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SPECIAL REPORT

Q&Q: Valuations for the private equity industry

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Q&A

Valuations for the private equity industry

FW moderates a discussion on valuations for the private equity industry between Richard J. Siladi at American Appraisal, James Dimech-DeBono at Grant Thornton, Jason Frank at Hilco Enterprise Services, Cindy Ma at Houlihan Lokey, and Attul Karir at PwC.

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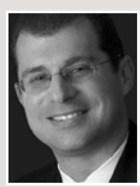

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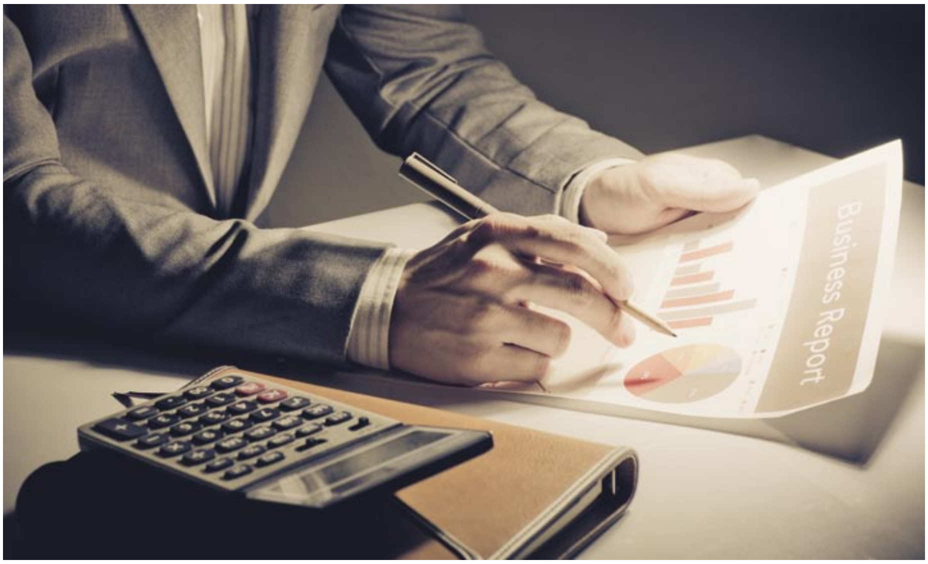

FW: Could you explain why it is important for private equity firms to obtain a written, detailed and independent valuation when assessing the value of their portfolio or making investments? Is there a rising demand for this service in today's market?

Siladi: Whereas portfolio managers possess a keen sense of the intrinsic value of their investments, the concepts of fair value measurement for marketplace participants are fundamentally different. Increasingly, limited partners want greater transparency about valuations, and regulators like the US Securities and Exchange Commission are both broadening their own oversight and expanding oversight and investigative resources to ensure that safeguards are in place to protect investors. Outsourced valuations are delivered with complete independence and help shield the firm from accusations of overvaluation. Although less than one quarter of private equity firms currently involve external specialists in their valuation process for illiquid assets, the use of external specialists for outsourced valuations and valuation reviews is increasing. Larger PE firms with greater resources have established robust valuation processes. Mid-size and smaller firms also are finding that outsourcing valuations allows for better management of scarce time and money resources.

Dimech-DeBono: The importance of having such valuations emanates from the need to provide transparent, independent and credible valuations to the various stakeholders. Independent valuations add to the robustness of the investment decision-making process and provide an additional degree of comfort to stakeholders. This does not mean that private equity funds do not have the necessary skills in-house to perform such valuations but investors place additional value on an independent party giving assurance on the valuation. Such valuation assurance ranges from negative to positive assurance. In other words, an independent adviser may be asked to review valuation marks using certain agreed upon procedures. Such procedures would enable the adviser to ascertain whether the valuation marks fall within a reasonable range and report whether the marks are 'not unreasonable'. At the other end of the spectrum, advisers can perform a 'full blown' independent valuation and opine on this. When reporting fund values, there would typically be a number of disclosures that would describe in some detail the type of work performed by the independent adviser.

Frank: As a response to the financial crisis of 2007-2010, the Private Fund Investment Advisers Registration Act of 2010 was enacted as part of the Wall Street Reform and Consumer Protection Act. One of the most important requirements of this law is to consistently mark investments, both liquid and illiquid, using a new definition of 'Fair Market Value'. Instead of marking and holding the investment at the acquisition or entry price registered, private equity firms are now required to periodically mark their positions at the price at which it would be sold, regardless of whether the fund plans to hold the assets for investment or resell it later. Because the new definition is market based rather than entity specific, the optimism that often characterises an asset acquirer must be replaced with the scepticism that typically characterises a dispassionate, risk-averse buyer. This change has significant ramifications not only for reporting to limited partners, but also impacts marketing activities, the use of track records in fundraising, secondary market trading of fund interests, estate and gift strategies for partners, and fund restructurings. As a result, investors and regulators have preferred to see third party, independent valuations.

Ma: When assessing the value of the portfolio or making investments, it is important to have a valuation function that is independent from the portfolio manager or deal team that purchased the investment. This helps provide an additional level of assurance to limited partners (LPs) and investors, to the fund's auditors, and ultimately to regulatory bodies that are only increasing their oversight of the private equity industry. Independence may also help identify situations where the portfolio manager becomes attached to his or her investment which may impact judgement regarding valuation, especially if the value is declining. In addition to an independent valuation function – which may be internal to the fund manager, but separate from the deal team – often it makes sense to have an independent valuation firm provide additional support and valuation reports for either the entire portfolio or selected positions. An independent valuation firm can be used to corroborate internal pricing calculations or models and can also act as a 'sanity check' for a deal team prior to executing a trade. The work performed by a valuation firm can be easily incorporated into the framework of robust pricing procedures. LP investors are increasingly demanding transparency from their managers. Use of an independent valuation firm signals to investors that a manager does not operate in a vacuum but rather uses both internal and external resources to triangulate on the best and most appropriate fair value indications.

Karir: There is an increasing focus on robust valuations, driven in part by increased regulation and oversight but largely from investors who are looking for greater transparency and consistency in portfolio company valuations. Although we have seen an increase in the number of PE houses requesting independent valuations, particularly for hard-to-value or highly material investments, most PE houses still perform their valuations internally. The input that more PE houses are looking for is how their valuations compare to their peers. So we are now more frequently called in to perform valuation framework, corporate governance and methodology reviews as PE houses seek to make their own internal processes, analysis and documentation more robust to reflect changing industry expectations. This is particularly the case when they are looking to raise new funds.

FW: Have you seen a rise in revaluation of management equity for portfolio companies given the volatile market movements over the past few years?

Ma: While we do have one-off requests from clients to value the management equity stakes in a given company, we have not noticed any obvious trends or increases in the frequency of management equity valuation exercises. In situations where we value the equity in a fund's portfolio company, the value of management's equity stake is essentially a by-product of the fund valuation exercise. It would be unusual for the client to request a separate analysis of the management equity stake. In situations where we provide direct valuation of management's equity or options, these tend to be done on a fairly regular basis regardless of market movements or volatility.

Karir: Providing your portfolio company's management team with shares is a great way of aligning incentives. In the UK during the financial crisis, however, a reduction in earnings meant that the management shares were often too far out of the money to be a meaningful incentive for management. This resulted in an increase in the number of schemes requiring a resetting of management hurdles and incentive scheme strike prices, or a restructuring of the scheme as new management teams were brought in. We continue to see management incentive schemes playing a key part in PE deals.

Dimech-DeBono: The rise in the valuation by external parties has increased, I would say, over the last six to seven years. This was mainly instigated by investor influence in the US. That trend came across the Atlantic soon afterwards, especially where funds have US- based investors. This was not the only change that we have necessarily experienced as funds have established better governance structures in order to ensure better compliance with regulation. Private equity funds that adhere to best practice have a distinct valuation back-office function, similar to the Independent Price Verification function in investment banks. The responsibility for producing valuations for the monthly NAVs lies with this function that would then report to the valuations committee for final approval by the board. Various industry bodies, such as IPEV, have also issued valuation guidance as an attempt for the industry to 'self regulate'. Another related trend that we have observed with institutional investors is the increase in due diligence performed before making any investment in such funds in order to ensure that there exist proper governance structures and that valuations are independently arrived at.

Frank: Given the dramatic rise in the number and value of illiquid investments, the scrutiny and attention by investors, regulators and auditors has increased dramatically. It is imperative that reported fair market values are not only accurate, but are also supported by a well-defined and consistently applied valuation analysis and policy. In light of the recent economic environment, it has become critical to review both specific investment performance as well as overall market performance. The current financial conditions have highlighted the importance of market inputs, and should be allowed to affect valuations beyond expected transaction close. Both individual asset performance and actual versus projected performance will dictate alpha movements. More importantly, the current environment highlights the fact that valuations should not be done in a vacuum.

Siladi: Albeit with some volatility, markets and valuation multiples have generally been moving upward. With this rising tide, the fair value of the investments held by private equity firms has increased. These increasing values may also hasten the firms' exercise of exit opportunities to lock in performance incentives. Irrespective of market movement, we are seeing a trend toward fairly robust valuations on a quarterly basis instead of annual valuations that had been the norm.

FW: To what extent are increasing regulation and oversight affecting unquoted investment private equity valuations?

Frank: Investors, whether entering or exiting a fund, auditors, regulators and board of directors need to understand the critical issues of such illiquid investments. For example, what are the processes and procedures and are they well-documented and consistently adhered to? How does the fund value this classification of assets? How frequently are the assets valued? Are the valuations balanced? Aggressive valuations may overstate performance, compensation and fees while overly conservative valuations may penalise redeeming investors and distort volatility measures. Use of third-party firms to validate or determine value alleviates several of these issues and is seen as best practice and speaks to a fund's credibility. Not only do independent valuation firms increase transparency, encourage consistent analyses and ensure constant monitoring, more importantly they increase investors' and regulators' ability to rely on net asset value.

Ma: The Dodd–Frank Wall Street Reform and Consumer Protection Act removed private equity's exemption from registration, requiring them to register with the SEC for the first time. Registration, in turn, subjected private equity firms to periodic examinations from the Office of Compliance Inspections and Examinations (OCIE). The SEC has repeatedly mentioned examining newly registered firms as a priority and started conducting 'Presence Exams' in September 2012 to "quickly establish a presence with the private equity industry and to better assess the issues and risks presented by its unique business model". Andrew Bowden, director of the OCIE, in a May 2014 speech discussed preliminary findings of their first 150 exams. Director Bowden specifically addressed observations regarding the handling of fees and expenses, and marketing and valuation. The fact that violations of law, or material weaknesses in controls, were present over 50 percent of the time is sure to have a profound effect on private equity firms. PE firms are reviewing their policies and procedures in these areas, making improvements where appropriate, and hoping to not add to this statistic. In Europe, the Alternative Investment Fund Managers Directive (AIFMD) became effective on 22 July 2014. PE firms, marketing within the EU, are now expected to comply with the valuation requirement of AIFMD and therefore fund managers need to ensure an independent valuation function of the portfolio. The trend of increasing scrutiny on the valuations of illiquid or hard-to-value assets in the old continent follows the developments experienced in the US market.

Karir: From a valuation perspective, the impact of increasing regulation has not been as great as expected for PE firms. The final version of AIFMD did not include a requirement for external independent valuers, so we have seen many firms continue to use their independent finance functions to own the valuation process. However, increased regulation and sharper oversight have kick-started a trend towards improved governance. Several of our larger PE clients have been keen to discuss what they can do to improve their valuation process and procedures to make them more robust. This has

helped them tackle queries from investors.

Siladi: The Investment Advisors Act of 1940 established the principle that fiduciaries must act in the best interest of their clients and affirmed their duty and obligation to disclose all material facts and avoid misleading clients. As fiduciaries, PE managers have responsibilities to their investors that overshadow the interests of their own firm. Regulators such as the SEC and its Asset Management Unit are increasingly interested in ensuring proper safeguards are in place. Recently, the SEC has also found it within its purview to mandate independent review of valuation policies and procedures where its review has deemed existing valuation policies and procedures to be deficient. The AIFMD mandates an independent valuation process but does not require that it be done by an external valuation specialist. Larger firms can create internal valuation committees that exclude those who stand to benefit from optimistic marks, whereas smaller firms may be unable to afford the additional infrastructure. However, as written, the AIFMD makes third-party valuers liable for losses suffered by fund managers due to a mispriced asset, a potential liability that third-party valuers will need to address when being retained.

Dimech-DeBono: The amount of regulation affecting the private equity industry has been on the increase whether we look at the US or Europe. Navigating through regulation has become like walking through a minefield. For example, in the US with the advent of Dodd-Frank and the Consumer Protection Act, increased disclosures to investors and the SEC have become significantly important. Needless to say, non-compliance is not an option. From a valuation perspective, there are a number of requirements, such as whether fair valuation policies and procedure have been formalised, and whether an independent third party is involved in performing the valuation. Specific questions around how illiquid securities are modelled and how independently valuations are arrived at need to be addressed and disclosed. These are only a few of the aspects that need to be addressed. In Europe, AIFMD makes similar compliance demands for alternative investment fund managers in order to give adequate protection to investors.

FW: Are regulators more inclined to scrutinise particular valuations and compare them to marketing material and investor communications released by PE firms? If so, what additional pressure does this place on the process?

Ma: OCIE Director Bowden specifically highlighted valuation and marketing material as a hot button topic. He referenced academic research supporting the thesis that valuations tend to become inflated during fundraising. He observed advisers using different valuation methodologies than those disclosed to investors. Director Bowden also pointed out that the SEC was not trying to second-guess the valuations but rather ensure that valuation methodologies were consistently and fairly applied. This scrutiny adds significant pressure to the valuation process, requiring managers to pay careful attention to validating inputs, ensuring consistent use of methodologies and documenting exceptions.

Karir: We are seeing regulators placing greater scrutiny on portfolio investment valuations, particularly the SEC with respect to PE firms that have been fundraising. Auditors and regulators have become increasingly aware of the risk of positive bias in portfolio investment valuations during a capital raising process, and this is certainly a valuation risk factor that regulators take into consideration. More recently, the SEC has also been checking whether management fees have been charged fairly. Where unrealised valuations impact management fees, this is further increasing the spotlight on valuation. The IPEV guidelines have been updated with a requirement to explain how the valuation of an investment has moved over time relative to its entry price – the art of 'calibration'. This should help valuers rationalise the judgements they have made and move valuation away from being just a mathematical exercise. We have always encouraged clients to apply judgment in their valuation.

Siladi: The SEC is most concerned about protecting investors. Whereas the typical private equity investor was generally a sophisticated accredited investor, there are now growing numbers of less knowledgeable investors that meet the *accredited investor* definition but lack an adequate understanding of the risks. As the alternative investments industry looks to expand with general solicitation of investors, the claims made in marketing materials will most certainly be carefully scrutinised to ensure small investors are not misled. When firms prepare to launch new funds, regulators are concerned that the historical performance of existing funds may be exaggerated by overstated valuations during the fundraising period. If the final investment returns do not match the interim returns, it will raise red flags. This concern may be magnified if the valuation was internally developed. The participation of a third-party independent valuation specialist provides additional transparency and insulation against claims of deliberate overvaluation.

Dimech-DeBono: Regulators have increased the focus on alternative asset managers and for good reason. A recent survey by McKinsey estimates that there is around $7.2 trillion invested in alternatives globally, split roughly in equal thirds between private equity, hedge funds and real assets. In the US, the SEC has definitely increased its focus on private equity funds as well as other alternatives, both in terms of investigations and enforcement actions. We observe similar reactions from European regulators. Institutions that do not comply with regulatory requirements are often in the news. In order to prevent this, private equity funds need to ensure that their governance and control frameworks are proper and implemented effectively in order to protect investors and supply them with adequate disclosures. Regulation, while positive, has put extra pressures on funds as they develop the proper structures and obtain the right resources. All this comes also at an economic cost.

Frank: There is definitely increased scrutiny by regulators, which has only amplified the importance of an independent, third-party valuation firm. The SEC has announced that new PE registrants must have "effective policies and procedures regarding the valuation of client holdings and assessment of fees based on those valuations, including their methodologies for valuing illiquid or difficult to value instruments". Bruce Karpati, former chief of the SEC Enforcement Division's Asset Management Unit, characterised the PE industry as "lacking transparency" regarding valuing illiquid portfolio companies, and said "valuations, while always important, take on greater significance during the period of fund marketing", citing past SEC experiences where PE groups would increase portfolio valuations in order to exaggerate performance of the holdings, thereby underscoring the need to ensure the integrity of interim valuations. Additionally, institutional investors are placing greater emphasis on these valuations to drive allocation decisions, as well as rebalancing overall portfolio holdings among various asset classes.

FW: What common pitfalls, areas of uncertainty and points of conjecture tend to arise during the PE valuation process?

Karir: Over the past six months, the key issues for PE firms relate to how they can ensure that valuations reflect an up to date picture of the investment's value, both with respect to changes in the market and also changes more intrinsic to the investment itself. For instance, some PE firms extract market data a few weeks prior to the year end. Some sectors saw movements of over 25 percent in market prices over Q4 2013 and therefore valuations using September or October data were materially out of date. Despite fair value standards being harmonised between Europe and the US, we have sometimes seen market practice diverge in recent years. For instance, you could conceivably end up with the same minority investment being valued differently. In Europe, some PE firms prefer to take a commercial approach and assume that they will exit their minority stake through the sale of the portfolio company as a whole. By contrast, in the US, there may be consideration around alternative exit scenarios – for example, the proceeds they would receive if they had to sell the minority stake in the secondary market, recognising that as a minority shareholder, they may not be able to affect a sale of the whole company.

Siladi: The forward-looking projections prepared by fund managers include a variety of assumptions. Even slight adjustments to the inputs and assumptions can cause significant differences in the fair value estimate. Also, the development of discount rates and market multiple adjustments must match the risks inherent in the projections, the quality of earnings, and the potential for growth. In spite of the recommended best practices and guidance from IPEVCG and PEIGG, we still see too many instances where fund managers rely too heavily on their acquisition price, promoter buyback options, or guaranteed IRRs without further analysis to support their fair value reporting. The challenge in arriving at fair value is to balance current market conditions with appropriate assumptions of market participants given the illiquid nature and characteristics of the asset being valued. Further, routine reliance on a particular valuation method without reconciliation to other value indicators is a recipe for disaster. The adoption of new methods in subsequent valuations gives the appearance of tinkering toward a desired result.

Dimech-DeBono: Valuation is not a science, especially when dealing with unquoted companies, as an element of judgment always comes into play. With any valuation, the business plan and its achievement is always a source of uncertainty. This uncertainty emanates from management's ability to execute the plan to external market forces. Performing the necessary due diligence on the business plan is always a must. This avoids using unrealistic assumptions and unsustainable growth rates in the terminal value calculations. Other pitfalls would be avoided by experienced valuation advisers, for example ensuring that cashflows and discount rates are not both risk-adjusted. If using a market approach, advisers need to ensure that the comparable companies used are suitable and transaction multiples do not relate to out-of-date transactions. Other avoidable errors may include using historical earnings with forecast multiples or vice versa. A very subjective area revolves around the application of minority, marketability and liquidity discounts.

Frank: Valuing illiquid, non-public assets can be difficult. However, this does not mean fair market value cannot be established. It just means the valuation must be done carefully and properly, especially with the probability of heightened scrutiny by investors, auditors and regulators. Information – historical, current and projected – is usually not readily available. The asset might be distressed or have negative cash flow. Additionally, no exact comparable companies or transactions may exist. Even if these issues do not exist, illiquid asset valuations usually have to deal with complexity, ambiguity, incomplete availability of inputs, liquidity considerations, as well as methodological differences of opinion.

Ma: Valuation has always been a combination of art and science. While there are industry-standard techniques and models that give guidance as to how to value an investment, there is almost always significant judgment involved. For example, there is judgment involved in estimating the appropriate valuation multiple – such as price to earnings or enterprise value to EBITDA – to use in valuing a particular company, or what discount rate to use in a discounted cash flow analysis. If a particular company has been underperforming, and is expected to continue to underperform, it is unlikely that an outside investor seeking to buy the company from its owner would attribute a high valuation multiple to the company. The 'story' behind the historical financial performance of the company and its expected future performance is a critical driver of these valuation judgments and is often a source of uncertainty in a private equity valuation. It is critical to document the rationale behind these choices and why a third-party buyer would likely make the same judgment.

FW: What approaches and methodologies are being applied to produce independent, robust, supportable and cost effective valuations of unquoted investments?

Siladi: The valuation of illiquid investments requires gathering marketplace information to develop applicable valuation models. Valuation methods include a market approach, in which earnings multiples are applied to different levels of earnings to arrive at value indications. Similarly, for the income approach, marketplace required rates of return are used to develop a discount rate applicable to projected cash flow from the investment. US GAAP and IFRS both refer to the fair value hierarchy and Level 1, 2, and 3 inputs. Level 3 in- ▸▸

puts are not observable in the marketplace, yet they are the only information available for the valuation of illiquid investments. When a private equity investment is made, it is highly recommended that a calibration of the investment's cost to its fair value be undertaken and documented. The calibration will determine whether the acquisition price reflected fair value, a premium, or a discount. Through the calibration process, robust models with market-participant assumptions can be developed and replicated in subsequent valuations.

Dimech-DeBono: Unquoted companies can be valued using a number of approaches, namely, using an income approach, also known as discounted cash flow, a market approach with comparable company and transaction multiples, and a cost approach. The situation becomes more complex in a distressed situation, as usually advisers look at asset-based and income-based techniques. Additional pressures come through that fact that in a distressed situation there are additional risks that need to be factored in. These relate to operational, business and additional specific risks. Once the underlying company has been valued, the adviser needs to look at the specific part of the capital structure that is relevant, debt, preference capital or equity capital. Some capital structures may be quite complex and securities may have conversion features, for example. In such instances, Contingent Claims Analysis (CCA) needs to be employed. By using CCA in valuing securities in the capital structure, a more accurate allocation of value, including the optionality of the particular security, is achieved.

Frank: Since all parties use essentially the same well-known and accepted valuation methodologies, inputs become the most important part of the equation. If the assumptions are accurate and are properly applied within the chosen valuation method, much of the subjectivity is eliminated and the valuation becomes more of a science. The three most commonly used valuation methods for private equity transactions are, first, the Market approach, guideline publicly traded company method, second the Market approach, guideline merged or acquired company method, and third, the Income approach, discounted cash flow method. Regardless of which method is utilised, it is very important to scrutinise the underlying assumptions. The quality, relevancy and accuracy of the inputs separate the valuation from a 'science' to an 'art'. A formula and its inputs can be manipulated to provide any result that is desired. A true valuation will not only follow the guideline methodologies, but will be realistic in its findings.

Ma: There are certain industry-standard techniques that are commonly used to estimate the value of a business or a security. To value a business, common methodologies include the market approach, in which the earnings of a business are capitalised based on trading multiples of publicly-traded peers or recent transaction multiples for similar companies; the income approach, in which expected future cash flows of the business are discounted back to the valuation date at an appropriate risk-adjusted discount rate; and the asset-based or cost approach. It is common to use several methodologies to 'triangulate' the value of an investment. Additionally, for investments in businesses with complicated capital structures – for example, start-up companies – or in securities with exotic or complex features, more advanced models may be needed. One such model that can be used to value investments in companies with complex capital structures is the 'equity allocation model' or 'option pricing model', which relates the value of a given security to a portfolio of options on the company taking into consideration the seniority and liquidation preferences. Regardless of the technical complexity of the model used, as they say, "garbage in, garbage out". It is important to use valuation inputs in these models that produce realistic valuations and to test the model output with real-world data to the extent possible.

Karir: The most robust valuations consider a range of valuation approaches in arriving at a conclusion on value. Generally for unquoted investment valuations we see the market approach used as the primary approach, unless the investment is in an early stage of development, does not generate revenues or genuinely has no comparable companies, which is rarely the case. However, we do see the discounted cash flow approach used as a cross-check to value for several of the most robust portfolio valuations. Where the market approach is used as the sole approach, we would certainly expect to see the results using one valuation metric, such as EV/EBITDA multiples, cross-checked to other types of multiple – such as P/E multiples – to identify any spurious results or anomalous comparable company multiples. This will be particularly the case where industry specific multiples such as value per user for social media companies have been considered.

FW: In what ways is technology playing a more important role in valuation and reporting processes?

Dimech-DeBono: Technology is certainly playing an increasingly important role in more ways than one. If we think of the valuation process, technology is present throughout. At the onset the information about the asset being valued is received and the necessary research is performed. This entails searching for comparable guideline companies and transactions, performing market-based research and deriving the valuation metrics. The process described so far is rather mechanical and technology-based, however, the adviser needs to apply his or her experience in order to establish how comparable the guideline companies and transaction are. This has a bearing on discounts or premia that would be subsequently applied. Although most of the calculations are performed electronically, an assessment of the reasonableness of the assumptions and finally the valuation has to ▸▸

be made. At the end of the process, valuation marks and the proper disclosures can also be reported electronically.

Frank: Advances in technology have definitely facilitated the efficiency, effectiveness and timeliness of the valuation process. Discovery, aggregation, distribution and storage of public and private information have improved with new technological tools. Standard reporting templates specific to investor, regulator or auditor can now be periodically updated by the press of a button. While the process has been aided by technology, the ultimate valuation conclusion is still dependent of the professional's competency and experience.

Ma: Technology is having a profound impact on valuation and reporting. Large limited partners such as CalPERS are now providing general partners (GPs) with templates to be populated with information on each of the underlying portfolio companies. The templates allow for standardised reporting of information. Templates and responses are provided and prepared electronically. Additionally, ILPA recommends GPs report using standardised reporting templates covering quarterly and annual reporting. Secondary market buyers of LP interests also make use of these types of reporting in order to evaluate the underlying portfolios of these LP interests.

Karir: There has been an increasing awareness of the importance of robust underlying market data in recent years. Where a PE firm relies upon a single provider for market data, auditors are now moving to checking against a separate independent source in addition to the PE firm's data provider to ensure there have been no technical issues with the download or data reporting errors. We have seen some larger PE firms embed more sophisticated financial systems where underlying company performance data and market information is automatically uploaded. This is more to stay close to performance, but it may also be used for quarterly valuation updates. Our view is that valuation will need to remain a largely manual process as it is an inherently judgemental exercise.

Siladi: The vast majority of information necessary to perform and report valuations is collected manually. For alternative investment firms with greater scale, this is often accomplished by means of standardised templates and perhaps a middle-office accounting group. Although data collection can be automated to save time, this does not necessarily result in better valuations. Many sophisticated automated valuation models are available in the marketplace that can turn inputs into answers, but none are a substitute for the substantial judgment required of fund managers and valuation professionals.

FW: Is it common to see particular types of PE valuations contested or criticised? What options are available to PE firms if a valuation dispute does arise?

Frank: It is extremely difficult to arrive at an accurate valuation of a privately-held company in today's market. Not only has the recession wreaked havoc on a business' operational, financial and strategic initiatives, but there are many other factors that contribute to the complexity of valuing the company. Companies are faced with severe liquidity concerns, unpredictable consumer demand and challenges to supplier relationships. These factors are creating significant uncertainty and unpredictability regarding current performance, as well as a lack of visibility for future projections, which makes accurately valuing a private entity an extremely challenging exercise. Privately-held companies are generally plagued by a lesser quality and quantity of information that can be used in an analysis. Also, a private company's capital structure could be more complex with various classes of equity and debt securities. Lastly, the final value of a closely-held, private business may differ from the value calculated using the established methods of appraisal – the income, market and cost approaches – because various types of discounts or premiums to the basic valuation methodology must be considered. If a dispute arises, PE firms should rely on their independent, third-party valuation professionals, assuming they have one. If there are two independent firms with differences of opinion, usually a third firm, mutually agreed upon, is brought in to settle the dispute.

Ma: Historically, it has been uncommon to see valuation disputes between LPs and private equity managers. In circumstances where there may be opportunities for criticism, it is considered best practice by many in the private equity community to have an independent valuation firm provide guidance to the fund manager regarding the value of a firm's investments, whether for financial reporting purposes or for more complicated situations, such as a transaction – particularly a related-party transaction.

Karir: It is not that common but there are instances where we do see valuation disputes. These include at entry, between funding providers, portfolio company management or the vendor. They may also arise during the holding period, between limited partners or with underlying portfolio management. Disputes can also occur during exit, between the acquirer, with portfolio management, or with the relevant tax authorities. The situations are wide ranging and the options available depend in large part on the situation. In terms of criticism, valuing early stage investments can be particularly tricky when valuations are held at the last round of financing. For instance, a pharma investment may have achieved – or missed – key milestones since that financing round, but quantifying the value impact of this is inherently judgmental and the valuer may feel more comfortable in pegging to the last financing round.

Siladi: Because of their illiquid nature, private equity investments are valued with inputs that are not observable in the marketplace. Therefore, the inputs, assumptions, models, valuation methods and conclusions are all immediately subject to criticism. Whereas fair value measurement within the context of financial reporting is now a familiar process for public companies, it is a relatively new concept for private equity firms and represents a different mindset for reporting values. When disputes arise, it is common for third-party valuation specialists to be retained for negotiations or expert testimony if the dispute results in formal litigation. More so than private equity valuations, the greatest concern is with the valuation of complex financial instruments. Regulators have lamented that in such valuations, when given the same set of facts, fund managers, valuers and auditors all produce valuations that are unacceptably divergent and not auditable.

Dimech-DeBono: It is not uncommon to observe challenges to PE fund valuations. If there is a significantly material difference between the independent valuation and that of the PE fund, the matter needs to be investigated to assess where the source or sources of the disparity lie. As long as both parties have used a recognised valuation method or methods and reasonable assumptions, then one would not expect significant differences. Valuation is not a science but an art, and as such there is always a degree of subjectivity. However, once a reasonable discussion takes place, common ground is usually found. In other words, more often than not, such challenges are resolved. It is worth pointing out that responsibility for the valuation remains with the PE fund's board and their decision ultimately prevails. ■