Listed private equity

Key investor considerations for understanding listed private equity portfolio valuations

Contacts

Deloitte
Garrath Marshall
Audit Partner
gmarshall@deloitte.co.uk

Yasir Aziz
Audit Senior Manager
yaziz@deloitte.co.uk

LPEQ
Douwe Cosijn
Chief Executive
Douwe.Cosijn@lpeq.com

Michael Mills
Senior Adviser
LPEQ

Introduction

Recent events in the listed private equity ("LPE") market give rise to questions about the value opportunity certain investors appear to be seeing in the sector. One factor may be varying degrees of confidence public market investors have in the underlying valuations of LPE portfolio companies.

The challenge for both LPE managers and investors is that valuing portfolios of private companies is complex and involves an inherent judgement, discretion and flexibility. This complexity also applies to actual levels of transparency and disclosure an LPE manager provides given the inherent sensitivities of investing in private companies.

Additionally, it should be recognised that private equity valuations and methodologies are not necessarily compatible with the investment priorities of public market investors. The challenge for LPE is to provide investors assurance that industry standards are robust and specifically address to the best of its ability the key public market investor concerns when investing in the LPE sector.

Objective

The aim of this paper is to explore a number of factors raised by investors about portfolio valuation by LPE companies. Investors in investment companies with listed equity portfolios generally expect to receive daily net asset value ("NAVs") information from the companies in which they are invested and like to be able to compare this with the prevailing share price in assessing their investment stance.

The key considerations explored in this paper are as follows:

- portfolio valuations of private equity investments are complex and involve inherent discretion and flexibility allowed by the accounting and regulatory frameworks;
- portfolio valuations might be conservatively determined, as implied by the uplifts often achieved when an investment is realised;
- valuations are not updated frequently enough and are out of date when published, especially when markets are volatile; and
- there is a lack of information disclosure and transparency to enable an investor to understand how the portfolio has been valued.

But, before exploring these considerations in detail, this paper assesses how valuation fits into the traditional private equity ("PE") model and explores the purpose valuation seeks to serve within a PE context.

Valuations within PE – market practices in accounting for investments

The most common investment vehicle through which PE investment is undertaken is the private fixed-life limited partnership fund. This is mainly because of the flexibility and tax transparency such a structure affords. These funds tend to have a ten-year life, with scope to increase this by a further period of up to 3 years at the discretion of the investors, with the first 4-6 years being the fund's investment period. Investors in such funds (Limited Partners or "LPs") are required to make commitments to the fund, which are subsequently drawn down as required by the fund manager (through the General Partner or "GP") in order to make investments or pay management fees. After the investment period, the GP spends the remaining life of the fund managing and realising investments.

Funds from realisations are not re-invested, but returned to LPs as soon as practicable following a realisation event, meaning that these funds have a self-liquidating character. Although there is a limited secondary market for LP interests in such funds, most LPs aim to hold their investment until the end of the fund's life. A key focus of GPs and LPs is the cash-to-cash returns generated by the fund, with a key metric of performance being the internal rate of return ("IRR").

The fund manager (or GP) within the PE model often plays a very different role from fund managers investing in quoted shares and securities, generally leading the development of the value creation strategy to be implemented by a portfolio business and then directing its implementation. The GP will be centrally involved in selecting the management team and working with them to deliver the strategy for the business where they have some degree of control over the portfolio company.

Given the cash-to-cash focus of LPs and GPs and the role played by GPs in connection with portfolio companies, frequent portfolio valuations are arguably less important within the PE context than for investment entities investing in quoted shares and securities. Fund managers within PE are not accountable to investors for their buy, hold and sell decisions on a day-to-day basis nor do LPs require daily NAVs in order to consider their own buy, hold and sell decisions. Management fees paid to the GP are often based on capital committed rather than the unrealised valuation of the fund and performance fees are often paid on realised gains so the valuations by the GP will not affect the fees paid by investors.

Clearly, portfolio valuation does still have an important role to play within PE, given that LP investors wish to monitor the progress of their investment as the fund's life evolves and will be required to report back regarding such progress to their own constituencies. In addition, given that a fund manager will usually look to raise its next fund prior to the end of the current fund's investment period, portfolio valuation is a key input into the track record performance of the GP.

Consideration 1 – portfolio valuations are complex and involve inherent discretion and flexibility allowed by the accounting and regulatory frameworks

Some investors believe that some portfolio valuations of LPE companies cannot be relied upon, since valuers are given too much leeway and discretion by "the rules". This point applies both to LPE companies that directly invest into portfolio companies through a single fund manager ("Direct LPE companies") and to fund-of-fund and secondary LPE companies that hold LP stakes in a number of LP funds run by one or more fund managers ("Fund-of-funds LPE companies"). It is noted, however, with the latter that there might be a netting-off, or portfolio effect in the portfolio valuation as a whole given that the valuations will be undertaken by a range of fund managers and will cover a significantly larger population of underlying investments.

Investors point to differences in valuations of the same underlying business where more than one PE house holds an investment in that business; and also to evidence that NAVs of LPE companies often do not reflect short term moves in equity markets. In addition, in applying an earnings multiple basis of valuation, they observe that different PE houses will inevitably adopt differing interpretations of concepts like "maintainable earnings", and that some houses use forward multiples and others use historical multiples.

In exploring this concern, we will look first at the financial reporting and valuation guidance relevant to portfolio company valuations by LPE companies.

Financial reporting and valuation guidance

The main financial reporting and valuation guidance applying to most European LPE companies (since they generally undertake to prepare their financial statements in accordance with International Financial Reporting Standards ("IFRS")) is contained in IFRS 13 "Fair Value Measurement" and the International Private Equity and Venture Capital ("IPEV") Valuation Guidelines. The latter guidelines were drafted so as to be compliant with IFRS 13.

Fair value (defined as "the price that would be received to sell an asset … in an orderly transaction between market participants at the measurement date") is defined by IFRS and the IPEV Guidelines outline the steps involved in the exercise of judgement when applied to investments that are not quoted on a traded market. It is also recognised that investment assets within the PE sector will inevitably vary by reference to a wide range of variables and inputs to the relevant valuation, such as whether the business is profitable or not or, if it is generating revenues, the nature of the business and the sector(s) and geographies in which it operates, the competitiveness of the environment in which it operates, the quality of earnings, growth prospects, etc.

IFRS 13 seeks to increase consistency and comparability in fair value measurement through the use of a "fair value" hierarchy. The hierarchy categorises the inputs used in valuation techniques into three levels, giving the highest priority to unadjusted quoted prices in active markets for identical assets and the lowest priority to unobservable inputs. IFRS 13 requires the use of valuation techniques appropriate for the measurement of fair value, considering the availability of data with which to develop inputs that represent the assumptions that market participants would use when pricing the asset and the level of the fair value hierarchy within which such inputs are categorised.

The IPEV Guidelines contain a number of valuation techniques commonly used to value investments in unquoted businesses and provide detailed guidance on the circumstances in which a particular technique may be considered appropriate and on the application of the technique itself. Because of differences between investments and in order to ensure the valuation itself is conceptually consistent with the definition of fair value, the IPEV Guidelines inevitably allow a significant degree of choice and judgement in the valuation process. Approaches outlined in the IPEV guidelines include;

- **Net Assets Approach** – using total assets less total liabilities of a portfolio company to arrive at fair value
- **Price of Recent Investment** – fair value derived from the price that was recently paid for the asset
- **Discounted Cash flow** – expected future cash flows from the asset discounted to take into account the time value of money;
- **Comparable Recent Transactions** – deriving fair value with reference to market transactions for similar companies; and
- **Multiple based approach** – using a basket of comparable listed entities to derive an earnings multiple to be applied to the portfolio company's maintainable earnings.

In contrast to a sell-side or buy-side analyst undertaking a valuation of a quoted business, the PE fund manager will generally have full "inside" information about the portfolio business, including the Company's performance against the investment case, the financial forecasts and projections, the status of significant contractual discussions with customers, etc. This allows the fund manager, in undertaking a valuation, to have a fuller picture of risk, growth prospects, quality of earnings and other key valuation parameters.

The accounting practices and processes are continually evolving and fair value is a topic that is under review by the standard setters. Auditing standards, which govern the activities of audit firms are also being assessed to ensure they are fit for purpose. A recent example of changing practices is the inclusion of the guideline within the latest IPEV valuation guidelines for firms to perform 'back testing' where realised values are compared against the last determined fair values to assess for and understand any material differences.

Governance around the valuation process

Given the judgement applied in determining fair value, the governance framework surrounding the valuation process becomes more important. Direct LPE companies generally strive to have governance structures and procedures in place to ensure that valuations are robust. Valuations will generally be prepared by an internal (or external) party independent of the individuals responsible for portfolio management of the relevant investment. Detailed valuation papers will generally be reviewed by a valuation committee and often also by the board of the LPE company. In addition, valuations are generally considered to be areas of focus for the auditor of the financial statements of the LPE Company on an annual basis, with auditor review often also conducted at the time of interim financial statements.

Fund-of-funds LPE companies will generally rely upon valuations provided by the fund managers of the LP funds in which they are invested. A key part of their role as a fund-of-funds manager will be the selection of funds where governance, including that relating to portfolio valuation, is strong. In addition, given the fuller information they as LPs receive from the underlying fund managers, investors in Fund-of-funds LPE companies will expect them to ensure that valuations appear to be reasonable.

Concluding thoughts

It is important to recognise that the fair value concept underpinning the valuation of PE investments for reporting purposes involves the exercise of judgement both as regards the choice of valuation technique(s) and in the choice of inputs in applying the technique(s). Nevertheless, both IFRS and the IPEV Guidelines do emphasise key qualitative principles that should be applied in determining fair value; and this, combined with the use of sound governance, including the audit or review of financial statements by an independent firm of auditors, means that portfolio valuations of LPE companies, both Direct and Fund-of-funds, are generally considered to be robust.

Consideration 2 - portfolio valuations might be conservatively determined, as implied by the uplifts often achieved when an investment is realised

There is a general perception amongst investors, analysts and commentators that PE valuations, including those of LPE companies, are often conservative, reflecting (it is argued) a desire by the fund manager or LPE company to smooth returns or avoid having to report subsequent reductions in value or losses on realisation of the investment. This perception is supported (it is argued) by uplifts achieved on realisation when compared with the latest reported portfolio valuation. A recent Deloitte survey found that, within a sample of PE funds surveyed, the average uplift on sale against the last reported fair value of the relevant asset was 36%.

While there is of course a natural desire on the part of a reporting entity, as with quoted companies across all sectors, to smooth results and avoid "unpleasant surprises", it is important to appreciate that realisation uplifts should, in the absence of any other changes occurring after the valuation date that impact on valuation, be expected to arise. Why this should be the case is discussed in the following paragraphs.

Firstly, the portfolio valuation should, under the IPEV Valuation Guidelines, reflect a liquidity discount when determining comparable companies to use as a basis for multiple based valuations. The rationale for applying a liquidity discount to a comparable company when a portfolio company is valued using quoted market earnings multiples is that a holder of an investment in two businesses that are identical save for one being quoted and the other private would be willing to pay more for the quoted investment since the holding is able, in theory, to be sold immediately on the stock market. The investment in the private business can only be realised following a lengthy sales process and the holder is exposed during this period to the risk that something will occur to impact the value of the investment.

Secondly, it is arguable that the price actually received in a sale of a portfolio company may reflect factors over and above those reflected in the carrying value of the investment. For example, if the investment concerned is a minority equity interest in a business, it is arguable that the fair value of that interest should not reflect the control premium that an acquirer of a 100% stake in the business would be willing to pay. Likewise, depending on the extent of competitive tension involved in the sale process, the price actually achieved on sale may reflect more or less of the synergy benefits that the acquirer may be targeting from the acquisition.

Concluding thoughts

Consistent with industry guidelines, LPE and, in the case of Fund-of-funds LPE companies, the underlying fund manager's desire is to manage both internal and external performance/returns expectations which some might consider could give a rise to a bias towards conservatism in portfolio valuations.

There are a number of reasons why gains could be be expected to be recognised relatively close to exit, such as the impact of control premia and the presence of a motivated buyer potentially impacting on the asset's fair value.

Consideration 3 – valuations are not updated frequently enough and are out of date when published, especially when markets are volatile

Consistent with the frequency of portfolio valuations provided to LP investors in traditional PE funds, investors in LPE companies tend to receive updated valuations quarterly or six-monthly and on a lagged basis, given the time involved in carrying out a valuation exercise.

In the case of Fund-of-funds LPE companies the lag may be even longer since they rely on quarterly valuations from the underlying fund managers. Some Fund-of-funds LPE companies do publish monthly NAVs, updated from the most recent quarterly valuations to reflect portfolio realisations and currency movements. As noted above, the frequency of these PE valuations is in stark contrast to the daily NAVs published by many other listed investment companies, though notably not those investing in other alternative strategies such as infrastructure or property.

While there are clearly practical constraints at play here, in terms of the time, resources, information and process involved in valuing a PE portfolio, the other main reason for the quarterly or half-yearly portfolio valuation by LPE companies is the reliance on the PE model and the importance of portfolio valuation within that. They also reflect the nature of LPE investments made as the investment horizon for an LPE investment is typically 3-5 years whereas traditional asset managers tend to generate more rapid portfolio turnover. As noted above, the PE model focuses on cash-to-cash returns and driving a value creation strategy for each business through to the point of exit or realisation. In this context, valuations are used primarily for monitoring progress over the life of a fund rather than for allowing buy/hold/sell decisions by the investor or fund manager to be made or assessed on a day-to-day basis.

Concluding thoughts
The time lag involved in publishing portfolio valuations is a reflection of the practical constraints involved, in terms of the time, resources, information and process involved in valuing a PE portfolio. The relative infrequency of reporting portfolio valuations by LPE companies also reflects the very different nature of the PE model from that of the management of quoted investments.

Consideration 4 – there is a lack of information disclosure and transparency to enable an investor to understand how the portfolio has been valued.
The amount and quality of information provided by LPE companies about portfolio companies and how the investments have been valued has undoubtedly improved over the years in response to demands from investors for greater disclosure and transparency. While wide differences remain between the approaches of Direct LPE companies, most now provide details on the portfolio including earnings growth, revenue growth and valuation multiples, most often in aggregated form.

While some investors in Direct LPE companies would prefer full transparency in this area to enable validation of valuations by reference to all relevant underlying information used, this is clearly not practicable in the LPE world. In such situations, LPE companies' disclosures, which are in compliance with financial reporting standards may often be at a comparably lower level to the much fuller information often provided to LPs in traditional PE funds (including, of course, Fund-of-funds LPE companies) within their quarterly investor reporting, where the LPs are bound by confidentiality obligations. Further, since the information on which valuations are based is very often forward-looking, reflecting growth plans and strategies of the portfolio business, it is very often highly commercially sensitive and could influence the sales price of any exit.

In the case of Fund-of-funds LPE companies, there is less concern from investors regarding disclosure and transparency, given the number of underlying investments held and the fact that the monitoring of information regarding valuations is seen as a key part of the fund-of-funds manager's role.

Concluding thoughts
As noted earlier, portfolio valuations are complex and involve judgement. Whilst there may be reasons for limiting the information disclosed, such as confidentiality and commercial sensitivity, certain Direct LPE companies may elect to provide more disclosure on investments than required by financial reporting standards - leading to varying levels of transparency and disclosure across LPE managers.

Many would consider that the sector and the investor community are best served by companies' providing relevant, detailed disclosures that promote comparability.

Conclusion

LPE managers recognise the importance of meeting international PE reporting standards and increasingly recognise that their success, whether in the public or private market, will significantly depend on not only fulfilling their obligations under industry valuations methodologies but also meeting the highest standards of disclosure and transparency to attract and maintain investor confidence.

Although this may take time for the broader public markets to recognise, recent developments in the LPE market would suggest a growing number of investors are recognising a potential value opportunity given a possible mismatch between the valuation of LPE portfolios, return potentials and prevailing share prices across many LPE companies.

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Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Tel: +44 (0) 20 7936 3000 Fax: +44 (0) 20 7583 1198.

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