Visions of valuation

The processes – and LPs' interest in them – have evolved significantly over the past few years. Six experts tell *pfm* what the future holds

by MARINE COLE

photography by DOUG HOLT

From left: Craig Ter Boss, Aryeh Sheinbein, Tom Angell, Federico Jost, April Evans, Jon Schwartz

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The attention to the role valuations play in private equity has increased in the past decade as the industry has matured and grown.

The two general partners and four valuation practitioners we gathered at a roundtable in New York in January predict that thanks to greater outsourcing and to the increasing use of technology, the valuation process will become even more refined in the next few years.

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LPs' demand

"In the last decade, improvements in disclosure to limited partners have been driven mostly by the LPs, not as much by the auditors," says Craig Ter Boss, a principal with EisnerAmper.

"Some 10 or 15 years ago when we would sit on meetings and go through each and every company, there were no questions asked. Nothing. Now a lot of questions are asked about methodology, about what you sold and tracking valuations quarter to quarter."

Federico Jost, a managing director with BRG Corporate Finance, who used to be a valuation expert at a sovereign wealth fund, explains that interim valuations in particular can be important to investors. "LPs closely monitor their investments and make asset allocation decisions based on the target weights of their portfolio," he says.

The reasons behind LPs' emphasis on this disclosure are many. Interim valuations are a starting point for pricing LP interests in the secondaries market, for example, which is widely used when rebalancing a private equity portfolio.

"Every LP has a different goal," Jost says. "A sovereign wealth fund has a very long-term investment horizon, while a small pension fund is likely to have liabilities that it needs to pay in the next years, as such, they have very different asset allocation decisions to make. If valuations are not at fair value, investors could face serious challenges. That's why it's so important."

"I agree that investors have needed to and have certainly gotten a lot smarter on what's going on in our industry in terms of what they need to see," concurs Jon Schwartz, president and chief operating officer of NewSpring Capital.

Unlike Ter Boss, he thinks more scrutiny has come from auditors, not just limited partners.

"You [previously] got a question if you changed the valuation," he says. "Now you get a question if you don't. I think that's been the only significant evolution in the past several years, the desire for the accounting firms to get a better handle on how to value these."

In recent years, the American Institute of Certified Public Accountants has issued plenty of guidance on the valuation of private equity assets, which has left it up to firms to catch up.

"The reason why audit firms were pushing the [option pricing model] back in 2013 was due to the release of the AICPA guide titled *Valuation of Privately-Held Company Equity Securities Issued as Compensation,*" explains Tom Angell, partner at advisory firm WithumSmith+Brown. "Audit firms had to follow the guidance, which made it difficult for funds at the end of 2013. The funds were asked to switch their methodology to follow the guidance in the guide."

More recently, the AICPA released a draft of its accounting and valuation guide, which is out for comment. "The guidance will be effective for 2019 audits and fund CFOs need to digest the information as well as the many examples," Angell says.

Secondaries to none

In the secondaries market, valuations aren't just gaining in importance in the eyes of traditional LPs. Secondaries firms, which reference their purchase prices of LP fund interests to the most recently-available net asset value of a fund or a group of assets, have also been paying closer attention to valuations as their market grows in volume.

AROUND THE TABLE

Tom Angell is a partner at WithumSmith+Brown, serving as the practice leader of Withum's financial services group based in the firm's New York office. He has more than 30 years of experience specializing in private equity and VC funds.

April Evans is a partner and the chief financial officer at Monitor Clipper Partners. Evans joined the lower mid-market firm after serving as the CFO of Advanced Technology Ventures. She is also on the board of the Women's Association of Venture and Equity.

Federico Jost is a managing director at BRG Corporate Finance's fund services valuation team. Previously, he led the private equity valuation activities for a sovereign wealth fund owned by the Emirate of Abu Dhabi.

Jon Schwartz is the president and chief operating officer at NewSpring Capital. Schwartz joined the growth equity firm in 2004, where he also serves as the chief compliance officer.

Aryeh Sheinbein is a managing director at Alvarez & Marsal. Sheinbein serves in the firm's valuations services practice and is a member of the firm's alternative investment services group. He previously served as director of business analysis at Centerbridge Partners.

Craig Ter Boss is a principal in the corporate finance group with nearly 20 years' experience providing valuation services to public and private clients. Types of engagements include allocation of purchase price, goodwill impairment, corporate strategic and tax planning, corporate transactions, litigation and arbitration.

Is outsourcing inevitable?

The two GPs at the table, Evans and Schwartz, explain how their firms prefer to keep valuation in-house, like most funds in the US.

Asked if they use independent specialists to value their portfolio companies, more than 80 percent of attendees at the CFOs & COOs Forum 2019 said no. Only 14 percent outsource.

"We don't get third-party valuation," says Schwartz. "For all the things we've been talking about, we think valuations are a team sport."

But there are some clear benefits to outsourcing valuation.

"As portfolios grow in number, size and into multiple industries, having an external advisor provides the finance team scalability, sector expertise and improves internal controls. All favorable from the eyes of investors and regulators," Jost says.

Angell sees it as the inevitable next step in the valuation world prompted in part by a push from investors, much as funds began outsourcing fund administration several years ago.

"More LPs are asking the question whether a fund outsources its valuation to a third party," he says. "Years ago, very few funds used an outside administrator but now it is becoming more common, especially in the mid-market funds. My prediction is that it will become more common in the larger funds. It will take the mid-market funds longer to adapt due to the additional cost."

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Aryeh Sheinbein

"In large part what our industry is experiencing, which is part of the maturation of the industry, is that it is moving from being completely illiquid to having some liquidity options for our investors," says April Evans, partner and chief financial officer at Monitor Clipper Partners.

"That shift has meant that it really matters that we be intentional about valuations and consistent about them, because now those valuations are informing these buyers and sellers. The secondaries market has matured to the point where those interim valuations make a difference."

Up-to-date valuations can also guide sponsors in figuring out the

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> **Federico Jost**

true value of their funds in a potential secondaries transaction and what the potential repercussions would be for their LPs.

"If we were to liquidate the fund today, even if that was a possibility, which it is not, where would the dollars go and what would be the tax impact of that?" Schwartz says. "It's an exercise that's needed to be done."

The power of tech

The roundtable participants all expressed enthusiasm at the prospect of how technology could alter the way valuations are calculated in the future.

"We're seeing a lot on the technology side, specifically machine learning (ML) and robotic process automation (RPA)," says Aryeh Sheinbein, who is a managing director at professional services firm Alvarez & Marsal. "We, along with the industry, are making strides toward leveraging ML and RPA to improve accuracy and efficiency."

He explains that Alvarez & Marsal has built its own shadow private credit rating system with machine learning. It uses a huge amount of historical data from a diverse set of comparisons, both public and private, and from internal processes.

"Our ML algorithm can predict the S&P credit rating with greater than

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Tom Angell

90 percent of accuracy," Sheinbein says.

"If you think of valuation as going from point A to point B and let's say there are 10 steps in that process. […] historically […] all 10 steps in the valuation process are being done by humans to go from point A to point B."

He thinks what will ultimately happen is the human component of the process will start halfway through, for example at step six.

"A combination of RPA and ML might complete steps one to five," he adds. "We'll be able to build models more efficiently. We will be able to have less errors, because an analyst's job – whether it is internal or external – is to analyze, and the new process will allow analysts to focus on the more analytical and thought-driven work. The machine can synthesize all the public company information, as well as much of the other data before the analysis takes place. This will allow the deal teams and CFOs to spend more time on the important issues."

"The amount of data that can be held and organized from machine learning is amazing," says Ter Boss. "A lot of people are starting to recognize that."

"I think machine learning and artificial intelligence, helping come up and analyze enormous amounts of data, is definitely something that's going to have an impact," agrees Jost.

Valuing a fund

Calculation methodologies have become well-oiled in the private equity space.

Monitor Clipper typically starts with EBITDA. "There are a couple of investments we have made where a revenue multiple was more relevant for that particular industry or for a particular company, given its stage, for example, certain growth equity investments," Evans says.

"Then you look at the comps that

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are out there. Our preference is to use precedent transactions. We have evolved to a place where we believe that the actual sale of another private equity backed-company is a better marker of what an appropriate multiple is for our particular companies. Then we consider the publicly traded comps. We use precedent comps wherever we can obtain enough to create a viable comparison set. If we can get four or five precedents, I’ll go with those.”

Schwartz says his firm follows a similar process, which begins in due diligence. “The valuation process, when you’re looking company by company, actually starts earlier, when we’re investing in a company,” he says.

“We need to support the basis of what we’re willing to pay because for the most part, as growth-stage investors, we need to look at the market and say ‘What’s a fair price for this asset?’ We would develop a concept from precedent transactions and public company comps to understand where this company should be. You’re at least starting with where you should be on a relative basis.”

Evans notes that the timeliness of the comps you use can be critical, particularly in times of volatility in the public markets.

“You also have to look at the cycle

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Craig Ter Boss

that we’re in,” she says, pointing to the latest bout of volatility in stocks. “What’s going on in the public markets impacts the valuations businesses are going to be sold at.”

Ter Boss explains that valuations methods used to use the latest round of funding. “Then they moved to how do we justify the latest round with the multiples and the comps,” he says.

“Now I’m seeing it go to a little bit of the scorecard method, where you have the qualitative factors, and the plus and the minuses and you figure out how that moves the needle. The hardest part is to explain to an auditor that it’s one turn or a half a turn, but I don’t have any data to support that because the comps are way bigger or the transactions are much older. We work with a lot of growth equity and that’s the hardest part.”

Although this qualitative approach may be more accurate, at the same time, auditors want to make sure fund sponsors don’t deviate from their methodology over time and are continuing to be transparent.

“From an auditor perspective, we are always more comfortable with the math,” says Angell. “The unobservable qualitative inputs require us to do some market research and determine their acceptability. The fund has to be consistent quarter over quarter and year over year.” ■