The McLean Group
INVESTMENT BANKING

Valuation Vantage

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Insights and perspectives on leading corporate finance valuation issues.

Inside This Issue

SEC Reviews Private Equity's Valuation of Portfolio Companies

The Investigation – An "Informal Inquiry"

In December 2011, the Securities and Exchange Commission (SEC) launched an "informal inquiry" asking private equity firms to provide detailed documentation as to how they value and report their valuation of portfolio companies.

The McLean Group has reviewed the SEC letter, which may be a potential precursor to a formal investigation or other regulatory action.

continued

"SEC Reviews Private Equity's Valuation…" continued

The Inherent Conflict of Interest

Many people – including lending organizations and investors, among others – rely on private equity firms' financial statements. However, the presentation of the financial statements poses several inherent conflicts of interest. Higher valuations help private equity firms demonstrate a successful track record, which helps them solicit new investors and attract and close more deals.

However, given the inherent illiquidity of a private equity firm's investments, the ultimate returns on investment cannot be known before the investment is sold. In the interim, fund managers must estimate the value of their investments and present their estimates to investors.

Although conflicts may exist, they are not as severe as those existing with hedge funds, where performance fees typically are paid annually. Private equity funds earn performance fees only when a gain has been realized through the sale of an underlying private equity investment, thereby making interim valuations less significant.

Potential for Different Valuations

Variances between a private equity firm's valuation and the portfolio company's valuations may also raise several issues. For instance, a private equity portfolio company will perform valuations throughout the year when stock options are being granted or in conjunction with a goodwill impairment test or for other accounting purposes. A portfolio company's board and management may present one valuation while a private equity fund presents another.

The Valuation Challenge

Privately-held business valuations have long been an issue. Since most portfolio companies are not publicly traded, exact values are not readily available. While the valuation industry's rapid development over the past decade helped establish more valuation standards and accounting guidance, private company valuations remain "more art than science," given the role of subjective assumptions and professional judgment in the process.

The fact that private equity portfolio valuation is not an exact science constitutes one of many risks that private equity fund investors encounter.

More frequent and effective communication and sharing of valuation models and assumptions among board members, management, private equity funds, and others involved in the oversight and management of the business is critical in order to provide the most consistent perspective and best estimate of value.

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"SEC Reviews Private Equity's Valuation..." continued

The New York Times' Peter Lattman reported that when The Carlyle Group filed for its initial public offering, it listed valuation as a "risk factor" in its SEC registration statement: "Valuation methodologies for certain assets in our funds can involve subjective judgments and the fair value of assets established pursuant to such methodologies may be incorrect, which could result in the misstatement of fund performance."

As a result, private equity funds incur greater costs to establish rigorous internal valuation processes and engage third party experts to incorporate a level of independence in the reported results. The resulting costs, in turn dampen financial returns.

Best Practices

More frequent and effective communication and sharing of valuation models and assumptions among board members, management, private equity funds, and others involved in the oversight and management of the business is critical in order to provide the most consistent perspective and best estimate of value.

Large private equity firms like KKR & Co. and publicly-traded private equity firms like American Capital Strategies minimize conflicts by engaging third party valuation firms and auditors to perform and review their portfolio companies' valuations. At January 2012's Dow Jones Private Equity Analyst Outlook conference, SEC asset management unit co-chief Robert Kaplan said, "Private equity law enforcement today is where hedge fund law enforcement was five or six years ago." Consequently, as regulation and scrutiny increase, more private equity firms will seek out third party valuation experts to analyze their portfolio companies. ◆

Using Fairness Opinions to Manage Risk in Middle-Market Transactions

In March 2012, The McLean Valuation Services Group's Andy Smith and Brian Sullivan authored the following article that was subsequently published in The CPA Journal. Below is an excerpt from that article.

Since the 2008 financial meltdown and the earlier enactment of the Sarbanes-Oxley Act of 2002 (SOX), there has been an ever-increasing outcry from the public for greater corporate transparency, accountability, and fairness.
But this heightened awareness and perceived lack of trust in the markets has created a dangerous environment for boards of directors; they must now demonstrate that they acted prudently and fairly, and considered shareholders' opposing interests, whatever their stock—preferred, common, or convertible—when evaluating acquisition and divestiture opportunities. Failure to make this effort may cause a board to face costly litigation and even potential personal liability from an unhappy shareholder who feels slighted during the process.
Transaction fairness is an issue that affects more than just public companies.

Traditionally, privately held middle-market companies have had little use for fairness opinions because such companies often have few shareholders or are owned by one group of family members. But as middle-market companies require more sophisticated capital structures to fund growth and expand into new markets, obtaining a fairness opinion may be worth the effort.

The Role of Fairness Opinions

A fairness opinion is an opinion from a financial advisor stating that a proposed business transaction is "fair from a financial point of view" as of a specific date. The advisor usually issues the opinion to shareholders or to those with governance responsibility and fiduciary duties owed to the shareholders.

It is viewed as both a necessity and a routine piece of information that a competent board of directors should consider when evaluating an offer to acquire a company.

A well-written and well-reasoned fairness opinion can assist in evaluating the merits of a proposal to buy or sell an asset, division, or company.

It also acts as exculpatory evidence that a board followed a reasoned, deliberative process; thus, it can help defend board members against potential legal challenges from stakeholders for a breach of fiduciary duty and care.

Fiduciary Doctrines and a Board's Responsibilities

In order for a board of directors and its advisors to best understand a fairness opinion, they should familiarize themselves with established doctrine and precedent, as discussed below.

continued

"Using Fairness Opinions to Manage Risk..." continued

A board should always keep its responsibilities in mind when evaluating fairness opinions.

A well-written and well-reasoned fairness opinion can assist in evaluating the merits of a proposal to buy or sell an asset, division, or company.

Established corporate fiduciary doctrine applies two standards of review in this context: the business judgment rule and the entire fairness standard.

The business judgment rule presumes that, in contemplation of any business decision, "the directors … acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company" (Aronson v. Lewis, 473 A.2d 805, 812, Del. 1984).

The entire fairness standard is limited to controlling takeover bids where a board or company's management may find themselves accused of acting in their own self-interest at the expense of other stakeholders. In this situation, the board has the burden of demonstrating that its conduct was entirely fair to the corporation and its shareholders, with regard to both process and price (Weinberger v. UOP Inc., 457 A.2d 701, 711, Del. 1983).

Generally speaking, if a disgruntled stakeholder can demonstrate that the board lacked independence when making a decision in this context, some courts (for example, the Delaware court) will apply the so-called entire fairness test.

This takes away the business judgment rule's presumptions and shifts the burden onto the board (fiduciary) to prove that the process followed was fair (so-called fair dealing) and that the price achieved was fair. Typically, fairness opinions do not address the fair dealing element of the entire fairness test and instead concentrate on a fair price.
A board should not simply file a fairness opinion upon receipt. As part of a board's efforts in exercising its fiduciary duty, it has an obligation to review and discuss a fairness opinion that it receives.

It is not uncommon for a board or a designated board member to review the details of a fairness opinion, paragraph by paragraph, with its preparer.

Typically, the board engages experienced investment bankers or business valuation professionals familiar with the industry to render an official opinion as to whether the contemplated transaction is fair from a financial point of view.
The fairness opinion itself is typically presented to the board in a detailed written analysis that includes ranges of values for recent transactions in the industry, current multiples, industry trends, and a discounted cash flow analysis. Ideally, the results of the individual valuation approaches should be consistent with the overall valuation range for the transaction.

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"Using Fairness Opinions to Manage Risk..." continued

In reviewing any fairness opinion, it is common for the report to include multiple valuation approaches and analyses to support the conclusion about a transaction's fairness. Different valuation professionals can choose different approaches. Thus, boards should understand why the opinion includes certain approaches and analyses while ignoring others.

Beware Conflicts of Interest

For many years, it was standard practice for an entity to prepare a fairness opinion even though it was also acting as the investment banker for the transaction.

Boards should also consider the inherent conflict of interest in situations where the entity that provides a fairness opinion also acts as financial advisor to the transaction and is compensated based on the successful closing of the transaction.

This type of conflict of interest has drawn the attention of regulators. In 2007, the Financial Industry Regulatory Authority (FINRA) drafted Rule 2290, Fairness Opinions, which requires FINRA members to expand disclosure requirements about potential conflicts and impose internal and procedural review requirements on the entity providing an opinion.

With this in mind, boards may wish to obtain a fully independent fairness opinion to mitigate any potential hint of conflict and avoid this issue from surfacing on a later date.

The Limitations of Fairness Opinions

A fairness opinion is not a judgment that the process leading up to proposed transaction was necessarily fair. It does not comment on the fairness of the transaction's legal merits, nor does it serve as a recommendation to accept the proposal. A fairness opinion focuses on the proposed fairness of the transaction from a financial point of view only.

Implications

Fairness opinions can serve as effective tools for evaluating the fairness of acquisition or divestiture opportunities and can assist a board of directors in demonstrating that it acted prudently for the benefit of all of the various shareholder classes and interests. In this environment, it is important for any board to be able to document its process in evaluating the merits of any significant corporate action. Prior knowledge of fairness opinions helps CPAs provide guidance to management when faced with a proposed business transaction. ◆

Smith, Andy, and Brian Sullivan. "Using Fairness Opinions to Manage Risk in Middle-Market Transactions." *The CPA Journal*. Volume 82.3 (2012): 48-51. Print.

The Phantom of Pre-Money and Post-Money Valuations

In February 2012, The McLean Valuation Services Group's Andy Smith and Ryan Berry authored the following article that was subsequently published in Thomson Reuters' Valuation Strategies. Below is an excerpt from that article.

When presented with term sheets from several venture capitalists (VCs) who are interested in investing a client's company, how does one determine which one is the best for the client and its shareholders from a financial perspective? The most obvious place to look is at the respective term sheets' stated pre-money and post-money valuations. It would then seem to make sense to choose the term sheet indicating the highest pre-money value.

But that is not necessarily true—where term sheets are concerned (as in many other realms), it is best not to judge a book by its cover. Paradoxically, while pre-money values tend to be straightforward and easily compared, they also can be quite misleading. This article will help to enable the valuation analyst to dispel pre-money and post-money valuation myths, and assist in focusing on potential investors' respective term sheets.

Pre-Money and Post-Money Valuations

Pre-money and post-money valuations are terms of art used in the VC investing world. A firm's post-money valuation equals the proposed invested dollars divided by the fully diluted equity ownership percentage. For example, if a VC firm wanted to invest $5 million in a company to own 20% of the company's fully diluted equity following the investment, the company's post-money value would equal $25 million ($5 million/20%). The pre-money value is the post-money value less the invested amount, or $20 million in the above example ($25 million - $5 million). The term sheet's stated pre-money value treats common and preferred stock as if they are the same, even though they are not.

Term Sheets

Term sheets are non-binding preliminary agreements that serve as a starting point for the more detailed negotiations required for a contract. As the name implies, term sheets outline the main terms and conditions for the proposed investment that is usually made in exchange for preferred shares in the company. They typically include (but are not limited to) some or all of the following:

- Amount raised.
- Price per share.
- Pre-money and post-money valuation.
- Capitalization.
- Liquidation preferences.
- Voting rights.
- Protective provisions.
- Conversion rights.
- Anti-dilution provisions.
- Redemption rights.

continued

"The Phantom of Pre-Money and Post-Money Valuations..." continued

Clients typically experience some shock when they first review their business valuations (generally related to equity incentive plans), because the concluded value almost always is significantly lower than the post-money valuation from a recent round of financing. Early-stage technology company clients often ask their valuation analysts, "Why is your valuation so much lower?" The simple answer is that recent investors (most likely) acquired preferred stock, and not common stock. Preferred stock is not the same as common stock, as it carries certain rights and preferences that make it more valuable than common stock.

Liquidation Preferences

One of the most important aspects of preferred stock is its right to a liquidation preference. A liquidation preference is an amount paid prior (and in preference) to a more junior security class. The liquidation preference is usually equal to the original investment; it may also include dividends that accrue (and may compound) each year on top of the initial investment.

Liquidation preferences provide preferred shareholders downside risk protection, and downside risk protection has value.

Occasionally, liquidation preferences are structured as multiples of the original investment (e.g., two or three times (2x or 3x) multiples). The higher the liquidation preference multiple, the more that is paid out to preferred shareholders before the common shareholders see a thing.

Liquidation preferences provide preferred shareholders downside risk protection, and downside risk protection has value. Simply put, it is difficult, if not impossible to get VCs to invest in an early-stage company in exchange for common stock. It can happen, but rarely does. Why? Because VCs want some protection in case the always optimistic young companies in which they invest stumble along the way.

While VC and company alike are hoping for a proverbial home run, it is much more likely that the company will strike out or fall somewhere in between. And that is where liquidation preferences come into play.

Liquidation preferences provide preferred shareholders rights to the first payment of the company's proceeds at the time of an exit event. It is entirely possible that common shareholders would receive no proceeds in the event of a distressed sale of the company, but preferred shareholders will likely receive some portion of their liquidation preference.

Although a distressed sale would not be what preferred shareholders were hoping for, it would provide some downside risk protection as some of their capital should be returned on the sale of the company.

continued

"The Phantom of Pre-Money and Post-Money Valuations..." continued

Participating Preferred

Preferred stock typically has the right to convert to common stock. This right has value because it gives preferred shareholders the option to participate in the company's upside. In addition, preferred stock may also carry another, more valuable right. A preferred stock's convertibility feature may be structured in two ways:

(1) Giving the preferred stockholder the option of receiving his or her liquidation preference or converting to common stock.

(2) Allowing the preferred stockholder to receive his or her liquidation preference, and then participating with common stockholders (also known as participating preferred).

The participation feature is especially beneficial to preferred shareholders, as it allows them to receive a liquidation preference prior to any proceeds distributed to common shareholders.

Once the liquidation is paid in full, the participating preferred shareholders also receive a pro rata piece of the remaining proceeds as if they also owned common shares. While preferred shareholders certainly appreciate this highly-attractive "double-dip" feature, it is highly dilutive to common shareholders. The participating preferred structure is especially prevalent in early financing rounds, when a company is generally considered a highly risky investment and VC investors want both downside risk protection and upside potential as well.

Other preferred stockholder rights that VCs may find valuable include anti-dilution provisions and compounding dividends, among other terms. But preferred stockholders consider liquidation preferences and participation rights the most important economic features when making these investments.

Whichever rights are included, the question is: How does one account for these rights and preferences when estimating a company's value?

Conclusion

Value is all about the underlying terms. The hyperbolic claim that "I would pay $100 million for your business if I can pay you in 100 years" is not stretching the truth in some situations, because of the way VCs structure their investments. The term sheet may list a $100 million pre-money valuation, but it may also come with a 2x liquidation preference, 10% dividends, and participation on the upside.

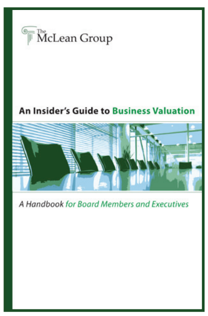
In short, a valuation analyst should not be fooled by the pre-money valuation. The focus should always be on the terms—not the window dressing—as the devil is in the details. ◆

Smith, Andy, and Ryan Berry. "The Phantom of Pre-Money and Post-Money Valuations." *Thomson Reuters' Valuation Strategies* (WG&L). Volume 15.3 (2012): 26-30. Print.

Practice Highlights

On May 10 and 11, 2012, The McLean Group held its fifth annual conference at the McLean Hilton in Tysons Corner, VA. More than 80 firm bankers, analysts and guests attended. FOX News Channel host and former Reagan Administration National Security Council member, Oliver North, was the keynote speaker. The McLean Group's Chairman Dennis Roberts stated in his opening remarks that the firm experienced its most successful year ever in 2011 and that 2012 is proving to be even more successful.

In April, Andy Smith participated in a highly attended panel discussion, "Successful Succession Planning: Retaining and Rewarding Key People (Including Yourself!)" in Tysons Corner, VA. The panel addressed such topics as: middle market companies' unique succession challenges, equity incentive plans, tax mitigation strategies, and retaining key personnel (a critical value driver).



Leveraging broad experience in business valuation, Andy Smith, authored *An Insider's Guide to Business Valuation*. The handbook provides board members and executives with a quick reference guide for conducting their business valuations and includes a useful appendix of important questions business owners and fiduciaries should ask when reviewing business valuation reports. Purchase yours here.

The McLean Valuation Services Group

As a core competency and complement to our M&A business, The McLean Valuation Services Group provides business valuation services, including intangible asset and financial security valuations for a variety of transaction, financial reporting and tax purposes. The McLean Valuation Services Group has the requisite experience and credentials to support litigation proceedings, including quantifying economic damages and valuing a minority interest in a business.

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The McLean Group

The McLean Group is an investment bank providing M&A, business valuation and strategic consulting services to middle market businesses. Headquartered in Washington, DC, we are among the largest independent middle market investment banks in the nation with a broad resume of successfully consummated financial transactions.