GUEST COMMENT

Public market pricing: an imperfect basis for private company NAVs

The pricing puzzle

Existing valuation methods don't cut it. Cyril Demaria asks what the fair price of a private company actually is

As governance slowly permeates private equity, the validity of net asset values (NAV) of private equity funds is under scrutiny. An example has been provided by the European AIFM Directive projects, which would create a third party evaluator to review fund managers' NAVs. The question is: how? And more specifically under which principles?

Our conclusion is that no third party will put its credibility on the front line by either certifying the NAVs of private equity fund managers or by producing alternative ones. Additionally, the generation of different NAVs for a given portfolio company in different private equity funds (which is likely to happen) would surely ruin the credibility of the process. Hence, the certification of a valuation process with an emphasis on the means will probably emerge. A rule-based automated "second opinion" on the NAVs produced by a general partner would be the next "best practice". This automated process could be viewed as an equivalent of "value at risk" or sensitivity test for the NAVs produced by fund managers.

However, this does not answer the central question: what is the fair price of a private company? Two methods are basically applied so far: discounted cash flows (DCF) and the comparable methods. The DCF method is criticised for being too sensitive to growth and discount rates, as well as to the calculation of a terminal value. Discount rates are implicitly given by comparables.

For that reason, the comparable method remains central, notably in venture capital where cash flow projections are far from reliable. The assumption is that listed companies are evaluated on a quasi-permanent basis by buyers and sellers. By gathering a set of companies close enough to a given private company, it is possible to derive the value of the latter (discounting here and there to refine the result). This relies on two assumptions:

i. That markets price listed companies correctly, integrating all the information available and reflecting the value of the company. This is regularly proven wrong, but the application of the comparable method should correct major biases, while a sufficiently large sample combined with the exclusion of outliers should provide meaningful information.

ii. That each listed company has a single price at any given point in time. This is probably one of the least questioned assumptions and totally wrong. This is, however, at the core of the debate.

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In fact, a given listed company at a given moment can have a different price, depending on how liquid a market is (in case of double listing, for example); on where its shares are exchanged (dark pool or stock exchange); on the quantity of the shares exchanged in the transaction; on the rights attached to these shares; and on many more factors. In fact, the market capitalisation of a listed company is wrongly assumed to be its total price. It is not. The price can be substantially higher. The rule of thumb assumes a 30 percent premium when private equity funds make a takeover offer. It can also be lower; for example, if the total number of shares of a company were to be sold in a single day.

This has three implications for the calculation of the net asset value of a fund:

• The rule goes that if a portfolio of private companies was going to be liquidated tomorrow, its price would be an equivalent – fair market value – of its listed comparable. However, listed comparables themselves are not in this situation ... unless they are being acquired, taken private or going into deep trouble. As a consequence, the fair market value of a private company does not provide the expected information: the value of the asset under normal and on-going circumstances.

• Comparing the purchase price of companies by private equity funds with the multiples of listed companies is not methodologically correct. If the market capitalisation does not reflect the price of a listed company, then its ratios are not reflective of the value compared to a meaningful result, such as EBIT, for example. In that respect, the argument could go that maybe the real price of a company is the price paid for a significant ownership stake (for example 15, 20 or 30 percent) and hence is the price paid by private equity funds. Investors in listed companies, meanwhile, are actually owning shares regularly trading at a discount. That would mean that liquidity implies a discount – and that illiquidity implies a premium – which is puzzling.

• As much as the private equity asset class discloses information, notably the price paid for portfolio companies and the multiples involved, it will slowly create its own pricing referential. There is no objective reason to keep this information confidential, as it does not harm the underlying portfolio companies. Of course, the question is about the frequency of the deals done and the number of operations. The capital deployed by private equity funds each year represents roughly 1.5 percent of the total cumulated capitalisation of listed companies. However, given what was said above, this measure may not be appropriate: if every listed company is sold tomorrow, the total market capitalisation would be drastically different than the one today.

The growing volume of funds deployed via private equity, and the fact that virtually all imply a significant or a full transfer of ownership, means that sooner or later, private equity may become its own reference for pricing companies ... and even shake the foundations of listed company pricing. That event alone would be the birth certificate of a new asset class. ■

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