# Post-investment valuation considerations for private equity funds in the current market condition

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Following the unstable period of the pandemic, the private equity fund investment industry has been increasingly focused on compliance in the context of changing geopolitics and the active guidance of China's capital market policies. Limited partners of private equity funds are particularly concerned about post-investment changes in the value of private equity fund portfolios, making post-investment fair value valuation a key focus for various private equity funds and funds' general partners. Private equity fund investment companies are often privately held, concentrated in emerging industries with many companies in their early stages, which brought challenges in post-investment valuation due to the difficulty and uncertainty involved.

This article will introduce the prevailing post-investment valuation regulatory system, commonly used valuation approaches and frequently discussed subjects in private equity funds.

## Overview on the post-investment valuation regulatory system

The limited partners of private equity funds typically consist of insurance companies, commercial banks and trust firms operating within the asset management sector. Regulatory bodies such as the former China Banking and Insurance Regulatory Commission (CBIRC), the National Administration of Financial Regulation, the Ministry of Finance (MOF), the China Securities Regulatory Commission (CSRC) and the Asset Management Association of China (AMAC) have actively published documents pertaining to valuation.

Regarding domestic standards, the MOF revised and released China Accounting Standard 22 - Financial Instruments (CAS 22) in 2017, with latest adoption date as of 1 January 2021. CAS 22, along with CAS 39 - Fair Value Measurement, forms the core accounting standards that must be adhered to for the post-investment valuation of funds in financial reporting. In terms of valuation standards, the China Appraisal Society has produced the "Guidelines on Valuation for Financial Reporting Purposes" and the "Guidelines on Asset Appraisal Practice-Enterprise Value." Additionally, the AMAC published the "China Fund Valuation Guidebook 2018," (Valuation Standards) which outlines comprehensive standards and guidelines for valuation practices aimed at fund professionals.

The International Accounting Standards Board (IASB) has established International Financial Reporting Standard 9 - Financial Instruments (IFRS 9) in alignment with international standards. Additionally, the International Private Equity and Venture Capital Valuation (IPEV) Council revised the International Private Equity and Venture Capital Valuation Guidelines ("Valuation Guidelines") in December 2021, which is being closely monitored by the EY team.

For the purposes of financial reporting, it is generally expected that fund managers will assess the value of each individual investment based on fair value at each valuation date. The Accounting Standards define fair value and outline its application along with the fair value hierarchy. Furthermore, the Valuation Standards and Valuation Guidelines offer direction on the appropriate valuation methodologies for estimating fair value, thereby establishing a theoretical framework for the post-investment valuation practices within the private equity fund sector.

# Valuation approaches

## 1. Commonly used valuation approaches for funds' investments and key considerations

The approaches typically employed for post-investment valuation of private equity funds consist of the income approach, the market approach and the cost approach, specifically:

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| Market quote | ► Evaluating fair value in relation to publicly available market prices. |
| Reference to the latest financing price | ► Employing the original cost of an investment or the expense of a recent acquisition as a benchmark for fair value assessment, alongside various other approaches. |
| Market multiplier | ► Assessing fair value through relevant valuation multiples derived from similar companies or transactions, as well as the enduring earnings of the entity under consideration. |
| Industry indicator | ► Examining fair value in light of specific market indicators, including subscriber counts. |
| Discounted cash flow | ► The assessment of fair value involves evaluating the anticipated profitability of the company.<br>► The analysis of fair value is conducted by examining the projected earnings of the company. |
| Guaranteed income | ► Investments that come with guaranteed or repurchase conditions are evaluated by integrating the outcomes of guaranteed returns alongside other valuation methodologies to determine the more favorable option and potential exit strategies. |
| Net asset (cost) | ► The fair value of net assets is established by appraising each asset category within the company. |
| Net fund value | ► In instances where the investment project is another investment fund, the fair value is determined by assessing the proportionate share of the relevant fund, while considering the net asset value attributable to the limited partners as reflected in the fund's net worth report, financial statements, balance sheet, and valuation documentation, among other available resources. |

The selection of valuation approaches typically hinges on the specific attributes and characteristics of the company under consideration, the basis of value, the accessibility of pertinent information and data, as well as the exercise of professional judgment.

In the context of early-stage companies and emerging industries, which often seek capital on a frequent basis, the most prevalent post-investment valuation approach employed by private equity funds is to reference the most recent financing price. When utilizing this method, it is essential to assess the appropriateness of using the recent financing price as a starting point for fair value estimation. If, for instance, there are no significant new investors participating in the latest financing round, the financing amount is not substantial for the company being valued, or if the company is experiencing a crisis that necessitates a rescue investment, the financing price is generally not regarded as the most accurate reflection of the company's fair value. Additionally, the relevance of the recent financing price diminishes as the time elapsed since the financing completion increases. If there have been considerable changes in the primary business operations or strategy of the company being appraised following the latest financing round, or if there are notable shifts in the macroeconomic landscape, competitive dynamics, or industry regulations affecting the company, it is typically necessary to adjust the latest financing price for subsequent valuation assessments.

In practice, it is observed that private equity funds frequently incorporate clauses for guaranteed repurchase or protected returns within their investment agreements to protect the interests of investors. For investments that include such guaranteed return or buyback provisions, the protective value of these guarantees should be taken into account. During the valuation process, this aspect is typically evaluated alongside the market multiplier approach. If the outcome of the market multiplier approach exceeds the present value of the guaranteed returns stipulated in the agreements, the value of these guarantees does not be considered. Conversely, if the market multiplier approach yields a result lower than the present value of the guaranteed returns, a thorough analysis of how the different valuation approaches affect the fair value of the investment portfolio company, along with the probability of activation of the guaranteed terms, becomes essential.

In the valuation of private equity funds through the market multiplier and discounted cash flow approaches, it is essential to conduct an analysis to ascertain whether specific discounts should be applied. Initially, if the entity being assessed is a private company or if there exists a liquidity-restricted equity interest in a publicly traded company, a discount for lack of marketability (DLOM) must be factored in, particularly in relation to the available and listed shares. Notably, private equity funds often rely on public listings as their primary exit strategy. In recent years, the China Securities Regulatory Commission (CSRC) has implemented clearer regulations regarding the reduction of shareholdings by shareholders of listed companies. Consequently, when evaluating DLOM in valuation practices, it is crucial to consider not only the illiquidity of shares during the restricted period but also to assess the overall impact of these restrictions on share liquidity in conjunction with the private equity fund's strategy for reducing its holdings. Furthermore, private equity funds, typically acting as financial investors with minor shareholdings, should also account for a discount of lack of control (DLOC) when appraising 100% of the equity of the company in question using the discounted cash flow approach.

## 2. Challenges in valuation for early-stage investments and responses

In recent years, private equity funds have notably intensified their early-stage investments in strategic emerging sectors, including semiconductors and biopharmaceuticals. However, conventional valuation approaches, such as market multiples and discounted cash flow analysis, encounter considerable obstacles when attempting to evaluate semiconductor and biopharmaceutical firms that have yet to achieve profitability.

For startups of this nature, the recent financing price method is frequently employed in their valuation, as these companies typically have not yet achieved consistent revenue or profit levels and are often involved in more regular financing activities. When applying this method, several critical factors are generally considered:

- The industry and developmental stage of the portfolio company, such as whether it operates in a research and development-focused or driven stage and sector
- The timing of the latest financing round relative to the specific valuation date of the portfolio company, along with any significant market or policy changes that may have occurred during that time frame
- The financial and operational performance of the portfolio company in relation to the initial investment expectations
- The adequacy of the portfolio company's cash reserves and any associated risks regarding its ongoing viability
- The achievement of significant milestones by the portfolio company
- The potential for a new round of financing for the portfolio company

In situations where there is an absence of recent financing prices, a portfolio company that has achieved a significant level of sales revenue but has not yet attained break-even can utilize income metrics as a multiplier. This includes ratios such as enterprise value-to-sales (EV/Sales) or price-to-sales ratio (P/S). The market multiplier method can then be employed to perform a valuation analysis of the portfolio company.

### 3. Updates to IPEV

Updates to the IPEV valuation guidelines have concentrated on aspects such as fair value measurements constrained by contractual terms and the consideration of environmental, social and governance IPE factors.

EY teams provided an analysis in 2023 regarding the updates: ([PE/VC Insight] Impact of the update to the IPEV Valuation Guidelines (2022 Edition) on the post-investment valuation of private equity funds)

## Frequently discussed subject in valuation

Private equity funds have various forms of investment, and the valuation of preferred shares and secondary funds (S funds) is a trending topic in the field of private equity fund valuation.

For the valuation of preferred shares, since they have specific preferential rights in liquidation and redemption scenarios compared to common shares, the valuation analysis of preferred shares needs to be analyzed based on the rights and obligations of different rounds of preferred shares agreed in the terms of the agreement and the probability of those scenarios of the preferred shares, so as to allocate the value of the equity of the company being valued between the preferred shares of different rounds and the common shares.

It is essential to consider the reasonableness of the valuation of the underlying investment projects held by the sub-fund for the valuation of the S fund. Additionally, attention must be given to the reasonable calculation of interests of the parent fund as a limited partner or general partner, in accordance with the relevant distribution clauses in the investment agreement of the parent fund. This includes assessing the reasonableness of the management fee and the carry. Furthermore, the introduction of relevant policies in Beijing and Shanghai has led to new exit option and valuation needs on a pilot basis, particularly in the trading of S-fund shares, creating opportunities for investors. Extended reading: (EY Insight: Market opportunities and valuation challenges for S funds)

### Conclusion

The EY Valuation, Modeling and Economic Advisory Services team possesses vast experience in private equity valuation, offering valuation services to numerous well-known private equity funds for pre-deal and post investment reference. Our team of skilled professionals in private equity fund valuation is ready for in-depth discussions.


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