ASSET MANAGEMENT INSIGHTS

AN ALERT FROM THE BDO FINANCIAL SERVICES PRACTICE

DEMYSTIFYING VALUATION METHODOLOGIES:

PART 2 – COMPARABLE COMPANY MULTIPLE ANALYSIS

INTRODUCTION

For the second insight in our valuation series, "Demystifying Valuation Methodologies," we will discuss commonly used valuation multiples our clients typically employ when attempting to arrive at fair value for their portfolio companies. These multiples include Enterprise Value/Revenue ("EV/Revenue") and Enterprise Value/Earnings Before Interest, Taxes, Depreciation & Amortization ("EV/EBITDA") under both Guideline Public Company (Comparable Company) Method in addition to Guideline Transactions (Precedent Transaction) Method.

In the current environment of COVID-19, CFOs are well aware that with the volatility in the public markets, the relative private company valuations using these public company multiples can vary wildly quarter to quarter. Therefore, a discussion of comparable company multiples in some depth is particularly important in order to ensure that the most accurate and relevant data set is selected. While the volatility in public markets cannot be contained, by minimizing the margin for error in selecting the appropriate comparable public companies, the CFO can at least feel more confident in the frameworks developed to estimate fair value.

BDO'S ASSET MANAGEMENT PRACTICE

BDO's Asset Management practice provides assurance, tax and advisory services to asset management entities, comprising hedge, private equity and venture capital funds as well as regulated funds. The practice services over 600 advisors nationwide with funds ranging from start-up funds to those with billions of dollars under management.

On their surface, these multiples seem extremely easy to apply. In reality, they are often misapplied and lead to a significant departure from any measure of fair value. Therefore, the valuation of a portfolio company may better present as a reasonable range of value than a point estimate. We will discuss the benefits and pitfalls of the Guideline Public Company and Guideline Transactions approaches, the building blocks (peer group data set) used to derive the multiple, and address each valuation multiple approach with an example.

Although there are many considerations in the multiple selection process, some or all factors may result in a net neutral effect, where the portfolio company has no real significant advantage or disadvantage in the market. The valuator should take into consideration the following factors before deciding whether an approach using market multiples is appropriate:

BENEFITS

- In general, market multiples offer a fairly straight forward and easy method of deriving fair value. In contrast to a discounted cash flow analysis, there are fewer subjective inputs such as the variability of future cash flows.
- Multiples can be based on a variety of metrics including revenue, EBITDA, or certain non-GAAP metrics (for example, users/subscribers). This can provide the end user with a high degree of flexibility in cases where, for example, a portfolio company is not generating meaningful EBITDA to apply EV/revenue multiple. Further, common operating metrics can be applied that are industry-specific adding further insight into the company's operating success.
- Market multiples offer a standardized approach that can be applied across multiple industry groups.

PITFALLS

- It is often difficult to find similar companies that are actively traded "pure plays."
- Temporary market conditions can lead to an unrealistic comparable multiple. For example, an outlier M&A transaction whereby a massive premium is paid for unusual reasons or a factor intrinsic to the comparable company can lead to a gross overvaluation.
- Judgement is required to assess the degree of "comparability" in the face of differences in size, diversity, growth expectations, and other risk factors.
- When peers are not available or are hard to find due to the unique nature of the target company, fair value calculations using comparable company multiples may not have as much meaning.
- It can be difficult to rely on precedent transactions due to the lack of reliable transaction pricing data and low reliability and transparency of reported revenue and/or earnings of private companies.

Selection of Comparable Company (Peer Group)

We often encounter small start-up companies with exponential growth using the likes of Apple and Microsoft as the foundation of the peer group set used to arrive at fair value. So, are these companies really comparable to the subject portfolio company? Searching for comparable companies in the same industry group is ideal and fits the narrative of peer group analysis. However, the result could be (and often is) meaningless. The reasons are numerous:

- Growth rates of the portfolio company and the peer group are misaligned leading to a distortion of the portfolio company's fair value. For example, if the portfolio company is a venture-backed firm and growing revenues at 50% year over year ("YoY"), yet the end user is applying a peer group multiple whose members are growing at 10% YoY, how can this comparable multiple yield a reasonable fair value?
- Inappropriate comparable companies can, in reality, be true competitors operating in the portfolio company's industry. However well-intentioned, these companies may be so diversified and large that the portfolio company's revenue may only represent a very minute percentage of the comparable company's overall revenues, rendering the comparable company multiple analysis less reliable.
- Even if the appropriate comparable companies are identified, their stocks could be thinly traded or could fluctuate without fundamental reasons, both of which could result in a distortion of fair value.

When selecting appropriate comparable companies, it may be much more meaningful to find companies that share similar growth and operating metrics, even if not directly in the portfolio company's comparable set. This might seem counterintuitive to a "comparable" company analysis. However, the public market is more likely to reward a young recent Initial Public Offering ("IPO") company with a compelling growth story much more than a decades old stalwart with revenues growing at 5% per year and with a 2% dividend yield.

So, it might even make sense to scour the markets for companies with similar characteristics, specifically growth, operating metrics, and capital structure within a broader industry group. Below we illustrate the disparity in fair value that can result from using an inappropriate peer group vs. leveraging a peer group that is truly representative of the portfolio company.

Impact of Peer Groups

Example 1 – Illustrates the impact of utilizing a niche competitor subset versus a broad competitor or industry set. The selection of peer group can have a significant impact on the multiple distribution depending on the observed trading multiples, as well as the forward analyst revenue estimates.

In this example, the portfolio company is a high-growth data analytics software as a service ("SaaS") technology company, which provides less diversified product offerings than its direct public competitors. In addition, the portfolio company is substantially smaller than its direct competitors but has exhibited significant historical revenue growth over the past three years and has not yet reached profitability as it continues to scale. Given that the portfolio company is not profitable and will not be for the foreseeable future based on its business model, an Enterprise Value/Revenue multiple is the most applicable valuation multiple to yield a company valuation.

As noted earlier, the comparable company sets were divided into two sets in this example: A broad competitor or industry set, versus a niche competitor set consisting of five directly comparable companies, of which a few had just recently gone public within the last few years. The multiple distribution for this data set is much wider, but the portfolio company's financials more directly compare to the fundamentals exhibited by the comparable companies. The portfolio company is on the high-end of the comparable company distribution in revenue growth and falls within the first quartile of the comparable companies in terms of profitability.

Example 1

GUIDELINE PUBLIC COMPANY METHOD – NICHE COMPETITOR SET

Guideline Public Company (Comparable Company)	EV/TTM Revenue	EV/NFY Revenue
Alteryx, Inc.	21.4 x	17.7 x
Anaplan, Inc.	20.2 x	17.2 x
Cloudera, Inc.	3.5 x	3.0 x
Fair Isaac Corporation	8.3 x	8.3 x
Teradata Corporation	1.7 x	1.8 x
Maximum	21.4 x	17.7 x
Third Quartile	20.2 x	17.2 x
Average	11.0 x	9.6 x
Median	8.3 x	8.3 x
First Quartile	3.5 x	3.0 x
Minimum	1.7 x	1.8 x
Selected Multiple	**3.5 x**	**3.0 x**

GUIDELINE PUBLIC COMPANY METHOD – BROADER COMPETITOR SET

Guideline Public Company (Comparable Company)	EV/TTM Revenue	EV/NFY Revenue
DocuSign, Inc.	13.0 x	11.3 x
New Relic, Inc.	6.5 x	5.6 x
Salesforce.com, Inc.	8.8 x	7.7 x
ServiceNow, Inc.	15.6 x	13.6 x
Splunk, Inc.	8.4 x	7.4 x
Maximum	15.6 x	13.6 x
Third Quartile	13.0 x	11.3 x
Average	10.5 x	9.1 x
Median	8.8 x	7.7 x
First Quartile	8.4 x	7.4 x
Minimum	6.5 x	5.6 x
Selected Multiple	**8.5 x**	**7.5 x**

The same is also true for the broader competitor set. However, the portfolio company is significantly smaller than the broader comparable companies selected, and almost all of them are profitable. In both cases, the rounded first quartile indications were observed to serve as a constant, showcasing that dependency of the distribution based on comparable company selection. If a broad competitor set was utilized, generally a larger discount would apply vis-à-vis a niche competitor set. After analyzing factors such as size, growth, and the breadth of the product or service portfolio, a selected multiple requires a greater degree of judgment on the part of the end user.

Also, we recommend not viewing the comparable company set as a static metric. Comparable companies grow and contract, and the comparable company set should be refreshed at every valuation date to reflect changes. Don't be afraid to refresh the peer group and document why you may believe an adjustment/replacement might be appropriate if you feel the current comparable company set intuitively no longer makes sense.

Trailing vs. Forward Multiples

Another important consideration in applying a comparable multiple analysis is whether to use a forward multiple or a trailing twelve months ("TTM") or last twelve months ("LTM") multiple to the portfolio company. Technically speaking, forward multiples, which are based on projected financial metrics, on their surface appear to be the reasonable fundamental approach as they are used to better incorporate future growth and profitability. However, one of the challenges with this is that company forecasts may not be reliable given the company's stage of development and operating history. Another challenge is that sometimes, particularly for a thinly-traded company, any depth of analyst forecasts may be completely absent. Therefore, future forecasts may be faulty at best.

While TTM revenue or operating metrics provide some additional certainty and the data for the analysis is readily available, past performance might not be an indicator of future performance. In addition, if a comparable company set and the portfolio company are on a strong growth trajectory, the TTM and LTM multiples may be understated, and therefore they may be considered in combination with forward multiples when estimating portfolio company valuation.

In the current environment of COVID-19, CFOs should be cautious when using forward multiples and perform additional due diligence to ensure both public companies' and the subject company's projected financial metrics are current and reasonably adjusted to take into account lower expected performance.

Common Valuation Multiples

Below, we highlight and define common valuation multiples that are most often used by our clients to arrive at fair value for their portfolio companies. We also provide an example for each valuation multiple. We would like to emphasize that valuation is time sensitive, and it needs to be refreshed at least annually to reflect changes in the company's internal development and external market conditions. In some cases, valuation may need to be refreshed more frequently upon significant value events (for example, new financing).

As a company evolves and matures, both the comparable company multiple method and the precedent transaction method might be applicable during the lifetime of the portfolio company. When switching a valuation approach or valuation multiple, be sure to carefully document why you are transitioning to the new methodology in your valuation policy.

1. EV/Revenue multiple: This method derives value using enterprise value to revenue multiple observed by public company trading multiples

2. EV/EBITDA multiple: This method derives value using enterprise value to earnings before Interest, taxes, depreciation & amortization multiple observed by public company trading multiples

3. Precedent Transaction: This method derives value using pricing metrics of mergers and acquisitions involving controlling interests of companies (public and private) in the same or similar lines of business as the portfolio company.

Precedent Transaction

Example 2 – illustrates the considerations taken when analyzing Precedent Transactions within an industry based on a portfolio company with an imminent sale.

The portfolio company is a semiconductor designer and manufacturer that specializes in microchips for artificial intelligence ("AI") application. It is on the verge of an exit and has been profitable for the last six years. The portfolio company has had continued success within the industry, landing notable customers. As of the transaction date, the company has quality balance sheet fundamentals and leverage coverage ratios.

Given the commoditization of semiconductors, almost all companies operating within this industry operate as substitutes. As such, the comparability of the product offerings between the companies are direct, and the transaction-implied EV/TTM EBITDA multiples serve as data points negotiated by market participants. The selection of the precedent transactions should consider the comparability of the portfolio company as compared to the target companies of the selected precedent transactions, as well as consideration of the portfolio company's fundamentals.

Example 2

Closing Date	Target Company	Acquirer	TTM EBITDA
1/17/2018	IXYS, LLC	Littelfuse, Inc.	17.15 x
7/25/2017	CNXT Holdings, Inc.	Synaptics, Inc.	21.07 x
5/12/2017	Exar Corporation	MaxLinear, Inc.	30.70 x
3/10/2017	Linear Technology Corporation	Analog Devices, Inc.	21.09 x
2/24/2017	Intersil Corporation	Renesas Electronics Corporation	30.88 x
9/16/2016	Fairchild Semiconductor International Inc.	ON Semiconductor Corporation	10.75 x
4/3/2016	Atmel Corporation	Microchip Technology, Inc.	25.57 x
Maximum			30.88 x
Third Quartile			28.13 x
Average			22.46 x
Median			21.09 x
First Quartile			19.11 x
Minimum			10.75 x
Transaction Implied Multiple			**25.00 x**

Enterprise Value/Revenue

Example 3 – Illustrates the considerations taken when analyzing a high-growth Series B technology company which is utilizing venture capital financing to scale, exhibiting phenomenal growth with high cash burn rate.

The portfolio company specializes in enterprise communication software. The portfolio company has been experiencing significant historical revenue growth and has been tracking its projections through each projection remeasurement period.

In this example, forward revenue multiples were utilized to determine the value of the portfolio company given that it has continued to track their forecasts and exhibited high growth trajectory. As the portfolio company is substantially smaller, has a less-diverse product offering, and is sacrificing current profitability to scale, its ability to raise future capital is uncertain. Therefore, multiples in line with the low end of the peer group were considered.

Example 3

Guideline Public Company	EV/TTM Revenue	EV/NFY Revenue	EV/NFY+1 Revenue
Alteryx, Inc.	21.4 x	17.7 x	13.3 x
Cloudera, Inc.	3.5 x	3.0 x	2.7 x
Coupa Software	36.9 x	31.9 x	25.8 x
Okta, Inc.	23.4 x	20.2 x	15.5 x
Salesforce.com, Inc.	8.8 x	7.7 x	6.2 x
ServiceNow, Inc.	15.6 x	13.6 x	10.6 x
Splunk, Inc.	8.4 x	7.4 x	6.1 x
Talend S.A.	4.6 x	4.2 x	3.5 x
Maximum	36.9 x	31.9 x	25.8 x
Third Quartile	21.9 x	18.3 x	13.8 x
Average	15.3 x	13.2 x	10.4 x
Median	12.2 x	10.7 x	8.4 x
First Quartile	7.4 x	6.6 x	5.4 x
Minimum	3.5 x	3.0 x	2.7 x
Portfolio Company Revenue Growth Rate	92%	72%	73%
Comparable Company Median Revenue Growth	38%	34%	24%
Selected Multiple		**6.5 x**	**5.5 x**

Enterprise Value/EBITDA

Example 4 – Illustrates the considerations taken when analyzing a mid-to-large PE-backed technology firm generating significant EBITDA in determining appropriate multiples.

This portfolio company is an internet software service that specializes in mapping family history and ancestry. The portfolio company has generated significant and consistent EBITDA margins, which are comparable to the upper-quartile of the distributed margins exhibited by the comparable companies.

In selecting the EBITDA multiples for the portfolio company, consideration must be given to the comparability between competitors, as well as the portfolio company's operating metrics. In this example, given the broad trading multiples data set exhibited by the comparable companies, as well as consideration of the portfolio company's significant, consistent profitability margins, smaller size, and low-end revenue growth, the median multiples were considered to be reasonable.

Example 4

Guideline Public Company	EV/TTM EBITDA	EV/NFY EBITDA
Endurance International Group Holdings, Inc.	8.1 x	7.5 x
GoDaddy, Inc.	39.3 x	17.7 x
Grubhub, Inc.	46.8 x	22.2 x
IAC/InterActiveCorp	24.2 x	18.9 x
LotMeIn, Inc.	11.3 x	9.0 x
Match Group, Inc.	34.9 x	27.1 x
Shutterstock, Inc.	19.1 x	10.6 x
Yelp, Inc.	39.3 x	10.3 x
Maximum	46.8 x	27.1 x
Third Quartile	39.3 x	19.7 x
Average	27.9 x	15.4 x
Median	29.6 x	14.1 x
First Quartile	17.1 x	10.0 x
Minimum	8.1 x	7.5 x
Portfolio Company EBITDA as % Revenue	35%	38%
Comparable Company Median EBITDA as % Revenue	15%	23%
Selected Multiple	**29.5 x**	**14.0 x**

CONCLUSION

In summary, market multiple analysis is a repeatable and transparent market-based valuation approach that can be leveraged across multiple industry verticals. In addition, the comparable company multiples are also flexible in the sense that both comparable company multiple method and the precedent transaction method could potentially be used throughout the life cycle of a portfolio company to arrive at a reasonable range of fair value.

Also keep in mind the portfolio company is still a private company regardless of how far along it is in its growth trajectory. It does not have the ability to raise capital in the public markets and its investors cannot immediately liquidate their shares in a public market. Therefore, the valuation derived from the multiple analysis must be discounted to reflect its status as a private company.

The next part of our series will focus on bringing the portfolio company back to the private realm. Specifically, we'll explore deriving and applying an appropriate "discount for lack of marketability."

People who know Asset Management, know BDO.

CONTACTS:

KEITH MCGOWAN
Asset Management Industry Co-Leader, Assurance Partner
New York
212-885-8037 / kmcgowan@bdo.com

KEVIN BIANCHI
Asset Management Industry Co-Leader, Assurance Partner
San Francisco
415-490-3241 / kbianchi@bdo.com

STEPHEN CUNEO
National Asset Management Director
San Francisco
415-490-3071 / scuneo@bdo.com

MATTHEW GOLDBERG
Valuation & Business Analytics Principal
Seattle
206-403-2473 / mgoldberg@bdo.com

NICK MAROULES
Assurance Partner
Chicago
312-730-1332 / nmaroules@bdo.com

ANTHONY MOSCATO
Transaction Advisory Services (TAS) Partner
New York
212 885-7361 / amoscato@bdo.com

VISHNU PATWARI
Assurance Partner
San Francisco
415-490-3220 / vpatwari@bdo.com

CHRISSA QIU
Valuation & Business Analytics Managing Director
San Francisco
415-490-3253 /cqiu@bdo.com

BHARATH RAMACHANDRAN
Assurance Partner
Boston
617-239-4161 / bramachandran@bdo.com

DALE THOMPSON
Assurance Partner
New York
212-885-7318 / dthompson@bdo.com

KEVIN WHARTON
Valuation & Business Analytics Director
Charlotte
704-887-4114 / kwharton@bdo.com

ABOUT BDO USA, LLP

BDO is the brand name for BDO USA, LLP, a U.S. professional services firm providing assurance, tax, and advisory services to a wide range of publicly traded and privately held companies. For more than 100 years, BDO has provided quality service through the active involvement of experienced and committed professionals. The firm serves clients through more than 65 offices and over 700 independent alliance firm locations nationwide. As an independent Member Firm of BDO International Limited, BDO serves multi-national clients through a global network of more than 88,000 people working out of more than 1,600 offices across 167 countries and territories.

BDO USA, LLP, a Delaware limited liability partnership, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. BDO is the brand name for the BDO network and for each of the BDO Member Firms. For more information please visit: www.bdo.com.

Material discussed is meant to provide general information and should not be acted on without professional advice tailored to your needs.

© 2020 BDO USA, LLP. All rights reserved.