



## Private Equity Valuation: A Riddle Wrapped in a Mystery inside an Enigma

Will outside scrutiny affect the valuation of private equity?

BY CYNTHIA HARRINGTON, CFA

**P**private-equity analysts and public-equity analysts follow a similar valuation process. Both value the company based on carefully chosen financial characteristics, such as earnings, cash flow, or assets. But without the evident pricing of a public marketplace, private equity investors apply varying methodologies to determine the ultimate price.

The lack of standardization has given rise to new global regulations requiring fair-value performance pricing, with some participants — and certainly some regulatory agencies — thinking that valuation standards are the answer.

### Choosing the Measure of Value

All investors are concerned with what their money buys in terms of earnings, assets, or some other measure of value. So valuation of private equity proceeds by deciding on a measure of value, applying a multiple to the measure, and possibly taking a discount from or adding a premium to that initial estimate. The discount or premium reflects the deal's special characteristics relative to similar investments.

Private equity refers to a broad range of companies not traded in public markets. Private deals range from startups with no sales or earnings to mature companies with multiyear historical financials. Investment structures of deals may involve common equity, preferred equity, debt, or hybrid instruments combining advantages of each basic form. Private equity investors use a variety of measures of value depending on circumstances. EBITDA works for the Riverside Company based in Cleveland, Ohio, USA, because they

seek only companies with 3–5 years of consistent earnings. The 15-year-old private equity investment firm has invested in 86 deals in the smaller end of the middle market. “We’re not looking for growth companies that we would need to pump more capital into,” says Riverside CFO Bela Schwartz.

Riverside takes care with the inputs and adds methodologies where useful. “EBITDA is less useful for capital-intensive companies, so we use DCF,” says Schwartz. “We also don’t pay up for a spike in earnings but average-out multiple periods as the basis for our bid.”

Fund-of-funds managers find that the managers they invest with use a variety of measures. “Private equity trades at multiples of cash flow, earnings, and assets,” says Barry Gonder, CFA, general partner of Grove Street Advisors of Wellesley, Mass., USA. “We use the managers’ valuation as a starting point, but we develop our own opinion as comparison.”

The methodology differs according to investor perspective as well. Peter Cogan, CPA, audit partner in charge of private equity at Eisner LLP, serves general financial services clients, including private companies, private equity managers, as well as funds of funds. “Investors value all the factors like cash flow and earnings and have a very clear understanding of the fundamentals of the company,” says Cogan. “No one factor rules unless an event or financing just happened.”

Cogan sees that clients can value the same deal differently depending on their entry point. He offers the example of three different venture funds bidding on the same deal at three different prices. “Each investor had participated

### KEY POINTS

- Underlying measures of value are cash flow, earnings, and assets.
- Valuation methodology depends on context — sale, financing, fair-value performance reporting.
- Competition for deals raises multiples.
- Proposed fair-value rules force regular valuations and promote consistency.

in the different rounds G, D, and A,” says Cogan. “Each valued the equity differently because of the liquidation preferences and rights of each round.”

### Illiquid Multiples

The range of valuations in the market ultimately depends on the discount or premium applied to the value measure. The investment after all is illiquid and investors look to be compensated for the disadvantage. Topping the list of preferred methodologies of the British Venture Capital Association (BVCA) is some multiple of earnings. “The truth of the matter is that despite the many different valuation models that exist, the one and only model used is the price-earnings ratio,” says Shahin Shojai, director of strategic research for Capco in London, United Kingdom.

Investors adjust a valuation up or down depending on many considerations. For instance, a company might be valued more highly because the new owner can negotiate cost savings on purchases of needed materials. Another reason might be the expectation of gains from restructuring the management team.

With young companies, venture capitalists can add value by contributing decision-making expertise. Shojai studied the effects of managers’ direct ownership of companies as the companies went private through an MBI (management buy-in). “What makes the true difference is improved management, either via the introduction of better people or better alignment of management objectives with those of the business,” he says. “It is remarkable how much better managers perform when they share in the performance of the business.”

Some investors have an absolute target ratio and make other adjustments for the underlying characteristics of the company. The Riverside Company looks at a variety of elements to assign a multiple, including the values of other deals done in the same industry, and company-specific factors. “We hate paying over 7 times earnings for anything,” says Schwartz. “But we might assign a slightly higher multiple for a company with greater than 20 percent sales growth, or sometimes we’d pay up for a cash cow that fits a particular position in our portfolio.”

Technical knowledge of the potential for a company’s products partially accounts for the range of valuations, especially in companies based on new technologies. “In venture-stage companies, subtle differences or subtle changes in a product can make huge changes in the valuation of one company over a seeming competitor,” says Gonder.

Some public data do exist and help form a sort of de facto marketplace. Prices of similar deals are readily available, and several vendors supply aggregated data. Private equity investors also have an informal network of information sources. As a fund of funds, Grove Street Advisors turns first to their database of companies. “We compare valuations across industries, types, and sectors,” says Gonder. “If the company is raising capital, we might talk with a number of firms in the same industry for their take on the valuations.”

Multiples are affected by supply and demand in the marketplace. Lots of money chasing a few deals floats all valuations higher. Now, after a two-year lull, investors are paying up again. Demand rose in the second quarter, with even early-stage and first-time financings showing some life. “General partners now have a large amount of capital, and acquisition multiples are creeping up,” says Schwartz. “We’re happy to be a seller in this environment, but we’re struggling to be a buyer.”

The loosening credit markets make it easier to pay up a little. “We understand certain companies are doing deals at 9 and 10 times earnings,” says Schwartz. “We’d pay over 7 if it really

excites us, and we can still make the deal work from an IRR [internal rate of return] perspective, given the lower cost of debt.”

#### Fair Value

Private equity valuation methods are in sharp focus due to the new demand for fair-value pricing. “For ongoing valuations, we take the numbers provided by the general partner,” says Joncarlo Mark, who as portfolio manager of Alternative Investment Management Group at CalPERS is part of an eight-person team managing \$21 billion and 300 private equity investments. “But in reality, we do an analysis of the IRR generated by

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the general [partner] and do our homework on the underlying cash flows of the businesses to assess whether the valuation methods are conservative or not.”

The need to find an updated value affects all players. Historically, most general partners kept the values at cost and would mark down the value only in the event of impaired earnings potential. Few would mark up positions, going by the rationale that private equity has no real change in value until it’s sold. “But auditors are now asking how they can sign off on reports if everything is held at cost,” says Mark.

Accountants are asked for advice on what fair-value pricing method to use. “I turn it back on my venture capital clients,” says Cogan. “I tell them to

look at the company financials and the budget and decide what they’d pay to buy the company at this point in time.”

In some cases, the participants decide together what value to place at regular intervals. Cogan sits on some committees of key limited partners organized by the general partner. “If the general partner presents three deals, two with glowing news and the third with some problem, the limiteds will focus on the third and ask about writing it down immediately,” says Cogan. “Limited partners would rather be pleased by good news than surprised by a sudden drop in prices.”

Valuation methods are of keen importance to limited partners because manager fees are based on the net invested capital. “Limited partners don’t want to be paying high fees based on too-aggressive valuations,” says Mark.

The industry is talking about creating standards to guide managers in methods for the now-required regular valuations. According to a survey by the Center for Private Equity and Entrepreneurship at the Tuck School of Business at Dartmouth, 51 percent of 368 venture and buyout managers surveyed wanted an industry association to take the lead in forming the guidelines. “The desire is that private equity valuations be more consistent and marked a little more to market based on a consistent, agreed-upon method,” says Mark. ▀

*Cynthia Harrington, CFA, is a financial journalist with 20 years’ experience in the investment business.*

#### RECOMMENDED RESOURCES

“Money Chasing Deals? The Impact of Fund Inflows on Private Equity Valuations”  
Abstracted in *The CFA Digest* (Summer 2000)  
(cfapubs.org)

“Alternative Asset Classes: Real Estate and Private Equity Provisions”  
CFA Institute webcast  
(cfawebscasts.org)

“New Dimensions in Private Equity”  
CFA Institute conference webcast highlights  
(cfawebscasts.org)

“Leveraged Management Buy-Ins”  
*Journal of Financial Transformation* (April 2004)  
(www.capco.com)