How to approach PE valuations

Tom Angell, practice leader of WithumSmith+Brown's Financial Services Group, outlines the AICPA's new valuation guide and how managers can keep LPs and a vigilant SEC happy by mitigating financial reporting risk

It has been said that exaggeration is the blood relative of falsehood, and nearly as blamable. On this, both the American writer Hosea Ballou and the Securities and Exchange Commission are in agreement – despite a three-century gap and variations in their definitions of culpability. While the private equity and hedge fund sectors have cautiously rejoiced at the prospect of deregulation under the current administration, industry veterans and newcomers alike may have been a little too quick to discount the powerful groundwork previously established by the SEC. In short, regulatory burdens are not easing any time too soon – and may even be tightening in the near future.

In a twist of fate in this high-leverage era where there is an abundance of capital, current and prospective investors are now demanding – as a matter of course – to be provided with information regarding a fund's valuation policies and procedures. Just like the SEC.

Expansion of the PE sector over the past several years and the free flow of capital has been the catalyst for elevated valuations, actual and otherwise. While theories abound regarding this surge and the motivation behind it – including, but not limited to, the proposition that exaggerated, self-reported valuation estimates make fund investments more attractive to investors, and also pave the way for enhanced LP interest in next-stage funds – one thing remains certain: the demand for transparency and consistency are here to stay.

Private securities valuation guide

For managers that not too long ago anticipated spending less of their resources on compliance and more on making and managing investments, the AICPA's accounting and valuation guide for venture capital and private equity shines a direct spotlight on the valuation best practices the industry itself has set for PE and VC. It also showcases what today's sophisticated fund managers are already doing to put LPs and regulators at ease. And, for those who are not, it is a how-to guide of what should be done to mitigate financial reporting risk, and avoid an unwelcome examination visit from the SEC.

In short, the Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies (the Guide) provides clarifications on how to approach private securities valuations. Following the roll out of a working draft last year, the final version of the Guide is debuting in May, 2019 to offer a "how-to" framework that ensures across-the-board best practices.

The Guide is a significant milestone. Although it is not meant to amend or replace any existing guidance, it represents the first directive to remedy the complexities of fair-value measurements for portfolio investments. It is an especially useful tool for investment fund managers, auditors and valuation specialists, as well as company management and boards of directors.

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The good news: if PE and VC entities are already collaborating with top-ranked public accounting firms as well as reputable advisory firms, they are on the right path. Most, if not all, of the guidelines have been in practice for quite some time.

Although an array of methods were once widely accepted just a few years ago, the Guide offers a new level of consistency and best practices – both of which mitigate risk. By covering a full scope of investment types, it addresses common valuation obstacles encountered throughout the varying stages of investment and related portfolio-company lifecycles. It documents systematic, replicable methodologies that yield the most desirable and attainable end results: certainty and transparency.

The Guide's fair-value related concepts that are of particular interest to investment fund managers include:

- Identification of key market participants, strategies and objectives of various investors;
- Determination of the units of account and measurement of the fair value of investments, which includes examples of club deals, multiple investments in various classes of port-

folio-company equity and valuing debt and equity investments with attached warrants;
- Valuation of debt instruments, including considerations involving valuing debt for purposes of determining the value of equity investments;
- Considerations for valuing an investment in an enterprise versus determining the fair value of the enterprise itself;
- Valuation of equity in portfolio companies with complex capital structures, selection of valuation methodology for equity allocation and when to consider using an option pricing model;
- Applications of control premiums, marketability discounts and minority discounts, as well as how these discounts and premiums impact calibration;
- Significance of calibration and its related applications;
- Backtesting;
- Factors to consider when estimating fair value at or near a transaction date.

There is also an entire chapter dedicated to special topics. These encompass the use of pricing services, broker-dealer quotes, entities with publicly-traded securities, valuation of equity interests in early-stage companies without a recent financing round, as well as considerations related to use of NAV and the practical expedient. Frequently asked questions and case studies round out the new guidance.

While most PE and VC fund managers – regardless of the fund size – have already implemented verifiable and replicable valuation practices, the Guide serves as a helpful reference point for existing funds to conduct a test drive. In contrast, it is also an invaluable tool for those contemplating a new fund launch and can provide a framework for establishing valuation policies and procedures.

Angell: some may have celebrated deregulation prematurely

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Valuation compliance

While clarification, interpretation and application were the key drivers for developing the Guide, it comes at a time when the SEC is demonstrating a renewed interest in valuation compliance and how it aligns with the regulator's focus on fees and transparency. In past exams, the commission has zeroed-in on everything from alignment of LP and GP interest to whether the fund's valuation method is impacting investor returns and fees.

In addition to ensuring compliance and transparency, a valuation specialist plays an integral role as an active participant in the overall valuation-assessment process. While advisory boards have become the most common structure, a mix of internal and external representatives is the only means to ensure effectiveness. As in most scenarios, external voices can educate or add a unique perspective. While this may seem logical and obvious, a significant percentage of committees actually *exclude* an outside advisor and rely solely on people who have invested in the fund. This is neither advisable, nor is it ever considered a best practice.

As the trend toward appreciating company valuations continues, the SEC and investors have been asking, and will continue to ask, the same questions. Have the self-reported valuation estimates been exaggerated to make them more attractive to investors? Was the methodology consistent, and if not, what was the basis for the deviations in reporting practices? Were historical financials used exclusively or were they combined with future financial performance expectations? To determine whether a methodology is sound and on target, too aggressive or too conservative, the "value" of an experienced advisor should never be miscalculated. ■

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