to this new perspective they had to consider."

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> "We fundamentally do a much better job of thinking about value for private investments today than we did 10 years ago"
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> **David Larsen**

> "I abhor discounted cashflows. There's way too much room to play around"
>
> **April Evans**

for private investments today than we did 10 years ago," agrees David Larsen, managing director at valuation advisors Duff & Phelps.

Should there be an economic downturn, the industry is much better prepared than it was in 2007, Larsen says, citing a decade of experience, the existence of the new Mandatory Performance Framework and third-party validation of fair value estimates. "The infrastructure around valuation is better today," he notes.

Examination prep

A significant driver of change has been increasingly rigorous regulatory oversight, notably from the Securities and Exchange Commission.

"I've heard multiple stories of SEC examiners really digging into the valuation," says Blinn Cirella, CFO at mid-market firm Saw Mill Capital. Rather than given an opinion on the valuation itself, the regulator is more interested in whether managers have stuck to their stated guidelines and valuation policies as outlined to limited partners in the limited partnership agreement and the private placement memorandum, she says.

Managers know to be prepared for the regulator's questions. "We have a valuations notebook that's ready for the SEC when they walk in," says Cirella. "Every quarter our valuation committee sits down, we go through it and compile it. We don't even have to look and pull papers off the server. It's all there."

Valuation is a "main focus" of the regulator in any presence examination, says Tom Angell, practice leader of WithumSmith+Brown's financial services group. "The SEC wants to see year over year consistency around valuations. They also want to see documentation surrounding the unobservable inputs. The SEC will talk to the auditors regarding their work on the valuations. They want to know what our approach was and how we got comfortable with the assumptions."

During an SEC examination, managers also need to be concerned with presentation, says McMahon, who notes that clients are often consistent in approach but "each deal team has their own view as to the most effective presentation, so you just couldn't see the methodological consistency. When we are engaged, many times the first thing we do is create a standard display template to eliminate the appearance of inconsistency."

One area that has drawn the regulator's focus is permanent impairment, says Larsen. "Often a fund agreement says the manager writes an investment down when it's permanently impaired and won't charge management fees on it, but it doesn't define permanently impaired," he notes. "The regulator will ask: Was the LP harmed because a manager didn't write an investment all the way down? It highlights [for the GP] why it's important to do a regular, quarterly valuation so you can assess where you are."

Want v need

Alongside regulators and industry bodies, investors also are paying closer attention to portfolio company valuation estimates. But dealing with different investors' demands for information and their different preferences can be challenging, the roundtable says. "I believe LPs

AROUND THE TABLE

Tom Angell is practice leader of Withum's Financial Services Group and has more than 25 years' experience providing audit, tax and consulting services to private equity funds. He advises emerging managers on all aspects of launching a private equity fund.

Noah Becker is the CFO at at technology and services-focused firm LLR, where he is responsible for financial reporting and oversight of all administrative financial matters. He has more than 20 years of experience in the corporate financial and public accounting sectors.

Blinn Cirella has been with mid-market firm Saw Mill Capital, which has focused on manufacturing, service and distribution businesses since 1998, for more than a decade. As CFO, she is responsible for managing all financial and administrative aspects of the firm.

April Evans is a partner, CFO and COO at mid-market firm Monitor Clipper Partners, where she has been since since 2005. Previously she was partner and CFO of Advanced Technology Ventures, a $1.5 billion venture capital firm and a founder of accounting firm Squillace & Evans.

David Larsen is a managing director in the San Francisco office of Duff & Phelps and part of the portfolio valuation service line. With more than 30 years of transaction, valuation and accounting experience, he specializes in fair value regulatory and financial reporting issues for alternative asset managers and investors.

Mark McMahon is the global practice leader of Alvarez & Marsal Valuation Services and leads the alternative investment services group. He specializes in the valuation of illiquid securities and provides advisory services to alternative asset managers to support of regulatory compliance, investigations and litigation.

always have and always will be more concerned with the reliability and directional accuracy of the valuations than the detailed methodology," says Noah Becker, CFO at the Philadelphia-based technology and services investor LLR Partners. "But over the years they are becoming more interested in the methodology and the underlying details and assumptions."

Cirella cites two instances where LPs questioned the firm's valuation methodology. In one case, the investor asked why the firm used the average of three valuation methods – discounted cashflow (DCF), public comparables and precedent transaction analysis – and did not pick the method that best suited the company.

"We said our approach took a lot of subjectivity out of the process. It removes the tendency to want to change methods because one works better than the other. I was surprised that the LP was advocating using the best model to get the highest valuation. We want accurate."

In another conversation, in response to the firm's preference to be conservative with its valuations, the LP replied: "Don't hold back. Value it where it should be valued," Cirella says.

Some LPs put up resistance to valuations being held at cost because their own compensation benefits from an uplift. This can be frustrating, Cirella adds. "It is a bit like the tail wagging the dog. Maybe those managers need to think about the asset class a little bit differently, rather than force us to do something that's a little unnatural and difficult to do."

"Transparency has become institutionalized"

Mark McMahon

Second guessing

The rise of the secondaries market, with investors considering liquidity before the end of a fund's life, means interim valuations do matter, says Evans. While the GP is less concerned about the purchase price when a single LP sells a stake in its fund – "I just want to know that it's all done properly and that both sides have the same information from us so that they can make their own set of decisions," says Evans – in the case of a tender offer to all LPs, the manager is typically providing a far greater amount of information, she says.

"That's a different world. The GP is part of the process. It's a lot of work. It's like selling a company. There's an extensive data room, lengthy due diligence and crafting legal documents," she says, noting that Monitor Clipper Partners has been through a tender offer process with its 2003-vintage $800 million

fund. "The way our LPA works, the first hurdle was obtaining LPs consent to even entertain the offer," she adds.

"Increasingly we're seeing in our secondaries practice a lot of different permutations and end of fund life issues," says Larsen. "In many cases secondaries are GP-led. For an LP to decide to sell its interest or continue on with the new fund, or new structure, they've got to have good information on the underlying value today of that portfolio company and then a view on where it is going in the future. Regular robust valuations provide LP's with additional information necessary when faced with secondary transaction decisions."

However, McMahon cautions against drawing conclusions on valuations from secondaries

"[Differing] valuations are not wrong because it's so subjective, but you can see human behavior issues"

Thomas Angell

Taxing reforms

The valuation industry is still getting its head around the new US tax rules

The US tax code reform bill that became effective on January 1 cuts the corporate tax rate from 35 percent to 21 percent, but for private funds valuation professionals, it has ushered in a period of uncertainty.

"For a very large portfolio company it could take a number of months to figure out what it means," says Larsen. If a manager does not close their 2017 books until April, "do I incorporate the benefits? Is that known and knowable to a market participant at that point in time? That's a very difficult judgemental question."

"And given the judgments involved, fund managers will need to have documented how they considered the impact of the new legislation at each measurement date," says Angell.

It affects net operating losses carried forward, levels of tax-efficient leverage and many other aspects of valuation, says McMahon. "All of these changes must be factored into a DCF by making relevant adjustments to projections and choosing appropriate discount rates."

Becker says he does use DCF "and part of the challenge is to assess what's been priced in the multiples during the year. You've got two effects - the moment in time event and tax law effect – so what dials are you turning? How do you manage it?"

> "LPs sometimes say what they want but they don't always tell the GP what they need"
>
> **Noah Becker**

transactions. "If an LP interest is sold at a discount or premium to net asset value, this does not imply that the portfolio companies were mismarked, but rather highlights the difference in required return between primary and secondaries LPs."

While managers' approaches to valuation methodology differ, Monitor Clipper Partners has chosen to apply the most appropriate valuation method to its each of its 20 portfolio companies, taking into account how that company will be valued by a buyer, says Evans. "What are they going to use – a revenue multiple, an EBITDA multiple or a DCF?" She adds: "I abhor DCFs. There's way too much room to play around."

Monitor Clipper Partners' preference is to use precedent transactions "wherever we can, as opposed to public comps, because a sale actually occurred," she says.

The panelists all agree that obtaining good data to support valuations can be a struggle. Angell notes that his firm has a database of its clients' investments and it is telling that sometimes disparities occur.

"Every so often we'll get two clients in the same investment with different valuations. [Differing] valuations are not wrong because there is some subjectivity to the assumption. Each client may approach their valuations differently but will have documentation to verify their inputs."

> "Don't hold back. Value [an asset] where it should be valued"
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> **Blinn Cirella**

This makes life difficult from an audit perspective, he adds. "It's hard to see two different valuations without wondering if one is correct and the other is wrong."

Ultimately, he notes, the key is having documentation from the client that details the valuation. ■