



## Belief systems

Valuing portfolio companies has always been something of an art, but the only true valuation is on exit, says **Jon Moulton**

**W**hen I first started working in venture capital in 1980 – when it consisted of just a few buy-out funds – managers and investors both relied heavily on cash in and cash out to decide if things were going well or not. It was pretty simple and pretty clear. You could only easily raise a new fund if you got some good, and preferably early, exits done. But that did not sit well with ambitious managers who were not keen on standing still and had a voracious appetite to do ever-bigger things ever more quickly. So managers started to value portfolio companies at the price of the latest – maybe the third – funding round. Mostly that was a fairly reasonable estimate of a market price, despite being somewhat objective.

Buy-out firms were different. Their portfolio companies were clearly more similar to businesses listed on a stock market and, as such, it was possible for managers to put a value on them. But this was perhaps not as objective as it might have seemed.

One large buy-out firm had portfolio values that barely twitched during the great financial crisis of 2007 and 2008. Their methodology was calculated using an estimate of the year-five EBITDA, multiplied by the 10-year historical market price to earnings ratios, then discounted using a rate based on the very low interest rates that prevailed at the time. Lo and behold, they arrived at a valuation that even an asteroid strike on earth would not move much.

The FCA has said it is looking at valuations of private businesses. Of course, estimated future profits are very much in the eye of the beholder. Variations, including that well-known, if elusive, ‘adjusted profits’, are commonplace today.

There is simply not enough data in the public sphere to know exactly what is going on in most funds, but at least the portfolio of one very large buy-out firm has not noticed much of the stock market turbulence of recent years.

### Risk of unknowns

In both buy-outs and venture capital there have been several pieces of good academic work revealing that valuations, especially for weaker-performing funds, tend to perk up remarkably sharply ahead of a fundraising. Caveat emptor for the investor.

While there are now industry standards on valuations – and even ‘audited’ valuations – in practice there is usually still plenty of scope for inventive minds to reach the desired outcome. The issue becomes very much harder in venture capital. Portfolio companies have all kinds of unknowns and risks. They don’t typically have meaningful financial statements. Technology, management, regulation, competition, government policies and funding are just a few items on the list of variables. But the general rules of markets still apply. Real values are only apparent on exits, and then only on cash deals.

But the money poured into the venture capital asset class over the past few years pushed investment prices up and this was, of course, reflected in valuations. The private world disconnected more than usual from the public markets, with entrepreneurs offering fresh investments on the basis of not very robust indicators of present or future exit value, such as being based on the forward revenue multiples used to value another manager’s deal. Valuations lifted, taking the valuation of the funds up with them.

‘Returns’ for venture funds began to consist of more than 70% unrealised valuation and less than 30% actual exits. More investors entered venture capital funds as these ‘returns’ moved upwards. Unsurprisingly, there have been some very large drops in value as both the cash and the over-optimism ran out.

Permanent capital vehicles for private equity typically trade at discounts to the net asset value of their balance sheets. It is not at all unusual to see these trade at a 30% – and sometimes more – discount to stated net asset value per share. Much of this discount must be ascribed to their investors’ disbelief in stated values. As we all know, belief always has its limits.

‘Unsurprisingly, there have been some very large drops in value as both the cash and the over-optimism ran out’