Portfolio Valuation : news features from the last IPEV publication

Thomas HACHETTE, SORGEM Evaluation Partner, Judicial Expert before the Paris Court of Appeal and the Administrative Courts of Versailles and Paris

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The IPEV[1] recently published a new version of its guidelines on the valuation of unlisted investments held by investment funds. The main changes relates to reinforced guidance on valuation in times of crisis, analysis of offers and transactions and ESG criteria.

Proper valuation of private equity portfolios is key as private equity investors must fulfill their fiduciary duties by monitoring invested capital, reporting performance to investors on a regular basis, and sometimes preparing financial statements in accordance with applicable accounting standards. These assessments can also impact asset allocation decisions, manager selection, and affect the compensation of funds and their teams. Since 2012, the IPEV has issued recommendations for periodic fair valuations of investments made by funds, which it updates regularly. The latest publication is from December 2022, and here we present the main developments we can see in it compared to the previous 2018 guidelines.

1. Valuation in times of crisis

The recent turmoil in the financial markets, with a sharp fall in March 2020 and a rebound of unprecedented speed, has certainly prompted the IPEV to provide new guidance on valuations in times of crisis. The IPEV thus reminds us that the Fair Value is determined on the basis of the market conditions existing at the valuation date. Thus, it is not because the markets are in crisis that one should consider that the transactions carried out on these markets are not relevant for the valuation. Practices that may have existed, such as the rejection of a stock market price without a detailed and relevant economic reason for retaining the acquisition cost (even if the investment is relatively recent), cannot be accepted, given that the rejection of the stock market price because of financial markets in crisis should not be considered as a valid reason[2]. Similarly, the practice of retaining the entry multiple, applied to the company's latest available results, cannot be considered in line with the IPEV's recommendations and would risk leading to an overvaluation of the investments when the markets are in crisis.

However, vigilance is also required to avoid undervaluing investments in times of crisis. For example, the IPEV reminds us that when the stock market multiple method is used, it is necessary to ensure consistency between the way in which the multiple is calculated for comparable companies and the way in which this multiple is applied to the company being valued. Thus, the valuator must analyze whether the results of the comparable companies have been adjusted to take into consideration the economic impacts of the crisis: if this is the case, the multiple must be applied to the adjusted results of the company being valued.

2. The valuation of a block of listed securities

The IPEV states that if a fund holds a stake in a company whose shares are listed on a sufficiently deep and liquid market, the value of the line should correspond to the stock market price multiplied by the number of shares held, without any discount, even if the block of shares held is much larger than the volumes usually traded on the market. This recommendation may come as a surprise when one considers the discounts that can be

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[1] International Private Equity and Venture Capital Valuation Guidelines (last publication of December 2022, that we compare to the guidelines released in 2018).

[2] This may echo certain practices that may have been denounced by the AMF and led to sanctions (see SAN-2018-01 - Decision of the Enforcement Committee of December 29, 2017 regarding the company A Plus Finance).

observed on accelerated bookbuilding (discounts that are generally all the greater the larger the block of shares appears to be compared to the volumes usually traded on the stock market).

3. The latest offers received: a good indicator of Fair Value?

The IPEV continues to consider that indicative offers recently received from third parties may be of interest for the valuation, provided that the context of the offers is looked at with great care. However, in its latest guidelines, the IPEV goes even further in the necessary distance that must be taken from indicative offers, by specifying that they should often not be considered as the sole basis for valuation: rather, they should be considered as one of the references to be weighted or cross-referenced with other references or valuation methods (with the weighting of each reference varying according to the evolution of the negotiations).

4. Reinforced focus on the reference to a recent capital transaction to deduce the value of the shareholding & recommendations on the valuation of securities issued by a company with a complex capital structure

The IPEV draws attention to the fact that the share price of the last fundraising (involving third parties) should not be automatically used to value the holding: in cases where several classes of shares coexist, the valuation should take into account the difference in value that can be attributed to the different classes of shares. The IPEV thus points out that the value often communicated in the press, which corresponds to the total number of shares of the company multiplied by the price per share paid at the time of the last fund raising for securities benefiting from the most important preferences, is often overestimated.

We have indeed seen in the last few years many issues of preference shares, and in particular so-called "simple" or "double" preferences which are supposed to guarantee to their investor to recover one or two times their initial stake (if the sale value of the company allows it), if necessary by diluting the other shareholders. The IPEV recommends taking into account the different economic rights of the shares in the valuation, notably through a scenario or option method. Indeed, this type of preference shares can be seen as equivalent to the holding of an ordinary share and a put option.

While the IPEV's strong recommendation on the subject seems to make a lot of sense, it may sometimes come up against the historical practices of certain investment funds and the difficulty of the teams in charge of valuation to master the specific valuation techniques that this requires: our survey of investment fund stakeholders carried out in 2019 showed that 56% of respondents did not carry out a differentiated valuation of the categories of shares and that 48% did not master the specific valuation methods required for their valuation[3].

5. ESG criteria & valuation

While ESG criteria played a very minor role in the previous guidelines, a specific section is dedicated to them in the latest publication.

However, no revolution is expected on this subject. In summary, the IPEV reminds us that investors are paying more and more attention to these criteria and that they can, in different ways, impact the valuations.

And it seems quite normal to us that the IPEV cannot issue very detailed valuation recommendations on the subject. Taking ESG criteria into account in the valuations seems to us to be far from obvious: it is already very difficult to get an idea of a company's "ESG performance" (for example, we can recall the case of Orpea, which in 2021 highlighted the good scores it had obtained from a number of extra-financial rating agencies, which were finally undermined by the book "Les Fossoyeurs" by Victor Castanet, the result of three years of investigation), and this would be only the first stage of the valuation process! It would also be necessary to carry out this same work on the companies in the sector used in the valuation methods (panel of comparable companies used in the multiples method and/or to assess the discount rate in the DCF method) and to define a method for estimating the premium or discount related to the ESG rating. Quite a program for the years to come!

The latest IPEV publication reinforces the previous one by highlighting some of the current valuation issues that can lead to errors with significant consequences. It reminds us that valuation requires specific expertise, and also highlights the importance of the independence of those who conduct or review the valuations.

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[3] "Survey on investment fund valuation practices", T. HACHETTE, SORGEM Evaluation, August 2019.