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TRENDS IN OPERATIONAL DUE DILIGENCE

Private Company Valuations Amidst a Potential Global Downturn.

"Valuation of private equity is an SEC exam priority. This makes sense considering so many US public pension plans are large allocators to P/E funds".

"The industry's highlighted need for MTM initially came out of well known valuation problems in the early 2000s including Enron and the dot-com era".

"Fair value reporting is designed to explain a fund's financial condition and its performance".

Most industries have been financially affected by COVID-19, with the exception of maybe healthcare, financial services, and technology. Valuations of private equity and private debt securities are therefore currently in the spotlight amidst COVID-19.

For March 31, 2020 valuations and looking forward in 2020, there are many more considerations than normal. Given that private equity interests generally fall into the level 3 category of fair valuation estimates, whether a true vetted valuation is being produced is even more important in times of global economic stress. A company's revenues, supply chain, customer base, Q1 shortfalls, available cash, outstanding debt, and ability to work or sell remotely need to be reviewed in light of COVID-19. With private lending funds, the analysis will be around each loan's par value; adjusted for surrounding market conditions, late payments, write-offs of bad debt, and the changing value of underlying collateral (e.g. receivables, land).

The importance on PE/VC valuation today lies in whether there are decreases in the valaution of the securities related to the sudden economic shut off, and whether a downturn in recent and upcoming revenue is being properly incorporated into the March 31 and June 30 valuations. While private equity LPs don't pay fees on unrealized appreciation, their baseline for paying management fees to the P/E fund manager often includes a reduction for any portfolio company impairments.

Further, it is important for investment managers to measure each company's performance accurately in order to help the companies succeed through difficult times. It is also expected that fund LPs will be able to monitor the value of their investments, so that there are no surprises later in the life of the fund. While private equity has long been a preferred asset class, especially in the last 5 years, past economic down turns, for example the dot-com era, resulted in negative IRRs for otherwise highly reputable and sought out private equity funds.

Historically, there has not been a lot of volatility in P/E valuations since FAS 157 went into effect in late 2007 (now known as ASC 820). Private equity valuations have been mostly marked upwards to reflect last round of funding, growth in sales, or other types of events; it is not however very common to see write-downs on private securities. With that said, the write-downs are typically taken with securities of a company that has undergone some type of negative event (e.g. litigation, sale, DOJ investigation).

In summary, applying visual mark to market changes on private equity and debt investments is required under GAAP and expected by investors and regulators. Documentation and commentary around intra-year changes will highlight the integrity around the valuation methodology and process.

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