INSIGHTS

FEBRUARY 2022



MIND THE GAP

PRIVATE EQUITY PREPARES FOR VALUATION RESET

EXECUTIVE SUMMARY

Welcome to Private Equity Wire's February Insight Report.
This month we are looking at valuations – a topic which has placed private equity firmly in the spotlight as public markets have reeled.
The quarterly valuation marks ascribed by private equity managers to their funds are important performance indicators for LPs. When markdowns occur elsewhere in their portfolios, it is logical to think there will be a knock-on effect on their private holdings too. This has not been the case for many private equity funds in 2022. Of course, private equity – and alternatives in general – are a long-term game, with performance measured across years, not months. Yet, there are growing fears that an adjustment is now inevitable for many private equity funds to take account of new public valuations, especially as inflation and a recession hang over the earnings in their portfolio companies. We look at the implications of this adjustment in Chapter 2.
Lower valuations at asset-level also have profound implications for the M&A market this year, which we explore in Chapter 1. Buyout funds with dry powder need to deploy capital but most will be reluctant to do so at bid prices which don't take account of new market conditions. The valuation reset here is playing out already in different sectors but, where exit multiples are contracting, managers will have to focus more on other ways to add value to their investments.
Elsewhere in this Report we look at what secondary market pricing means for fund valuations and how software is (yet) to solve the valuation question for many managers and their consultants.
Enjoy reading,

COLIN LEOPOLD
HEAD OF RESEARCH & INSIGHT

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METHODOLOGY

Private Equity Wire surveyed over 90 private equity professionals in December 2022 on the topic of fund and asset-level valuations. Of the group surveyed, more than 75% were fund managers, around 15% were investor LPs and the remainder were a mix of service providers and other groups. The results of the survey were analysed by Private Equity Wire and discussed with a range of named and unnamed private equity sources in the industry during January 2023.

KEY FINDINGS

1

Multiple arbitrage is dead

New macroeconomic conditions have forced a reset in deal valuations – seen in the public markets in 2022 but still to translate fully to private M&A. According to a Private Equity Wire survey, the greatest mismatch between buyer and seller price expectations sits in tech M&A. Private equity managers expect a rebound in deal activity during 2023 under a new valuation framework. It will be based less on a decade-long rise of multiples and more on mechanical value creation

2

Expect revised NAVs in H1

While many private equity managers held off from making substantial downward revisions to their Q3 NAVs where portfolio company performance remained stable, their end-December externally audited net asset values (NAV) may represent a flashpoint. The majority of respondents to a Private Equity Wire survey now expect private equity funds to revise NAVs in line with the public markets through the middle of 2023

3

Secondary pricing stretches

Towards the end of last year, uncertainty around private equity fund net asset values (NAVs) contributed to a pause in LP-led secondaries, but among forced sellers and those looking for price guidance, steep discounts were reported – in some cases of up to 30% or 40% below NAV. As an increasing number of overallocated LPs turn to the secondary market in search of liquidity, true value will be in the spotlight – our survey found only 17% would accept a discount of 20% or more of NAV.

4

Valuations lack ‘killer app’

Data and analytics software may be revolutionising the origination process for many private equity firms, particularly in the mid-market, but how companies are valued pre-acquisition is still a question of deep sector experience and insight, say industry sources. While PE funds may have improved on Excel or turned to outsourcing, only one in 10 survey respondents say they have onboarded new software or technology to support their valuation process over the past 12 months.



RESET IN DEAL VALUATIONS BEGINS

In an M&A market where deal multiples are contracting, private equity managers are heralding to return to more authentic methods of value creation

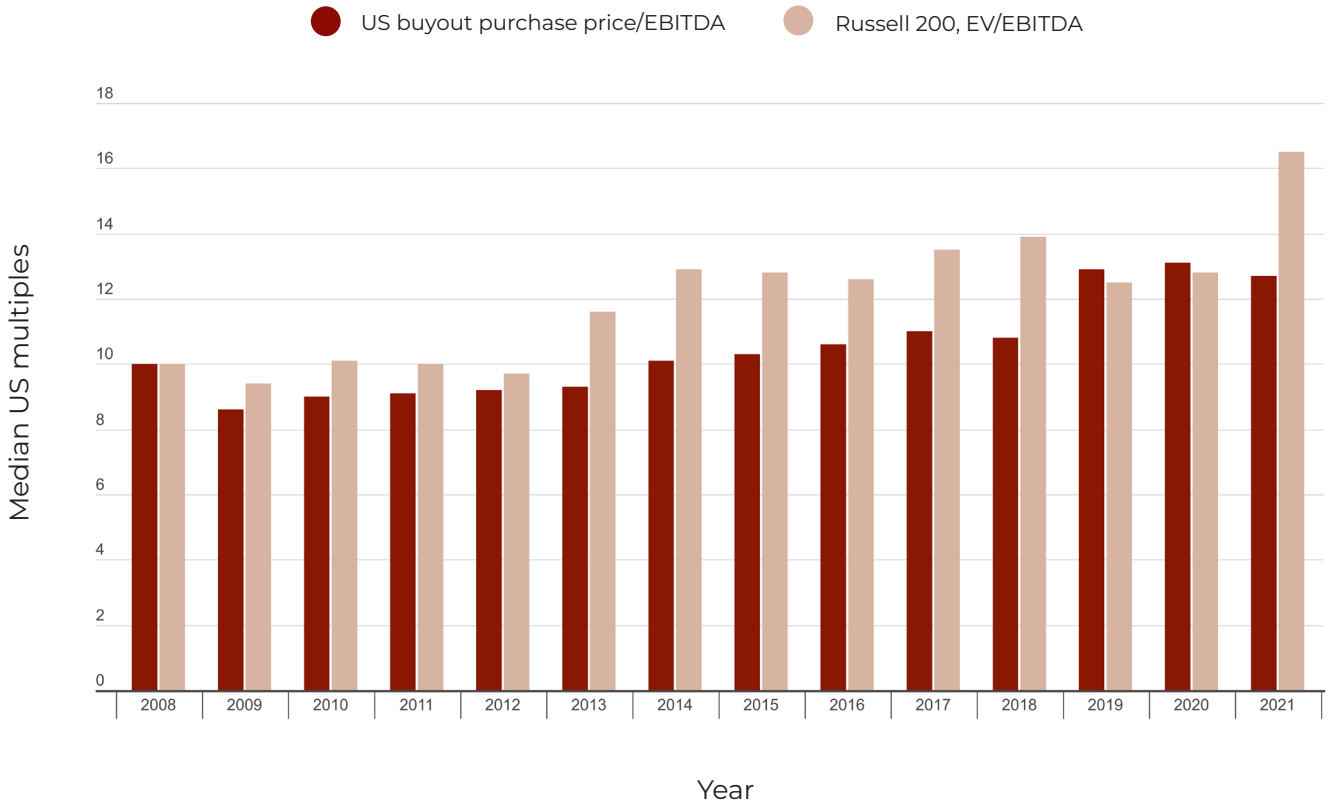
Multiple arbitrage is dead, long live 'operational value-add'. Private equity's manifesto is being re-written for the tight money era and managers are going back to basics – or at least most of them are.

"In the last 10 years, the infusion of low interest rates, cheap money and broad multiple expansion has been a strong tailwind for most portfolios," says Johan Van de Steen, a managing partner at IK Partners. "In the current headwinds and multiple contraction, the approach of the last 10 years is no longer effective and needs to be more active".

THE FLOAT UP

Since the Global Financial Crisis, average entry multiples for leveraged buyouts in the US and Europe have floated up from below 10x to 12x or more, as private equity was ploughed into companies showing growth and new technology. Swimming in a rising tide of easy money, most investors could generally assume a higher multiple on exit. In 2023, the

Figure 1.1 US buyout multiple growth plateaus



Source: Refinitiv, S&P Capital IQ

outlook is not so clear: buyouts have slowed, and multiples are uncertain. The total value of buyout-backed exits now looks to have peaked in 2021, when it hit US$957bn globally – almost twice as high as any other year since 2005.

A prolonged war in Ukraine, persistent inflation and a turn in the credit cycle have forced a reset in deal valuations – seen in the public markets in early 2022 but still to be fully realised in private M&A.

NEW NORMAL

"Valuation memories are sticky. Boards and management teams will become more balanced and realistic in their views on valuation, but it will take time," said Avinash Mehrotra, co-head of M&A Americas at Goldman Sachs in a report by Mergermarket in December. "The question really is whether the current valuation reset is the aberration or if it's now the new normal."

The current impasse puts pressure on private equity funds with excess dry powder, placing them in a waiting game for buying opportunities as potential fees on new assets under management slip away.

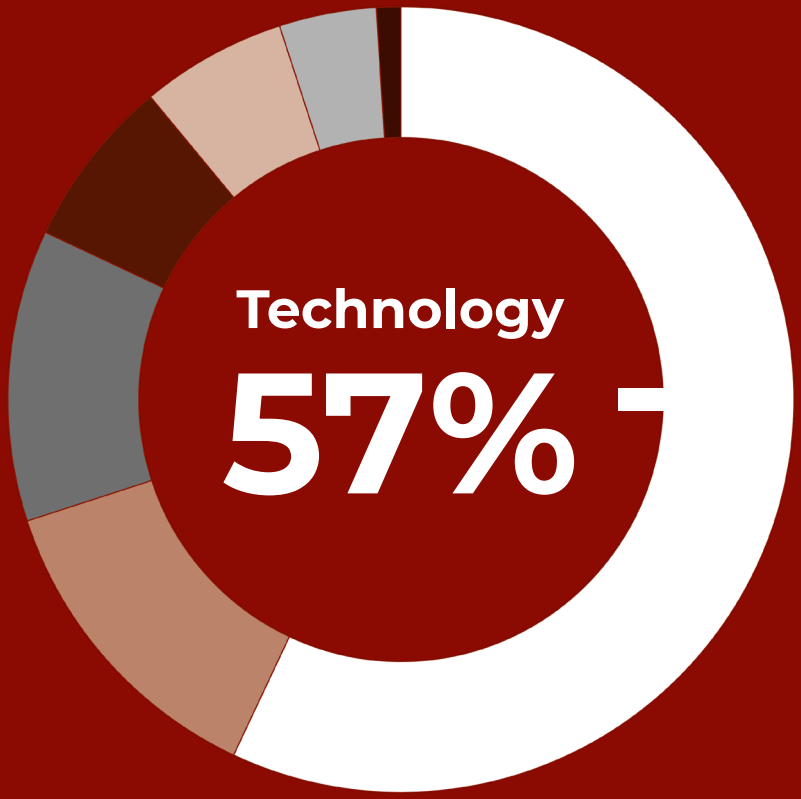
"We anticipate a rebound in deal activity, albeit under a different valuation framework," said Alexis Maskell, partner at BC Partners at the end of last year. "As a GP, we view this as time to be an investor, not a deployer. This new cycle will provide an attractive opportunity for investments, but the focus should be on asset quality, and prices need to reflect the new valuation environment."

So, what does the valuation reset look like for private equity?

KEY FINDINGS

Private equity believes widest bid-ask spread lies in tech

Private Equity Wire survey in December 2022 asked: ‘In which M&A sector do you see the greatest disparity between buyer and seller price expectations?’



INSIGHTS

> The question really is whether the current valuation reset is the aberration or if it's now the new normal

There are some early indications. The first can be seen in a swing to smaller acquisitions.

Last year, UK companies experienced a wave of interest from foreign investors, particularly US sponsors looking at potential take-private opportunities, but larger buyouts are typically more vulnerable to volatility and tighter borrowing conditions.

"Given the level of valuation uncertainty in the markets, large buyouts face a huge amount of scrutiny at board level, so it makes them more complicated, along with the increased level of regulatory scrutiny and the higher cost of debt," says Andrea Guerzoni, EY's Global Vice Chair, Strategy and Transactions.

With fewer mega deals taking place, smaller acquisitions (US$100m-US$500m) have surged – increasing by 27% globally in number last year compared to pre-pandemic levels, according to EY.

Smaller acquisition targets can be harder to find but often quicker to price and complete, especially by sector specialists with strong conviction. Bolting on smaller assets to an existing private equity-owned portfolio company or platform – for example in software or medical diagnostics – can also grow a valuation at exit when multiples are contracting elsewhere.

Research by StepStone published in January found that when buyout managers invest in smaller, less established companies, there is more room to create value by installing skilled management teams, upgrading technology, and developing the sales team.

Around the same proportion of value creation

was generated by "multiple expansion" as it was by revenue growth in an analysis of pre-pandemic buyout funds by Preqin, but this balance will have to shift in the years to come as market dynamics change. An increased focus on operational value is the second feature of private equity's valuation reset.

"There's an inherent conviction that you can create synergies [with bolt-on acquisitions] so you can mitigate the risk of pricing uncertainty and ensure that these platforms can continue to grow, even in this environment," says Guerzoni. "It can also be more appealing to go for something that can be better analysed by the management team you have in your portfolio company – they know the environment and understand the risks."

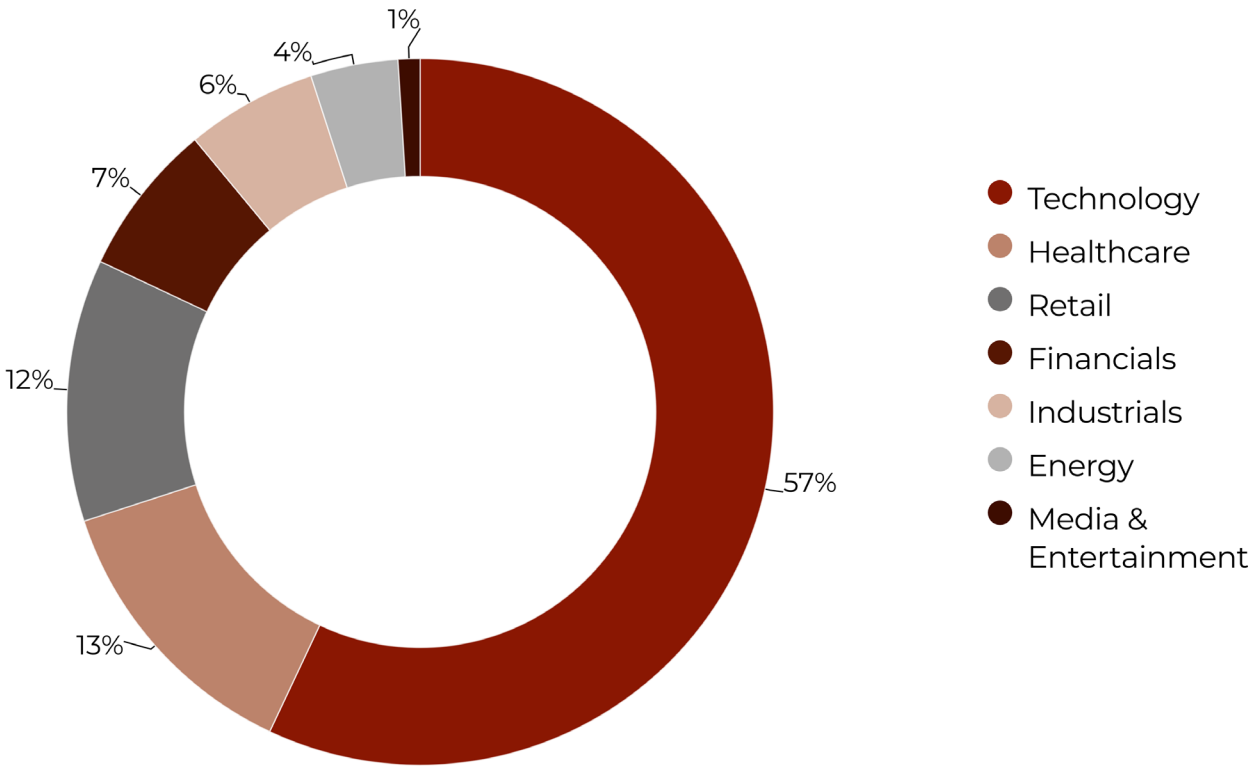
Buy-and-build is the base case for almost every IK deal, says Van de Steen, and he believes the current environment is likely to lead to more M&A opportunities of this type.

BORROWING LENS

A third way to see the shift in private deal valuations is through the lens of debt financing.

Guerzoni believes the valuation reset will be most evident in sectors where multiples have been driven up by a lower cost of funding. If cheap debt and highly leveraged buyouts have driven up entry multiples through the previous cycle, then the opposite will be true in the years to come. According to Schroders Capital at the end of last year, if only 50% leverage is available pre-acquisition, entry prices would have to fall by 12% for investors to still earn an 18.5% return. With 40% debt in the transaction, the purchase price would have to drop by

Figure 1.2 Survey asked 'In terms of M&A/asset sales, in which sector do you see the greatest disparity currently between buyer and seller price expectations?'



Source: Private Equity Wire reader survey, December 2022

THE NEXT TECHNOLOGY RESET

Some of the world's biggest tech companies were the first to be hit by a public market reset in valuations when the Nasdaq fell by almost a third in the first half of 2022. But despite subsequent write-downs in late-stage venture capital, the reset has been a lot slower to hit the private markets.

The result is that tech M&A slowed considerably last year, falling by 40% in value across Europe according to Bloomberg data, as price expectations widened between buyers and sellers and private equity funds focused on the takeover of publicly listed tech companies.

In a survey by Private Equity Wire, the overwhelming majority (56%) of respondents now believe technology to be the M&A sector with the greatest mismatch between buyer and seller price expectations.

Month-by-month, assets are becoming more affordable, wrote Bain & Company in it's January tech report. "High-growth companies have been hit the hardest, with an average 70% decline in valuations from November 2021 to October 2022," it added. "This makes it more of a buyer's market for tech companies."

Lower price expectations on the sell-side could spur tech M&A in the private markets this year.

"Certainly, in tech, buyers are expecting much bigger revisions downward compared to the more defensive kind of plays," says Joshua Maxey, co-founder at investor research firm Third Bridge. "But, that said, cybersecurity deals are happening at the moment and tech is such a broad space so there are people still excited to do deals."

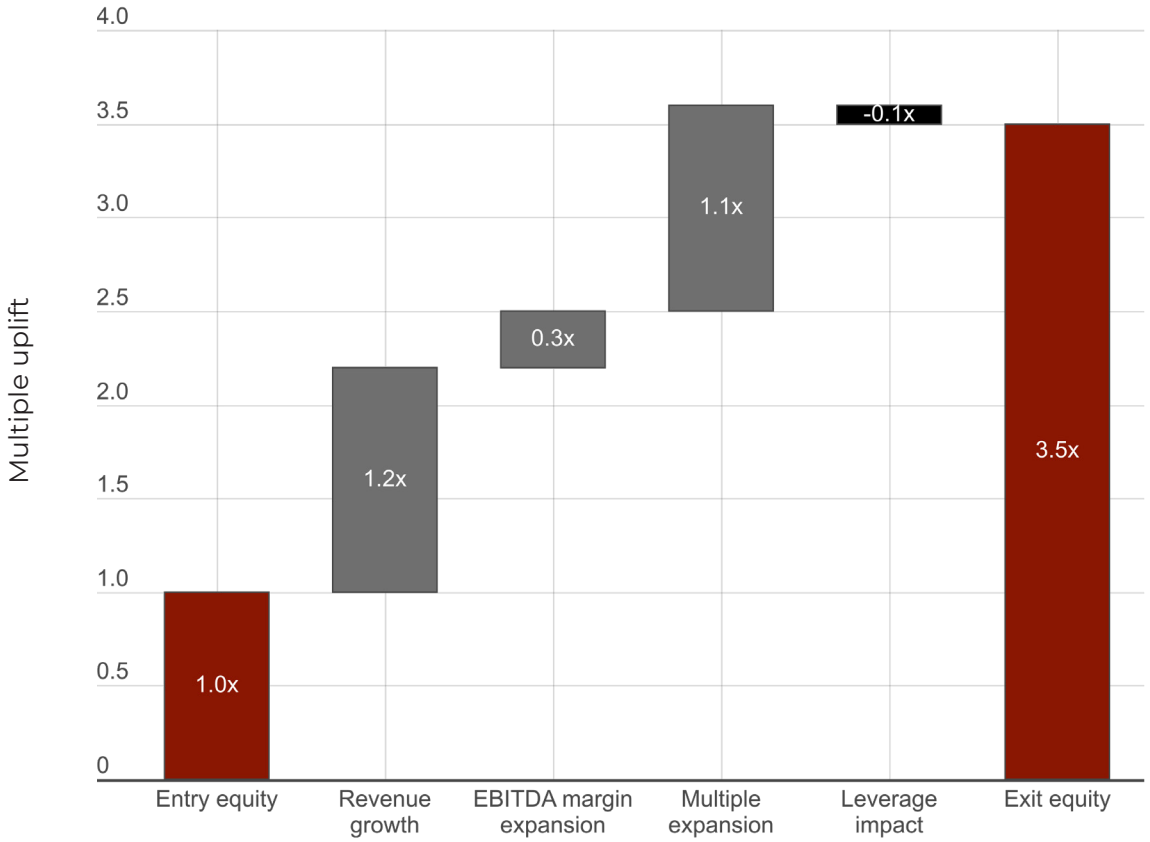
IT-managed services remain a bright cloud on the horizon due to the strong performance spurred on during Covid, says Nick Holman of European private debt firm Kartesia, but he agrees that it is defensive sectors such as IT services and healthcare that currently show the widest price gap between buyer and seller.

Technology was followed by healthcare as the second sector with the greatest buy-sell price mismatch in the Private Equity Wire survey but they are not the only areas where a valuation reset may be overdue.

"Some ESG-related companies still have this premium attached but a lot of this has been down to marketing and some funds have pulled back because they've been called up by regulators for misrepresenting," says Tomas Freyman, head of valuations at Grant Thornton UK. "But I would say, broadly, many things tech-enabled, for example health-tech, ed-tech, recruitment-tech, is where there could be a mismatch [in pricing expectations] currently."

> "Certainly, in tech, buyers are expecting much bigger revisions downward

Figure 1.3 Deal value bridge for global buyouts (vintages 2015-2019)



Source: Preqin

18.6% to earn the same return.

Of course, once acquisition prices fall, a new multiple expansion cycle can start all over again. This is difficult to predict. M&A activity is expected to remain flat for the first six months of 2023 with an acceleration in completed transactions before the summer, says DC Advisory in an M&A Report at the end of last year. Dealmaking confidence will return in H2 2023 when "the impact of inflation is better understood, and the new valuation reality is established", it says.

For younger private equity managers that have only known a market of easy money and multiple expansion, adjusting to this new reality could be painful. For many outside the industry, the return to more genuine value creation should be a welcome change.

KEY TAKEAWAY

GPs – In the tight money era where multiples don't float up so easily, private equity managers are returning to the nuts and bolts of value creation

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In the current headwinds and multiple contraction, the approach of the last 10 years is no longer effective and needs to be more active

Johan Van de Steen
Managing Partner, IK Partners

AWAY FROM THE PUBLIC EYE

While depressed public market valuations in 2022 put pressure on some private equity funds to reassess the value of their investments, they provided a buying opportunity for others.

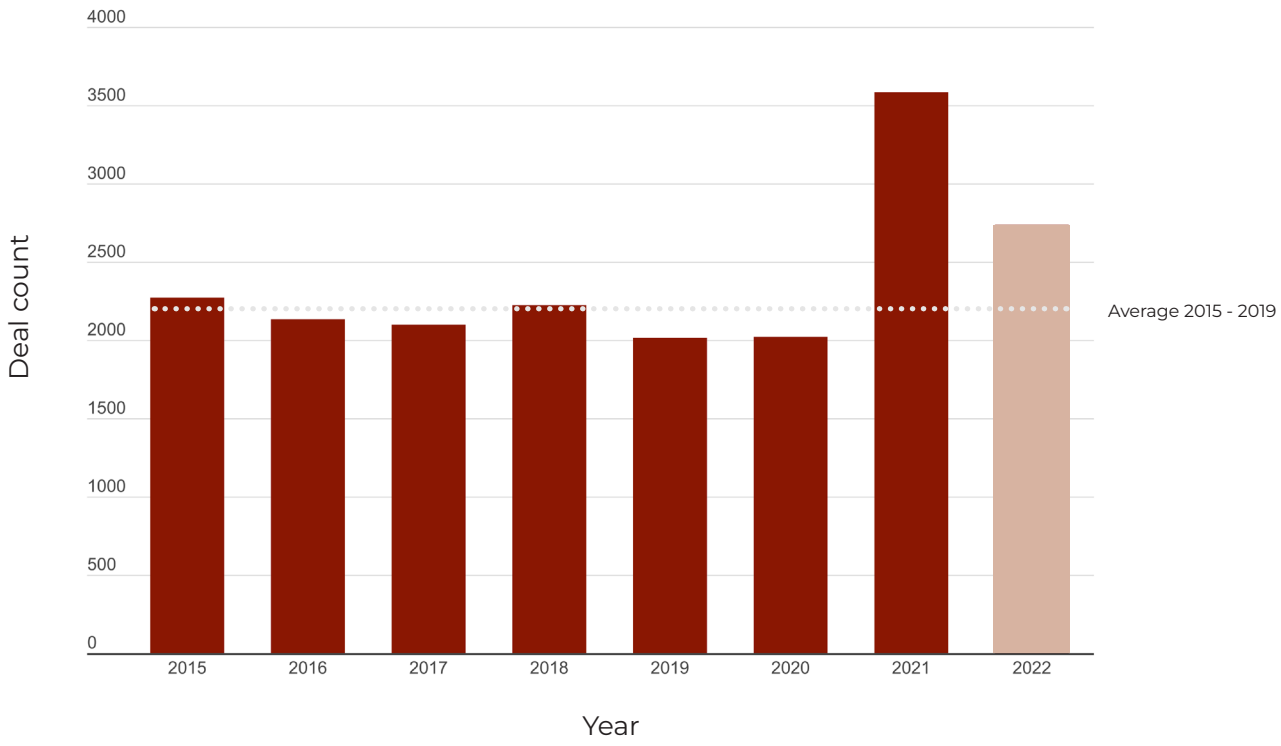
As public markets fell, a frenzy of take-private deals were made in the first half of last year at deep discounts – some at up to 50% off their 52-week share price high according to analysis by PitchBook. Lower public market valuations saw USD 216 billion in public-to-private transactions up to the end of the third quarter in 2022 — a 24 percent year-on-year increase.

"With equity valuations depressed, and a number of recent IPOs well below offering price and orphaned in the public markets, look for private equity firms to be more aggressive in pursuing take-privates," said Davis Noell, senior managing director at US-based Providence Equity Partners at the end of last year. "Public company boards will be in a better place to accept those offers next year as the 52-week highs will no longer include the 2021 stock prices, and more closely reflect current conditions."

Public-to-private takeovers typically require months to pull together, making most quick share price movements irrelevant, but pressure on listed companies to consider advances from private equity buyers is increasing for other reasons too.

The first is an easier price discovery process on the buy-side. "Public companies are always

Figure 1.4 Number of smaller M&A transactions ($100m-$500m) globally, by year



Source: Dealogic, EY

> Some private equity funds are betting that public companies will welcome even 'low ball' take-private offers

in the shop window so there is no fog around their price as in the private market – there's also less funds realistically willing to compete for public assets so there is less price tension among the private equity bidders," says Henrik Persson, head of PLC Advisory at FinnCap Group, adding that UK listed companies have tended to be more conservatively priced than their US counterparts during 2021 and 2022.
But there are two more immediate reasons why public-to-private transactions are set to continue at pace, as valuation uncertainty hangs over the private markets.

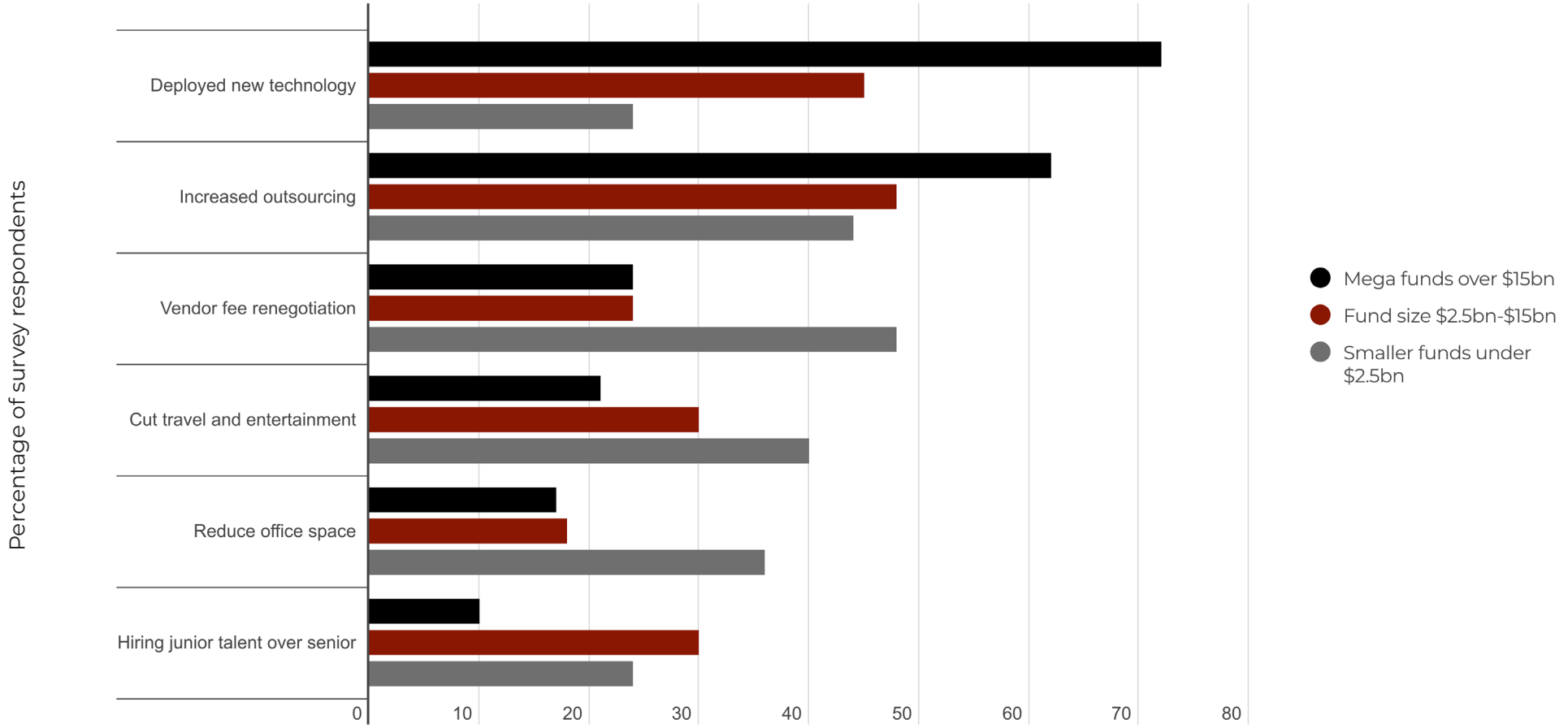
Public companies need liquidity. 2022 was a record year for investor outflows and some private equity funds are betting that public companies will welcome even "low ball" offers as a result, according to a dealmaking source who is working on three such situations.

The second reason is the theory that the public markets have 'given up' on a lot of companies and are therefore not valuing them correctly. The "woeful" recent on-market performance of some IPOs has allowed private equity to buy back certain public companies at sizeable discounts – in some cases only months after their listing, the source adds.
"I think the public markets are a good source of some interesting value plays because PE firms may believe that the public market valuation doesn't necessarily reflect the long-term value of those businesses," says Dan Aylott, head of European private investments at Cambridge Associates.

Writing in Private Equity Wire's Global Outlook 2023, Thoma Bravo's senior partner A.J. Rohde argues that public markets don't always value tech companies the same way the private markets do: "Even during times of deceleration and drops in share price, we can see the immense value these innovative companies have to offer and the accompanying growth potential."

While the FTSE 100 is back to almost record highs, many companies in the FTSE 250 and small caps still appear relatively "unloved", says Persson. Some in the management teams of these companies may see the advantage of a private equity owner who can fund their strategy, simplify the ownership structure and reboot their team's performance incentives more favourably, he argues.

Figure 1.5 How PE funds have mitigated margin erosion at management company level



Source: 2023 EY Global Private Equity Survey

DON'T LOOK DOWN

Private equity funds have been slow to adjust their valuations to volatile public comparables in 2022. As end-December NAVs are reported, that could be about to change

Private equity is not known for its knee-jerk reactions to macro volatility. Fund LPs – most of whom have capital locked up for years – don't dwell on daily or weekly price fluctuations in the public markets as long as the fund can deploy capital ahead of a profitable exit.

When price fluctuations in the public markets start to resemble something more fundamental, those same LPs may get twitchy. Their private equity fund may be near maturity and suddenly facing a less profitable exit or their new fund commitments may be held back by the denominator effect.

Since the end of last year, an increasing number of private equity LPs have been twitching. While the enterprise value of firms held by private-equity funds globally rose 1.9% in Q3 2022, leaving them up 3.2% for the year to date, the S&P 500 fell 22.3% in the same period, according to Lincoln International.

Is this mismatch between the value of private equity funds and the public market a cause for concern? According to a survey by Private Equity Wire, for some it is. Over 21% are concerned, and 30% are "somewhat" concerned.

"It's difficult to understand how valuations on private assets haven't moved when public markets are down double digits last year," says Patrick Ghali at investment advisory firm Sussex Partners, "So to me, there's a disconnect there. I understand they have extended liquidity and hope that by the time funds come to the end of their lives, markets



will have recovered and caught up but whether that's going to happen remains to be seen."

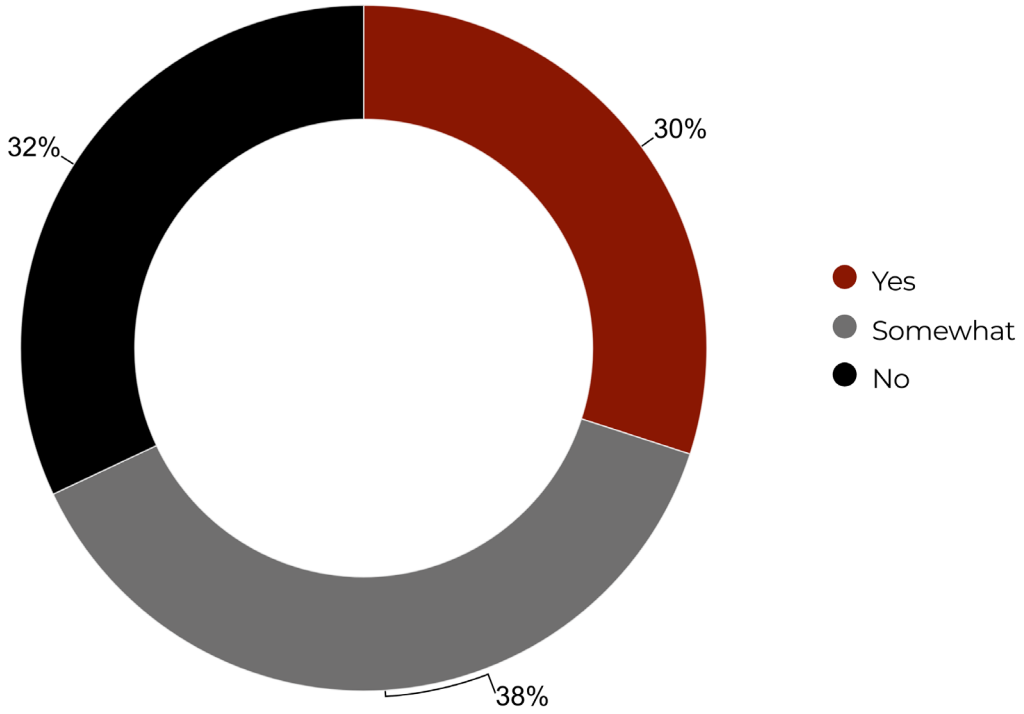
At the time of writing, the 2022 year-end net asset value (NAV) marks for private equity funds were still being reported. According to sources, the majority of managers held off from making substantial downward revisions to their Q3 NAVs where the performance of their portfolio companies remained stable.

SHARPER PENCILS

"While valuations, as of September 2022, are yet to take meaningful write downs or adjustments to 2022 public market comps, this is not unexpected – we have historically seen a meaningful lag from public to private market correction, often taking at least three quarters, if not more," said Dana Haimoff, Managing Director and Portfolio Manager, Private Equity Group, JP Morgan Asset Management in December. "This indicates PE valuations will likely be adjusted downward, as full year 2022 LTM earnings are captured among other factors, reflecting a softness well into 2023."

The 2022 year-end marks represent an important flashpoint in a volatile year. Unlike the quarterly NAVs before them, year-end marks tend to be externally audited and therefore often more reflective of changed economic conditions, says Dan Aylott at Cambridge Associates. "There's more scrutiny, pencils are sharpened, so you could say more realistic valuations will come through here. I think the general expectation is that we'll see further downward revisions. I'm not going to say it will be a spiral because I don't think it's quite as dramatic as that, but I think the

Figure 2.1 Survey asked 'Do you feel that the private equity funds you are managing or invested in have been re-valued in line with public market movements during 2022?'

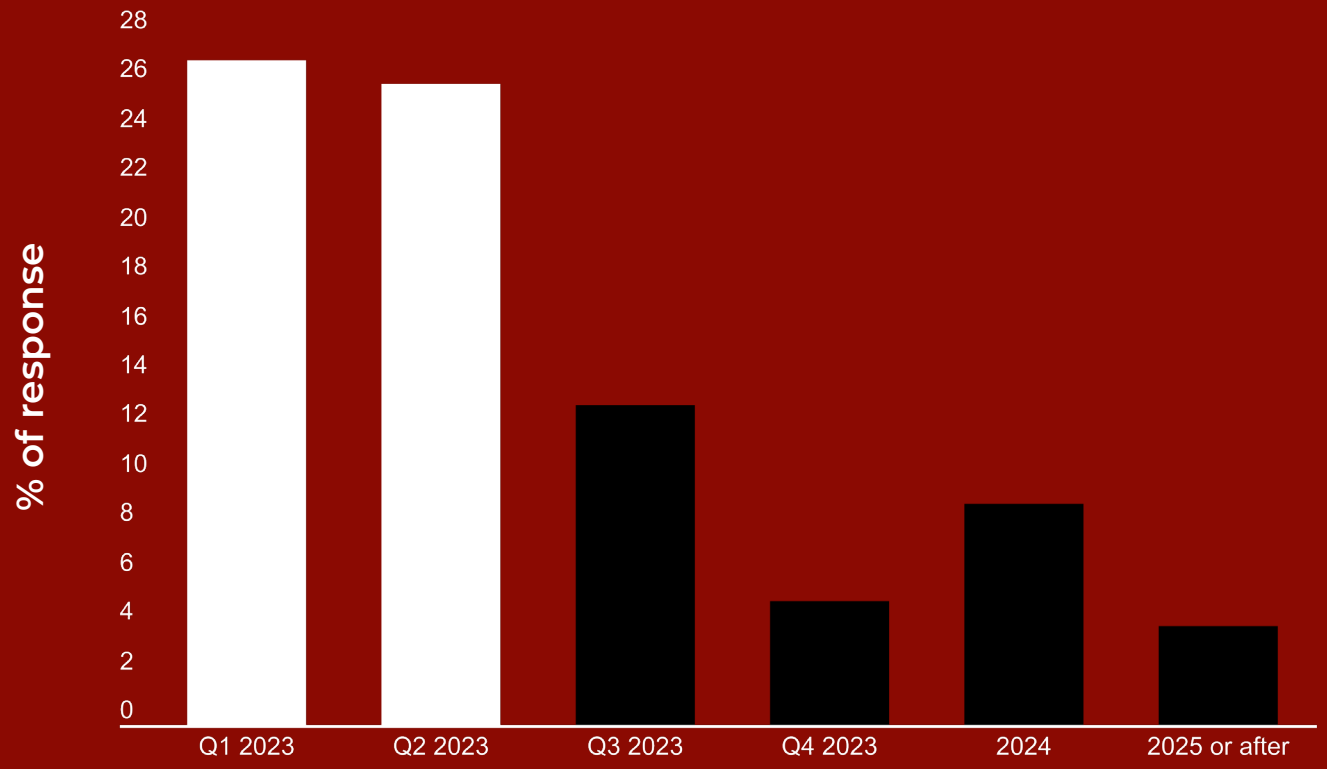


Source: Private Equity Wire reader survey, December 2022

KEY FINDINGS

A year after public markets crashed, private equity NAVs prepare to adjust

For respondents currently seeing a mismatch between private equity and public market valuations, Private Equity Wire in December 2022 asked: ‘When do you expect private equity fund net asset values (NAV) to revalue?’



INSIGHTS

> Historically we've seen a meaningful lag from public to private market correction often taking at least three quarters, if not more

downward trend will continue from year-end into 2023 across the board."

The majority of respondents to the Private Equity Wire survey expected private equity funds to revise their NAVs in line with the public markets in one of the three quarterly opportunities they will have by mid-year 2023: end-December, end-March 2023 and mid-year 2023.

REVISING UPWARDS

At a conference held by the British Private Equity & Venture Capital Association (BVCA) in December, the general view from an industry panel was that 2022 year-end valuations would be either flat or down around 5%, but in the same way the public markets contain a range of different valuation assumptions, it is difficult to make general observations on private equity fund NAVs across different fund maturities, manager strategies and sectors. For example, while EQT's fund valuations for infrastructure and real assets remained stable or even increased between December 2021 and December 2022, they were almost all down by a range of between 0.3x and 0.1x for EQT's Europe and North America private capital funds, according to the firm's 2022 year-end report.

There are also good reasons why many private equity funds would not revise their NAVs downwards and may even do the opposite.

Some managers argue that the valuation of their funds was disciplined when public market equivalents increased so a corresponding decrease is less necessary. Some might

appear to be slow at marking down investments, but they were also slow to mark up, they say.

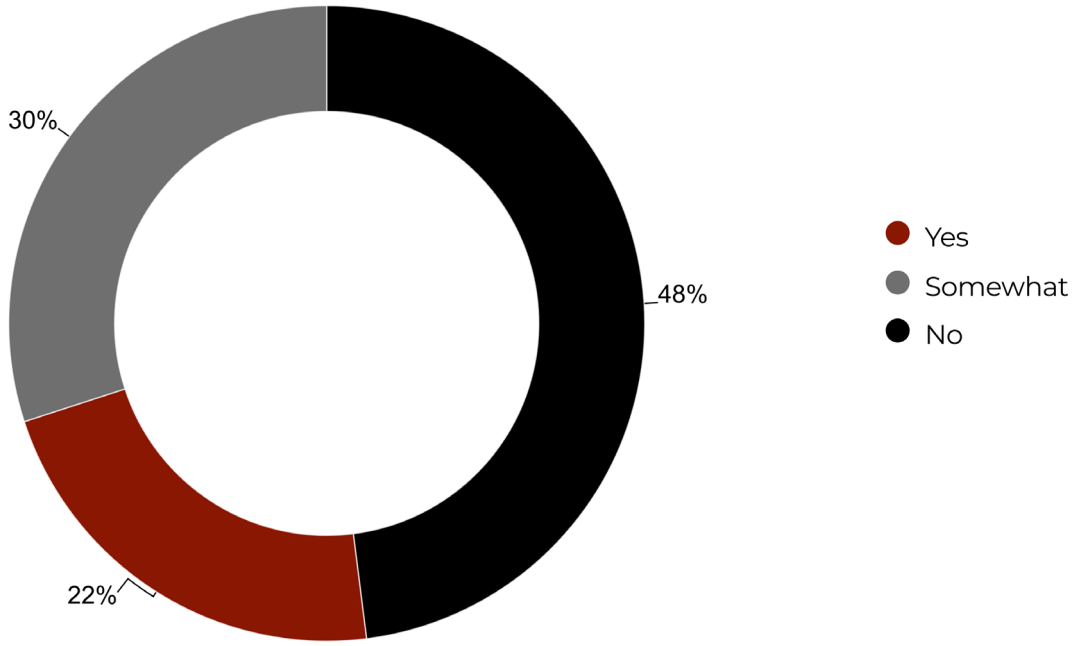
A second, more fundamental point is that – for many managers – their portfolio companies still remain profitable and have not yet been impacted by the general macroeconomic conditions of 2022.

PORTFOLIOS PERFORM

Paul Newsome, head of investment solutions at Unigestion said in a note at the end of last year that the vast majority of portfolio companies in Unigestion Direct II Fund recorded positive EBITDA growth for the 12 months to 30 June 2022 versus the same period a year ago. “These companies are typically highly cash generative and able to pay down debt. Thus, even with multiples going down in certain sectors such as technology, overall performance remains positive,” he says.

The strong performance of portfolio companies during the first half of 2022 may justify elevated valuations but the risk of a recession eating away at earnings still remains in many cases. According to Licoln International in November, only 54% of private companies experienced year-to-date EBITDA growth as cost pressures proved difficult to overcome. Most LPs in a recent survey by Capstone believe the impact of a recession in 2023 will be long-term. More than two thirds anticipate volatility in valuations for more than 12 months, while nearly 20% envisage 18 months or more of disruption. Europe will be the most impacted, say almost nine out of 10 LPs.

Figure 2.2 Survey asked whether the mismatch between private equity fund valuations and the public market in 2022 has been a cause for concern



Source: Private Equity Wire reader survey, December 2022

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The general expectation is that we’ll see further downward revisions to NAVs... I think the downward trend will continue from year-end into 2023 across the board

Dan Aylott
Head of European Private Investments, Cambridge Associates

> Given the significant scope for use of judgement, I would expect any movement to Q4 NAVs to be modest

A fall in public markets does not trigger new private equity fund NAVs in and of itself, it is the reason for that fall in the first place. A discounted cash flow (DCF) approach to valuation, which estimates the current value of an investment based on expected future cash flows, may present an alternative view. From this angle, significant write-downs are much harder to predict, says Iyobosa Adeghe, partner at Coller Capital.

"Between pressure on earnings and movement in public multiples, markdowns across buyout funds would be expected but it isn't clear that audits will be the primary driver of any movement. Managers have always been able to place reliance on a range of datapoints beyond just public comparables and to change the weighting put on those various datapoints," he says. "Given the significant scope for use of judgement, I would expect any movement to Q4 to be modest."

KEY TAKEAWAY

LPs – Externally audited NAVs from end-December may show downward revisions as managers take account of new economic conditions through 2023

FUND PERFORMANCE TRENDS DOWN

2022 is set to be a mediocre year for private equity performance but with a time-lag in reporting and uncertainty around current fund net asset values (NAV) it is too early to say if 2023 will be any better.

In December research association Equable Institute published a report which pointed to “warning signs” for US public pensions invested in the asset class.

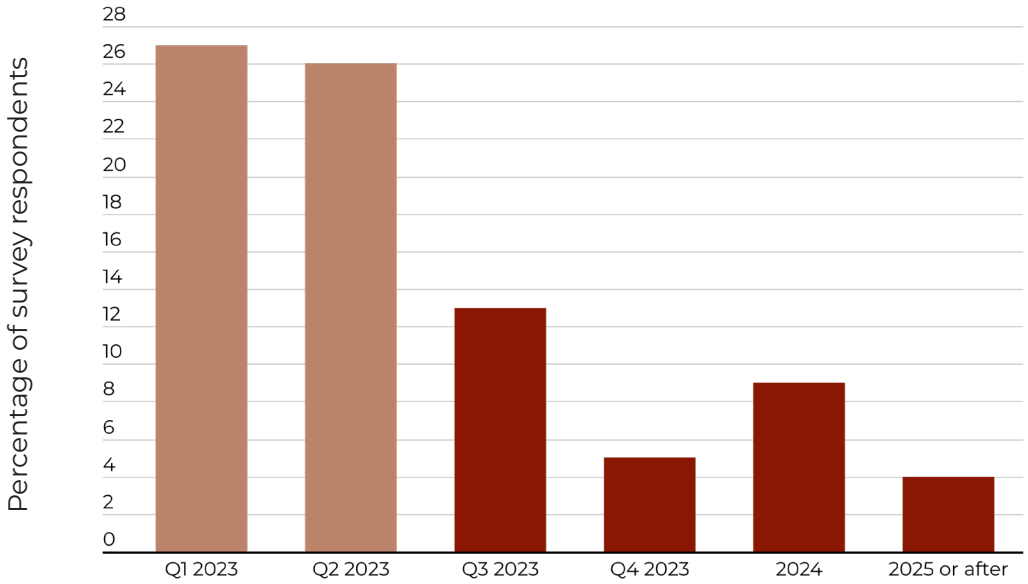
“Private equity returns get reported on a lag of up to six months, and with each update in 2022 values were coming down — which means 2022 numbers were including overstated private equity asset valuations and 2023 numbers are going to incorporate those losses,” said the report.

This time-lag in reporting makes it difficult to forecast how revised valuations will impact average fund performance this year.

According to John Stake at Hamilton Lane, writing at the end of last year, “we have a good sense that PE will likely be flat to slightly down for Q3 2022. This implies that we have seen a contraction of about 7% through the first three quarters of 2022.”

Preqin’s quarterly index for private equity shows performance peaking at the end of 2021 and trending down through 2022. Based on historical data, a correction should be expected this year. For 2023, Stake believes that “compelling deal valuations” should contribute to high single digit to low double-digit returns for the asset class, slightly below the long-term historical average of 16%.

Figure 2.3 Survey asked respondents still expecting a full fund revaluation when this might occur



Source: Private Equity Wire reader survey, December 2022

A SIGN IN THE SECONDARIES

Hefty price discounts in private equity's secondary market may indicate the true value of some funds as overallocated LPs seek liquidity



Secondary markets can provide vital clues to the value of unlisted assets, and private equity is no different.

Towards the end of 2022, uncertainty around where private equity fund net asset values (NAVs) should lie caused a pause in LP secondaries, but among forced sellers and those looking for price guidance, steep discounts were reported – in some cases of up to 30% or 40% off NAV.

As is the case across private equity fund valuations, it is difficult to generalise on secondary pricing where trades range in fund maturity, manager/asset quality and sector. Yet, according to some sources in the private markets, this drop in secondary pricing hints that some private equity funds may have been overvaluing their funds and now face a comparable downward revision in soon-to-be-released valuation marks.

RECORD DISCOUNTS

Private equity secondaries have traditionally priced between a discount or a premium to net asset value (NAV) within an average range of 90 to 105, where 100 is par. Given that NAVs are typically updated quarterly, this method of secondary pricing usually lags movements in the public market by a number of months. Speaking to Private Equity Wire for an Insight Report on secondary market activity last year, Nigel Dawn, senior managing director and head of Evercore's Private Capital Advisory Group, said: "It's hard to have strong conviction when there is so much volatility". Since then, discounts in private equity's secondary market

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Between pressure on earnings and movement in public multiples, markdowns across buyout funds would be expected but it isn’t clear that audits will be the primary driver of any movement

Iyobosa Adeghe
Partner, Coller Capital

have grown to some of their highest levels over the last decade.

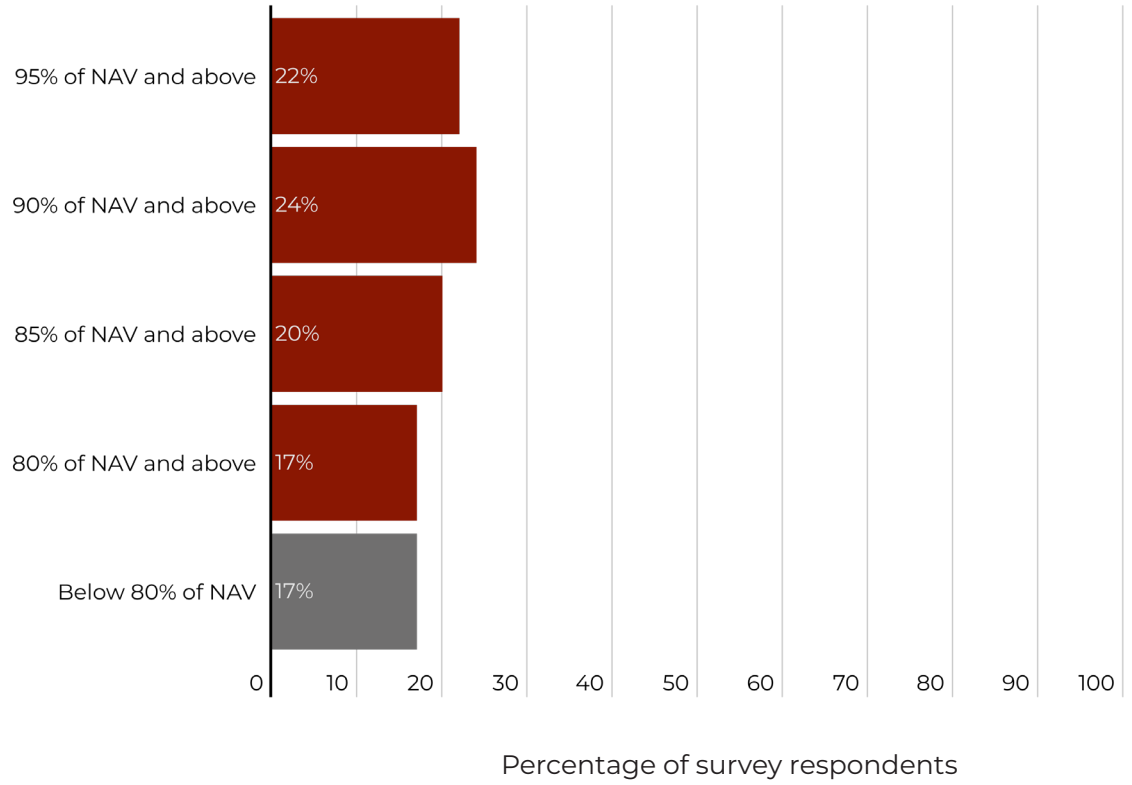
Petra Bukovec, a partner in Pantheon's global secondaries team, acknowledges secondary pricing varies significantly depending on the quality and type of companies in the portfolio and maturity of the funds, but high-quality buyout funds, which priced close to par or in some instances above par previously, today price at discounts "in the high teens or even above 20%".

A report by NEPC for Maine's public employees' pension, reported by Buyouts Insider in November, found that general private equity funds can expect discounts of 20 to 30 percent. "This is higher than usual due to the lag in PE valuations fully reflecting current public market and economic outlook," the report said, citing discounts of 30% to 50% for managers with dedicated energy or real asset secondary funds, based on the quality of the assets.

The reporting of 2022 year-end fund NAVs and public market valuations in the first quarter of 2023 should provide some much-needed clarity to buyers and sellers in secondary market. It is worth saying also that buyers are increasingly looking for other methods of valuing fund stakes in the secondary market, away from the NAV.

LP-led transactions represented $55bn (53%) of the secondary market in 2022, down from $66n in 2021 but still well above the $28bn seen in 2020, according to data from Evercore. Overallocated LPs will continue to seek liquidity in the secondary market this year, but at the same time may be reluctant to accept haircuts of more than 20% for a sustained

Figure 3.1 Survey asked how much of a discount to NAV would you accept in the secondary market

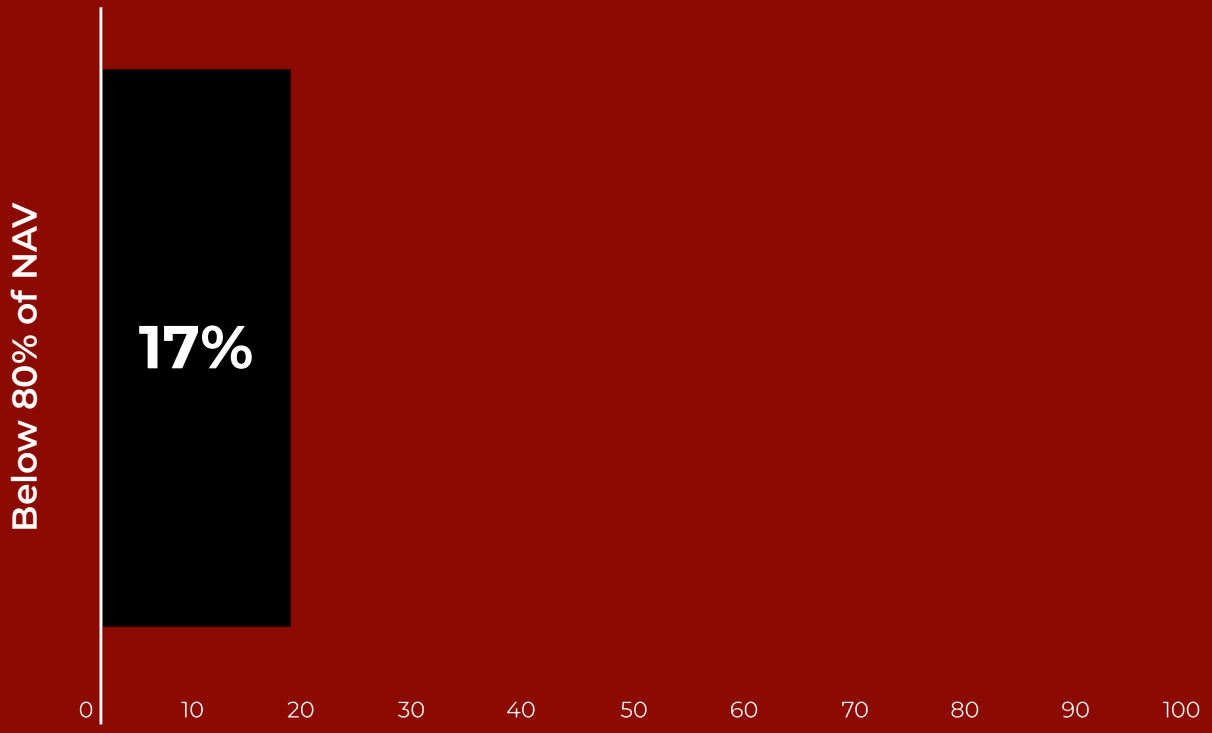


Source: Private Equity Wire reader survey, December 2022

KEY FINDINGS

Steep price discounts in secondaries may force LPs to re-think

Private Equity Wire survey in December 2022 asked:
‘How much of a discount to NAV would you accept in the secondary market?’



INSIGHTS

> Over time, many sellers may reluctantly accept today's lower pricing environment

period. In a Private Equity Wire survey in December, only 17% of those surveyed said they would accept lower than 80% of NAV (or a 20% discount), with the majority (66%) willing to accept only 85% of NAV and above.

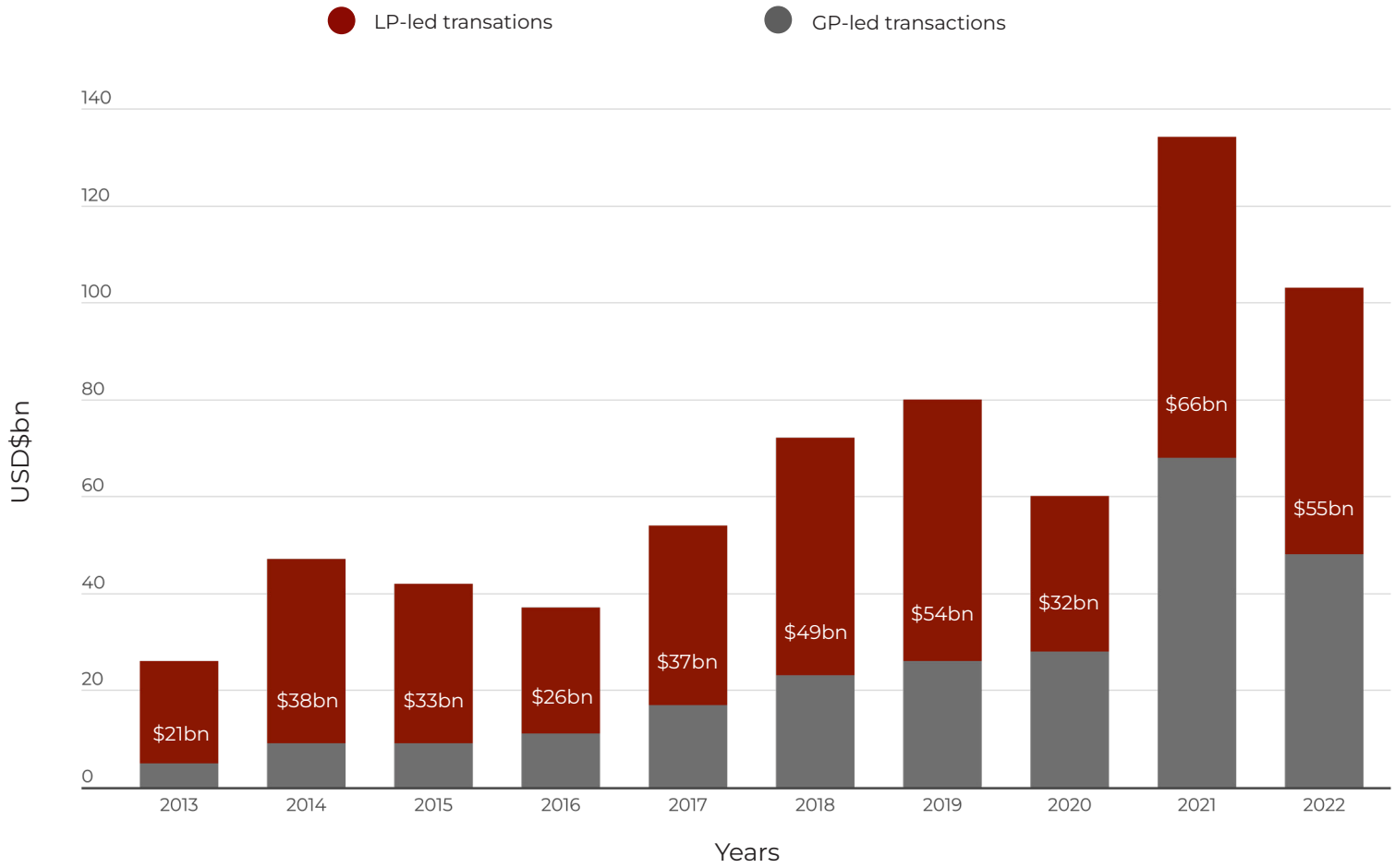
To achieve the best price, LPs typically bring their best assets to the secondary market. How private equity NAVs adjust in the primary market – if at all – in 2022 year-end and 2023 figures will be a key factor in how the secondary market moves forward in the months ahead.

"To the extent they are selling alts, LPs are sequencing initial sales with assets that produce higher pricing and achieve liquidity more easily," says Mike Bego, Managing Partner of Kline Hill Partners. "These first sources of liquidity for limited partners today are specifically credit and infrastructure and, to a lesser extent, buyout (but especially recent vintage and more unfunded buyout). Typically, there is a lag when pricing shifts for buyers or sellers to get acclimated with the new normal pricing (whether paying high prices or sellers accepting bigger discounts). Over time, many sellers may reluctantly accept today's lower pricing environment."

KEY TAKEAWAY

LPs – The secondary market has become an established route to liquidity for many LPs but significant discounts to NAV may force a re-think

Figure 3.2 Private equity secondary market activity, by year



Source: Evercore



WHY SOFTWARE HASN'T SOLVED VALUATIONS, YET

The amount of company data now available to private equity firms has revolutionized the valuation process, but the competitive advantage still lies with humans

The tale of fintech start-up Frank – the founder of which allegedly fabricated millions of customer emails before a sale to JPMorgan – is a lesson in the value of data, and in the data that can drive a valuation.

It is sometimes said one of the reasons private equity managers have grown to love acquiring tech companies, particularly in the later-stage of growth, is the relatively high number of data points available to project a valuation. In the case of Frank, the data was there but according to reports it was not what it seemed.

In almost all sectors of the economy, private equity firms are sucking up more and more company data points and using better tools to analyse them. In December data provider Preqin launched a new set of asset-level valuation benchmarks and large PE houses have been building out their internal data teams to crunch numbers and test different investment hypotheses for years.

"The amount of data that clients want to have before they take a step towards an acquisition or joint venture is increasing all the time," says Andrea Guerzoni, EY's Global Vice Chair, Strategy and Transactions.

VALUE CHAINED

At the end of last year, investor research firm Third Bridge launched new product 'Maps' which presents tens of thousands of company value chains to help investors fast-track early-stage research. Other fintech platforms are

“

Typically there is a lag when secondary pricing shifts... [but] over time many sellers may reluctantly accept today’s lower pricing environment

Mike Bego
Managing Partner of Kline Hill Partners

attempting to do something similar but third-party solutions to valuing these companies have been slower to emerge.

Around 60% of valuations can be more than 15% off their verified value, wrote M&A banker David W. McCombie III in a recent Forbes article, adding: “In any other industry this performance would result in someone getting fired. Valuations are more art than science (can easily be manipulated) and results relative to market value or even between reputable firms can be significantly off (as in a 10x difference in value) for private businesses”.

So, what to do?

According to a survey by Private Equity Wire, not much: only one in 10 respondents say they have onboarded new software or technology to support their valuation process over the past 12 months. In some cases that capability may already exist, or it may have been outsourced, but according to people working on private company valuations, the finding also reveals how technology is only half of the solution.

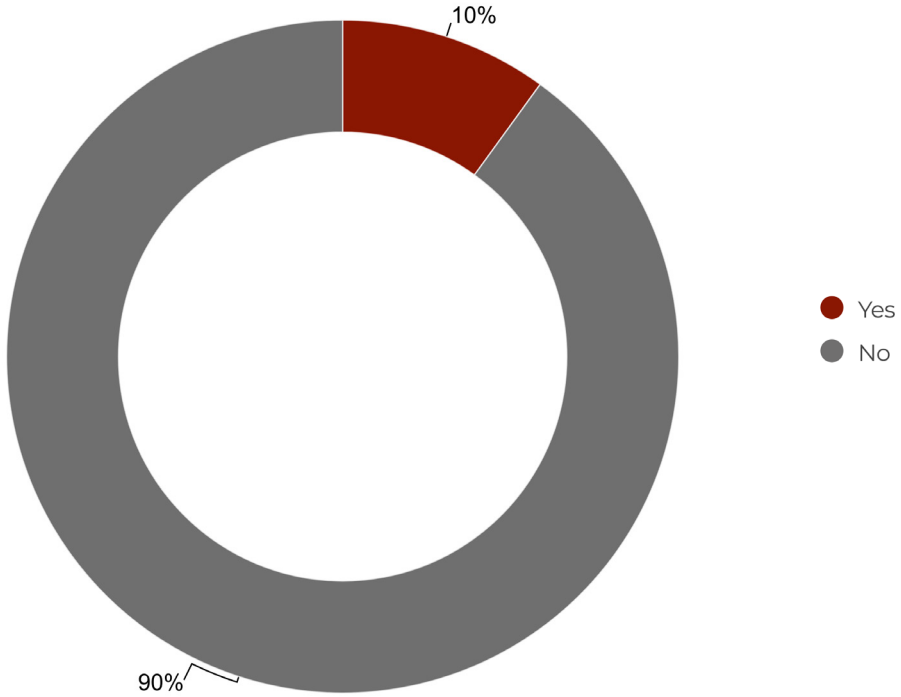
HUMAN FACTOR

Even with the advent of ChatGPT and a potential revolution in generative AI, private equity firms are looking to human experience when it comes to deal valuations.

“You can have data engineers who clean the data and come up with correlations or interesting perspectives, but, ultimately, what counts most in the valuation process is the questions you ask,” says Guerzoni.

“You still need to have people deeply involved in the dynamics of a sector and you need to work more on the human factor – an

Figure 4.1 Survey asked ‘Have you onboarded any new software or analytics technology which helps your valuation process over the past 12 months?’

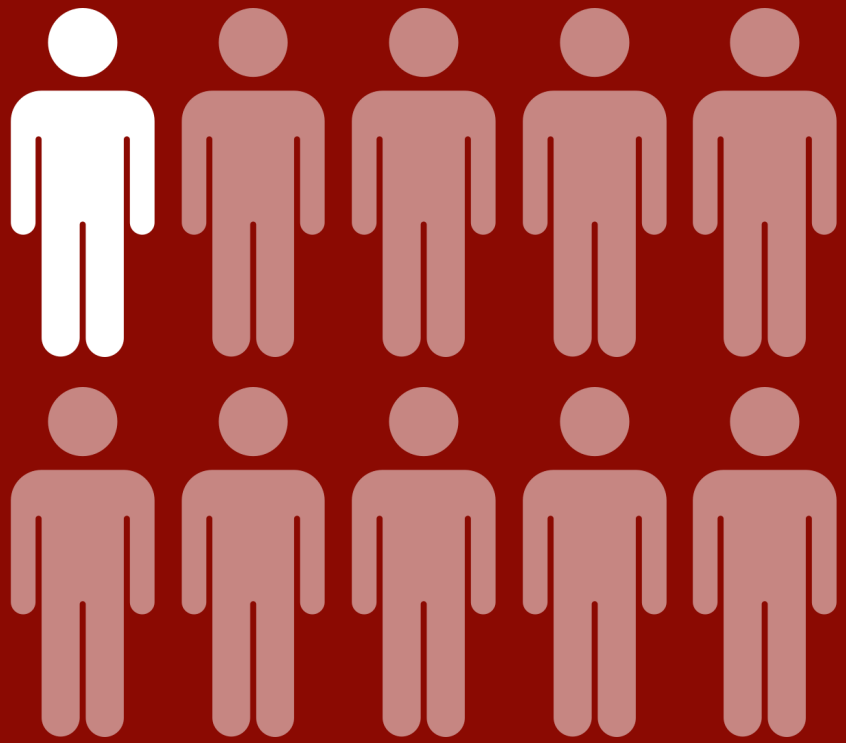


Source: Private Equity Wire reader survey, December 2022

KEY FINDINGS

Technology is yet to disrupt the valuation process

Only 1 in 10 survey respondents say they have onboarded new valuation software



Private Equity Wire survey in December 2022 asked: 'Have you onboarded any new software or analytics technology which helps your valuation process over the past 12 months?'

INSIGHTS

> Human insight and experience ensure a valuation is robust and can withstand scrutiny

ecosystem of different perspectives. Even for smaller deals, having the possibility to spend more time with the local management can add incredible value and it is still a model that should be followed."

This is particularly true in venture capital where comparable public valuations often don't exist for many nascent sectors (ChatGPT's own $29bn valuation being a good example).

Tomas Freyman, head of valuations at Grant Thornton UK, admits that with private equity funds amassing so much data, there has been a move away from spreadsheets towards more sophisticated tools but agrees that fundamental approaches to valuation have stayed the same.

Data may help private equity funds build conviction on an acquisition target, he adds, but human insight and experience remain "just as important to ensuring a valuation is robust and can withstand scrutiny".

With increased regulatory pressure on private equity firms, it is also humans – rather than machines – that are being pulled in front of management teams to justify this valuation.

For this reason and others, one private equity adviser, unnamed, says that some of the larger private equity funds are growing suspicious of new "black box" tech solutions because they want more subjectivity in the valuation process. "The kind of finger in the air, human interaction element of valuation is much more of a craft than a science – as opposed to pumping all this data and outcomes a number and it must be right. But, you know, as these robots get more and more sophisticated, who knows?"

KEY TAKEAWAY

SPs – A leap forward in data analytics software is helping managers identify new acquisition targets, but a 'killer app' for fast and accurate deal valuations is yet to emerge

PRIVATE EQUITY WIRE

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