COVID-19: Bringing clarity around private equity asset valuations

The timing of COVID-19 has brought uncertainty and confusion not only to year end valuation processes but more critically to the ever increasing number of full quarterly valuations that are prepared and reported to Limited Partners (LPs) in Private Equity (PE) Funds.

General Partners (GPs) have been faced with immediate and urgent action to stabilize and support their portfolio companies while also finding the right methods to continue to fair value them.

Even though there are, fortunately, relatively few PE Funds with March or June 2020 year ends, these quarterly valuation periods have brought challenges in assessing the market approach to valuations.

A valuable voice for the industry — International Private Equity and Venture Capital Valuation (IPEV) — were quick to release guidance for GPs and we have worked closely with them through the IPEV Board to assess the changes required in the market. We have shared KPMG market insights and considerations to help bring clarity during these uncertain times.

Don't panic

The message we are seeing and delivering to clients is clear — "Don't panic." We might be in unprecedented times but uncertainty in financial markets is not that uncommon and the strong valuation policies and procedures maintained by many GPs do not need to be significantly, if at all, altered.

Those with good governance, critically in the form of appropriate layers of review and independent challenge will find that the results, while a little unpleasant to see, are not as difficult to derive as might be expected.

However, the commercial reality is that investors are ultimately concerned with realized cash returns more than unrealized paper valuations, and unlike other asset classes, PE funds are legally committed and cannot be withdrawn on demand. The fears of the last financial crisis that PE would not survive proved incorrect and in fact very healthy returns were made from funds raised at that time. Investors have clearly learned from that experience and do not anticipate them to be unduly concerned by the corrections to valuations in Q1 and Q2 2020. However, they will be far more interested in the underlying stability of the portfolio and the steps taken by GPs to see them survive and thrive through COVID-19.

Avoid the double dip

It might not be expected that valuations could decrease too much in the current economic turmoil but there is a risk that this is more likely than investments being overvalued. Due to the nature of the reward structure in the PE industry — carried interest — there is less incentive to over value an asset and with the typical valuation being based on a financial metric such as maintainable earnings, earnings before interest, taxes, depreciation, and amortization (EBITDA) and an applied multiple, there is a risk that both will be adjusted down to reflect the uncertainty in the market.

This creates the 'double dip'. Risk adjusting EBITDA as well as the multiple may disproportionately lower the valuation below a true 'arm's length — willing buyer/willing seller' amount. When performing a valuation assessment it is often easier to project the changes expected in earnings than assessing what the market consensus will be on multiples, this is truer in times of extreme duress as at the current time.

Follow the markets

The decline in listed prices as at 31 March 2020 was clearly considerable, and we've already seen a strong re-bound in certain markets in the two months since. Therefore care should be taken as to whether this level of decline should also be reflected in private equity valuations. The benefit of the sector is the ability to avoid short term shocks and hold investments for the longer term improving them throughout that period. Current uncertainty is creating more risk and that risk will lead to lower valuations. However it is critical to look at assets individually.

Some investments will be in sectors relatively lightly touched by COVID-19 such as telecoms or logistics, but equally some of those investments may not be competitive with their peers and therefore should reflect a larger decrease in value than the listed markets would suggest. Likewise, other investments may be in sectors more obviously impacted by COVID-19 but if they are stronger, more adaptable and already with a clear advantage over their peers then valuations should remain robust.

The smell test

Robust and tested processes will generate sensible fair values but the 'smell test' is even more critical in the current market. When the results are in, GPs must stand back and make sure that they make sense. Is the value a true reflection of what a willing buyer would pay (is it too much?) but equally is it a true reflection of what a willing seller would accept (quite possibly it will look too low!).

No amount of science and mathematics can get away from this critical assessment.

Disclose, disclose, disclose

It is inevitable that there will be difficult decisions to make in the assumptions into valuations; how long will the lock-down and social distancing last, what exit approach will governments take, what is the impact on consumer and business spending and what will be the new norm are all key questions to consider.

Given that no one has the answers to these right now, disclosure and transparency will be the GPs' friend.

LPs will want to understand the rationale behind the valuations that are presented to them. They will need to understand and perhaps for the first time make adjustments to those valuations if they have fundamentally different conclusions to the key questions. Therefore good quality disclosure of the valuation inputs, the sensitivities applied and the rationale for the assumptions will be key.

A valuation may turn out to be wrong, but clear and concise explanation of how a valuation arose will ensure that LPs can take them at more than just face value.

Ranges not points

While the ability to derive a fair value still exists, the potential for assessing 'ranges' as typically seen in infrastructure valuations may become more prevalent. The uncertainties in the market will lead to differing views on what is 'free cash', what is the 'maintainable earnings' as a result providing a range of the fair value of the asset, along with the selected point in that range will be helpful.

Such an approach, as noted in the Disclose section above, will enable LPs to consider in more depth the valuations provided to them and, where appropriate, enable them to conclude on a different point in the range for their own financial statements.

More art than science

In stable times PE valuations can sometimes be very mathematical, multiples are steady, which in the last 12 months EBITDA is reflective of maintainable EBITDA and therefore there is little artistic flair needed. That is less likely for the valuations throughout the remainder of 2020. The assumptions will be fluid and the comparable companies less comparable. Therefore greater subjectivity will exist and more effort is required to arrive at a sensible and fair valuation but it is in no way impossible.

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