Increased Volatility:

Considerations when valuing private portfolio company investments

The past 12 months have seen a tremendous amount of volatility in the global public equity and bond markets. Inflation expectations set by the Federal Reserve played a pivotal role in lifting the yield curve and, in many instances, fueling recession fears. As we have entered the second half of 2023, many investment advisors have asked themselves if we are currently in calmer waters, as inflation seems to be trending lower, or if this is the calm before the next storm.

No one can predict the future. However, since the valuation review of privately held portfolio companies accounts for a large portion of year-end audits, it's important to address **investment advisors' concerns regarding volatility**, particularly since the valuation of private company investments often relies on inputs from publicly traded asset prices. During periods of high volatility, frequent and extreme swings in these publicly traded asset prices have resulted in large changes in the valuation inputs that advisors rely on. These large, erratic movements have caused the fair value of private company portfolio investments to rise and fall dramatically quarter over quarter and even month over month, depending on the level of market volatility during a given period.

The following are some commonplace concerns of advisors that arise in a highly volatile economic environment. We will provide some commonsense practices for advisors to consider surrounding these topics so they can be better prepared to interface more effectively with key partners during prolonged periods of high volatility.

The Impact of Relying on Public Market Inputs During Periods of Volatility

High volatility in public market inputs has resulted in material swings in private company valuations when fair-value calculations rely on public market inputs such as discount rates and comparable public company multiples. These large price movements in publicly traded assets may lead to material and frequent mark-ups and mark-downs to the fair value of a private company investment. However, the underlying fundamentals in a private company holding often stay relatively stable from period to period. The portfolio company may even be hitting its financial forecasts and have plenty of liquidity. This can present significant challenges for the advisor, particularly when explaining such large swings in portfolio valuation to investors as well as their auditor during the year-end audit. For companies in certain industry verticals with little or no revenues such as life sciences or clean tech, these movements in portfolio fair value can be particularly acute when holding these difficult conversations.

Company fundamentals

In situations where advisors continue to hold a high degree of conviction in existing private company investments, it's important to document and track key metrics to demonstrate that an underlying portfolio company's fundamentals have stayed relatively consistent. For example, a portfolio company's cash position and burn rate can demonstrate that the company has sufficient resources to ride out the storm. Increased monitoring and scrutiny of private company forecasts are also important to justify previous fair value marks. If the private company is continually meeting or exceeding key metrics, then the advisor will have a much more cohesive argument upon which to justify a fair value that was established under previous market conditions or based on prior transaction. In certain instances, these factors may prove to be more relevant to justifying a valuation than relying on a multiple set composed of a handful of large-cap publicly traded companies that are simply moving up and down to relative to public markets. It's important for advisors to methodically document this information and have it readily accessible in an easily understood format, particularly in cases where the advisor is attempting to demonstrate a private company's fair value is subject to less volatility than that of the public market.

Investor perception and terms

While not perfectly applicable or linear to all private portfolio companies, a general thesis around industry fundamentals compared to the general market volatility can help an advisor to create a narrative to support investor sentiment. For example, advisors can consider whether the private portfolio company can continue to garner the same level of investor interest at prior post-money valuation levels. This is particularly important for venture-backed companies. If conviction exists that fair value will not change and is still based on a prior fundraising round, it's important for the advisor to query existing and new investors and document the fact patterns and rationale. For example, a binding term sheet demonstrating investor interest at certain valuation thresholds may help justify current fair value even in an environment of negative public market perception. Similarly, an advisor can point to industry deal flow and whether general market volatility has caused investment terms in the portfolio company's industry vertical to become more or less favorable to investors. There may even be a more applicable and narrowly focused public company industry-specific index the advisor can assess (e.g., ticker: "NBI", biotechnology index) that is more indicative of how a specific comparable public company industry segment is performing relative to the general market.

Valuation policy and contingency planning

By outlining certain contingencies in advance within the advisor's valuation policy and discussing with one's an auditor, a more thoughtful analysis can be in place to avoid last-minute subjective changes in valuation approaches to justify fair value. An exception in valuation policy can help create a contingency plan for approaching valuation in times of extreme and prolonged volatility where conventional approaches may lose their relevance. For example, during periods of high volatility, general public market perception may be negative while, in reality, there have been little or no fundamental changes in an advisor's private company portfolio. In such cases, an advisor may consider placing more weight on the most recent financing round, if applicable, while considering the impact of current market conditions. Solely relying on a specific public company comparable set or a discount rate may no longer prove to be as reliable an input in the calculation of a private company's fair value due to sudden and extreme changes.

Valuation Models and Model Inputs

Even small changes to valuation models and model inputs can significantly impact valuation outcomes, particularly in periods of high volatility. For example, in 2022 higher "risk-free" rates (represented by the U.S. Treasury or other widely used benchmarks) used to derive discount rates meaningfully changed and, in many instances, had a material impact on the net present value of a company which relied on a discounted cash flow valuation. Increased volatility in both publicly traded equity and debt will also affect a private company's time to exit and ability to raise capital.

Update models

To the extent a private company's fair value is driven off a model-based approach, such as a public company comparable analysis or discounted cash flow model, the advisor should periodically update model inputs to ensure it can withstand scrutiny in prolonged periods of high volatility. Oftentimes, the valuation model is only viewed at fixed intervals, and inputs can become stale. It's important for the advisor to regularly revisit and update valuation models and key inputs.

Avoiding subjectivity

Often, in an attempt to justify private portfolio company fair value during periods of high volatility, an advisor may be tempted to subjectively adjust valuation models by throwing out certain comparable public companies used to derive a comparable set or subjectively modify a specific discount rate used in a discounted cash flow model. Advisors may even attempt to change their valuation approach at the last minute if their desired fair value outcome is not achieved. While this may be appropriate in certain circumstances, such last-minute moves may raise concerns with the advisor's auditor and could lead to multiple out-of-scope conversations and cost overruns. It's important for the advisor to be consistent in approach and avoid last-minute, subjective calls that may result in a loss of credibility not only to investors but to their auditor, resulting in lengthy year-end conversations.

Transparency

A transparent valuation approach is extremely important. A valuation model/approach should avoid highly subjective inputs and be capable of withstanding periods of extreme volatility. Back testing a model periodically can provide some degree of trust that the valuation approach can withstand significant moves in valuation inputs and be capable of calculating fair value under periods of high volatility.

Third-party valuation specialist

During periods of extreme volatility, the advisor may consider an independent third-party provider to assist in calculating fair values of the underlying portfolio companies. Third-party valuation specialists typically have access to a robust database of financial and market information that will enable them to perform valuation analyses in a more comprehensive manner. Third-party valuation specialists also tend to have the benefit and insight of understanding and seeing other firms' private company valuations within the context of a highly volatile public company setting. By having an independent outside party conducting the valuation, a consistent outcome may be more feasible, and credibility can be retained with key stakeholders. However, even with an independent valuation specialist, the advisor must ensure the output is considered within the context of the current economic environment. Rigid application of a model-based approach can result in the same issues the advisor itself will face in a period of high volatility.

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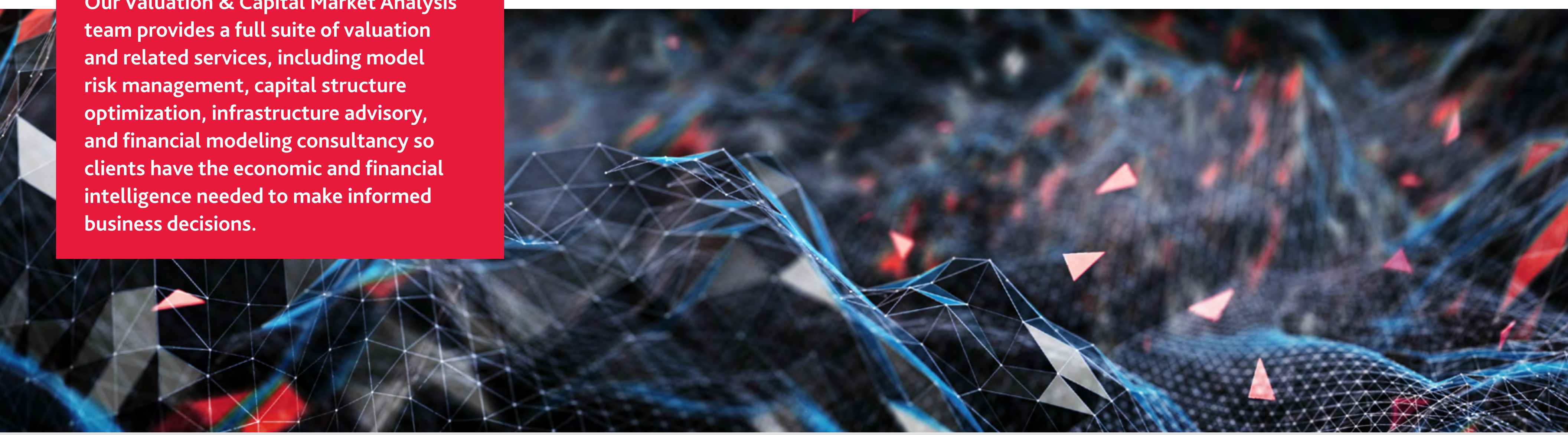
Discounts for Lack of Marketability (DLOMs)

The DLOM is a common application to valuations of private portfolio companies. Privately held companies have several disadvantages to their public company peers, one of which pertains to the lack of marketability associated with the equity securities within their capital structure. During periods of high volatility, it can become increasingly difficult for a private portfolio company to raise capital or for an advisor to monetize an existing investment stake. Volatility will also often affect a private portfolio company's ability and timing to exit through an M&A event or initial public offering. Therefore, the DLOM tends to increase with rising volatility.

When arriving at a fair value for a private portfolio company, the DLOMs applied to valuations should be indicative of the current market volatility, as well as the volatility associated with the specific class of equity instrument within such company's cap table. Advisors should be realistic and aware that DLOMs should and will change during periods of higher volatility.



Communication

Often, in periods of high volatility and subsequent swings in the value of investment portfolios, the advisor may spend exorbitant amounts of time explaining away these changes in valuation to both investors and auditors alike. A chain reaction can occur that puts the advisor in a difficult position that not only negatively affects its ability to raise future capital but can also result in adversarial conversations with service providers, specifically auditors, and possibly even regulators.

During periods of high market volatility, increased frequency of communication with key stakeholders is the most obvious first step to undertake. Keeping a close pulse on the drivers of private portfolio companies is another important consideration. Oftentimes, an advisor can be distracted by deal flow or other considerations and lose track of current portfolio performance. Taking the time to periodically understand the underlying drivers and fair value of private portfolio companies is critical when interfacing with various parties and allaying any misperceptions that can arise when, in fact, nothing fundamental in the private company investment portfolio has changed.

By interfacing with auditors on a more frequent basis, an advisor can also keep them informed on changes in private company fundamentals and valuations. For example, if an advisor's auditor is in periodic contact with the advisor and the advisor is continually updating and documenting changes to the portfolio and sharing these changes with the auditor, there will be fewer surprises that arise during the year-end audit.

The Road Ahead

While higher market volatility continues to present real and impactful consequences for investment advisors, it is important for advisors to be well prepared by implementing the appropriate framework to justify private company valuations during periods of high volatility. Keeping a close pulse on the health and viability of private company performance is important for advisors. Equally important, it is critical to understand and gauge investor sentiment in existing private portfolio companies as well as the current environment and investor appetite underscored by key investment terms that would accompany follow-on investment commitments.

During heightened periods of market volatility, any contingencies and varying valuation approaches should be clearly outlined in an advisor's valuation policy. By discussing and vetting private company valuations in advance with service providers, more buy-in and credibility will prevail, saving the advisor time, and potentially money, when the year-end audit does occur. In extreme cases, if a situation warrants a change in valuation approach due to extreme volatility, it will be much easier for the advisor to have the trigger point for the change in approach clearly outlined and explained in the valuation policy in advance. Advisors should avoid subjectivity in calculating fair value by maintaining, updating, and back testing models with timely, relevant, and observable inputs so that a consistent outcome can be produced during periods of high volatility.

Finally, increased communication with key stakeholders will help to inspire confidence and achieve important buy-in during periods of extreme market volatility. Ongoing communication with auditors can surface any material events or changes with portfolio company investments and pave the way for a much easier year-end audit conversation regarding private company valuations.

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