New private equity valuation requirements in 2019

Three things you should know

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About Plante Moran

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year founded

3,100+
professionals

25
offices

20,000+
clients

1,525+
private equity and portfolio company clients

10
affiliates including investment bank, PMCF

Today’s presenters

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Overview of today's discussion

- New 2019 fair value guidelines for financial reporting
  1. PE/VC investments
  2. Contingent consideration *aka earnouts*
  3. Profits interests
- Highlights and overview of key changes
- Discussion of valuation methods
- Information to help prepare for 2019 audit

Impact of New Accounting & Valuation Guide

Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies

Overview of the AICPA PE/VC Valuation Guide

- Objective:
  - Harmonize the diverse views of industry participants, auditors, and valuation specialists
  - Provide user-friendly guidance with case studies
- Scope:
  - Applies to companies covered by FASB ASC 946, *Investment Companies*, and reporting fair value in accordance with FASB ASC 820, *Fair Value Measurement*
  - May apply to investments valued under IFRS and for corporate investors
  - Assets covered: equity and debt instruments in privately held portfolio companies and certain enterprises with traded instruments
  - Doesn't address disclosures
- Nonauthoritative (similar to all other AICPA guides)
- No transition period — expect to consider the impact of the guide for 2019 valuations

Overview of the AICPA PE/VC Valuation Guide

Timeline

- May 15, 2018: Working draft released
- Aug. 15, 2019: Final draft issued

Changes incorporated in the final version, based on comments received:

- Case study #5: Real estate investment financed with debt
- Case study #14: Investment 6 – Investment in nonperforming distressed debt
- Market participant consideration of transaction costs at interim measurement dates
- Underwriter lockups
- Reference to IFRS

Impact and areas of focus

- Exit price notion
- Calibration (Chapter 10)
- Value of debt for purpose of valuing equity
- Backtesting (Chapter 11)
- Transaction costs

Calibration

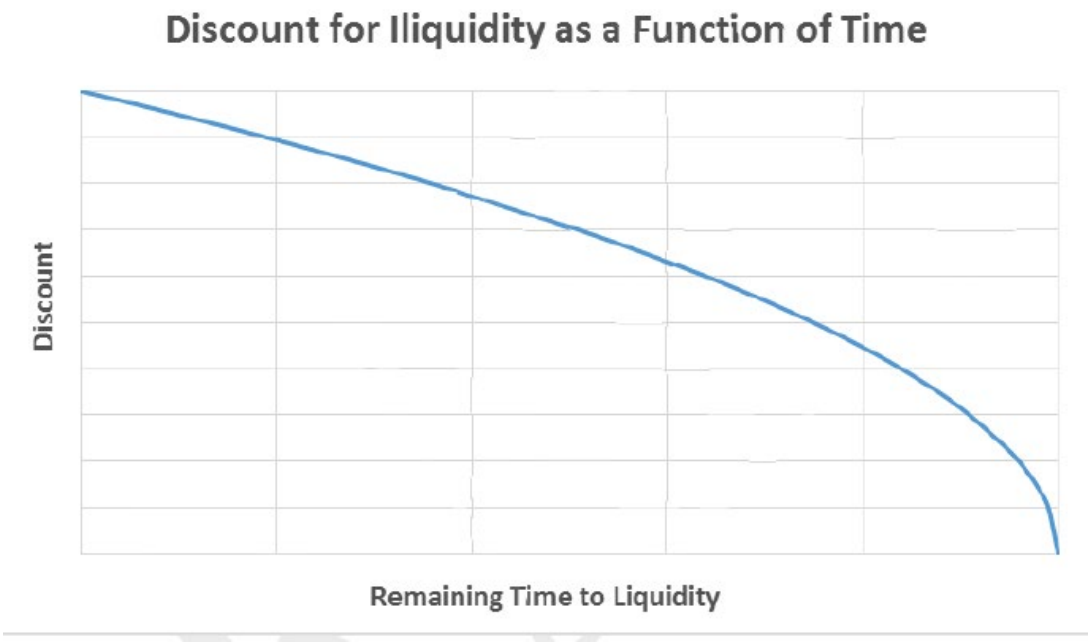
- Reduce subjectivity
  - Control premiums and marketability discounts
- Imminent sale
- Passage of time

"*Calibration is the process of using observed transactions in the portfolio company's own instruments, especially the transaction in which the fund entered position, to ensure that the valuation techniques that will be employed to value the portfolio company investment on subsequent measurement dates begin with the assumptions that are consistent with the original observed transaction.*" – 10.02

Calibration: Valuation of equity interests

Considerations when relying on a transaction in the portfolio company's instruments:

- Market/arm's-length transaction
- Marketable, nonmarketable, and illiquid
- Control or minority
  - Stock rights and preferences
- Passage of time



Calibration example

Case facts:

- Initial purchase price: $500M (10.0x LTM EBITDA of $50M)
- Debt financing: $300M (7.25% senior Note)

Document qualitative notes at time of initial purchase:

- Investment thesis and exit strategy
- Key risks
- IRR/WACC reconciliation

Quantitative model produced to support transaction price (DCF and market approach)

Calibration: Market approach

Case facts

	Initial transaction	12 months later	Variance
Equity (excl. cash)	$ 200	$ 256	28.1%
Debt	300	305	
Total Enterprise Value	**$ 500**	**$ 561**	
TTM EBITDA	$ 50	$ 55	
NTM EBITDA	$ 60	$ 64	
TTM Implied Multiple	**10.0x**	**10.5x**	5.00%
NTM Implied Multiple	**8.3x**	**8.5x**	
GPC TTM EBITDA	8.0x	8.4x	5.0%
GPC NTM EBITDA	7.0x	7.4x	5.7%
GPC Median Revenue growth	5%	6%	
Subject Company Growth	9%	11%	
GPC Median EBITDA %	10%	10%	
Subject Company EBITDA %	12%	12%	

Assess multiple one year later based on calibrated multiple from initial transaction.

How should the calibrated multiple be adjusted for market conditions?

Has the company's performance relative to peers changed? How does this impact the valuation?

Calibration: Income approach

Macroeconomic downturn

- Revenue decreased by 3.3% (rather than expected growth of 2%)

Cost overruns at company's largest facility eroded previously stable margins

- EBITDA decreased by 23%

Response: Management updates plan (layoffs, lowers forecast expectation)

C.01.19 As a result of these changes, the fund prepared new prospective financial information for the five-year period from 2X19 to 2X23 using the following assumptions:

Selected assumptions	2X18a	2X19e	2X20e	2X21e	2X22e	2X23e
Revenue growth rate						
Original projections	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Revised plan	-3.3%	-2.0%	-2.0%	-1.5%	0.0%	2.0%
EBITDA margin						
Original projections	25.0%	25.0%	25.0%	25.0%	25.0%	25.0%
Revised plan	19.9%	20.0%	22.5%	25.0%	25.0%	25.0%

Calibration: Income approach

Cost of debt:

Increases due to increased credit risk

Cost of equity:

2% Company specific risk premium increases due to addition of high-cost debt

Original WACC

Discount rate assumptions	Actual capital structure	Typical industry capital structure
Cost of equity	26.0%	20.0%
Cost of debt (pre-tax)	7.50%	5.20%
After-tax cost of debt	4.84%	3.38%
Equity (%)	40.0%	60.0%
Debt (%)	60.0%	40.0%
WACC (rounded)	13.3%	13.4%

Recalibrated WACC

Discount rate assumptions	Actual capital structure	Typical industry capital structure
Cost of equity	28.0%	22.0%
Cost of debt (pre-tax)	11.0%	7.1%
After-tax cost of debt	7.3%	4.6%
Equity (%)	40.0%	60.0%
Debt (%)	60.0%	40.0%
WACC (rounded)	15.5%	15.0%

Valuation of debt instruments

Debt valuation considerations

- Yield analysis:
  - Expected remaining term
  - Market participant's required rate of return, given the risk
- Don't use payoff value
- Restrictions on refinancing
- Detach warrant value
- Calibration to initial issuance

Backtesting

- Comparison of exit price to prior valuations
- Expect differences
  - Specific buyer synergies
  - Price vs. value
  - New information becomes available
  - Changes in market conditions
  - New markets develop
- Reconcile and document

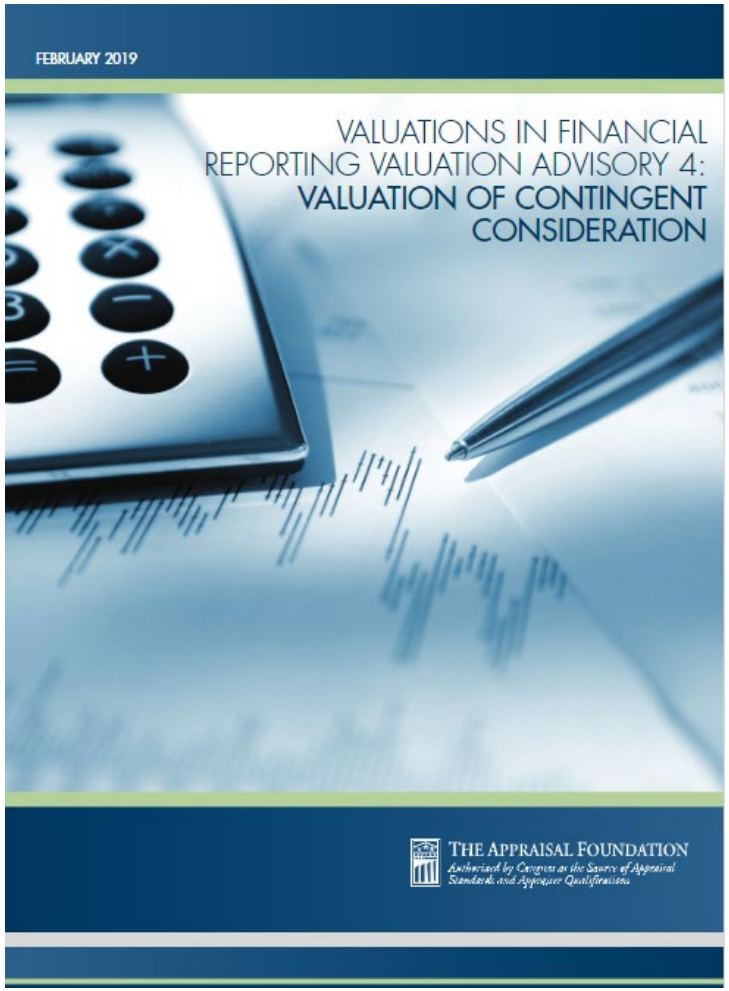
What you should be prepared to answer

- What changes did you make to your valuation policy and process to ensure consistency with the new AICPA guide?
- How do you apply the concept of calibration?
- What backtesting do you perform?
- What is your approach to transaction costs?
- How do you value debt:
  - For the purpose of valuing equity?
  - When the unit of account is a debt investment?
- How does your model consider stock rights and preferences? Control and minority interest?
- How do you consider and weight observable inputs compared to unobservable inputs?
- How do you value options and warrants, including out-of-the-money options/warrants?
- How do you value contractual rights, such as earnouts?
- How do you verify that prices received from brokers or pricing services represent fair value?

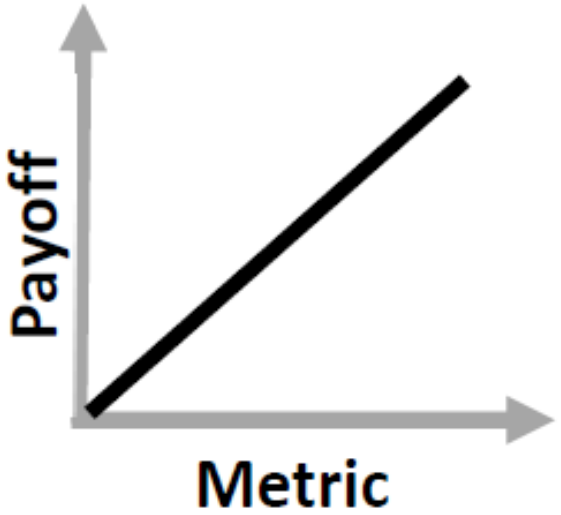
Contingent consideration

Aka earnouts

What happened this year?



What stayed the same?



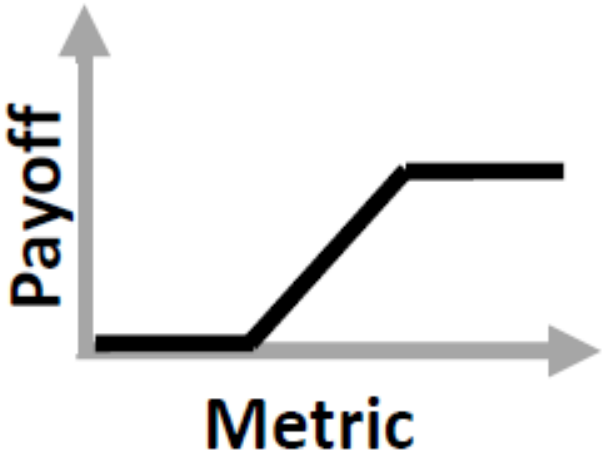
Linear

- Payment is equal to a fixed percentage of the outcome for the underlying metric.
- Linear payoff, where the risk of the earnout cash flow is the same as the risk of the underlying metric, plus counterparty credit risk.

Popular example #1

- Guide recommends using scenario-based method (probability weighted methodology) to estimate value of earnout
- Similar to approach utilized by many valuation specialist prior to guidance
- For linear earnouts based on EBITDA, only one scenario is necessary, discounted at the WACC

What changed?



Threshold and cap (capped call)

- Payment is equal to a percentage of the excess of the underlying metric above a performance threshold, with a payment cap.
- Nonlinear payoff, where the risk of the earnout cash flow depends on the risk of the underlying metric, the impact of the nonlinear structure, and counterparty credit risk.

Popular example #2

- Guide ***specifically recommends*** using option pricing method (Black-Scholes or Monte Carlo) to estimate value of earnout
- Prior to guidance, it was up to valuation specialist to determine methodology
- Guide also provides detail example of how to perform calculation

Why is there change?

Consistency > Consistency > Consistency

Transparency

RISK!!

Risk: The old way

Scenario-based method or probability weighted expected return method (PWERM) typically used

Scenario 1: Upside
- Management projections plus 10%
- Assigned a 25% weighting

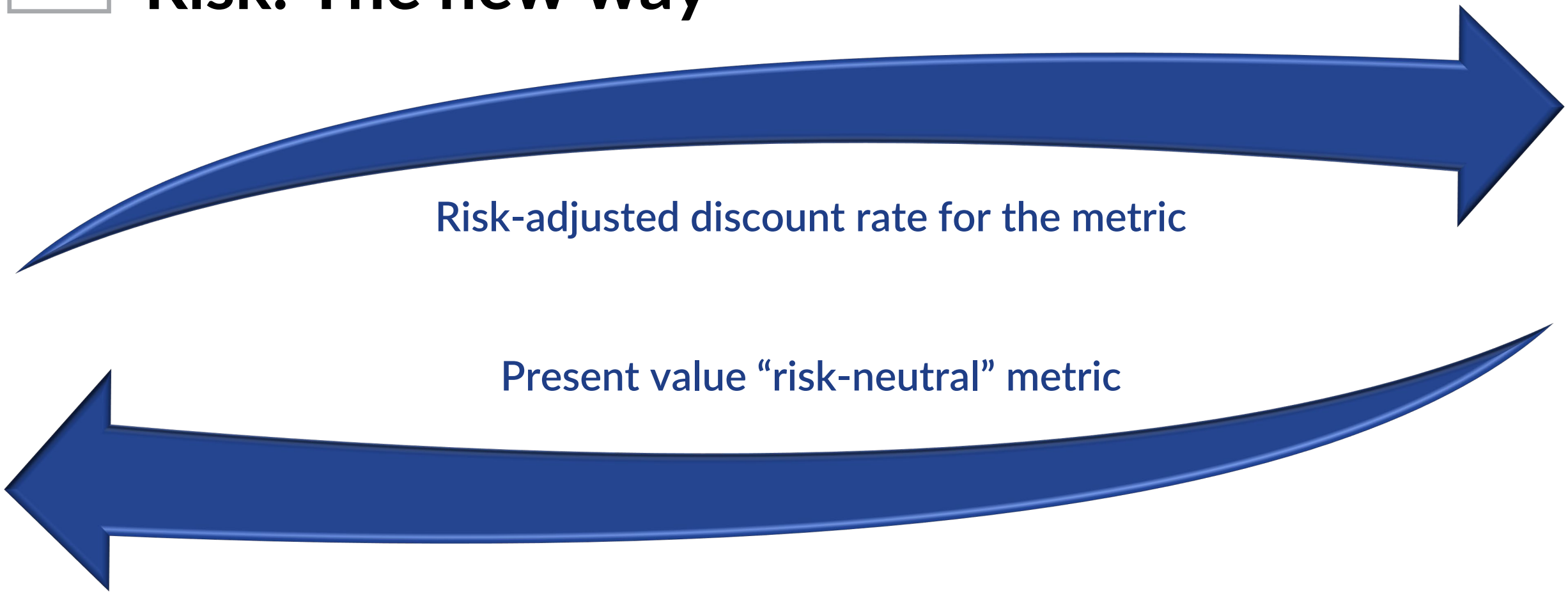
Scenario 2: Management forecast
- Management projections
- Assigned a 25% weighting

Scenario 3: Downside
- Management projections less 10%
- Assigned a 25% weighting

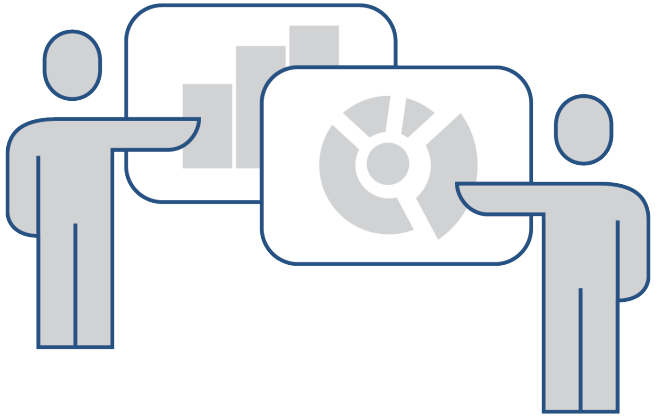
Scenario 4: $0 scenario
- No payout expected
- Assigned a 25% weighting

Weighted average of scenarios are added up and discounted to present value. Typically utilizes a discount rate less than the WACC.

Risk: The new way



Earnouts: Keys to success



Collaboration is critical

Attention to detail

Use the examples provided

Profits interests

What are profits interests?

- Unique form of equity incentive compensation — only in LLCs and partnerships
- Normally designed to comply with IRS safe harbor provisions – favorable tax treatment
- #1 equity incentive in PEGs: attract, retain, reward and align key employees with investor objectives

Accounting requirements under ASC 718 can be a surprise

What's the issue?

Help you be aware of requirements that can impact your audit, GAAP compliance, EBITDA, loan covenants, or exit diligence.

Profits interests: The basics

General features

- Go by many names
- Defined by contract in grant and operating agreements
- Broad flexibility

Economic features

- Share in future “profits” — income and/or capital distributions
- No cash paid by employee
- Vesting — service, performance, market
- Restrictions - nonvoting, waterfall, sale/transfer

Value “at risk”

A little story . . .

During the year, NewPortCo, LLC issued profits interests to key employees

When issued:

1. Employee paid nothing
2. Zero payout in waterfall
3. IRS 83(b) election $0 basis
4. Vesting requirements
5. Forfeiture if leave company

LLC operating agreement, cap table, and grant documents:

- Subject to a minimum value threshold
- Behind investor preferences
- Small, junior position in the capital structure
- Restrictions on voting, transfer, and sale

Other factors:

- No payout expected until exit
- Future company value and any payout uncertain
- Exit years down the road

Scenario 1

The company concludes the profits interests have no value and don't intend to record anything on the financial statements

Scenario 2

The auditors think otherwise. Identify the need to comply with GAAP and consider financial statement recognition

Profits interests: The saga continues

Tax vs. GAAP

TAX – Fair Market Value

- Comply with safe harbor provisions of IRS revenue rulings 93-27, 2001-43, 2005-43
- No share of existing equity if company were liquidated on grant date
- Participate only in future income and distributions
- If qualify, not taxable at grant
- May qualify capital gains treatment at exit event
- $0 tax basis at grant and 83(b) election often filed

GAAP – Fair Value

- Classified as share based payments under ASC 718 (i.e. options, restricted stock, phantom shares)
- Grant date fair value is rarely zero
- Grant date fair value is expensed as compensation over service period
- If subject to liability treatment, record obligation and mark to market until settled
- Footnote disclosures

Cash value $0

Different basis
Different result

Option value $X

Let’s talk about fair value in financial reporting for profits interests

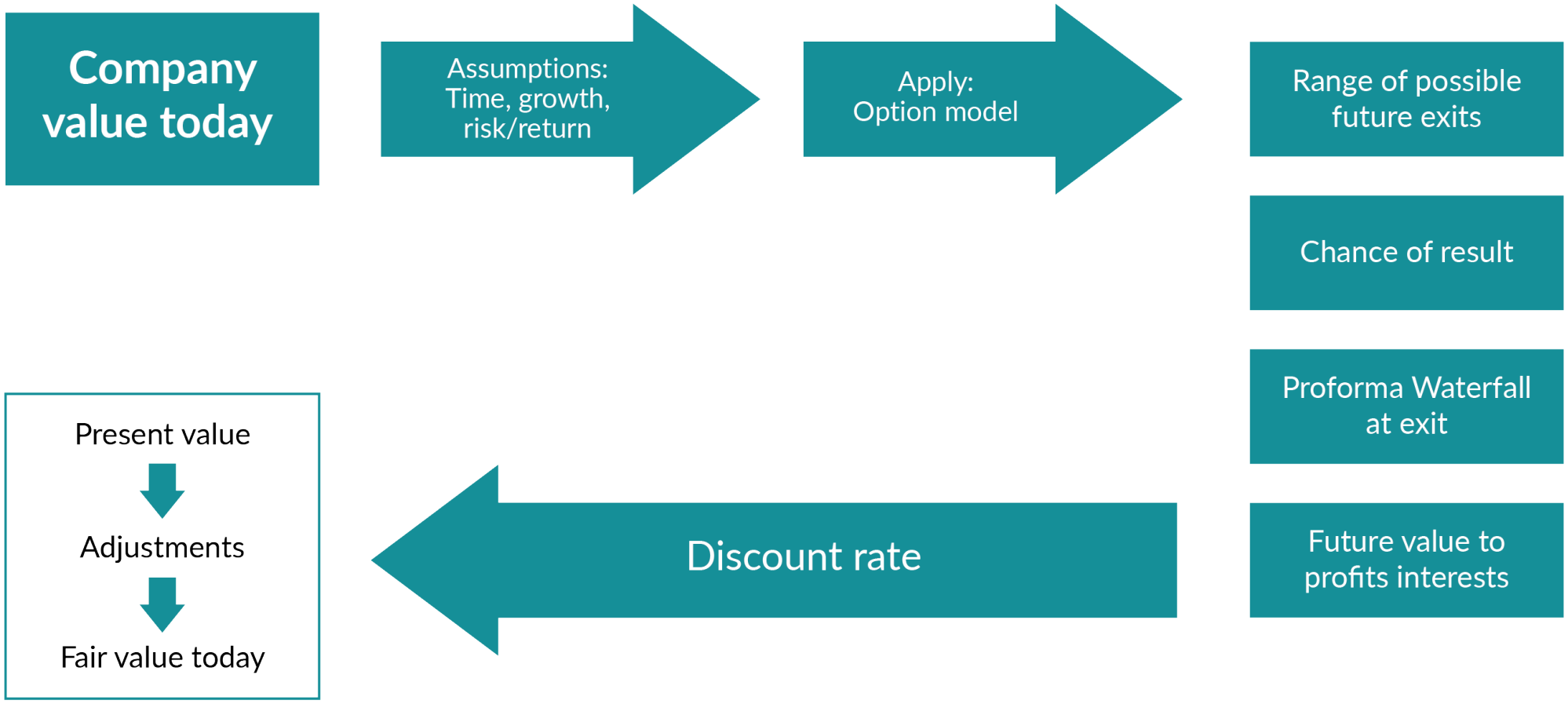
Basis:

- Recognize potential future value implicit in equity compensation.
- Follow AICPA guidelines in Cheap Stock Guide and echoed in PE/VC Guide
- “Not Worthless”

Valuation:

- Special option-based valuation methods: Black-Scholes, OPM Backsolve, Monte Carlo, Hybrid, SBM/PWERM
- Identify a range of potential future value
- Support fair value for ASC 718 and document IRS safe harbor provisions

Option-based valuation methods



Profits interests: Simple example

- PEG acquires OpCo LLC, a new platform acquisition, total equity value of $50M.
- Transaction funded by Series A Preferred: liquidation preference, 8% cumulative preferred return
- OpCo LLC issues Class M profits interests to key management, designed to comply with IRS safe harbors, 10% of fully diluted ownership
- Vesting on service 20% per year, 100% upon a change in control
- Exit in about five years

Result: Option method, Black-Scholes, fair value of grant = $1.4M

Profits Interests: Complex example

- PEG acquired OpCo LLC, a new platform acquisition, total equity value $75M
- OpCo LLC issues Class Z incentive units to management, structured as profits interests intended to comply with IRS safe harbors, 15% of the fully diluted ownership
- Transaction funded with investor Series A Preferred, liquidation preference, 8% cumulative preferred return, and management rollover of 20% into Class B preferred, 6%
- Units vest 50% based on service over four years, 25% if a Series A gets MOIC of 2.0x, and 25% if a Series A achieves an IRR of 25%
- Exit expected in about five years

Result: OPM/Backsolve or Monte Carlo, fair value grant = $2.6M

Profits interests: audit planning tips

- Identify any profits interests grants during the year
- Assemble documentation — grant/award agreements, LLC operating agreement, cap table, transaction documents, OBS
- Don’t assume fair value is $0
- Discussions with auditors
  - Terms and features of units granted
  - Accounting research/memo
  - Equity/liability treatment
  - Valuation support (approaches/methods)
  - Preliminary assessment and next steps

Thank you for attending!

Please feel free to reach out to us with any questions.

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As a principal in the valuation practice, David Howell and his team give management, investors, and stakeholders confidence that the value they have for equity-related interests and intangible assets satisfies all tax, financial reporting, and transaction requirements. David has significant expertise working with private equity and venture capital-funded companies and specializes in valuations for portfolio investments, equity compensation, intangible assets, buyouts, and complex securities.

David is a nationally recognized expert in valuation of profits interests in limited liability companies. David is an Accredited Senior Appraiser (ASA) in business valuation and has a B.A. in economics and an M.B.A. in finance from Northwestern University.

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Dan is a senior manager in the valuation practice at Plante Moran. His professional experience includes the valuation and assessment of numerous financial instruments and alternative assets including contingent payments, convertible debt, corporate loans, and a variety of equity and credit derivatives. Dan advises clients for the purposes of portfolio valuation, shareholder planning, financial reporting, gift and estate tax, employee stock ownership plans, and purchase and sale advisement. He also has experience providing financial and strategic due diligence services and has expertise in a wide range of industries including automotive, manufacturing, service, construction, distribution, healthcare, and technology.

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Chris holds an Accredited in Business Valuation (ABV) credential granted by the AICPA. Chris has a B.B.A. in accounting and marketing from the University of Michigan.