Unveiling Valuation Challenges

in reporting of NAV by AIFs under SEBI (Alternative Investment Funds) Regulations, 2012

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As at December 2018, India had over 500+ funds registered with SEBI under Alternative Investment Funds (AIFs), who together have raised investment commitments of INR 1,795.9 billion and have already invested INR 748.9 billion by June 2018. Given that a large part of these privately pooled in investments have been deployed in start-ups, early stage social ventures, real estate assets and distressed assets through series of investments in equity, debt or structured financial instruments issued by the investee entities, reporting of fair value of such investments as part of net asset value (NAV) disclosure has come to hold an overarching necessity for fund managers.

Fund managers must not see fair valuation as a mere accounting exercise, but as a fiduciary and a corporate governance responsibility aimed at true and fair disclosure of approaches, methodologies by giving due consideration to factors concerning portfolio companies which inter alia include analysis of competition, barriers to entry, industry attractiveness, cost and financial structure.

Interestingly, the recent reforms in the Companies Act, 2013 which bring in force Registered Valuers rules and changes in accounting policies following adoption of Ind AS are also having an overwhelming effect on conundrums inherent in a valuation exercise.

Deep diving into challenges in performing valuation merits our attention also because unlike mutual funds, whose NAV is linked to the prices of the listed investments, for AIFs the investment policy may be defined to direct investment in start-ups, social sectors, debt/equity of private enterprises or compound financial instruments where price discovery has its own challenge. Not to forget business restructuring situations such as demerger or business carve-out from listed to unlisted entities and may require additional consideration while computing NAV.

This article highlights the requirement of valuation under SEBI (Alternative Investment Funds) Regulations, 2012, challenges faced and impediments that require further attention. We hope this article will be helpful to gain view on interesting aspects while valuing interests in portfolio companies.

Requirements of valuation by SEBI (Alternative Investment Funds) Regulations, 2012

Overview

Clause 23 of the regulations requires the AIFs to provide to its investors, a description of its valuation procedure and of the methodology for valuing assets.

- Category I and Category II AIFs are required to undertake valuation of their investments, atleast once in every six months (subject to extension of upto one year), by an independent valuer appointed by the AIF.

- Category III AIFs are similarly required to independently calculate the net asset value (NAV) which must be disclosed to the investors at intervals not longer than a quarter for close ended funds and at intervals not longer than a month for open ended funds.

The extant regulation is silent on who is an 'independent valuer'. However, amended SEBI (Real Estate Investment Trusts and Infrastructure Investment Trusts) regulations define "valuer" as any person who is a "registered valuer" under section 247 of the Companies Act, 2013 or as specified by the SEBI from time to time. As such, if the applicability of the definition were to be extended to SEBI (AIF) Regulation, 2012 then investment managers may have to reconsider the qualification of the valuer before appointing them for determining the NAVs.

Registered Valuers – low availability of specialists

Registered Valuers rules look beyond the realm of chartered accountants and merchant bankers who until now had been responsible for issuing fair valuation certificates for tax and regulatory purposes. However, despite the Insolvency and Bankruptcy code, 2016 bringing in the concept of registered valuers, the availability of pool of professionals who can undertake valuation is presently at the low end of the dimension. IBBI website shows that as at end of first week of December 2018, the total number of registered valuers for 'securities and financial assets' were only 87 in number.

The problem is further compounded by the fact that beyond the Big4 accounting firms and some valuation specialist firms, most of the tier-2 and below accounting firms in India are lacking the brawny capabilities which are required to carry out complex valuations – such as derivatives, unlisted bonds, valuation of compound instruments, valuation of start-ups, etc.

Valuation challenges & impediments

"No single method exists for estimating fair value in good faith because fair value depends on the facts and circumstances of each individual case."

The section below summarises the various challenges and potential impediments which a fund manager may encounter while determining the NAV.

Unit of account measurement

The first impediment that a fund may come across while reporting its NAV or fair value as part of schedule of investments, is deciding on the unit of accounting. Fund may consider grouping of assets in a given portfolio company held within the fund (e.g. the debt and equity together) and may present in the schedule of investments the aggregate fair value of the investment in each portfolio company along with each class of debt and equity owned in that portfolio company at its allocated value.

In practice, many private equity and venture capital funds report the total value of their aggregate capital position in a portfolio company, and then identify each instrument and its allocated value. This approach assumes that market participants would transact in the various classes of debt and equity as a group of assets, rather than individually.

Consideration is required in allocating on a reasonable basis, possibly by estimating fair value of each instrument independently and then allocating value on a proportionate basis. Alternately, funds may determine the residual fair value for one of the instruments after subtracting the fair value of the other instruments. This is usually seen in situations where funds have both equity and debt position in a single investee company.

Determining the rate of return and time horizon

In many cases, especially when considering measurement dates prior to an IPO or sale of the portfolio company as a whole to a strategic investor, the desired rate of return should reflect the outlook of market participants. Thus where the market participants are likely to be other portfolio managers, it is helpful to view valuation from their perspective.

Similarly, while the time horizon (cash flows for the investment under current ownership through a liquidity event which could be say, IPO or sale of the portfolio company) is initially considered at the time when the fund invests in the equity or debt instrument, at subsequent measurements, this is a market participant input. The strategies and market considerations will therefore have to be considered in view of the market participants. Determining expected probability, timing and impact of a change of control from market participants' perspective is challenging.

[1]The "good faith" requirement is addressed in SEC Accounting Series Release (ASR) No. 118, and in the December 19994 and April 20015 letters of the SEC Division of Investment Management to the ICI regarding valuation issues. SEC Accounting Series Release No. 118 can be found at https://www.sec.gov/rules/interp/1970/ic-6295.pdf

Choice of methodology in determining enterprise value

Estimating fair value is not an exact science, therefore value indications from different methods will not necessarily reconcile, but the results of one valuation method can be used to corroborate, or can otherwise be used in conjunction with the results of one or more other valuation methods in estimating value.

Market approach:

Two commonly used valuation methods for valuing a portfolio company within the market approach are the guideline public company method and the guideline company transactions method. Consideration needs to be given to the following aspects:

- The market approach may be used to value the interests in a portfolio company directly, based on transactions in the company's own instruments. However, calibration may be required to infer the equity value for the investment held by the fund

- When valuing privately-held, early stage portfolio companies, the guideline public company method has significant limitations and challenges. For instance, truly comparable guideline public companies, at a similar stage of development with similar growth and risk expectations, may be unlikely to exist.

- In addition, there may be instances where the portfolio company is comparable to a division within a guideline public company or is comparable to only part of the guideline public company, or vice versa. Consideration would need to be given to assess the importance of these differences in business models.

- Valuation multiples (such as EV/Sales, EV/earnings or EV/net assets) can be calculated on a historical basis or a forward looking basis. The selection of historical versus forward looking multiples requires judgment about which measure(s) are most indicative of a normalized level of operations going forward.

- Consideration will also be required for non financial metrics and key performance indicators sometimes used by market participants. These include price per subscriber in a telecommunication or cable business, price per bed in hospital, price per room in a hotel business, clicks or visits for an early stage internet company

- Valuation multiples may require to be adjusted. These adjustments relate to factors including profitability, anticipated growth size, leverage, working capital, nonrecurring or non-operating income or expenses, or differences in accounting policies or principles.

Similarly, subject portfolio company's financial data may need to be adjusted for non-operating, non-recurring, one-time or exceptional income or costs.

Income approach:

The valuation method commonly used in applying the income approach to value an interest in a privately-held company is the discounted cash flow (DCF) method. The DCF method requires estimation of future economic benefits and the application of an appropriate discount rate to equate them to a single present value. Key considerations in application of DCF are as follows:

- While determining the discount rate, one should keep in mind that venture capital and private equity portfolio rates of return reflect a return considering the diversifiable risk across the entire portfolio. To the extent that an investment in a specific company has additional non-diversifiable risk or financing risk, the discount rate for expected cash flows should be higher than the portfolio rate of return.

- For start-up portfolio companies with little or no operating history, forecasts beyond one or two years are likely to be speculative and unreliable.

- Terminal value is often a significant component of the total enterprise value and it should be carefully considered. Acceptable and commonly used methods for calculating a terminal value include a long-term growth rate method such as the Gordon growth model, the two-stage growth method, the H-Model method, and the observed (exit) market multiple method.

- Another consideration in applying the income approach is the basis of the valuation i.e. whether the resulting portfolio company or portfolio company's instrument value would be considered controlling or minority and whether it would be considered marketable or nonmarketable. Valuation will be adjusted accordingly.

- Amount of leverage available could be another critical factor in estimating the value of a business and the overall cost of capital for the business.

Asset approach:

Asset approach serve as a 'reality check' on the market and income approaches, and provide a 'default value' if the available data for the use of those other approaches are incomplete or speculative.

The asset approach is typically more relevant for valuing enterprises and the interests in the enterprise in the earliest stages of development, prior to raising arm's-length financing, when there may be limited or no basis for using the income or market approaches. For example, at the early stages of real-estate development projects or other development projects, market participants may not assign value for the potential future profits of the business beyond the amount spent in developing the tangible assets to date.

Valuation of portfolio companies with simple structure

In a simple capital structure, the value of the single primary class of equity interests in the portfolio company typically is calculated based on a pro rata share of the total enterprise value less the value of debt for valuing equity.

It is important to note that the assumptions used in valuing the equity interests in the enterprise generally should be consistent with the portfolio company's plans under current ownership. This is because a market participant acquiring an equity interest would not have the unilateral ability to change the portfolio company's strategy and policies.

Consideration should be given to adjustments ensuing from controlling or minority and marketable or nonmarketable interest. Furthermore, in case of complex structures, fund may have to evaluate utilising more sophisticated methods to fair value.

Equity interest in complex structures

Thus far INR 417 billion has been deployed by category II AIFs who are essentially private equity funds or debt funds. It has been observed that many (if not most) venture capital-backed and private equity-backed portfolio companies are financed by a combination of different classes of equity, each of which provides its holders with unique rights, privileges, and preferences. This results in a valuation challenge. When estimating the fair value of the fund's investment, the fund is required to determine how each class of equity would participate in future distributions from a sale or other liquidity event, and the implications for the fair value of each class of equity.

Quite often venture capital and private equity investors seek downside protection and significant control or influence over the portfolio companies' activities. In such cases investors may receive preferred stock that conveys various rights to its holders. Such rights are meaningful, substantive rights and often are intensely negotiated and bargained for by the investors. Therefore, an understanding of the rights associated with each class is vital for valuing these different classes of preferred stock in a portfolio company.

Key considerations in complex structures involving compound instruments:

- Preferred stocks usually carry liquidation preference and estimate of fair value is therefore linked to the future payoffs at the time of the liquidity event. It is therefore critical to identify various break-points for correctly allocate enterprise value to various series of preferred stock, stock warrants and equity.

- One has to be mindful of the rights received by the preferred stockholders which are in the nature of economic and/or management rights. While these rights are meaningful and substantive, not all can be valued objectively. Some of the critical rights which allocation methods can value include right to cumulative preferred dividends, liquidation preference, participation, and conversion rights.

- Evaluate various available techniques to value compound instruments. Four commonly applied techniques include – a) probability-weighted expected return method, b) option pricing method, c) current value method, and d) hybrid method, a hybrid of scenario-based methods and option pricing method. Each method has merits and challenges and no single method for valuing equity interests appears to be superior in all respects and circumstances over the others.

- In several situations VCs invest with bimodal outcomes or high probability of conversion. They frequently value equity on a fully diluted basis on an assumption that not much benefit will accrue through liquidation and value will be realised only through sale of the company or an IPO. Complex valuation techniques are therefore not utilised in such situations.

- In some cases, the investment may be in participating preferred rights. These have two components: a debt-like preferred instrument corresponding to the liquidation preference, plus an as-converted interest in the common equity. Valuing such instrument will require an assessment of probability of a sale or other exit and qualified IPO.

Valuation challenges in early stage investments

Value creation in such portfolio companies is frequently a high-risk process and fund manager is likely to come across series of challenges in such valuations.

Portfolio companies often have unproven business model, little or no infrastructure, an incomplete management team, and little or no short-term prospects of achieving a self-sustaining business with revenue, profits, or positive cash flows from operations. As such, determining enterprise value is not easy for such businesses and valuation techniques such as Berkus method, First Chicago method may be employed to arrive at a range of value. Most businesses in the early stage may take quick strides and value creation metrics can be assessed on a quarterly basis. As such, fair value of such investments could be monitored on a quarterly basis from NAV stand-point. Assessing value at intervals shorter than three months will be challenging.

Valuation challenges in roll-up and turn-around investment strategies

Certain private equity funds at times adopt investment strategies around roll-up or turn-around of businesses. These are long terms strategies where value creation will come with some gestation period. It is therefore reasonable to have the NAV determined on a bi-annual or annual basis as review period of less than six months is unlikely to present a vastly different picture.

Investment in debt instrument or debt-like preferred stock with a specified cumulative dividend rate

Observable price of debt which is listed can be readily obtained from the relevant exchange where it trades. Challenge arises when traded price as of the measurement date is not available. In such situations the best practice for estimating the fair value of a debt-like preferred stock is the yield method.

In applying yield method, market yield for the debt as of the valuation date is required to be assessed. This can be measured relative to the market yield at the issuance date by observing-

- The change in credit quality for the portfolio company.
- The change in credit spreads for comparable debt instruments, considering the characteristics of the debt compared to the comparable traded debt, including the seniority, strength of the covenants, portfolio company performance, quality of the assets securing the debt, maturity, early redemption features or optionality, and any other differences that a market participant would consider in determining its fair value.
- For fixed-rate debt, the change in the reference rate matching the remaining maturity of the debt (that is, the change in the LIBOR swap rate or risk free rate).

Furthermore, in cases where credit rating of the portfolio company is not available, the credit risk will need to be derived synthetically using a variety of metrics and some form of regression analysis. However, such analysis does not take into consideration any qualitative factors that may impact the credit rating of the portfolio company

Other considerations in valuing debt include:

- Debt may in certain instances include change of control provisions. In assessing the value to the debt holders, the penalty (or benefit) associated with the below- (or above-) market yield will typically continue only through the anticipated liquidity event for the portfolio company.
- If the debt has prepayment features (such as call or put rights), it may be necessary to consider the optimal timing of repayment for the issuer (call features) and the holder (put features)
- In some leveraged buy-out situations, the debt may have much higher leverage than is observable in the public debt markets. As such, it may not be possible to estimate the market yield from public debt data. In such situations, entire enterprise value may be allocated to debt.
- In some cases, fund may have only limited information on the debt's terms and it may be therefore difficult to assess the value of debt.

Judgement is also required to estimate the value of debt for the purpose of valuing equity i.e. enterprise value less value of debt. In many cases, funds valuing equity interests may use the par value, face value, book value or payoff amount as a proxy for measuring the value of debt for the purpose of valuing equity. Change in basis of value of debt will therefore cause the value of equity to be range bound.

When market is in distress

If on the measurement date, the market was in distress for private company equity interests, and the fund intends to sell such investment, the fair value measurement would still consider how market participants would transact on the measurement date. Such considerations would include factors such as a market participant's longer expected time to exit or a higher required rate of return, irrespective of the asset holder's intent to sell.

Minority investment

When a fund makes a minority investment it will typically negotiate a path to liquidity (for example, a put right or mandatory redemption feature that forces the company to repurchase the investment at the higher of cost or fair market value or a negotiated formula price after a specified amount of time). Such liquidity rights should be considered when estimating the fair value of the investment.

Calibration

Calibration is required when the transaction is at fair value at initial recognition. The goal of calibration in this context is to ensure that at subsequent periods, valuation techniques use assumptions that are consistent with the observed transaction, updated to take into account any changes in company-specific factors as well as current market conditions. For example, in the market approach:

Suppose that a company is acquired for 10 times the last 12 month (LTM) earnings before interest, taxes, depreciation, and amortization (EBITDA). Further, suppose that the median multiple observed for the selected guideline public companies in the guideline public company method is 8 times the LTM EBITDA. The difference in this example was due to the market participants' assessment that the near term financial performance for the company was likely to exceed that of its peers.

In the next measurement period, it typically would not be appropriate to ignore the multiple implied by the transaction and assume that the multiple used to estimate the company's value would suddenly fall to be consistent with the median of the guideline public companies. Instead, at subsequent measurement dates, the valuation would consider the company's progress and changes in observable market data to estimate the fair value under current market conditions. For example: Suppose that after considering the company's recent performance and positioning, market participants would still expect the company to outperform the guideline public companies. Further, suppose that the median multiple for the guideline public companies has improved to 9 times the LTM EBITDA instead of 8 times. Then, when calibrating the model, it might be appropriate to select a multiple higher than the 10 times LTM EBITDA implied in the initial transaction.

Impact of control premium and marketability

Calibration also resolves around the challenges faced in valuing private equity and venture capital investments – namely, assessing the valuation impact of the level of control and illiquidity associated with an investment.

For example, under the income approach, the fund would initially estimate the expected cash flows for the investment under current ownership through a liquidity event or through the maturity of the instrument, and then calibrate to calculate the required rate of return for the investment on the initial investment date. Since the transaction price already incorporates market participants' required rate of return, no additional discount for lack of control or discount for illiquidity would apply.

For subsequent measurement dates, the fund would consider the updated expected cash flows and the updated market participants' return assumptions given current market conditions. A similar thought process would be used under the market approach.

Empirical studies of premiums paid for acquisitions of companies when compared with the minority trading prices prior to the acquisition announcement suggest that control premium could range in the median of 35 percent in India. Likewise, there are various international studies such as annual Mergerstat study and Coolidge study which indicate similar range. These are only empirical values and due consideration must be given to each deal dynamics.

Similarly, a discount for lack of marketability is often applicable if there is no ready market for the interest being valued, as is the case for most small businesses. The various benchmark approaches such as restricted stock studies, pre-IPO studies and security based approaches such as the Longstaff study, the Chaffee study, etc. indicate the range of applicable discount to be 20-35 per cent. Clearly, a valuation specialist will need to bring in deep judgment when questions of such adjustments arise.

[2] These are results of analysis of closed transaction between 2005 and 2015. It excludes negative premium and premium in excess of 100 percent.

Inferring value from transactions – special situations

In several cases value of instrument needs to be inferred from transaction in the portfolio company's instruments. Few of such cases are discussed below:

When transaction price includes strategic premium

At times price includes premium for strategic benefits such as in case of strategic preferred stock financing transactions. This is typically common when pharmaceutical companies invest in biotech companies at relatively early stages of development and may pay a premium for new drug discovery potential. Transaction price may therefore have to be adjusted to strip out the additional benefits.

Preferred stock investment in tranches

In situations where investment in preferred stock happens in tranches, existing portfolio investors having interest in equity must adjust the transaction value appropriately as the initial investment price typically reflects a premium to the value on the initial investment date, and the later investment is at a discount to the value.

Use of own shares in acquisition

When portfolio companies use their own shares in the acquisition of other companies, the transaction documents may specify a value for these shares. It is important to carefully consider the rights and preferences of each class of equity when estimating the aggregate fair value implied by the transaction.

Direct common stock acquisition

In some cases, PE or VC funds may purchase common stock directly from common stockholders in the company. Frequently, these transactions involve the purchase of the common stock at the same price as the preferred stock. These situations therefore require careful analysis of the negotiation dynamics to understand the investor motivations and the implications for the fair value of the common stock.

Demerger of the portfolio company

In limited situations, the portfolio company may decide to restructure their businesses by carving-out or demerging certain business undertaking. The process will involved issuing instruments with similar feature as the original. Enterprise value will thus need to be bifurcated between the two businesses. In case of listed portfolio company, consideration may be given to difference between the last trading price prior to demerger and the opening price of the demerged entity for determining the price of resulting business.

Role of management

Valuation specialists typically rely on management for supply of business plan and information on the business. Their analysis and understanding may be limited to the information provided and discussion with the management. Hence, it is quintessential for Funds to ensure that projections supplied by management of portfolio companies are based on analysis of historical performance and projected market growth for their products/ services. Benchmarking with peers could also throw light on industry wide performance metrics.

Closing thoughts

Valuation has come to play a centre stage role in corporate governance. SEBI (Alternative Investment Funds) Regulations, 2012 clearly directs the funds to provide to its investors, a description of its valuation procedure and of the methodology for valuing assets. The stakes involved in correctly presenting NAV have therefore enhanced enormously and funds must take on reporting of NAVs as a serious fiduciary responsibility.