Avoiding Gray Areas Part 2: Documenting a Valuation's Subjective Inputs

David Mesner, Valuation Analyst | Ipreo Private Capital Markets

In our first article on valuation assumptions, we looked at the best practices for supporting four standard assumptions, including time to exit, volatility, interest rate on outstanding debt, and weight placed on financial performance.

In this follow-up segment, we will look at some of the main areas of a valuation report that benefit most from additional documentation and provide best practices for adding subjective inputs that help to shape a report and convey an opinion.

Subjective inputs in a report are just that: subjective. These selections are the drivers to best represent the company regardless of methodology selected, and while sculpting your opinion with the available tools at hand, there are plenty of metrics, comparable entries, and weightings from which to choose. Any subjective inputs that are selected—and especially customized selections for each new report—should incorporate the evidence behind these adjustments. This is not just for the reader's benefit, but for your own benefit as well. If you've ever tried to remember the thought processes that went into those inputs after any length of time, you know they're sometimes difficult to reconstruct.

The backsolve method

For the backsolve method, there are not nearly as many subjective changes that can be made. The backsolve hangs its hat on being one of the most objective views of a company's value, relying on the terms and conditions of the capital structure and pricing of the most recent equity transaction. However, there are some inputs that can adjust a backsolve's value where written support is a great addition to the report:

Market equity adjustments (MEA)

This is used more frequently when revenue has not yet accumulated to a significant level—normally in the early life of a start-up. Qualitative information is a great tool to help bolster the adjustments here, as there's not always a good picture to be drawn from financials alone. For example, a pharmaceutical application will have a longer runway before revenue is realized and more qualitative information may shift the value.

Normally, there is a wider range of adjustments as the transaction date moves farther from the valuation date as time passes. This will be industry specific, as some sectors represent different levels of equity shifts over time.

Volatility and time to exit

Volatility and the time to exit will be the largest contributors to fluctuation in the backsolve method because of their influence on said value. The first article in this series discussed general assumptions around volatility selection, including the use of an entire sector.

Volatility is usually derived from either a pre-determined list of public companies, or, in some cases, by creating a custom sector to best encapsulate the subject's volatility. In either application, it is best to outline the reasoning behind volatility selection or include possible company lists used to determine volatility when regression analysis or other general assumptions are not followed.

CONTINUED ON THE NEXT PAGE...

The market approach

This is where the real fun begins. The market approach segment of methodology includes lots of inputs and plenty of selections to be made when shaping a market approach value.

No matter where weight is applied, the metrics selected should be best suited within a specific market. Some industries are more revenue-based when looking at value since the companies operating in the space (even those that are public) are normally not operating at a profit. Conversely, some industries will rely more on profitability to determine its best performers. In most cases of venture-stage companies that are still developing, revenue will be the heavy favorite here.

The weight applied in a market approach could be revenue versus EBITDA performance: growth, risk, and profitability. In this case, it's good to ask yourself: How has the subject performed versus the comparables? Where would the company fit in the mix of the comp list?

A market approach could also use historical versus projected performance—specifically when using a Guideline Public Company market approach. Ask yourself: What is the probability of meeting projections based on historical performance? Are projections reasonable or out of left field?

It is always good practice to review a set of comps and refresh the market data from one report to the next to assure a good comparison. For example, adding a new public company to a Guideline Public Company approach or a new transaction to a Guideline Transaction approach should be addressed in the footnote section to outline why the respective adjustment was warranted.

When setting comparable company or comparable transactions for market approaches, keep in mind that one major focus is changes in these inputs from one period to the next, with removal of comparable information scrutinized more heavily than additions. Conversely, while adding a handful of comps in 3, 6, or 12 months down the road will gain some attention as well, any reasonable additions made can be easily explained in footnotes.

A revenue or EBITDA multiple selection including quantitative comparison is paramount when developing an opinion through a market approach. There are two different market approaches to consider here (Transaction and Guideline Public Company), but both rely on available market data. Then multiples are derived from a group of comparable selections and applied to the subject's financial metrics. When selecting a single multiple or set of multiples, include a general outline to explain why it is the best choice out of the available selections.

When weight is applied to different approaches to reach a value, highlight which method is most applicable and why.

Make documentation a habit

These inputs don't encapsulate all subjective adjustments for reporting purposes, but they give you a general idea of what will be on the horizon. The reports require a specific perspective on the investment that helps to make these decisions once the groundwork is laid. Even if you can answer the question, "Why was this chosen?" by only looking at the report, it is still a best practice to document your reasoning for subjective selections.

In any portfolio, there will be a portion of these inputs that will stand out, and that's okay. It's just a matter of preparing suitable support for those selections based on the information and financial performance that can be collected from each investment.

And as recommended in the first article: when in doubt, add a footnote!

For more information contact Ipreo Private Capital Markets at PCM-info@ipreo.com