

Fair value challenges in the current environment

A review of the current valuation requirements and practices in the private equity industry

October 2008



Key messages

- There is increasing demand for transparency over fair value reporting in this industry
- Valuing investments has never been more difficult due to a lack of transactions and volatile markets
- We should expect some large write-downs in the value of investments given the significant declines across global markets
- The IASB and FASB have recently issued additional guidance on values in inactive markets and fair value accounting in accordance with IFRS and US GAAP. This covers the use of transactional data, valuation models and the ability to reclassify certain financial instruments and hold them on an amortised cost basis
- Improved valuation processes will help with regulators, investors and auditors

Introduction

Fair value is one of the hottest topics facing the alternative investments sector today. The ever-increasing investor, regulatory and accounting pressure for companies to focus more attention on valuation has coincided with the credit crunch and the most difficult economic conditions in years.

The combination of a significant decrease in stock market values across most sectors, an increased focus on debt values and a decrease in the number of transactions promises to make the current valuation process extremely difficult and is likely to mean large write-downs for private equity investments at the year end. This sequence of events comes at a time when most focus is on maximising returns to attract and retain clients.

As a result, we expect to see a high degree of internal and external challenge in the valuation process this year for private equity companies.

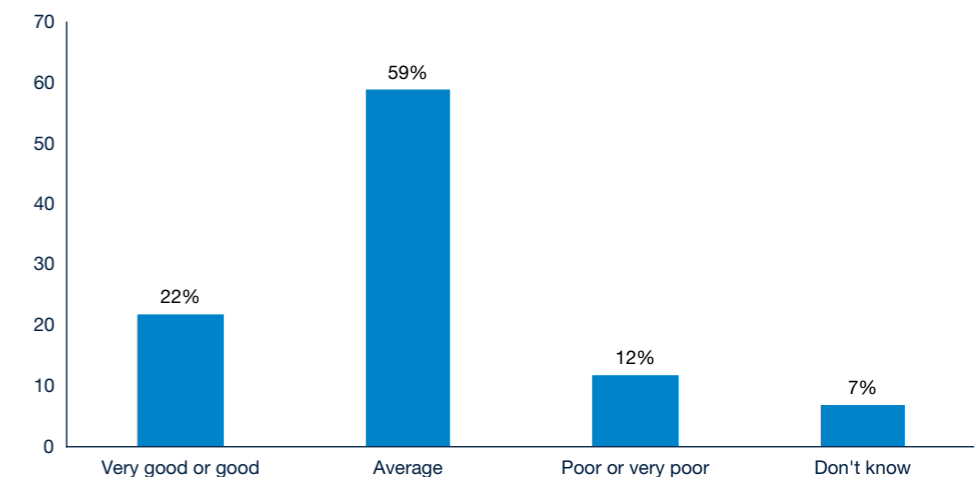
The old principle of keeping investments at cost (less any diminution) provided far fewer challenges, especially in a rising market. Now fair value is increasingly required due to the accounting requirements of IFRS and US GAAP and the increased application of the International Private Equity and Venture Capital Guidelines (IPEVCG or 'the Guidelines') and US Private Equity Valuation Guidelines (PEVG).

We have observed that some companies have responded well to this challenge whereas many have struggled. As a result there is some inconsistency in approach and policy in the industry. This factor, alongside the lack of transparency of valuation techniques and assumptions, is in part responsible for initiatives such as the Hedge Fund Working Group and the development of IOSCO and AIMA guidelines – all of which highlight valuation as a key area for improvement. In addition, in the UK we have seen the Walker Guidelines that look at transparency in its wider context surrounding private equity.

This is supported by the recent PricewaterhouseCoopers¹ (PwC) briefing on alternatives 'Transparency versus returns: The institutional investor view of alternative assets – March 2008'². This highlighted the disconnection between the perceptions of investors and providers of information. 63% of companies considered that their valuation policies were effective at managing risk but investors largely disagreed. Only 25% of private equity investors thought that valuation policies were effective in this respect.

In addition, it emerged that only around one in five respondents considered the current disclosure levels to be good or very good across the alternatives industry, as shown below:

Institutional investors' views on the quality of information of valuation techniques produced by private equity



So why is fair value important? Some in the private equity industry would argue that, as portfolios are usually held in close-ended funds, cash at exit is all that matters and therefore fair values are purely an accounting issue.

However, the briefing again provides an interesting perspective on this. Performance was the overriding criterion for considering a third-party provider of alternative investments with 72% of respondents highlighting this compared to just 33% for quality of reporting. However when it comes to deselecting a provider these are considered of equal importance, at 41% and 40% respectively.

¹ PricewaterhouseCoopers refers to PricewaterhouseCoopers LLP (a limited liability partnership in the United Kingdom)

² Page 12 and 27 of the briefing

Section 1

Clearly investors want regular and robust information and may exit funds if this is not made available.

There are clear benefits from a rigorous and regular valuation process, including the ability for investment managers to:

- communicate to investors where value is being added or lost over time in a Fund by reference to the fair value of specific portfolio companies;
- make informed decisions on entry and exit by understanding upside and downside scenarios;
- meet the requirements of IFRS and US GAAP accounting standards and therefore to satisfy auditor review; and
- produce regular valuations where investors trade on monthly net asset value (NAV) in respect of open-ended funds.

Private equity investments evolve rapidly as changes are made to management teams, margins are optimised and operations refined. As a consequence, one year's results are often unrecognisable from those reported 12 months earlier. In addition, in this industry, the investments range from the multi-national to the domestic, the manufacturer to the seller, the established to the new. Therefore one size does not fit all and the valuer needs to exercise judgement and common sense in arriving at a robust fair value.

Arguably funds of funds have the biggest challenge given their reliance on General Partners to provide sufficient details for them to arrive at robust valuations. Fund of fund investments are inherently illiquid given the lack of a redemption option. Industry debate is ongoing regarding the need for an illiquidity discount. An AICPA task force has been established and is currently reviewing this issue with the expectation of detailed implementation guidance in 2009.

Current thinking suggests that while NAV is a good starting point, all relevant factors need to be considered, documented and resolved to determine whether an adjustment is required. While NAV may also be an appropriate ending point this must be supported by a rigorous and documented process.

In summary, the IPEVCG provide an overall framework for the valuation process. They set out a context within which a valuer should seek neither to understate nor overstate the value of the investments within their portfolio.

What is required is careful consideration, proper internal review and documentation to arrive at a supportable view for reporting purposes.

In this paper, we set out the following:

Section 1 – a summary of the current reporting requirements and guidance for valuation;

Section 2 – the practical difficulties in the application of the valuation process; and

Section 3 – our views on some areas for improvement.

Whilst this article is primarily concerned with private equity valuations, many of the issues raised are also relevant for hedge, infrastructure and real estate funds.

A summary of the current reporting requirements and guidance for valuation

Background

IFRS provides limited guidance to the valuation process but sets out the following key parameters for financial assets in IAS 39 which covers 'Financial Instruments – recognition and measurement'.

Under IAS 39, the valuation process needs to 'establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations'. IAS 39 (paras AG75-76) states that the model used should incorporate a technique which:

- makes maximum use of market inputs and rely as little as possible on entity-specific inputs;
- incorporates all factors that market participants would consider;
- be consistent with generally accepted economic methodologies for pricing financial instruments; and
- should be calibrated periodically to current prices.

IAS 39 defines fair value as 'the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction'. The price at which an asset could be exchanged is the price an entity would have received if it had sold the asset. Similarly, the price at which a liability is settled is the price an entity would have paid if it had been relieved of the liability. This implies that fair value is an estimate of the market 'exit' price that is determined by reference to a current hypothetical transaction between willing parties. However, under IAS 39, on initial recognition instruments might often be recognised at entry price due to the assumption in IAS 39 that the transaction price represents the best evidence of fair value.

FAS 157 provides a consistent definition of fair value throughout US GAAP. It defines fair value as 'The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.' This is the 'exit' price at which an asset would be sold or a liability transferred in its principal market (or most advantageous market) from the perspective of the reporting entity.

FAS 157 also clarifies that fair value is a market-based measure, not an entity-specific measure, and that it does not include transaction costs.

Accounting Standard Setters

The International Accounting Standards Board (IASB) currently have a project on fair value measurement and there is a significant agenda of fair value measurement discussion points currently being debated. The IASB is working with the Financial Accounting Standards Board (FASB) on this project and the discussion paper issued by the IASB in November 2006 was based on FAS 157. Whilst this is a joint project with the FASB and the discussion paper was based on FAS 157, there could still be differences in the final guidance issued by the IASB compared to FAS 157 as there are several areas still under discussion by the IASB.

More recently, the IASB and FASB have released guidance on fair values in inactive markets and on fair value accounting. Amongst other things, this guidance suggests that even in times of market dislocation it is not appropriate to conclude that all market activity represents forced liquidations or distressed sales. Nor is it possible to conclude that transaction prices are representative of fair value. Judgement needs to be applied to the available data.

In addition, on 13 October 2008, the IASB announced that banks will be able to reclassify certain financial instruments and hold on an amortised cost basis instead of marking them at market value. Further changes may emerge over time.

The Guidelines

As noted above, there are specific industry valuation guidelines published in Europe and the US which are broadly consistent with the accounting regimes in which they are applied.

It is important to note that the IPEVCG (which superseded the BVCA and EVCA guidance), and PEVCG follow the spirit of IFRS and US GAAP respectively.

These guidelines were developed by the industry bodies, AFIC, BVCA and EVCA to include a wide range of investments including early stage ventures, management buyouts, management buy-ins and growth or development capital.

In the introduction to the IPEVCG, it is stated that: '...the requirements and implications of the Financial Reporting Standards and in particular International Financial Reporting Standards and US GAAP have been considered in the preparation of these Guidelines. This has been done, in order to provide a framework for arriving at a fair value for private equity and venture capital investments which is consistent with accounting principles.'

The Guidelines provide further clarification that: 'Where there is conflict between a recommendation contained in these Guidelines and the requirements of any applicable laws or regulations or accounting standard or generally accepted accounting principle, the latter requirements should take precedence.'

Likewise in the US, it is explicitly noted that the PEVCG which were re-issued in March 2007 are consistent with US GAAP including FAS 157, the new standard on fair value which was released in 2006.

We note that there are minimal differences between the standards and associated guidelines. For example, discounts can be applied for the liquidity of investments not traded with a quoted market price under US GAAP or not quoted on an active market under IFRS. However, we note that there is a difference in the treatment

of a control premium under US GAAP and IFRS. In IFRS a premium cannot be applied to quoted market prices but may be factored into a fair valuation for some private investments (although this is under review by the IASB) whereas a premium is permitted under US GAAP.

We observe that the wording in the IPEVCG is not exactly the same as the PEVG even though the concepts are almost identical. In Appendix 1, we set out a summary of the key areas from the guidelines.

The PEVG have now been updated to be compliant with FAS 157, making exit price a prominent concept and removing all reference to a willing seller from the equivalent IFRS definition. This is further summarised in Appendix 2.

Future plans and developments which a private equity company intends to make prior to disposal cannot be factored into the current value. It must be a current exit price.

Methodology

In terms of valuation methodology, there are a number of key points to note from the Guidelines:

Price of recent investment

Recent pricing for additional financing rounds can prove a useful reference point to the value of an investment. The rationale often cited for preference to this method is that it gives greater consideration to current market conditions.

Clearly this is the most directly relevant data for a valuation of a specific investment; however, in our experience, care should be taken where the rights attaching and level of investment differ from those of the subject of the valuation as well as the size of the additional financing and its relevance to the value of the overall investment.

The recent turbulence in financial markets has made a price of recent investment approach increasingly difficult to apply. With fewer transactions and more distressed sales, there are fewer reliable multiples available for use.

Given the significant change in market conditions, the use of a twelve month time period may no longer be appropriate as current market conditions are unlikely to be accurately reflected. Therefore, given the current economic climate, we would recommend reviewing the circumstances of each transaction before placing any reliance on them.

Earnings multiple

The Guidelines are mainly focused on the market multiple approach to valuation and there are a variety of ways that this approach can be performed. The Guidelines also state a preference for first calculating enterprise value then deducting the value of net debt, rather than a direct equity value calculation.

The Guidelines offer the following guidance on this subject: *'In general, because of the key role of financial structuring in private equity, multiples should be used to derive an Enterprise Value for the Underlying Business. Therefore, where a P/E multiple is used, it should generally be applied to a taxed EBIT figure (after deducting finance costs relating to working capital or to assets acquired or leased using asset finance) rather than to actual after-tax profits, since the latter figure will generally have been significantly reduced by finance costs.'*

There has been a lot of confusion about the appropriate earnings and multiples to be applied. In simple terms applying post tax earnings and a P/E multiple arrives at an equity value whereas taking EBIT and an EBIT multiple takes you to an enterprise value. Some private equity houses focus on P/E multiples rather than EV/EBIT multiples. So how can a P/E multiple be applied to a 'normalised' earnings to estimate enterprise rather than equity value? The Guidelines suggest that

this can be achieved by multiplying the EBIT by the P/E multiple. In order to be consistent, however, a taxed EBIT should be used as the P/E multiple is derived on a post-tax basis.

We also note that the Guidelines do not state a clear preference for multiples from transactions as opposed to comparable companies beyond the statement that *'the Valuer should be biased towards those methodologies that draw heavily on market-based measures of risk and return'*. In fact the Guidelines³ caution against the use of transactional data due to lack of reliable and transparent information. Notwithstanding this concern, we often refer to transactions in our analysis and would seek to rely on actual market evidence as much as possible.

Discounted Cash Flows (DCF)

The Guidelines explicitly state that DCF should be avoided as a reliable approach in isolation, whereas IFRS is more supportive of DCF as an approach. Whilst market based benchmarks are clearly desirable, the reality is that there will be instances (such as for early stage development projects or debt valuations) where DCF is the most applicable method to use.

A further instance where DCF is strongly advocated is long term projects such as PFI projects where cash flows are not necessarily steady state but they can be reliably forecast over a 20-30 year period based on detailed PFI contracts. Since IAS 39 needs to cover all types of investments not just PE investments (e.g. including PFI investments), this may partially explain why IFRS is more supportive of DCF as an approach. We would therefore recommend that valuers are not deterred from using this approach.

It is sometimes commented by private equity fund managers that they do not consider the value of the investment on a discrete multiple basis. They are often more interested in the fundamentals of a business over the strategic time horizon to exit and therefore view DCF as their favoured approach.

As valuation practitioners, we find DCF to be very useful as growth prospects can be difficult to recognise in multiples and the importance of cash in this industry should never be underestimated.

In practice this approach has often been mis-used, without proper consideration of the expected cash flows or how the discount rate should be derived. For instance, the difference between 'expected' and 'contractual' cash flows could be important and should impact the discount rate being used. This does not mean that this method should not be used. In fact, in many circumstances, (notably in valuing debt) it may be the only true way to determine fair value.

Indicative offers

It is often suggested that indicative offers may provide a good indication of fair value. However one must consider the motivation of the parties involved. Indicative offers may be made deliberately high to gain access to the company's books or to entice the seller into negotiations and subsequently reduced as the sale proceeds. The independence of the party making the offer also needs to be considered as anything other than an arm's length offer is unlikely to be a fair indicator of value. Therefore the Guidelines suggest that:

'Indicative offers should be used to provide useful additional support for a valuation estimated by one of the valuation methodologies, but are insufficiently robust to be used in isolation.'

Summary

In summary, we would support the use of several approaches (normally at least two) to arrive at a robust view.

This is referred to in the Guidelines⁴ as an important step in the process, whereby values can be cross-checked or corroborated.

Case Study – Use of DCF

When applying a DCF, the underlying assumptions need to be robust and supportable. The value of a mortgage provider was calculated using a DCF over a 20 year time horizon. Due to the current debt market, this was modelled on a run-off basis. However, we disagreed that liquidity would not return to the market for 20 years. Furthermore, the discount rate applied was the IRR for the private equity house and was significantly higher than the weighted average cost of capital of the mortgage provider. The result was a proposed value materially below fair value.

³ Page 18 of the IPEVCG

⁴ Page 14 of the IPEVCG

Section 2

The practical difficulties in the application of the valuation process

Case Study – Comparable companies

We often see an incomplete set of comparable companies in valuation analysis. An example included a company being compared to a group of 9 companies, the majority of which were much smaller and less profitable. This gave a 9x EBIT multiple which had been used in the valuation. According to management, there were two almost identical companies which had very similar growth prospects, but which were smaller and slightly less profitable – the multiples for these were 15x and 17x EBIT. It was unclear why the multiple used in the valuation was at such a significant discount.

Interpreting current guidance on fair value is challenging. Based upon our experience, there is some inconsistency in the valuation process in terms of methodology, interpretation of guidance and in documentation.

Whilst one of the primary objectives of the trend towards fair value reporting has been to promote transparency and consistency for investors and shareholders we believe that this benefit is yet to be fully achieved.

We now set out some issues that often arise in practice.

Comparable companies

A key element of a multiple-based approach is to ensure that the appropriate comparable companies have been selected as benchmarks and for sufficient analysis to be performed to support the selection.

The comparables are often selected in terms of either industry or size without reference to fundamental underlying risk characteristics or profitability.

In our experience, the comparables used are often changed year on year without proper justification. The evolution of a company is likely to change its relative ranking in the spectrum of comparables as opposed to changing the comparables themselves and consistency will help to identify market and industry movements.

It is also extremely important to distinguish whether the comparables are based upon trading or transaction multiples. Best practice would be to consider both trading and transaction multiples. However, caution should be applied when taking transaction multiples without consideration of the particular circumstances surrounding the transaction.

Such circumstances may include:

- whether the transaction multiple being relied upon is based on the acquisition of a private business or a public business;
- whether the transaction was a distressed sale;
- whether the fee had a contingent element;
- whether the purchase price within the transaction multiple was for a majority stake and therefore included a control premium; and
- whether the purchase price within the transaction multiple included any deal specific or market participant synergies.

It is important that the valuer is able to explain how the particular comparable company benchmarking relates to the actual multiple applied.

Typically the investment manager will provide a view on the fair value of the investment and the multiple implied by this. They may have been involved in the original acquisition or be very close to the management of that investment and therefore this tends to provide an important sense check to corroborate the value derived from a robust analysis based upon data from comparable companies and transactions.

The process of identifying comparable companies should be used to corroborate the manager's sentiments. Generally, the value from the financial analysis should be adopted while the view of the investment manager should be considered and any points of difference between the investment and the comparables reconciled.

Averaging of multiples and approaches

In particular circumstances the IPEVCG allow the valuer to use an average of multiples from a 'basket' of comparator companies without adjusting for points of difference. However, we are not in favour of such an approach. By using a comparable population of say two market leaders and two underperforming smaller companies, taking an average is likely to result in the assumption that the investment is a mid-tier firm when this may not be the case. The valuer needs to consider what type of company the resultant multiple implies is comparable to the investment.

Simply averaging comparable companies is precisely that, too simple.

We have also seen examples where multiple approaches have been used and an average from these approaches has derived the proposed value. While we disagree with this practice we do support the derivation of values based upon a minimum of two approaches.

Generic assumptions – marketability discount

Marketability is described in the Guidelines as *'the relative ease and promptness with which an instrument may be sold when desired. Marketability implies the existence of current buying interest as well as selling interest'*.

There is, however, often confusion over what this discount actually represents. The Guidelines suggest that the level

of marketability discount to be applied should depend on factors such as:

- the closeness to realisation;
- the level of influence of the fund over the timing of realisation and control; and
- timing of a potential exit strategy.

It is clear from this list that each investment needs to be reviewed carefully to assess an appropriate discount.

However, we often see a single marketability discount of say 20% applied to each investment without proper consideration of the specific factors relevant to the investment under review.

Adjustments to earnings and appropriate multiple

The fair value of an investment should be based upon a sale in its current condition and the most realistic assessment of likely 'maintainable' earnings without future, unproven enhancements or developments.

Changes can be made to derive maintainable earnings but in doing so it is important to avoid factoring in fundamental changes to the operations of the business. Adjustments should generally relate only to one-off exceptional items and should not include the add-back of central or management charges which are expected not to be incurred by a bidder.

Case Study – The danger of averaging

To value a highly profitable, well known retail chain, an average of three methods was used:

- Break-up value yielded a value of \$400m;
- An earnings multiple gave a value of \$800m; and
- A DCF gave a value of \$600m.

These were averaged to derive an equity value of \$600m, despite the fact that the above methods yielded a mixture of both equity and enterprise values.

Case Study – Earnings multiple

A common error with a multiples approach is the inappropriate derivation of maintainable earnings. In one instance, maintainable earnings were reduced by €40m (20% of the total) in order to minimise the value of the business.

In another instance, the fair value of the investment was reduced by 50% due to the inclusion of a discontinued line of business within the estimate of maintainable earnings.

Errors in applying multiples

In this example, the enterprise value of the company is 700. By applying the incorrect earnings and multiples together, this value can be incorrect by up to 40%.

	Historic	Current	Future
Implied multiple	7	6	5
EBITDA	100	117	140
EV	700	700	700
Error from applying historic multiple	-	17%	40%
Error from applying current multiple	-14%	-	20%
Error from applying forecast multiple	-29%	-17%	-

Section 3

Summary of practical difficulties in the valuation process

1. Use of companies which are not comparable or an incomplete list of comparable companies used

When using an earnings based approach, the choice of comparables and where this changes from prior year needs to be understood.

2. Averaging

The averaging of multiples is not best practice valuation and while it is mentioned in the IPEVCG and PEVG, it is not recommended best practice. The average of values derived from different approaches is also to be avoided.

3. Application of generic assumptions

Items such as marketability discount rates should be assessed on an investment by investment basis.

4. Maintainable earnings and application of a consistent multiple

The fair value of an investment should be based upon a sale in its current condition and based on an appropriate multiple.

5. Debt value

It is important to consider the fair value of debt and do not simply assume book value is appropriate.

There should be consistency between the earnings being used (i.e. current or historic) and the multiple.

We often see forward-looking multiples being incorrectly applied against current maintainable or historic earnings as opposed to the 12 month forecast earnings as at the valuation date. As shown on the previous page, this can lead to significant errors.

Value of debt

In many valuations the value of debt is simply included at cost, without reference to whether this could actually be achieved in a sale between market participants.

If the cash flows of a business are negative, for instance in a DCF valuation, too little consideration is given to whether this could lead to default on credit instruments held by the private equity fund. In any narrative supporting a valuation, reference to what the realisable value of debt as well as equity instruments should also be given.

However when thinking about 'fair' or realisable value in a transaction scenario the value of debt, like equity, is dependent on market conditions. Marking down debt only in extreme circumstances may not be appropriate in the current market conditions.

As equity is often the lowest-ranked form of financing in a capital structure, a sign of a company's potential distress has traditionally been any mark down to the value placed on higher ranked debt. When the debt trades well below the credit's face / par value – the value of which is decided by the economic return made if the paper is held to its maturity – investors are indicating there is a greater chance the company will default, which could diminish the value of the equity.

However, the connection between debt and equity values has, to a large extent, been broken by the current economic conditions in credit markets.

The level at which debt is priced in the secondary market should be considered in a fair valuation as this may indicate factors other than the underlying performance (or solvency) of the company that could be the cause of the mark down in value of the particular debt instrument.

Suggested areas for improvement

Resolving these issues is work in progress as fair value reporting is still evolving. However, there are a number of areas where short-term improvements are possible.

Increased involvement of the investment manager and early engagement with auditors / external advisors

In determining the value of an investment, it is critical that the investment manager is involved in the review process.

The combination of the investment manager and the finance team should enable the valuation to be robust from a commercial and accounting viewpoint.

This will require closer co-operation and an acceptance from the deal-makers that they have a role in the ongoing valuation process. This should also facilitate the year-end audit review where we would recommend early engagement particularly on the most complex investments.

External advisors may also be a useful reference point. Issues which may be new to a valuer are likely to have been seen elsewhere in practice thereby allowing a robust, market practice approach to be identified.

Documentation - Overall

There is greater focus on supporting the judgements used in valuation. For example the PEVG state that:

Qualitative (narrative) disclosures about the valuation techniques used to measure fair value are required in all annual periods.

While these guidelines do not indicate exactly what kind of narrative is required, we would consider it best practice (irrespective of whether you are in the US or not) to prepare a narrative supporting the choices and key assumptions that have been made during the valuation.

Documentation - Methodology

The IPEVCG offer a number of methodologies and note that a valuer should exercise judgement in selecting the most appropriate valuation methodology for a particular investment.

The narrative should include:

- the valuation methodology which has been selected and used as the primary valuation approach along with the rationale for selecting this approach rather than other available alternatives;
- any secondary (or cross-check) valuation methodology that has been used and why this has been selected. Where no secondary approach has been used, justification for this given that it is recommended practice in the Guidelines to do so; and
- where the valuation methodology has changed from the prior year, an explanation for this should be provided. Indeed, even changes in the time horizon used (e.g. historic, current or future) should be explained.

Documentation - Price of recent investment

Where the fair value of the investment has been determined based upon the price of recent investment the following points should be documented:

- details of the process used to consider any changes or events that have occurred subsequent to the relevant transaction that may impact the investment's fair value; and
- where the recent investment used in the valuation was external, consideration of whether the rights attaching to this investment are the same as the investment being valued and, therefore, whether this is an appropriate valuation basis.

Documentation - Earnings multiple

Key points to document in a supporting narrative include an explanation of which multiple (P/E, EV/EBITDA etc.) has been used and why this was selected.

Some best practice tips

- **Involve the investment manager**
Do not leave the valuation in the hands of a member of the finance team alone as they may not be involved in the management of the investment.
- **Document your rationale**
All valuations are underpinned by judgement – ensure the thoughts and drivers are clearly documented and cover all key points.
- **Sense check results**
Think about and document how the proposed value compares to last year, recent transactions, and the entry multiple. Does it make sense?
- **Be consistent**
Use the same valuation methodology from one period to the next and avoid changing approaches unnecessarily. This will help identify real value movement.
- **Consult**
Developing a robust approach can be time consuming. Be sure you have consulted internally (and with external advisors) before developing the valuation process.

Appendix 1

Differences between the International and US guidelines

Case Study – Marketability – a house view

We often see practitioners incorrectly applying generic marketability discounts. In one instance, an investment had applied the generic 'house discount' of 20% to an investment which was subsequently sold 2 weeks later. This would have resulted in a £40m understatement in asset value.

Documentation - DCF

Where the investment has been valued using a DCF approach the following points should be documented:

- an explanation of how the cash flows used in the DCF valuation have been determined and an assessment of particular factors that may cause uncertainty to their achievement;
- details of how the discount rate, applied to the cash flows in the DCF, was derived, including supporting information (i.e. comparable company beta analysis, risk free rate etc.); and
- an explanation of any other relevant key assumptions in the valuation that would help a reviewer to interpret the fundamental performance of the investment.

Where adjustments have been made to the value calculated using one of the methodologies above in order to arrive at an enterprise value (for example in relation to surplus assets or excess liabilities), the source and explanation for these adjustments should be documented.

Likewise where adjustments are made to this enterprise value to arrive at the gross attributable enterprise value, in respect of financial instruments ranking ahead of the highest ranking investment of the fund, an explanation of the source of these adjustments should also be documented.

Documentation - Marketability discount

The following should be documented in relation to any discount that is made:

- an explanation of what level of marketability discount has been applied, why and on what basis it was selected; and
- the status of realisation, i.e. any potential acquirers that have been identified and the value of any written offers that may have been made for the investment.

Conclusion

Historic criticisms aimed at some private equity firms have been that they apply excessive caution - quick to write down, slow to write up. This approach is not consistent with fair value.

We would observe that some firms report a fair value in the annual financials to their investors but report valuations based on other assumptions at annual meetings or in letters to investors. Others gravitate towards a lower of cost or market approach or may state 'our valuation policy is to carry investments at cost until a significant event dictates otherwise'. These approaches are generally no longer consistent with GAAP and such practices are coming under increasing scrutiny from investors, regulators and auditors.

Valuations and the associated assumptions contained therein should be prepared, in our view, by a combination of those closest to the investment and the back office or finance function, and should be clearly documented.

Finally, the available guidance (principally the IPEVCG and PEVG) should be followed carefully and used to help prepare a robust value.

Both existing investors and potential future investors have a real interest in the fair value of investments in financial statements and this is an important reason to get control of this process and to be seen to be operating at the top of the peer group in terms of the valuation process.

	IPEVCG	PEVG
Fair value definition	The amount at which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
Valuation methodology	<p>The valuer should select the most appropriate methodology in light of the nature, facts and circumstances of the investment... biased towards those methodologies that draw heavily on market-based measures of risk and return.</p> <p>5 methodologies are identified, in order of preference:</p> <ul style="list-style-type: none"> • Price of recent investment • Earnings multiple • Net assets • Discounted cash flow (underlying business) • Discounted cash flow (investment) • Industry benchmarks 	<p>The valuer should place the most weight on valuation methodologies which are clearly objective and timely... but are encouraged to use market based approaches.</p> <p>3 methodologies are identified:</p> <ul style="list-style-type: none"> • Cost/latest round of financing • Comparable company transactions • Performance multiple <p>Other methods noted which 'may be appropriate in certain circumstances' are:</p> <ul style="list-style-type: none"> • Discounted cash flows • Net assets • Industry benchmarks
Price of recent investment	This methodology is likely to be appropriate for all private equity investments, but only for a limited period (stated at 12 months) after the date of the relevant transaction. The valuer should assess whether changes or events subsequent to the relevant transaction would imply a change in the investment's fair value.	Such an approach is incompatible with the concept of fair value. At each valuation date a manager must make a determination of fair value for each investment. Managers may consider historic cost or the price paid at the most recent round of financing in making their fair value decision, but this should not be the sole determinant of fair value.
Multiples	<p>Apply a multiple that is appropriate and reasonable. This will be derived by market-based multiples, reflected in the market valuations of quoted companies or the price at which companies have changed ownership... It is important that the earnings multiple of each comparator is adjusted for points of difference between the comparator and the company being valued.</p> <p>Use of sector or sub-sector multiples for a 'basket' of comparators may be acceptable in particular circumstances.</p>	Identify a 'current average' of either trading or transaction multiples which may need to be adjusted for differences in terms of growth prospects and risk attributes 'the most appropriate and reasonable multiple... which will be applied to the relevant operating performance metrics of the company'.
Liquidity discount for publicly traded stock	Marketability discounts should generally not be applied to prices quoted on an active market. If [a discount] is appropriate in light of the particular circumstances of an investment, the rate applied and rationale should be disclosed.	Discount (blockage) factors for unlisted securities that trade in an active market are prohibited.
Additional	The valuer should be wary of applying excessive caution.	The valuer should be 'consistent, transparent and prudent'.

Appendix 2

The major changes in US GAAP following the introduction of FAS 157

	Previous US GAAP	GAAP under FAS 157
Definition of fair value	Focus on exchange price and price that would be paid to acquire an asset.	Focus on EXIT price. Will challenge General Partners' ability to leave at cost or to maintain purchase multiples for future valuations.
Measuring fair value	No framework, which resulted in diversity in developing approaches and procedures.	Prescribes the use of one or more of three acceptable valuation approaches.
Use of blockage discounts	Allowed in funds that had this as a stated policy in annual financials prior to May 31, 2000.	Prohibited for listed securities. Discounts allowed on restricted securities (for market restrictions, not holder restrictions).
Transaction costs	Capitalised costs are often included in value. Exit costs are often considered in fair value.	Neither acquisition costs nor expected exit costs should be considered in fair value estimates.
Disclosure and transparency of approach	Generic disclosure of fair valued assets with little transparency of approach / procedures.	Establishes a hierarchy with required disclosures, particularly for Level 3.

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