VALUATION Q&A

BUSINESS DEVELOPMENT COMPANIES

VRC

BUSINESS DEVELOPMENT COMPANIES (BDCS) are increasingly mandating the use of valuation firms to obtain independent valuations for the more complex or hard-to-value securities in their portfolio. As new BDCs form and existing BDCs grow, Valuation Research Corporation (VRC) has received many questions from both boards of directors and partners about the portfolio valuation process. The following is a conversation with VRC's John Czapla, Parag Patel and Shane Newell who address questions about best practices in BDC portfolio valuation. VRC's portfolio valuation practice works with more than 25 BDCs.

Q: HOW DOES A TYPICAL VALUATION PROCESS FOR A BDC PORTFOLIO WORK?

A: The process begins at a high level as we seek to understand the scope of the fund's investments. What is the fund's composition between credit and equity securities? On which market segment does the fund focus (upper, middle or lower)? Does the fund have any industry focuses or does it operate agnostically across industries? Accordingly, we initially strive to understand the manager's investment selection process and the nature of the fund's portfolio investments. Once we understand the investment thesis and portfolio, VRC focuses on their valuation process. First, how many securities are outsourced to third parties and what is the timing of such valuations? This is generally determined by the BDC's valuation policy. Given that traded BDCs file with the SEC and publicly report on a quarterlybasis, the vast majority of these BDCs perform quarterly valuations.While the utilization of an independent valuation firm varies among BDCs, many do use a valuation firm to perform 100 percent of their quarterly security valuations. Other BDCs employ a sampling approach in which they use valuation firms to provide independent valuations for 25 percent of their holdings each quarter, which allows them to then rotate through their entire portfolio once a year. Additionally, many BDCs have a watch list of underperforming credits, which are valued more frequently, if necessary.

When VRC receives a list of securities to value from our clients, we gather information from the fund manager for new investments, or first-time valuations, and any new information on existing investments. The new investment information often includes credit documents, articles of incorporation, ownership tables, fund investment memoranda, and financial projections.

For recurring investments, we look for any amendments to the credit agreement, updated ownership or capitalization tables, updated financial information, updated financial projections, any current investment management presentations, and any updated internal fund memos or valuations. At each valuation, VRC has conversations with the BDC analysts to understand deal terms and gather information on the investment. We also conduct our own research on comparable companies, comparable securities, and comparable transactions, and gather general information on equity and credit markets. Financial reporting deadlines, scheduled board meetings, and often an audit review ultimately dictate the valuation process timeline. To meet critical client reporting deadlines, we often need to complete our valuation conclusions on the month end or quarter end valuation date, up to about seven days post valuation date. Accordingly, we work backward from the client's deadline to allow approximately three to four weeks to complete the valuation process. To facilitate communication with VRC team members and the client, we establish deadlines for when information is due from the client to VRC, when due diligence meetings and/or conference calls are to occur, and when the draft and final reports will be delivered to the client. One third of VRC's efforts are dedicated to requesting and collecting support information, conducting research, speaking with fund analysts, and building the valuation model. Another third of our efforts are focused on developing, discussing, and reviewing both the first draft and the final valuation report. The last portion of VRC's assignment includes participating in conference calls and meetings with auditors, investors, and the board to review the valuation.

Q: ARE BDCS GENERALLY LOOKING FOR A SIGNOFF OR ASSURANCE OPINION ON THEIR OWN VALUATION OR ARE THEY LOOKING FOR A NEW BOTTOM-UP VALUATION?

A: The type of valuation is driven mostly by best practices and limited internal resources to create auditable valuation analyses. Most of our clients prefer an independent valuation versus a positive or negative assurance opinion. We will conclude our valuation with a narrow range in values or a specific number, depending on the client's stated valuation policy. Occasionally we are asked to complete an assurance opinion in which we independently research and review a client's valuation model to determine whether the model is reasonable and if the inputs are appropriate. Generally, clients recognize this is a lesser opinion than a full valuation. In addition, board members generally understand the difference and know an assurance opinion is not as supportable or ntransparent, which opens them up to more risk because they ultimately must sign off and approve the BDC's valuation.

Q: WHEN YOU DRILL DOWN TO THE ACTUAL VALUATION PROCESS, HOW DOES IT VARY FOR DIFFERENT INDUSTRIES?

A: While the process is similar, the specific models and inputs can deviate among industries. VRC performs more than 2,000 valuations each year and is versatile because our firm has valued securities in many different industries. As generalists who cover all industries, it is important that we understand what drives value as well as which multiples and metrics should be used when valuing different companies. For some industries such as oil and gas, biotech, or pharmaceuticals, we do employ designated specialists offering focused expertise. VRC also has a real estate team that specializes in valuing real estate specific assets, which are more difficult to value and require a professional who hasspecialized valuation knowledge and expertise. Occasionally, we also rely on partner consultants for technical expertise, such as our geologists who work solely with modeling of geological estimates.

Q: HOW MUCH OF VALUATION WORK IS REACTIVE TO THE EXISTING NUMBERS VERSUS PREDICTIVE AND FORWARD LOOKING?

A: In many cases it is both, but it ultimately will depend on the information available. We receive quarterly or monthly financials and generally the current year's budget. We assess reasonableness of budgets or projections based on year-to-date (YTD) trends. For example, we will compare trailing EBITDA to the current year EBITDA budget. If trailing EBITDA is not tracking to budget, we will put little or no weight on that budget as a valuation basis. If current performance is tracking well ahead or well behind the original budget, we often receive a revised budget. In this case, if it is well above or below current YTD figures, we may put more weight on forward estimates as a better proxy for a current valuation basis. Overall, we generally factor in information that would be pertinent to any market participant when making a valuation or investment decision.

Q: WHEN COMPLETING A VALUATION, HOW OFTEN DO YOU INTERACT WITH THE COMPANIES? DO YOU ONLY INTERACT WITH THE ADVISOR OR DO YOU ALSO INTERACT WITH THE AUDITOR?

A: We do not often talk to financial professionals at the underlying companies, mostly as a matter of the scope of our engagements. Due to a fund's time and budget constraints, we are generally engaged to perform our analysis on information that is supplied to us. We must rely on the funds to collect and supply all information that is pertinent to the valuation. Ideally, the information that we are provided is exactly the same information the fund is using for its internal analysis. VRC requires clients to be fully transparent and supply us with all information in their possession. Ultimately, we want to view and know everything the fund manager knows, which requires working closely with them. We also work with auditors regularly and at least annually for the full audit of our valuations.

Q: WHAT HAPPENS WHEN A SECTOR DISLOCATES FROM THE GENERAL ECONOMY SUCH AS COMPANIES TIED TO THE OIL AND GAS INDUSTRIES OR FINANCIAL COMPANIES DURING THE GREAT RECESSION? HOW DO YOU ADAPT?

A: In a stable market, equity and credit securities generally have similar valuation metrics and tend to move within narrow bands relative to historical standards. But when markets dislocate, those once narrow bands can become quite wide. Having supportable market data compiled from both internal and external sources is key to providing industry-specific or sector-specific comparable data to support VRC's valuations. For example, with upstream oil and gas companies, we focus on similarity of geography, similarity of oil versus gas production, and reserve value metrics. Particularly in distressed markets, we rely on certain performance metrics such as leverage, cash flow, and liquidity levels. It is crucial to separate performing companies and their relative performance metrics from those that are not performing, and ultimately understand how each group relates to our subject company performance and metrics. For other industries, we focus on understanding specific industry metrics to see where our subject company fits.

Q: WHAT HAPPENS WHEN YOUR ASSESSMENT OF A CREDIT AND A PORTFOLIO MANAGER'S ASSESSMENT OF A CREDIT ARE WIDELY DIFFERENT? WHAT IF TWO BDCS OWN THE SAME SECURITY AND HAVE DIFFERENT VALUES?

A: VRC's process includes a discussion of qualitative and quantitative variables; we try to make sure we are all looking at the same facts. Assuming we have the same information the BDC has, we will complete our analysis and share our independent valuation with the BDC. When clients finalize their marks, if there are differences, it is important to identify reasons for a value that is different or outside of our valuation ranges to report to their board. Generally, valuation differences result from different data, different assumptions, or different timing. If it is caused by a lack of accurate information then the valuations can be adjusted accordingly to reflect accurate valuations. However, if the variance is due to a difference in opinions or outlooks, it is important to present that information to the board. There can be a variety of reasons for situations in which two BDCs own the same security and mark them differently. Generally, these differences are also caused by differences in data, timing, or assumptions. Two BDCs may each have different sets of financial data (e.g. November YTD data versus December YTD data), which may cause a difference in valuations, or there may be timing differences related to when each BDC invested in the security. Finally, the data and timing could be identical, which leads to an identical valuation range, but each BDC may choose different marks within the same range of values. The two BDCs may each have different forward views or analysis informing why one may mark it at the high end of the range and another may take a low or midpoint in the range. In most cases, we generally find that if two BDCs are using the same information and valuation timing, then the valuations should be similar or even the same.

Q: DO YOU FIND CLIENTS HAVE MISPERCEPTIONS ABOUT A THIRD-PARTY VALUATION PROCESS?

A: The biggest misperception we hear is, "Why should we use an external valuation service when our fund manager lives and breathes the investment and knows it so well?" While it may be true that some clients know a company better than we do, it is also true that VRC's professionals are very experienced and take the time to conduct a deep dive into our client's investment details. VRC has valued numerous securities and companies, and we get to know each company intimately alongside our clients over several subsequent recurring valuations. The more important point is understanding the real reason for the valuation. We generally provide valuations for financial reporting and therefore understand that the fair market value of a company or security requires deep knowledge and data about the market in which the company operates. This is where a third-party valuation firm differs from a fund's internal valuations. Also, our ultimate audience is often the BDC's investors and board, making an unbiased determination of current fair value extremely important. Some funds may hold the opinion that independent valuations are just another cost. However, the upfront valuation costs can be much less than back-end litigation costs from a regulatory review or an investor lawsuit, including the damage done to a BDC's reputation, if your internal valuations are deemed inaccurate or misleading.

Lastly, we sometimes hear that if the BDC is directly paying our fees, our valuations may not be independent. The fact is VRC's reputation for independence and ethics has kept us in business for 41 years. Our name and long-term reputation is too critical to risk by rendering biased opinions.

ABOUT OUR CONTRIBUTORS

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ABOUT VRC

Valuation Research Corporation is an independent, global valuation firm. Our global network of nearly 1,000 valuation professionals has provided objective, supportable conclusions of value for more than 45 years to domestic and international clients ranging from Fortune 500 companies to privately-held organizations of all sizes across all industries. VRC also works closely with private equity firms, attorneys, not-for-profit institutions, fiduciaries and individuals.

OUR CORE SERVICES INCLUDE:

Valuations of tangible and intangible assets, business enterprises and fixed assets

Financial opinions with respect to valuation in support of allocation of purchase price, goodwill impairment, stock based compensation, legal entities and deferred compensation

Solvency, capital adequacy and fairness opinions in connection with mergers, acquisitions, divestitures, leveraged buyouts, recapitalizations, financings, and financial and tax reporting matters

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