Facebook has dramatically changed how people interact with each other on a truly global scale. It has about 550 million users (equating to one out of every dozen people on the planet) who speak approximately 70 languages and collectively spend billions of minutes on Facebook every month. Its membership is still growing at an incredible rate every single day, with the company reportedly doubling in size since 2009. If Facebook were a country it would be the third largest, behind only China and India.

But how much is it worth? Goldman Sachs acquired shares in Facebook in January 2011 in a deal that valued the company at US$50 billion. Now reports suggest that Facebook is about to file for an initial public offering, with a likely price range of $85 - $95 billion.

However, not everyone values Facebook at these incredible levels, especially when looking at the financials (such as actual profits). Indeed, there is a growing belief that inflated value estimates for social networking sites such as Facebook and Twitter are signs that a social networking ‘bubble’ is developing.

So it is clear that valuation is hugely important in the current business environment. It is also clear that, for a number of reasons, obtaining universal agreement on a valuation is very difficult indeed.

**Valuation in Private Equity**

Fair Value is defined as ‘the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm’s length transaction’. However, clearly there is a high level of ambiguity regarding valuation, particularly for entities that are private in nature.

Private equity, by definition, refers to any type of equity that is bought or sold in a privately negotiated transaction and is not traded on a public stock exchange.

Given the rise in prominence of private equity funds, there has been increased analysis on overall fund performance, and a growing push by limited partners to gain a clear understanding of the measurement of portfolio company returns and valuation. Unfortunately there is no definitive answer, nor a one stop shop for such measurements. Private equity valuations are innately subjective because there is no public exchange for the funds’ underlying assets, nor for the trading of limited partnership interests.
within the funds themselves. In the absence of a perpetual market for such interests, fund managers set a value for each underlying portfolio company based on the periodic application of valuation policies and methodologies – which may not accurately reflect ‘open market’ value.

**THE FAIR VALUE PROCESS**

As the alternative investment industry has become increasingly prominent, limited partners and advisors have become dependent on reliable fund analytics. Accurate valuations are needed for a limited partner’s understanding of their investment, along with their requirement to closely monitor their own financial performance.

As domestic and international Generally Accepted Accounting Principles (GAAP) have evolved to a fair value orientation, implementing a fair value process has had a significant impact on the private equity industry’s operations. In particular, prior to fair value accounting, private equity funds would commonly value their investments at cost until a significant event, such as a subsequent round of financing, provided evidence that the value should be changed from its original cost basis.

The industry’s argument for this reasoning was that these investments were not meant for quick sale; rather that the investment was to be held and managed for an intermediate period of time in order to derive value over the longer term. Most investment managers believed that fair valuing these investments was too subjective and that the investments’ cost or latest round of financing was the best fair value indicator. However, in keeping with the above, fair value accounting and reporting has rendered the historic prominence for original cost valuation obsolete.

Clearly, investments for which there is no active market pose challenges when attempting to derive a pertinent valuation. Creative deal structures, the threat of regulatory change or competitive encroachment often pose challenging valuation questions. What valuation methodology is most appropriate? Is this a stand-alone entity or are there synergistic values to assess? Do we hold a controlling interest? Indeed, there are so many factors to consider that it is abundantly clear why valuation in private equity is so challenging. Are management sufficiently competent? Are marketing strategies effective? The list goes on.

In response, industry guidelines and accounting standards have increased the amount of fair value disclosure within financial statements in order to provide increased transparency and provide reliable, relevant information to the users of the financial statements. Guidelines dictate that, if possible, the determination of fair value should consider multiple methodologies, enabling the inclusion of multiple criteria impacting the valuation. The investment’s acquisition price, investment type, market conditions (both local and national), comparable security values on public exchanges and company performance are all areas that need to be analysed, and their respective merits considered.

When considering the value of a privately-held company, simply determining the value of the company from its historical financial statements is insufficient. There is clearly a need to go beyond the financial statements and understand the economic, geographical, and business conditions within which the company operates. In addition, consideration of management strategy and operational acumen are vitally important in preparing a reliable valuation, as are some more tangible qualities, such as a company holding surplus cash on its balance sheet. As such, a variety of valuation methodologies should be sought when deriving a valuation if possible, falling into five distinct categories:

- Price of recent investment
- Multiples
- Net Assets
- Discounted Cashflows or Earnings
- Industry Benchmarks

Each method has its respective strengths and weaknesses, with the price of recent investment perhaps being the most reliable. However, often the price of a recent investment is not
available and, as such, an alternate valuation methodology is required.

In theory, all of the methods used should result in similar values. Unfortunately, given the nature of private equity valuation, it is inevitable that each methodology will generate a different value. Sometimes the differences are minor, but in many cases they can be significant. If the valuation differences are minor, mathematically weighting the results may be a satisfactory solution. However, if the differences are material, mathematically weighting the results may lead to an incorrect conclusion.

Thankfully such discrepancies will lead to a reconciliation process between the two respective values. This is an important step in the valuation process, as the reconciliation process dictates that positions must be supported and the underlying logic discussed and challenged, ultimately resulting in an increasingly robust final valuation. Ultimately, the valuer should use their judgement when considering the specific terms of the investment and must also, when relevant, consider the substance of the investment, as opposed to its legal form.

CONCLUSION

Valuation remains at the top of the agenda for private equity firms and reflects the ever increasing demand from investors for transparency. This is especially pertinent in the current economic environment within which the valuation of private equity investment continues to be extremely challenging given market volatility and scarcity of transactions. As such, independent oversight and review, strong corporate governance, and continual documentation of valuation methodologies are key.

Jane Pearce is a partner and Charles Le Cornu an associate director at Ogier Fund Services

Supercharge your Administration

Our clients tell us that our people, our client relationship management and our highly responsive approach sets us apart from other firms.

Our systems selection is based on implementing the best and most reliable systems to provide clients with a unique fund platform.

We deliver accurate, efficient and bespoke reporting to our clients and their investors whilst maintaining a rigorous central framework. By connecting our front and back-office processes we can provide customisable accounting and investor relations capabilities.

Find out how we can help you. contact: Jane Pearce, Partner - Ogier Fund Services
T: 01534 753806 E: jane.pearce@ogier.com

Ogier Fiduciary Services (Jersey) Limited is licensed and regulated by the Jersey Financial Services Commission.