How to Approach Your Q2 Private Company Valuations

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Q2 is all about ensuring you do not "Double Count" Q1 valuation considerations but rather "True-Up" analyses with incremental findings and new information

As the first quarter ended on March 31 and COVID-19 took hold globally, businesses were disrupted and stay-at-home orders were implemented leading to an unprecedented shock across the global economy. As investment professionals of private equity and credit funds scrambled to understand the impact of COVID-19 on each portfolio company, chief financial officers were faced with the task of marking-to-market their portfolio company investments in accordance with fair value accounting standards (ASC 820 / IFRS 13).

As a result of the pandemic, the credit markets experienced spread increases and the stock markets experienced significant valuation declines. Unlike prior reporting periods, it was clear that almost every company was going to be negatively impacted by COVID-19 in the first quarter, but there was no financial information that reflected its impact. Therefore, given the limited portfolio company data, the fair value of investments on these private companies as of March 31 primarily reflected expectations of performance as well as the shift in market dynamics and was not based on actual fundamental performance.

In the upcoming second quarter (June 30) valuation process, there is greater visibility as to the impact COVID-19 is having on businesses. However, along with greater visibility also comes new challenges. This article seeks to answer common valuation questions we are receiving regarding preparing second quarter valuations.

WHAT IS THE APPROPRIATE FINANCIAL METRIC TO CONSIDER WHEN ESTIMATING ENTERPRISE VALUE?

Unlike the first quarter, updated post-COVID forecasts are expected to be prepared for most medium and higher COVID impacted businesses. With this new information, chief financial officers along with investment teams will be faced with the question of evaluating which financial metric - trailing, forward or a blend- is indicative of future run-rate expectations.

To date, our Valuations & Opinions Group has observed that the average decline in revised 2020 earnings forecasts is approximately 20%[1]. As a result, market participants will need to assess whether the revised earnings estimate for these portfolio companies are temporary or permanent.

ASC 820 and IFRS 13 mandate that fair values should reflect all information that was known or knowable as of the valuation date. As such, when available, we would advise that both trailing and forward indicators of business performance be factored into one's valuation analysis. However, if the forward earnings indicator does indeed reflect the "new normal", then relying on this forecast more heavily may be prudent.

And while we recommend one consider all available information, including revised earnings forecasts, in your analysis, of importance is reconciling the impact this new information may have on enterprise value to ensure one does not double count what was already factored into the first quarter analysis. Said differently, just

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because a new 2020 forecast is available in the second quarter does not mean valuations will change materially. Instead, one must confirm whether enterprise values in Q1 already factored in expected declines or increases in earnings when reconciling the change in concluded enterprise value between the two quarters.

WHEN ESTIMATING ENTERPRISE VALUE IN Q2, WHAT IS THE RIGHT VALUATION METHOD?

Lincoln, consistent with AICPA's *Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies* guide released in 2019, recommends using multiple valuation methods to estimate enterprise value. Ultimately the level of information and the view a market participant would take should dictate which approach or approaches are best to rely upon.

The following chart depicts each method and the key considerations in the second quarter.

Income Method ("DCF Analysis")	A DCF Analysis is a powerful valuation technique as it accounts for the free cash flow a company will generate into perpetuity. As such, we recommend that chief financial officers collaborate with investment professionals and their portfolio management teams to develop a post-COVID long-term forecast. Of consideration is that while lower-COVID impacted businesses may only require an update to the 2020 cash flows, higher COVID-impacted businesses could see significant changes to the long-term growth and margin expectations. In these instances, it may be appropriate to build a multi-scenario model which accounts for downside, base, and upside cases to properly capture all potential outcomes. By in large, when a post-COVID forecast is available, the DCF Analysis could be viewed as a superior approach to other methods because it not only encompasses the company's future earnings, but the timing as to when cash flows will be generated and the liquidity necessary for the company to achieve them. In addition to the forecast itself, the discount rate is of equal importance. The discount rate used will likely need to be adjusted given the current low levels of risk-free rates and that certain indicators such as beta and the equity risk premium may only reflect pre-COVID levels.[2] Lastly, in instances where post-COVID forecasts are not available, but an Income Method is relied upon, consideration should be given to (a) lowering the weighting of this method or (b) reassessing the discount rate of cash flows given the risk in achieving a stale forecast.
Guideline Public Company Method ("GPC Method")	It is well known that private company enterprise values are less volatile than public company valuations. However, changes in guideline public companies ("GPC") may prove to be a good directional barometer for determining EV rather than an absolute indicator. These differences were evidenced by Lincoln's proprietary middle market index which measures changes in enterprise value of private companies. While in the first quarter of 2020 the enterprise value of private companies declined by approximately 7.5%, the S&P 500's enterprise value declined approximately 15%. As a result, we do not believe that changes in the stock prices of GPCs should be reflected on a one-for-one basis when valuing a private company. Through early June, we observed that the public equity markets have rebounded. When assessing the degree of the rebound one should account for in a particular company's valuation, chief financial officers and other investment professionals should consider how much the GPC Method impacted fair value in the first quarter and a consistent approach should be taken when establishing enterprise value in the second quarter. Additionally, unlike the first quarter, post-COVID revised forecasts are being prepared. In these instances, the use of a forward valuation multiple in the valuation analysis should be considered.
Guideline Company Transactions Method ("GCT Method")	From the onset of the pandemic, global M&A markets stalled as buyers and sellers alike re-assessed the impact the virus would have on earnings. Since this time, however, the M&A markets have begun to re-open, and sale processes are commencing. In the second quarter, consideration should be given as to whether transactions are resuming in each industry and if the post-COVID multiples have deviated from historical levels. As such, if an industry is not active today with limited visibility on post-COVID multiple levels, consider a lower weighting or eliminating this methodology until the M&A market for that industry opens.

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HOW DOES ONE ASSESS THE REASONABILITY OF POST-COVID FORECASTS?

As post-COVID earnings forecasts are prepared and the shape and timing of recovery is estimated by portfolio company management, chief financial officers must assess the reasonability of achieving these revised forecasts. According to S&P CapitalIQ, as of June 1, 2020, over 70% of US public companies either removed guidance or have yet to report 2020 earnings estimates, so the outlook for public companies is still highly uncertain. While public equity analysts' forecasts are available, the lack of public company provided earnings estimates makes it even more challenging to compare the impact of private company revised forecasts relative to GPCs.

The following considerations should be taken into account in making such assessment:

Review consensus estimates prepared by public equity analysts of GPCs to compare both the shape and the timing of recovery relative to the subject portfolio company.

Compare historical growth and margin trends of both the subject portfolio company and the GPCs to determine the reasonability of revised forecasts.

Consider differences in sources of liquidity between private and public companies as recovery times could be impacted by the support the sponsor and lender group have for private companies.

HOW DOES LIQUIDITY IMPACT VALUATIONS?

With the shock waves of COVID-19 impairing the liquidity of many businesses, Lincoln observed that revolvers were drawn at unprecedented levels. More specifically, in the first quarter, of the companies which drew their Revolvers, ~40.0% drew down 100.0% of their outstanding commitment.[3]

As investment professionals bifurcate higher impacted, liquidity stretched, portfolio companies from those that were not, certain incremental borrowings and government aide were precautionary in nature. In fact, from a valuation perspective, the incremental borrowings should not be viewed as an impediment to equity value as cash would sit on the balance sheet and not be utilized for operations.

In contrast, for those portfolio companies which will require incremental liquidity to return to their base case earnings level, this additional capital should be factored into the enterprise value and equity value, all other things being equal, should decline. Said differently, fair value accounting standards suggest that a market participant would identify the working capital shortfall and adjust its purchase price accordingly to account for the liquidity need.

Ultimately, in the second quarter, it is likely that there will be greater clarity on the liquidity runway of each business. In practice, one should only adjust the valuation for the incremental shortfall identified between the first and second quarters, in essence "truing-up" any incremental capital needs relative to those considered in the Q1 valuation.

LINCOLN PERSPECTIVE

There are subtle but significant differences between valuing privately held companies between the first and second quarters of 2020. As additional financial information has become available during the second quarter, the liquidity outlook coalesces, and the public markets rebound, it is important to assess the valuation impact of this new information and in particular understand whether the business performance has been in-line with, better or worse than expectations reflected in the first quarter fair values. The real challenge, this quarter, is to reflect only the new known or knowable information received during the second quarter in order to avoid double counting any impact from COVID-19 already reflected in the first quarter fair value of portfolio company investments.

[1] Lincoln International Valuations & Opinions Proprietary Database

[2] Given that beta is generally based on a trailing time series of historical stock prices and equity risk premiums may be computed annually at the end of the year, relying on historical data to compute the cost of equity will inadvertently omit or ignore the economic impact of COVID.

[3] Lincoln International Valuation & Opinions Proprietary Database, 2020 Q1

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