Privcap/
Context for Private Capital Investment
TRANSCRIPT

Using "Comps" The Right Way
Valuations in Private Equity

David Snow, Privcap:

We're joined today by John Lambrech of W Capital Partners, Mitch Coddington of Energy Investors Funds, and Kevin Vannucci of McGladrey. Gentlemen, welcome to Privcap. Thanks for being here.

We're talking about valuation and private equity—a hot button issue. All of you are valuation experts, so I'm fascinated to hear your perspectives on this very important aspect of managing a private equity fund and communicating its value to investors.

I'd like to learn more about comps. Using a comparable valuation to try to find the appropriate valuation for a portfolio company or an asset in your portfolio is a common practice and yet, there are important complexities that all of you are very aware of. Let's start with a question for John Lambrech from W Capital. Can you walk us through some scenarios in which it would be appropriate and advisable to use a public market comparable to find a value for one of your private companies?

John Lambrech, W Capital Partners:

Thanks for having me. The notion of using a comparable, to step back and to simplify it, is to say, "I'm tasked with figuring out the value of my company." Comps involve looking at other companies you believe are a good proxy for my company here that ought to trade in the same range given that they have so many similar characteristics.

The benefit of using a public market comp is this: if you have a company in your portfolio that, under a reasonable set of circumstances, could be a public company and has enough similar aspects and metrics to that particular company, you can build a case and a thesis that says, "It's reasonable for me to believe that, if my company can do these one or two things, including going public, it ought to trade like these companies."

In a perfect world, you would have a significant sample size, right? You want to make sure you're not comping to just one company. You want to have a meaningful number of companies that you can

say, “Look at these five or six or eight companies. My company looks and feels a lot like these—similar markets, similar structures and a similar margin structure,” depending on what they're doing. You step back and look at how those five or eight companies trade and you say, “It's a fairly reasonable proxy for how my company should trade in the future. “

Typically, that’s when public comps are used for a private company. We use them quite a bit. There are a number of challenges around using public comps. Are you measuring the public comps at one particular point in time? Are you looking at how they trade over a period, whether it’s the last 12 months or if there's a longer history? Do you look at how cyclical they are over time? What's the volatility of these companies?

If they're highly volatile companies, you start to rely less on a comp being an accurate measure. A number of factors need to be looked at but, generally speaking, those are times when we would use public comps.

Snow: I'd like to hear from Mitch, because you're in the energy world and have a slightly different set of assets. But first, a quick follow-up question for Kevin. Based on what John said, is that what you're seeing across your private equity clients? What are the complexities they face when they're trying to find a proxy on the public markets?

Kevin Vannucci, McGladrey:
Like John said, the big thing is identifying those publicly traded companies, the market participants as referred to in fair value literature, and trying to identify those market participants. Then, adjust the market participants' multiples, whether it's a revenue multiple or EBITDA multiple, down to a multiple you can apply to the subject portfolio company.

You have to look at all the things John mentioned; it's not simply looking at an unadjusted range and then taking a median of the five or eight EBITDAs and saying, “The median's the right fit and if the median's seven, that's what I'm going to apply to my subject company” and you're done.

You have to take the dive of looking at differences in growth size, risk and margins and making those adjustments, whether it's a quantitative or qualitative model or a combination of both in order to get a meaningful result. If we would just have a client take an unadjusted multiple and not give us a reason behind why that may

or may not be supported, we would definitely have questions back and it would be questions between the audit firm and our clients to try to get comfortable with that.

Snow: Mitch, your firm invests in energy assets. Are there public market comparables for what you do or do you need to look for other alternatives?

Mitch Coddington, Energy Investors Funds:
Generally, there aren't public market comps, but in the trade rags and other industry publications, you can find sales transactions where actual sales have taken place and use that information as a comparable for a portion of our valuation analysis.

We're not in the public markets at all. None of our assets are public. Generally, the assets we acquire, and when we're sellers, are all outside the public arena. We are aware, publicly, in the public domain—when I say public, I mean publicly available information, not a public market—of valuations of particular assets usually measured as dollars per kilowatt hours that are applied to assets. We use those in a portion of our analysis, typically in terms of determining a terminal value or exit value for a particular asset. We use that and we prepare and supply that information to our auditors to justify a particular terminal value that we may use for an asset valuation.

Snow: How often are comps incorporated into the determination of fair value? Is it most of the time? How do auditors look at this?

Vannucci: The energy sector is unique. Outside that sector, a comparable sales transaction, essentially, the two methods under a market-base approach consist of the guideline public company method, which we spoke to. Now, we're speaking about the other method—the comparable sales transaction method.

With a comparable sales transaction method, for the fact that that information isn't publicly known, there's not a lot of information out there that will help you adjust some multiples down on those market participants to fit the subject company.

Most funds will do the three methods now: they'll do a discounted cash-flow method, the guideline public-company method, and comparable-sales transaction method. They'll weigh them accordingly, based on how they feel the results and the best fit. Looking at comparable sales outside the energy sector, I always

struggle a bit because there's not a lot of information and you can't adjust those multiples down to the subject company.

Now, some funds that keep track in their databases of portfolio companies they sell have their own internal database that, obviously, lets them know how comparable those transactions are. Then, they would just have to help the audit firm get comfortable around that.

Lambrech: I would add that there are hard measures with comps and then, there are a number of soft measures that you have to factor in that can have a meaningful weight. The hard measures are easy: revenue, EBITDA, running cash flow—whatever you want to take. Things like management teams make a big difference. In my experience, they certainly do. Intellectual property: does someone have a more defensive position and a competitive advantage over the market?

We always talk about the art and the science. The science part with comps is easier. The art part is about saying, "I've got to be ahead of that comp" or "I should be at a discount to that comp." That one usually involves more art thinking and, typically, is one we will spend more time with the auditors to get them comfortable with.

Vannucci: You have to be careful about the idea that, if synergies are baked into the price that was paid because under a fair value, it's marketplace participant assumptions and not synergistic value. It's fair value. If you're using comparable sales transactions, you have to be careful that synergies aren't embedded in there. If they are, that's not fair value unless a market participant would pay for those same synergies.

Snow: Mitch, it sounds like, looking at comparable sales, that's almost a check on the work you've already done to arrive at a certain valuation and you want to see if it makes sense in the real world.

Coddington: That's exactly right. Our valuation technique is, for most assets, a discounted cash flow analysis, so the inputs are the stream of discounted cash flows for a period. Then, as I mentioned earlier, the terminal value, often a dollar-per-kilowatt-hour measure—that's where we look at transactions in the marketplace to determine if, in fact, the terminal value we're using for that particular asset at the end of that stream of cash flows is reasonable. As you said, it is a reasonableness check; it's important

to our auditors to see that the valuations we're using on those terminal values are appropriate and supported by market activity.

Vannucci: On the terminal value, whether it's using an exit multiple or comparable sales on multiple versus the Gordon Growth model, the ultimate thing on terminal values and exit multiple is getting comfortable with that exit multiple and making sure if it's five, six years when that exit then occurs that it's still a legitimate multiple based on the multiple's determined stay a different lifecycle of the company than the future. That's always one of our concerns—to make sure you're matching the same time horizons, the same stage of that company and that lifecycle if you're using an exit multiple.

Coddington: We have newer funds that are acquiring assets and, of course, older funds that are liquidating. So, what's important is that the valuation technique we use, a discounted cash flow analysis, is the same analysis we use when we're buying assets and the same analysis other buyers are using when they acquire assets from us. So, we have a history of understanding, having been in the business for 25+ years of understanding how both buyers and sellers look at these assets and how the discounted cash flow analysis is performed by both sides.

Lambrech: Both sides, right.

Coddington: At the end of the day, because we're in the so-called "level-three" category of fair value for GAP purposes, that helps us and our auditors get comfortable that we're valuing assets in a way that is representative of what the market participant would transact.