



HOW PRIVATE MARKET VALUATION METHODOLOGIES HELP TEMPER VOLATILITY

Differences in available data and timing help explain how private equity can outperform public equities with less perceived volatility.

Recent market volatility has many investors searching for assets that can deliver a smoother ride. Public equity markets are known for their transparency and real-time pricing, which can be significant volatility drivers, especially during periods of crisis when emotional investing runs high.

In contrast, private markets are opaque, highlighted by relatively long hold periods, a lack of observable market prices, and less frequent reporting by fund managers on the financial performance of their underlying portfolio companies. While most private fund managers closely monitor their companies, often speaking with them weekly or even daily, they report to their investors on a quarterly basis. This can make it difficult for investors to evaluate the overall performance of their holdings between quarters. While this dynamic is often overlooked under normal market conditions, many investors are relieved not to have to experience the daily volatility in this segment of their portfolios. For investors new to the asset class, there also may be a heightened interest in better understanding the reporting lag and valuation methodologies.

DIFFERENT VALUATION AND REPORTING METHODS IN PUBLIC AND PRIVATE MARKETS

While private market valuation methods can appear less transparent and slow compared to public markets, they also tend to be more measured. And even though research indicates that the performance of private companies have a relatively high correlation to public equities,¹ the fact is that investors in private funds are purposefully choosing a longer-term investment approach and are placing the decision of when to sell underlying companies in the hands of the fund managers who are closest to the assets and generally wait for opportune times to exit each individual investment. Moreover, public company valuations comprise only one of three major elements of how private equity firms calculate their fund values (more on that later).

As a result, private equity investments have historically been less volatile, which has proven true in past recessions. Public assets are traded on a daily basis, so prices reflect not only the financial results that a company reports, but also investor sentiment, which may include market trends or recent news about that business. Since these factors are accounted for in real time, it leads to far greater price fluctuation than we see in private markets, where any information from a given quarter is reflected at one time, weeks after that quarter ends.

The following charts illustrate how private equity funds performed relative to public markets during the dot-com bubble in the early 2000s, as well as during the Great Financial Crisis (GFC) later that decade.

PERFORMANCE OF PUBLIC VERSUS PRIVATE EQUITY DURING RECESSIONS

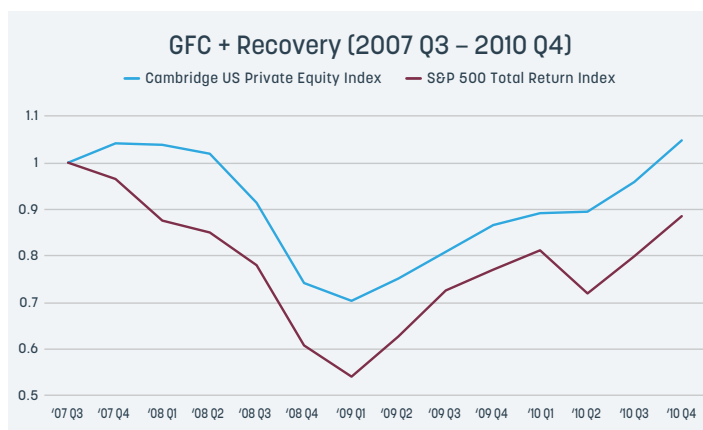
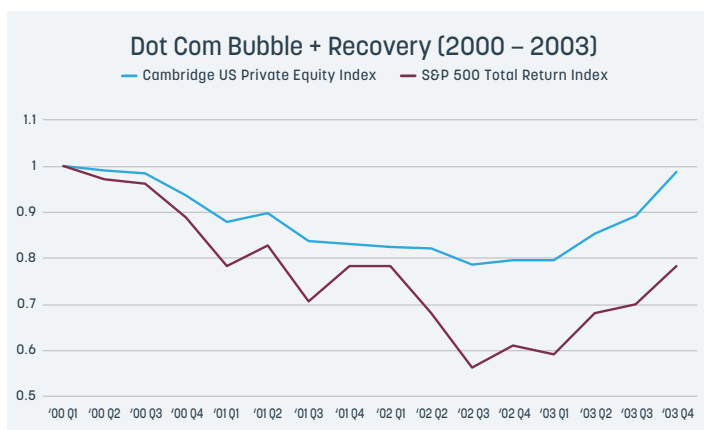
During the dot-com bubble, private equity funds (measured by the Cambridge US Private Equity Index), fell by 21% from the first quarter of 2000 through the third quarter of 2002. They then gained 26% over the following five quarters, bringing the index close to its pre-crisis levels by the end of that stretch. Over the same time periods, the S&P 500 Total Return Index fell by 44% before a subsequent 40% gain. It did not return to pre-crisis levels until late in 2006.

During the GFC, private equity fell by 30% from the third quarter of 2007 through the first quarter of 2009. The index returned to its pre-crisis levels by the end of 2010, delivering a 49% return during that recovery period. During the same time periods, the S&P 500 contracted by 46% before experiencing a 64% gain. However, it took until early 2012 to fully regain its losses from the sell-off.

Both instances suggest that private equity managers tend to be less aggressive in marking down their portfolios during a downturn and correspondingly less aggressive in writing them up during a recovery. Over the full cycles, private equity funds have outperformed public markets. This suggests that private investments can provide investors with both higher returns and lower perceived volatility than their public counterparts during a recession.

We are still in the early stages of the downturn caused by COVID-19, but today's market appears to be following a similar pattern. Preliminary data gathered by Hamilton Lane

Exhibit 1: Comparing Private and Public Equity Performance During Downturns



Source: FactSet and Pitchbook. For illustrative purposes only.

suggests that private funds marked their portfolios down by about 10.9% on average in the first quarter of 2020.² By comparison, the S&P 500 Index was down by approximately 19.6% for the quarter. While public markets regained a significant portion of those losses during the second quarter rally through mid-June, the rebound has come with high levels of volatility, which we do not expect to see from private investments.

PRIVATE VALUATION METHODOLOGIES TYPICALLY FOLLOW A CONSISTENT FRAMEWORK

While publicly traded securities are valued based on quoted prices in liquid markets, there are typically no observable prices that can be used to value a privately owned asset. As a result, managers must use a variety of other inputs to determine the fair value of their holdings. To accommodate this process, most private equity managers use Financial Accounting Standard 157 (FAS 157), which was developed by the Financial Accounting Standards Board (FASB) to set a consistent framework for valuing assets in the absence of observable, quoted prices. The main inputs used in this process are 1) public market comparables (“comps”), 2) private transaction comps, and 3) discounted cash flow models.

Public market comps look at a set of similar publicly listed businesses operating in the same sector as a given portfolio company to determine the average price/earnings (P/E) ratio at which they trade. That number is then applied to the trailing 12-month (“TTM”) EBITDA (or in some cases projected forward EBITDA) of a private company to estimate its fair value.

Private transaction comps take a similar approach, but instead of examining publicly traded securities, they look at the purchase price multiples of private deals for similar companies. The average multiple of purchase price-to-EBITDA across that dataset is then applied to the portfolio company’s EBITDA to strike a value. In many cases, this can be the best indicator of a company’s value, as an adequate set of publicly listed businesses with truly comparable business models may not exist.

Finally, the discounted cash flow model estimates the fair value of a business by calculating the present value of its future cash flows. To do this, a manager must project the earnings of the company over the next several years, as well as its terminal value at exit. The model would then apply a discount rate to these amounts, which represents the required rate of return on the investment. The resulting

figure gives the manager an approximation of the asset’s value. It is important to note that the terminal value can often be difficult to project because the market price of an asset (which is typically expressed as a multiple of EBITDA) can fluctuate under various market conditions, and may contract during a recession.

Most private equity managers use a weighted average of these three methods to assess the value of each portfolio company. While managers may vary in how they weight each method, and some may be more aggressive than others in adjusting their marks, this provides a basic framework that should lead to some level of consistency in how valuations are determined across the private equity industry. This has been particularly true in the decade following the Global Financial Crisis (GFC), as auditors have generally applied greater scrutiny in examining the subsets of public and private comparables that are used by managers as well as the inputs that are used in the DCF models.

WHY PRIVATE EQUITY VALUATIONS LAG BEHIND PUBLIC MARKETS

Given the greater number of inputs used to value private assets versus public assets, as well as procedural hurdles, which often include annual audits and third-party valuations, the process of striking a net asset value is conducted on a quarterly basis and typically takes several weeks. This means that new data regarding a company’s performance is not reflected in actual valuations until statements are released, typically 45-to-60 days after quarter-end. During normal market conditions, this reporting lag does not generally draw much attention, however in times of high volatility, it can be both a source of some relief from the market swings and anxiety as the quarterly valuations are finally disclosed, revealing the actual impact. In response to the current pandemic, many businesses across the world were forced to shut down in March 2020, leading to a sharp decline in revenues. While public markets were quick to respond by selling off risky assets, the effects of the pandemic were not seen in private market valuations until mid-May or later. In the meantime, many private equity managers were just finalizing valuations from Q4 of 2019, which were not only much rosier, but were no longer relevant and created confusion for some investors. Further, when Q1 valuations were released, they only reflected the tip of the iceberg, as most businesses were operating as normal for the first two-plus months of the quarter. The real impact of the pandemic will not be seen until Q2, but those financial results will likely not be fully reflected in valuations until August.

IMPLICATIONS FOR INVESTORS

Investors in private markets need to be aware of the differences in valuation methodologies between public and private markets to properly assess the performance of their portfolios. During times of sharp economic downturns, investors will not see the full impact on their private investments for several months. Conversely, it may take longer to see gains during the recovery. It is therefore important that investors understand the methodology process and expected time horizon of their investments.

Private equity funds are intended to take a long-term view that allows them to execute multi-year value creation plans and capitalize on longer-term market trends to outperform public markets over an extended time period. A proper evaluation of performance requires patience and an understanding that immediate feedback will not always be available. However, the reporting lag has historically been worth the wait, as private markets have demonstrated the ability to deliver outsized returns with lower levels of volatility than public markets.



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END NOTES

All performance, assets under management, number of employees/investment professionals, offices, and active investments are as of December 31, 2019, unless otherwise stated.

1. Refers to the correlation between the Cambridge Private Equity index and the S&P 500 Total Return Index for the 20-year period ending March 31, 2019.

2. Source: Hamilton Lane. *COVID-19 and Market Update*. May 26, 2020.



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