

Asset Management

Fair value challenges in the private equity industry

2009 update

December 2009



Summary

Valuation remains at the top of the agenda for private equity firms and reflects increasing demands for more information and transparency from investors. This is at a time when valuation of private equity investment continues to be extremely challenging given market volatility and few transactions.

It was in this environment that the Updated Private Equity Valuation Guidelines (“Updated Guidelines”) were released by the International Private Equity and Venture Capital Valuation Board (the “Board”) on 9 September 2009 with immediate effect, replacing the previous 2006 version of the Valuation Guidelines (the “Guidelines”).

We also note that the current draft EU directive on Alternative Investment Fund Managers (the “Directive”) raises the prospect of increased valuation requirements for the industry by establishing the need for independent review over the valuation process for funds. While it is not clear at this stage exactly what this will mean in practice, it would appear that additional external reviews of management’s valuation process are likely when the Directive is finally issued. Our own perspective on this emerging issue is that it is consistent with the general trend towards increased scrutiny of valuation and the processes that surround it and that this remains an area where improvements can and should be made.

In this paper, which follows our publication last year titled “Fair value challenges in the current environment”, we provide our detailed thoughts on the Updated Guidelines and general observations relevant for upcoming 2009 year-ends including views on the treatment of debt which is attracting particular interest at the moment.

In summary, the strong rebound in public equity markets may not necessarily translate into private equity valuations given the continued challenging trading conditions. In this context, we believe that current earnings performance, potential covenant breaches and future earnings prospects will come under much scrutiny for 2009 year-ends. Private equity firms will need to continue enhancing internal valuation processes and evidencing especially in the short term as they embed the changes suggested by the Updated Guidelines.

	Summary of top 10 considerations for 2009 year-ends	Updated Guidelines - page reference
1.	Fair value is a hypothetical exchange price at the Reporting Date. The Updated Guidelines do not change Fair value even though they suggest different procedures	11
2.	Valuation needs to be considered from a market participant viewpoint and is not entity-specific	11
3.	Valuation is judgemental and should not be performed with excessive caution	13
4.	The explicit 12 month ‘window’ for holding investments at cost has been removed	16
5.	The risks associated with the lack of marketability of an unquoted investment and any impact from control should be incorporated into Fair value through an appropriate adjustment to the multiple	19
6.	Maintainable earnings need to be assessed carefully with a preference for historic rather than forecast figures	20
7.	Discounted cash flow (“DCF”) analysis remains a useful cross check in some circumstances but should not be used in isolation	21
8.	Compliance with IFRS and US GAAP has been considered (but is not, in our view, automatically achieved)	7
9.	Guidance is now provided on the use of net asset value for fund interests and the requirement to fair value mezzanine debt based on current yields	24, 28
10.	Debt is assumed to be repaid at par in the Updated Guidelines without consideration of any need to fair value debt which in the case of investments without change of control clauses may ignore the ‘option value’ of equity	28

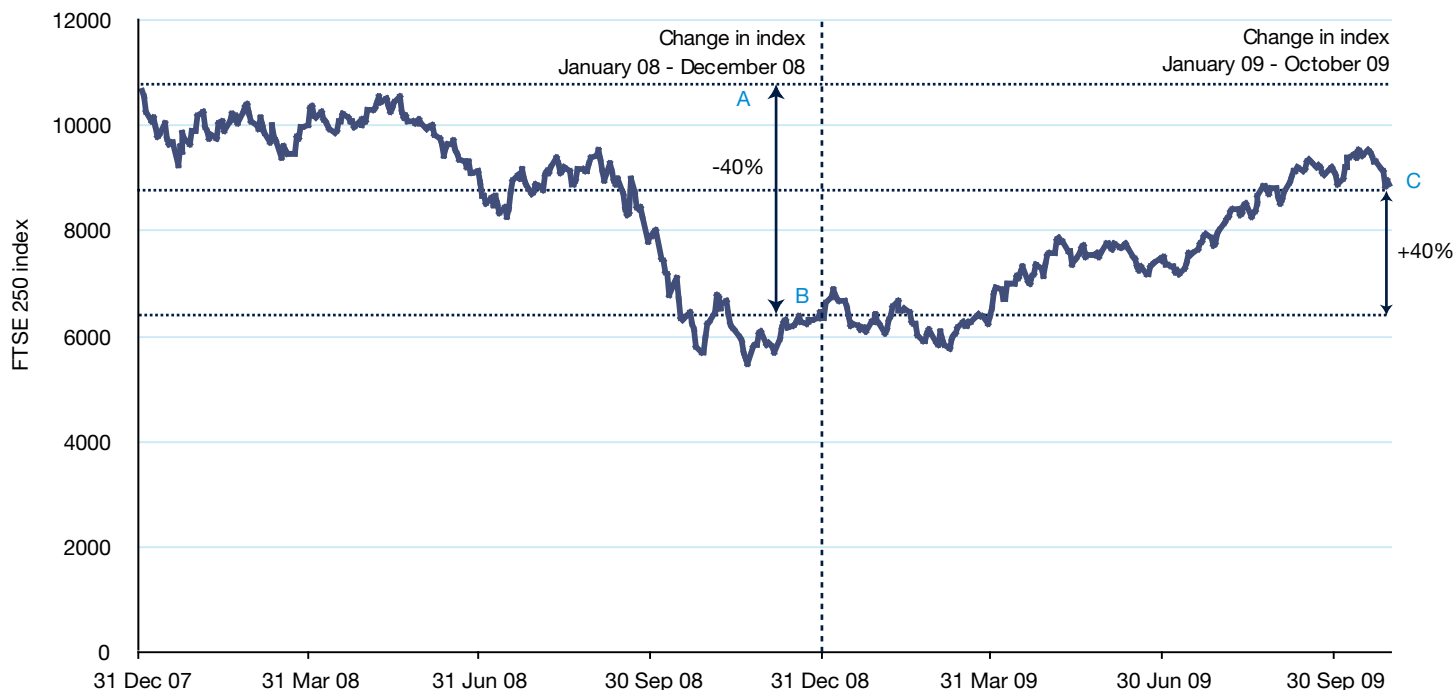
Introduction

While there has clearly been a strong rebound in equity markets during 2009, it is difficult to predict the extent of any increases or decreases in values for investments as any recovery in public markets may well be offset by challenging trading conditions.

The value of investments therefore needs to be considered carefully especially as we note that the value of private companies tends to lag behind their public counterparts and is generally less volatile, as evidenced by transaction multiples which tend to be less volatile for private compared to public companies. The impact of this is that significant collapses and rallies in public markets may not lead to equivalent changes in the value of private companies – i.e. we may not observe significant uplifts in the value of investments at the end of 2009.

In terms of the equity market rebound, the FTSE 250 as at 31 October 2009 had increased by 40% since 1 January 2009 against a 40% decrease in 2008, leaving it 14% below the index at the start of 2008:

Figure1: Change in the FTSE 250 index since January 2008



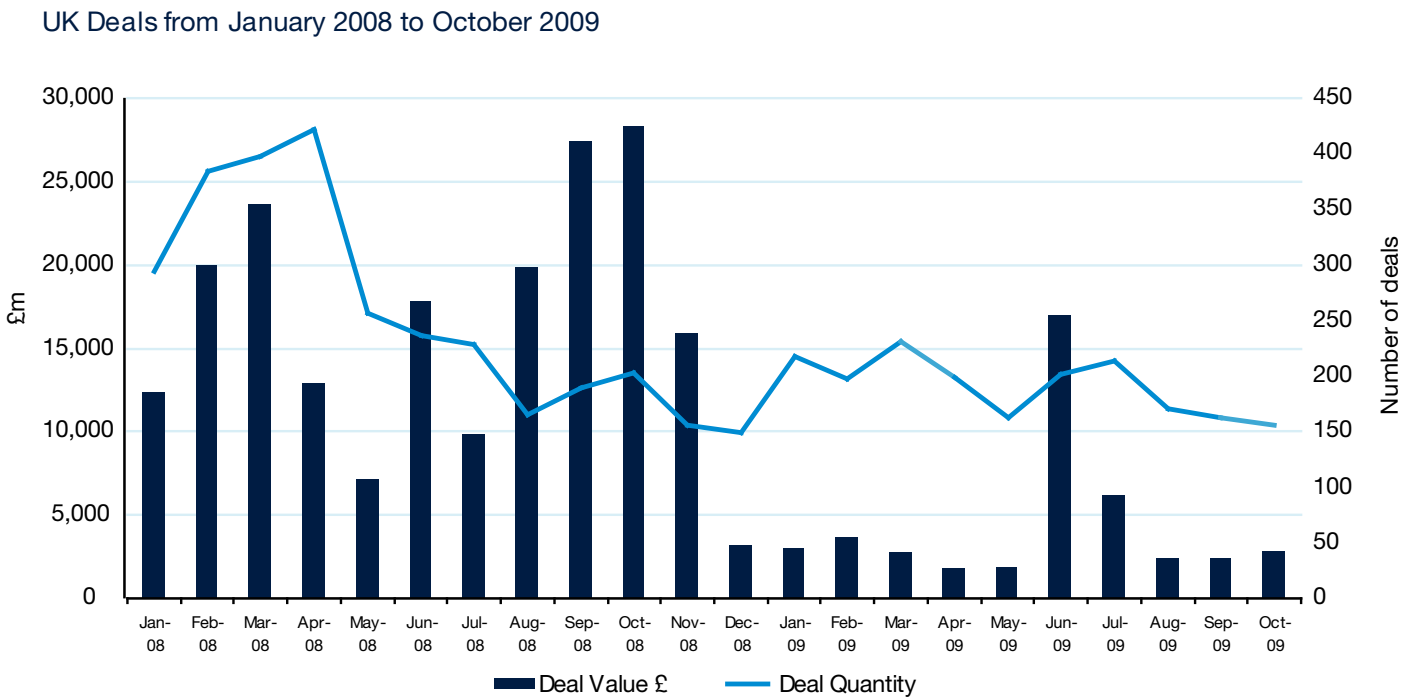
Note:

- A → B = -40%
- B → C = +40%
- A → C is still -14%

Source: Capital IQ

At the same time, the number of transactions in the UK has remained depressed during 2009 (1,912 deals in the 10 months to October 2009), representing a 31% decline compared with the same period in 2008 (2,777 deals) with a significant decline in transaction value. Transactional data is extremely useful for arriving at Fair value and the lack of deals contributes to the current challenges.

Figure 2: Transaction volumes for UK deals since January 2008



Source: Dealogic



Background

The Updated Guidelines were released by the Board on 9 September 2009 with immediate effect in a particularly challenging environment. In a statement accompanying the release, the Board stated that the Updated Guidelines take account of the evolution of global Fair value accounting requirements and practices. Further, the Board explained that the changes were made to ensure 'consistency with converging international accounting standards' – i.e. International Financial Reporting Standards ("IFRS") and US Generally Accepted Accounting Principles ("US GAAP") (together the "Reporting Standards").

We note that the Guidelines have not been widely adopted in the US as entities often use other published guidance including the American Institute of Certified Public Accountants ("AICPA") Audit and Accounting Guide for Investment Companies. However we do observe a number of European private equity firms reporting in accordance with the Reporting Standards using the Guidelines as the basis for assessing the Fair value of their investments.

In its release letter, the Board highlighted the principal updates as relating to:

- Clarifying how the marketability discount should be applied;
- Eliminating any reference to the 12 month period which had been used in practice for retaining investments at cost (referred to as 'Price of Recent Investment');
- Additional guidance on how to include additional milestone analysis into the 'Price of Recent Investment' concept; and
- Guidance on the valuation of fund interests.

As part of the consultation process, PwC provided a number of views to the Board focusing on these principal updates and other areas. We summarise below our observations given the recent release of the Updated Guidelines.

The Updated Guidelines were released on 9 September 09 in the context of converging international accounting standards



PwC observations

1. Concept of Fair value

The concept of Fair value is a hypothetical exchange price as at the Reporting Date regardless of whether there is actually any intention to dispose of the investment. In our view, the assessed Fair value should not change as a result of the Updated Guidelines and the need for proper process (including robust, independent internal challenge) and evidencing remains essential. The valuation process is under increasing scrutiny from investors in terms of valuation approach, earnings, multiples and consistency of approach with any general changes from previous periods likely to attract particular attention. These also remain key areas for discussion with auditors.

Although the updates to the Guidelines were made with a view to ensuring consistency with the Reporting Standards, we note that the definition of Fair value in the Updated Guidelines does not fully comply with the exit price definition of Fair value within US GAAP (SFAS 157) or with the IASB's Fair value measurement exposure draft.

2. Market participant basis

According to the Updated Guidelines and consistent with the Reporting Standards, the concept of Fair value is considered from a market participant view point as opposed to the way a specific owner or acquirer might value the investment.

3. Need for judgement

The Updated Guidelines continue to emphasise a key valuation concept i.e. the assessment of Fair value is a subjective exercise requiring forward-looking estimates and judgements about the underlying business, market and other conditions at the Reporting Date.

While the Updated Guidelines express a preference for historical earnings figures given their greater reliability, we support the use of multiple valuation approaches to arrive at a conclusion which may include the use of historical, current and forecast earnings figures to the appropriately derived historical, current and forecast earnings multiple. Where these multiple approaches suggest widely different values, the underlying reasons for these differences need to be considered, rather than for example, adopting a value based on the average of the various approaches.

4. Price of recent investment

The reference to the 12 month 'window' for holding investments at cost has been removed in the Updated Guidelines and more guidance is provided on the need to assess any Fair value impact after a limited period (albeit this period is now undefined). That said, we would not necessarily expect significant changes in value in the first three to six months but this ultimately depends on the facts and circumstances specific to each investment.

Further, the Updated Guidelines now include milestone analysis to facilitate this review for an investment in early or development stages. We note that this milestone analysis may be particularly applicable to biotech, pharmaceutical, real estate and venture capital investments.

Fair value should not change as a result of the Updated Guidelines

Valuation is inherently a subjective exercise which needs to be considered from a market participant viewpoint

We support the consideration of multiple valuation approaches but taking a straight average of the approaches should be avoided

Holding investments at cost for 12 months is no longer supported

5. Marketability discount and control premium

The Updated Guidelines now suggest that consideration of the risk associated with a lack of marketability should be incorporated within market multiples under the market approach alongside other considerations such as size, growth and risk. This has the effect of applying the discount at the Enterprise Value level i.e. against both equity and debt even though the effect of adjustments such as marketability discount and control premia are typically observed at the Equity rather than Enterprise Value level.

We note that applying an adjustment to the multiple to reflect a lack of marketability at the Enterprise Value level rather than the Gross Attributable Enterprise Value level under the previous Guidelines, will generally reduce the marketability discount percentage compared with previous practice depending on the level of gearing in the portfolio company.

We illustrate this in Figure 3 below where a 20% marketability discount, which under the previous Guidelines was applied at the Gross Attributable Enterprise Value, would result in a significantly lower value for a 10% equity stake of £0.6m as opposed to £2m if the same 20% adjustment was made to the EBITDA multiple. To arrive at the same Fair value for the 10% equity stake as in the previous Guidelines would mean a discount of only 5% being applied to the EBITDA multiple:

Figure 3: Potential impact of the marketability discount adjustment

	Previous Guidelines	Updated Guidelines - Incorrect	Updated Guidelines - Correct	
	£m	£m	£m	
EBITDA	10.2	10.2	10.2	Effect of a 20% marketability discount applied directly to multiple (9.5x * 0.8 = 7.6x)
EBITDA multiple	9.5x	7.6x	9.0x	
Enterprise Value	97.4	77.9	92.3	Marketability discount should now be 5% not 20% applied directly to multiple (9.5x * 0.95 = 9.0x) to achieve the same Equity Value
Net Debt	(72.1)	(72.1)	(72.1)	
Gross Attributable Enterprise Value	25.2	5.8	20.2	
Marketability discount of 20%	(5.0)			
Equity Value	20.2	5.8	20.2	
Fair Value of 10% equity stake	2.0	0.6	2.0	
Cost	5.0	5.0	5.0	
Write down implied £m	(3.0)	(4.4)	(3.0)	
Write down implied %	-60%	-88%	-60%	

Note: Moving the marketability discount to the EBITDA multiple, ceteris paribus, will require the discount to be lower if the portfolio company is geared. For instance, in the example above, significant gearing requires a considerable reduction in the marketability discount from 20% to 5%.

At the same time, any impact from having actual or implied control is now specifically mentioned in the Updated Guidelines as a factor to consider although no more specific guidance is provided. In our experience, this has not been explicitly adjusted for by private equity firms but has sometimes been considered by increasing the marketability discount where no control exists.

In our view, the exit options for the investment need to be considered at the Reporting Date to assess whether a control premium or lower marketability discount is applicable. For instance, for a minority equity stake, the most likely exit route may be a sale in the secondary market for that stake whereas for a controlling equity stake, the exit route is likely to involve an initial public offering or a sale of the entire portfolio company. In this context, care needs to be taken in using transaction multiples given the specific facts and circumstances around recent transactions as well as the need to consider whether those transactions involved the sale of a controlling or minority stake.

Overall, the multiple is a critical component in assessing Fair value and it is therefore important to review the multiple against other data points such as the original acquisition multiple as well as current and, where possible, forecast multiples to assess whether it is reasonable.

6. Maintainable earnings

We believe that earnings will be a key area of scrutiny for 2009. Given the challenging trading conditions, we expect a number of portfolio companies to be experiencing decreases in sales and profits which may take time to reverse. This must be carefully considered in assessing the level of maintainable earnings against which multiples are applied and it will also be important to consider how a market participant would assess earnings in terms of a potential deal price. As always, it is critical that the appropriate multiples (current or forward) are applied against the equivalent earnings.

Earnings will be a key area of scrutiny for 2009

7. DCF analysis

The Updated Guidelines appear biased against DCF analysis even though this is a technique recognised by the Reporting Standards and represents standard market practice for certain assets (such as infrastructure). While we understand that DCF analysis is not typically the primary valuation methodology for a private equity group's investments it can be useful as a cross check especially for material investments, early-stage investments or in those rare circumstances where no comparable companies exist. Where DCF is used, we believe that it is still important to calibrate the underlying assumptions to market data such as analysts reports or other industry analysis. With respect to discount rates, in order to arrive at Fair value it is important to base the inputs on those of a market participant rather than the holder of the investment.

DCF analysis can be useful as a cross check

8. Compliance with IFRS / US GAAP

The Updated Guidelines suggest that ‘their application can achieve compliance with the Reporting Standards’. We believe that following the Updated Guidelines in their current form may not automatically lead to compliance with the Reporting Standards particularly in the areas of discounts and debt:

Discounts

We note that IFRS can be interpreted to prohibit the application of discounts (such as for marketability) at all levels of the Fair value hierarchy and not just Level 1 (as is the case under US GAAP), a point which is currently being discussed and clarified with the IASB. US GAAP is more specific about discounts being allowed where listed prices are not available – i.e. for Level 2 and 3 investments under the Fair value hierarchy in US GAAP (SFAS 157). Private equity investments are generally classified as Level 3 in our experience.

Impact of debt on Fair value

The Updated Guidelines appear to follow a ‘settlement’ rather than ‘transfer’ notion for financial liabilities such as debt by assuming repayment of the debt is at face value at the Reporting Date. This is consistent with IFRS which also has a settlement notion as opposed to US GAAP where a financial liability is measured based on the price that would be paid to transfer that liability to a third party.

In our view, the guidance in the Updated Guidelines is appropriate for controlling equity investments where it is assumed that the sale of the stake is likely to lead to repayment of the debt at par (i.e. a change of control clause will likely be triggered).

However, we believe that there may be a different treatment required where a change of control clause would not be triggered – i.e. for some minority investments where the investment could be sold in the secondary market without triggering a change of control clause. In these cases and especially where the Fair value of debt may be significantly less than face value (i.e. as might be the case for distressed investments), it may be appropriate to deduct debt from Enterprise Value at Fair value – i.e. at lower than face value.

There is a concern that deducting the portfolio company’s debt at Fair value will overstate the value of the portfolio company’s equity which would not make sense where a portfolio company is distressed. However, we note that there would be no uplift in Equity Value if the Enterprise Value of the portfolio company is lower as a result of its distressed state. This would principally arise where lower maintainable earnings are expected but might also be the result of an industry as a whole or publicly traded comparable companies being in distress. Such distress might manifest itself in the

Following the Updated Guidelines may not automatically lead to compliance with the reporting standards

For minority investments, the treatment of debt in the waterfall may require separate consideration than that outlined in the Updated Guidelines

Fair value of comparable company debt being significantly below its face value, thereby resulting in a lower multiple being applied to arrive at the portfolio company's Enterprise Value. As a result, we do not anticipate any immediate uplift in the Fair value of equity if the Enterprise Value of the portfolio company has been adjusted downwards to reflect distress.

9. Fund interests and mezzanine debt

The Updated Guidelines now provide additional guidance on valuing fund interests and, in particular, suggest that NAV is appropriate as a starting-point assuming that the underlying process is reliable and sets out a number of circumstances (e.g. timing differences, carried interest accrual) where adjustments to NAV may be necessary. Additionally, there is more guidance on how to consider secondary transactions and the need for considerable judgement given information limitations.

In addition, guidance on mezzanine loans is provided which suggests that current yields for comparable instruments need to be factored into valuations and that a DCF analysis should typically be used for private debt where market prices are unavailable or unreliable.

10. Option value of equity

For investments in companies in distress where potential covenant breaches have been identified or where the amount of debt appears to be higher than the investment's Enterprise Value, we believe that the potential for option value of equity needs to be considered.

As discussed above in Section 8, in scenarios where the sale of the equity investment will trigger a change of control provision on the debt, the Fair value of debt is not expected to be an issue because Fair value is based on a hypothetical sale price at the Reporting Date and if the sale of the equity investment triggers a change of control provision, debt will likely be settled at face value. We have provided an illustrative example below (see 'traditional waterfall' approach) to highlight why the deduction of debt at face value may result in zero option value being attributed to equity in some circumstances.

However where no change of control provision exists, for instance in the case of a minority equity interest, the equity holder may be able to sell its interest without triggering a settlement of the portfolio company's debt at face value. In such instances, the Fair value of that debt will reflect any favourable financing. By avoiding settlement of the debt at face value when the equity interest is sold, the minority equity holder is able to transfer the benefit of favourable financing to the secondary buyer of the equity interest.

The benefit of having time for a portfolio company to turn around its financial performance means that the ability to exploit favourable financing over the term of a debt agreement may translate into incremental value

Discount rates for valuing mezzanine loans should be based on current yields

The 'traditional waterfall' approach may not always be appropriate for investments in distressed companies as it can ignore the option value of equity

for equity holders. This incremental value may not be evident if debt is deducted at face value under the ‘traditional waterfall’ approach. Favourable financing typically translates into debt with a Fair value that is below its face value and deduction of debt at the lower Fair value enables the recognition of the option component to Equity Value.

In such situations or where portfolio companies are generally experiencing difficulties, the Updated Guidelines do not provide guidance on how to assess whether the equity has been fully impaired and what techniques can be used to measure any option value. We have observed more consideration of probability weighted models in valuation techniques in the US and believe that this may be useful in considering option value to equity which, on the face of it, appears to be underwater.

An example of the probability-weighted model is the ‘multiple outcome’ approach which, in contrast to the ‘traditional waterfall’ approach, involves a forward-looking analysis of the possible future outcomes available to the enterprise. This comprises the estimation of ranges of current and future value under each outcome and the application of a probability factor to each outcome as of the Reporting Date to arrive at an ‘expected value’. By considering only one scenario for a distressed company which would typically be settlement of the debt at face value (or lower depending on available proceeds from a sale of the enterprise), the ‘traditional waterfall’ approach may overvalue debt and undervalue equity by ignoring the option value of equity, as shown in figure 4 below:

Figure 4: Estimating the option value of equity

Enterprise valuation allocation summary (£m)				
Traditional waterfall approach		Multiple outcome approach		
		Estimated value		Probability weighted expected value
		Low scenario ⁽¹⁾	High scenario ⁽¹⁾	
Business Enterprise Value	£260	£100	£420	£260
Debt	£260 ⁽²⁾	£100	£400	£250
Equity	-	-	£20	£10

Fair value of debt

Option value of equity

⁽¹⁾ 50% probability
⁽²⁾ Face value of debt is £400

In the example above, the high and low scenarios are of equal probability and some value to equity is provided in the high scenario with an Enterprise Value of £420m, (we note that there would need to be proper justification of underlying assumptions if this technique was to be applied) as opposed to £100m in the low scenario, providing a probability weighted expected value of £260m. This may mean that there is some value to equity which an

acquirer might also identify – in this case £10m for the equity compared to zero under the traditional ‘waterfall’ approach.

The low scenario might represent a situation where the company’s performance is deteriorating such that the debt holders may, at some point, be able to take over the business thereby extinguishing all Equity Value. The high scenario might represent a situation where the absence of a change of control provision means that the equity holders are able to sell their stake at the Reporting Date without being forced to repay debt at face value.

It is crucial to consider the position of the debt holders and it may be that covenant breaches mean that the debt holders already have effective ownership of the entity and any Equity Value is therefore extinguished at that point. We therefore note that the option value of equity may be a more relevant consideration where debt covenants have not yet been breached. We also note that the option value of equity can be impacted not only by the Fair value of debt but also other securities which rank above it in terms of liquidation preference so that it may be necessary to consider the Fair value of preference shares in more complex capital structures.

Given the recent downturn in the economy, the discussion above focuses on scenarios where companies are distressed or experiencing difficulties. We have set out below other scenarios where the Fair value of debt and / or preference shares should be considered, both from a comparable company and portfolio company perspective:

- Expected term - given the changes in the credit and equity markets, leveraged buyouts that were expected to be exited in two to three years may now have considerably longer terms than were contemplated in the original analysis or pricing of the debt;
- Off market covenants - prior to dislocation in the credit markets, debt securities were sometimes issued with limited protections afforded to the lender. Such covenant-lite debt may have limited or reduced marketability in the current environment, which in turn impacts its Fair value; and
- Widening spreads - general market conditions have resulted in significant tightening of credit markets reflecting the increased perceived risk of bankruptcy and of other financial difficulties (as observed by widening yields on debt securities).

These factors require careful consideration in arriving at the Fair value of equity stakes when a sale of the equity interest does not trigger a change of control provision on debt.

Option value of equity may be a more relevant consideration where debt covenants have not yet been breached

A number of factors can result in the Fair value of debt being lower than its face value. Most of these factors are related to recent market conditions

Conclusion

In our view, there is likely to be vigorous debate within private equity firms and with external parties around both the multiple and the maintainable earnings for the valuation of investments for 2009 year-ends.

However, the need to arrive at a best estimate of Fair value remains the core principle and, in many ways, the Updated Guidelines facilitate this by their increased focus on multiples which is consistent with how the industry generally considers values when making original investments.

Finally, it will be important for private equity firms (and their auditors) to ensure that any changes in values from 2008 have been assessed in the context of earnings performance, future prospects and recovery in market prices to arrive at robust valuations. Firms will continue to rely heavily on proper process and evidencing given the increasing level of scrutiny in this industry.



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For more information contact our UK team set out below:



Nick Rea

Partner

Tel: +44(0) 20 7212 3711

Email: nick.rea@uk.pwc.com



Peter Clokey

Partner

Tel: +44(0) 20 7804 5557

Email: peter.clokey@uk.pwc.com



Attul Karir

Assistant Director

Tel: +44(0) 20 7213 4952

Email: attul.karir@uk.pwc.com



Ashley Coups

Private Equity Assurance Leader

Tel: +44(0) 20 7804 9609

Email: ashley.coups@uk.pwc.com

www.pwc.co.uk

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