

# Understanding the changes to the Private Equity Valuation Guidelines.

17 December 2012



Checked and  
checked again.

A revised version of the International Private Equity and Venture Capital Valuation Guidelines ("IPEV Guidelines") was issued on 17 December 2012. The revised Guidelines are intended to be applicable across the whole range of private equity funds and to all financial instruments commonly held by private equity funds.

The revised Guidelines place additional emphasis on the Market Participant perspective contained in the previous version as a critical component in the concept of Fair Value. The Guidelines further introduce the accounting concept of Unit of Account, and focus on the need for calibration of all valuation techniques at the time of entry. The changes do not represent fundamental changes to the concepts contained in the previous Guidelines, but rather refine the concepts and ensure consistency with accounting standards and the principles of the International Valuation Standards Council's (IVSC) valuation standards.

RisCura Fundamentals has summarised the changes to the Guidelines for ease of use. This summary is not intended to be an exhaustive list of all changes, but rather an overview of the significant changes to enable a user to understand the substance of the revision to the Guidelines. The full Guidelines should be read to fully appreciate the changes, and can be found online at: [www.riscura.com/IPEV-Guidelines-Dec-2012](http://www.riscura.com/IPEV-Guidelines-Dec-2012)

## Effective date

The new Guidelines are effective for reporting periods post 1 January 2013 and should be regarded as superseding previous versions of the Guidelines.

## Addition of Unit of Account concept

Unit of Account is an accounting concept used to define the level of aggregation or disaggregation when reporting the Fair Value of assets. The following guidance is given by the new Guidelines:

*Some private equity managers invest in multiple securities of the same portfolio company. If Market Participants would be expected to purchase all positions in the same portfolio company simultaneously, then Fair Value would be measured for the aggregate investment in the portfolio company. If individual tranches of securities would be purchased by Market Participants individually, then the Unit of Account and the basis for determining portfolio value would be the individual tranche.*

### Impact for users

Valuers must consider whether a Market Participant would purchase all tranches of the investment into a portfolio company. If a Market Participant would purchase all tranches, then all tranches can be valued together. If not, then different tranches should be considered separately and valued according to what a Market Participant would pay for each tranche individually.

## Value of outstanding debt

Further guidance is also given regarding the calculation of the value of debt to be subtracted from Enterprise Value:

*When subtracting outstanding debt from Enterprise Value to measure the Fair Value of Equity Instruments, judgement should be exercised to ensure that the Fair Value of debt represents a Market Participant perspective. For example, if debt must be repaid upon the sale of the Underlying Business, which is often the case in a private equity transaction, then a Market Participant transacting in their economic best interest, may deem the Fair Value of debt to equal the Par Value of debt (or the amount to be repaid) for purposes of determining the Fair Value of equity. If debt would not be repaid when the Enterprise is sold, then the Fair Value of debt would not necessarily equal the Par Value of debt.*

*It should be noted, however, that if debt is a standalone investment, a Market Participant would take into account risk, coupon, time to expected repayment, and other market conditions in determining the Fair Value of the debt instrument, which may not be equivalent to Par Value.*

### Impact for users

Valuers must consider whether the debt will be repaid on sale of the underlying business. If this is not the case, then par value of the debt may not necessarily equal Fair Value for deduction from Enterprise Value to arrive at Attributable Enterprise Value.

## Refined definition of Fair Value

There is a renewed emphasis on the Market Participant perspective in the consideration of Fair Value:

*Market Participants are potential or actual willing buyers or willing sellers when neither is under any compulsion to buy or sell, both parties having reasonable knowledge of the relevant facts and who have the ability to perform sufficient due diligence in order to make orderly investment decisions related to the Enterprise in the most advantageous market for the asset.*

Other changes in this section do not fundamentally change the previous position, but rather clarify the exact definition of Fair Value:

*The estimation of Fair Value assumes that the time period required to consummate a transaction hypothetically began at a point in time in advance of the Measurement Date such that the hypothetical exchange culminates on the Measurement Date. Therefore, Fair Value should reflect the actual amount that a seller would receive in an Orderly Transaction between Market Participants under current market conditions at the Measurement Date. An additional discount for Marketability (where Marketability is defined as the time required to effect a transaction) is not appropriate. Liquidity or illiquidity (meaning the frequency of transactions) is taken into account by Market Participants and should be a factor used in assessing Fair Value.*

### **Impact for users**

Discounts applied for marketability constraints in excess of the normal illiquidity discounts of an unlisted investment may not be used.

## **More emphasis on calibration**

The change with the greatest impact is the inclusion of calibration of the entry price for all valuation techniques that are expected to be used in the Guidelines. The requirement for calibration is worded as follows:

*When the price of the initial investment in an Investee Company or instrument is deemed Fair Value (which is generally the case if the entry transaction is considered Orderly), then the valuation techniques that are expected to be used to estimate Fair Value in the future should be evaluated using market inputs as of the date the investment was made. This process is known as Calibration. Calibration validates that the valuation techniques using market inputs will generate Fair Value at inception and therefore that the valuation techniques using market inputs as of each subsequent Measurement Date will generate Fair Value at each such date.*

This approach makes two important assumptions:

- The entry transaction was indicative of a Fair Value at that time.
- The enterprise is in a similar form at valuation date as it was at entry date, or that changes are identifiable.

While this approach will certainly fit many circumstances, there are also situations where a business is undergoing significant change where the process of calibration may not be appropriate.

### **Impact for users**

Valuers must consider the calibration of all valuation techniques they expect to use to calibrate the valuation model to the price paid at entry. While this approach was part of the multiples methodology in the previous Guidelines, Valuers must now calibrate all methods. This is likely to have the greatest impact when using the DCF methodology where there are several variables to calibrate. Please refer to the illustrative example at the end of this document for more details on how to perform this calibration.

## **Clarifications on valuing fund interests**

Changes have been made to this section to clarify a number of issues, these changes include:

- NAV may only be used if it is derived from the Fair Value of the underlying investment and is on the same Measurement date as that used by the Valuer of the Fund Interests.
- NAV may not be used if the interest is actively traded.
- When a Valuer does not use NAV, DCF is the alternative, but this is not expected to be used often.

### **Impact for users**

In most cases these changes will not have an impact on the valuation of fund interests, as long as the investments of the fund are themselves carried at Fair Value and valued on a regular basis.

## **Consideration given to valuation of contractual rights**

This section is in the Guidelines for the first time and gives guidance on the valuation of contractual rights such as additional consideration dependant on future events, for example, profitability targets. These should be valued using a DCF methodology taking into account the probability of cash flows at any given time in the future.

### **Impact for users**

Contractual rights must now be specifically considered and Fair Valued based on the probability of future cash flows.

## Smaller changes

The smaller changes are as follows:

- Reference to materiality as a factor when establishing the appropriate valuation technique has been removed.
- Wording has been inserted to ensure transactions are viewed from the perspective of Market Participants.
- When determining the ranking of instruments to be deducted from Adjusted Enterprise Value to determine Attributable Enterprise Value, Valuers must use the ranking of instruments on sale rather than liquidation.
- The Price of Recent Investment methodology has been amended to specifically exclude transaction costs from the Price of the investment.
- Instruments quoted on an active market may now be valued at the point in the bid-ask spread that is most representative of Fair Value. This replaces the previous guidance to use Bid Price.

## Illustrative example: DCF Calibration

To demonstrate the concept of calibration in a DCF method, an illustrative example has been put together as detailed below:

### Entry:

#### Portfolio Company A

Instruments used in acquisition:	Total Value \$(m)	% held by PE fund	PE fund holding \$(m)
Preference Shares (Cumulative, Redeemable)	13.0	100%	13
Ordinary Shares	25.0	40%	10
Third Party Debt	20.0	-	-
<b>Enterprise Value (Calculated):</b>	<b>58.0</b>		

**Calibration:** To calculate what the valuation calibration input is at entry date, a WACC is calculated at which Enterprise Value obtained from discounting the cash flows is equal to the Enterprise Value implied by the transaction price. All the elements of WACC are based on observable market input data except for beta, the debt equity ratio and the specific risk premium, where further judgment is required. After the estimation of beta and the debt equity ratio, the specific risk premium can be calculated and allocated to specific factors. In this example the premium is broken up between the two factors detailing the additional risk spread, a lack of liquidity and an undiversified client base.

	Year 1	Year 2	Year 3	Year 4	Year 5	Terminal
FCF	8.0	8.0	8.2	8.4	9.5	74.8
PV of FCF	6.8	5.7	4.9	4.3	4.1	32.2
EV	58.0					

#### Cost of Equity **21.0%**

Risk free rate	7.8%	- Yield on long-term government debt.
Beta (Comparator Approach)	1.2	- Based on a relative comparator set.
Market risk premium	6.0%	- Based on a recent market survey.
<b>Specific risk premium</b>	<b>6.0%</b>	
- Liquidity	<b>3.0%</b>	
- Client base	<b>3.0%</b>	
Debt	5.0%	- After tax cost of debt based on terms of the loan.
D/E	20%	- Based on target D/E ratio.
WACC	18%	
Terminal growth rate	<b>5%</b>	- Based on long-term growth forecasts.

## Valuation date (t+3 years):

**Calibration:** 3 years later at valuation date, the business has grown. The company is still unlisted and there is no change to the assessment of liquidity risk. The client base has diversified and there can now be an adjustment down to the specific risk premium from 3% to 1%.

The other components of the equation are calculated using the most up to date market information.

	Year 1	Year 2	Year 3	Year 4	Year 5	Terminal
FCF	10.0	13.0	13.5	14.5	15.0	148.8
PV of FCF	8.7	9.7	8.7	8.1	7.3	72.1
EV	114.7					

### Cost of Equity 17.7%

Risk free rate 8.2%

Beta (Comparator Approach) 1.0

Market risk premium 5.5%

→ Specific risk premium 4.0%

- Liquidity 3.0%

- Client base 1.0%

Debt 5.0%

D/E 20%

WACC 16%

Terminal growth rate 5.0%

- Calculated using appropriate government T-bills at t+3.

- Same comparator set as entry date, using market data at t+3.

- Based on most recent market survey at t+3.

- After tax cost of debt based on terms of the loan.

- Based on target D/E ratio (unchanged).

- Based on long-term growth forecasts.

### Waterfall

Instruments used in acquisition:	Total Value \$(m)	% held by PE fund	PE fund holding \$(m)	
Third Party Debt (at Interbank -1%)	17.2	-	-	(a)
Preference Shares (Cumulative, Redeemable)	15.0	100%	15.0	(b)
Ordinary Shares (balance)	82.5	40%	33.0	
<b>Enterprise Value</b>	<b>114.7</b>		<b>48.0</b>	

Unit of Account:

(a) Debt is to be settled at sale date, therefore valued at par.

(b) Preference Shares are linked to Ordinary Shares, therefore valued at par.

## Illustrative example: Unit of Account

Taking the same example above, but adjusting the conditions of the instruments at valuation date, the Unit of Account principle is demonstrated. In the example below, portfolio Company A is valued at the same date, with all factors remaining constant except for:

- Debt is not expected to be settled at sale date.
- Preference Shares are not linked to ordinary shares.

### Valuation date (t+3 years):

**Calibration:** 3 years later at valuation date, the business has grown. The company is still unlisted and there is no change to the assessment of liquidity risk. The client base has diversified and there can now be an adjustment down to the specific risk premium from 3% to 1%.

The other components of the equation are calculated using the most up-to-date market information.

	Year 1	Year 2	Year 3	Year 4	Year 5	Terminal
FCF	10.0	13.0	13.5	14.5	15.0	148.8
PV	8.7	9.7	8.7	8.1	7.3	72.1
EV	114.7					

### Cost of Equity 17.7%

Risk Free Rate 8.2%

Beta (Comparator Approach) 1.0

Market Risk Premium 5.5%

→ Specific Risk Premium 4.0%

- Liquidity 3.0%

- Client Base 1.0%

Debt 5.0%

D/E 20%

WACC 16%

Terminal Growth 5.0%

- Calculated using appropriate government T-bills at t+3.

- Same comparator set as entry date, using market data at t+3.

- Based on most recent market survey at t+3.

- After tax cost of debt based on terms of the loan.

- Based on target D/E ratio (unchanged).

- Based on long-term growth forecasts.

### Waterfall

Instruments used in acquisition:	Total Value \$(m)	% held by PE fund	PE fund holding \$(m)	
Third Party Debt (at Interbank -1%)	20.6	100%	-	(a)
Preference Shares (Cumulative, Redeemable)	14.0	100%	14.0	(b)
Ordinary Shares (balance)	80.1	40%	32.0	
<b>Enterprise Value</b>	<b>114.7</b>		<b>46.0</b>	(c)

### Unit of Account

- (a) Debt is not expected to be settled at valuation date. Market rate for a similar Instrument is lower than interbank -1% and therefore the value of the Third Party Debt increases, based on the present value of the expected cash flows at a lower discount rate.
- (b) Preference Shares are not linked to Ordinary Shares and are therefore valued separately. A similar market rate is expected to be higher than the 15% rate attached to the instrument. The value of the instrument therefore decreases based on expected future cash flows discounted at a higher rate.
- (c) The net effect is a decrease in the investment value based on the market value of the Preference Shares and Third Party Debt.

**Conclusion:** The terms of the instruments at valuation date and the assumptions applied can result in a different enterprise value attributable to instrument holder. In the example above, the Enterprise Value attributable to the PE fund decreased from \$48 million to \$46 million.

## About RisCura

RisCura is a global, independent financial analytics provider and investment consultant. RisCura services institutional investors with over \$200billion in assets under management, as well as a significant number of asset management, hedge fund and private equity firms.

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## About RisCura Fundamentals

RisCura Fundamentals is the leading provider of independent valuation, risk and performance analysis services to investors in unlisted instruments in Africa. We work in partnership with our clients to deliver the transparency and accountability that is increasingly demanded by investors and auditors. Our clients include private equity funds, pension funds, credit funds, banks and other investors in Africa, and cover industries as diverse as agriculture, retail, manufacturing and the extractive industries.

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