The Five Tools of Private Equity – Part Two: Evaluation

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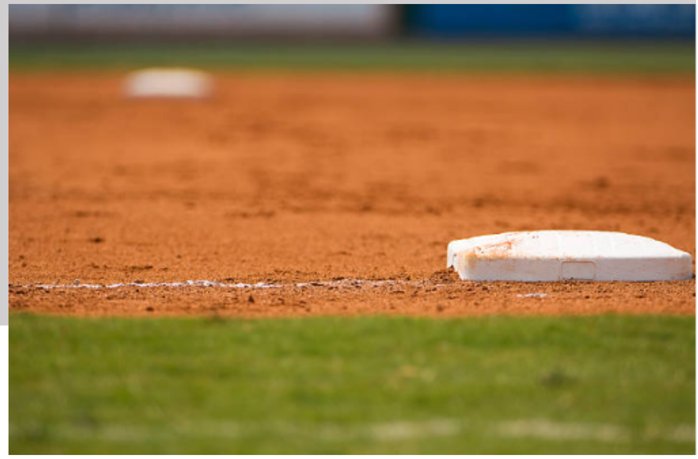
You have to know what you're looking at before you decide if you like it.



In our previous installment of the Five Tools of Private Equity series, we investigated the "sourcing" tool, how firms generate investment opportunities. Once the sourcing segment has done its job, now the investor has a tangible investment to consider: an actual company, with a willing seller, open to discussion on price and terms.

Now the critical review starts: how does the investor decide if an opportunity is worth more than a cursory review? A path forward has to be possible, if not yet certain: (1) the investment has to provide an attractive return given its risks, which is influenced by the total price paid and in what form it's paid; (2) the envisioned deal has to be actionable; and (3) it has to be relatively attractive given the investor's other prospects.

The investor's evaluation tool is how it arrives at the answer to the first of those three questions. In this installment, we'll explore how an investor thinks about investment evaluation, the tools and capabilities used, and the implications it has on the rest of the investment process.

Evaluation: Characterizing the Investment Opportunity

Evaluation, at its core, is the process by which an investor arrives at a range and likelihood of an investment's returns (its "return profile"). This can only be done by holistically assessing the business's performance and opportunities, while understanding the range and severity of its inherent risks, given a specific price and structure of a proposed transaction. Later on, the investor and his team can worry about whether the risk level is acceptable at any price, or if the price that makes the return acceptable is actionable, or if the overall return is attractive given its other prospects. All good questions, and all questions that require that the return profile of the opportunity is first thoroughly understood and characterized.

A well-characterized investment layers these three considerations in order: (1) a view on the future performance of the business under the ownership of the investor; (2) a quantification of the risks to that future performance, both specific to this business and general to any private company; and (3) a proposed price and structure for the transaction. We'll look at each in turn to see how they build up to a useful output.

Starting Out: The Investment Thesis

No investment opportunity can be evaluated without a starting point: a hypothesis of why an investment should make sense, or an "investment thesis." Included in the thesis should be a plan for what will be done with the business post-close, and the financial implications of those actions.

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For a minority investor without control, that plan might be "nothing," so the investment thesis will depend entirely on qualifying the current trajectory of the business. For an extremely hands-on investor, or an investor in a distressed asset, the plan may be a complete overhaul; in this case, past financial statements are almost meaningless, as the investor may intend to create a functionally new business out of the old one. Either way, taking the plan and using the investor's understanding of the current business's financials, operations, markets, an inclusive financial forecast (and ultimately a cash flow stream), combined with a specific plan for how the business will change under the investor's ownership, creates an analytical backbone onto which risk and structure can be applied.

Evaluating Risk

Risk is arguably the trickiest of these elements, as it has to be quantified to incorporate into the evaluation, but in real life it represents a variety of human, messy, qualitative elements that are challenging to reduce to numbers. To combat this complexity, most investors use proxies for risk to help evaluate an investment's overall profile. You may recognize some of these proxies from private equity firms' "investment criteria" website sections, as they make their way into the sourcing function as a pre-screening tool. These investment criteria might look something like this: *"At BlueGray StonePine Capital, we look to invest in mature, established, family-owned businesses with leading market share in defensible, growing markets; high margins and scalable operating structure; low working capital requirements and asset-light balance sheets; no seasonality or cyclicality, insulated from market swings; diversified customer and supplier bases; and a best-in-class in-place management team."* (Aren't we all.) Each of those elements represents a characteristic that lends itself to consistency and safety, implying that past performance is in fact indicative of future performance.

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Depending on a particular investor's capabilities and experience, these proxies might actually be used to filter opportunities early in the evaluation process to save time ("we pass on companies with >40% revenue concentration with a single customer"). It's not an actuarial analysis; you'd be hard-pressed to find a private equity investor who would be able to tell you how the likelihood of default rises with each additional 10% of customer concentration, and ultimately where boundaries should be set. More often, rules are dogmatic, passed down through "generations" of private equity principals, and originally borne out of a single poor investment outcome; maybe a business lost its largest customer six months after investment, so that firm is particularly sensitive to that occurring again.

If an opportunity makes it through all of an investor's risk-averse rules of thumb, it doesn't mean it's without risk. Someone must still assess the risks, aggregate them, and quantify them in some way that builds on the company's expected outcome to show how risk impacts the company's value.

Incorporating Risk into the Evaluation

Folding risk into the forecast is tricky. A discounted cash flow analysis would have you believe that a forecast with "mean" performance years, when an appropriate discount rate is applied, will result in an accurate present-day value of the business. But this approach does a poor job of accounting for different kinds of risk. The average dollar impact to a business in a single year of a rare, catastrophic event and a common, mildly bad event might be identical, but the insurance industry exists because different parties value those risks differently. More creative means than a single all-encompassing forecast have to be employed to try to describe a range of outcomes.

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Since it's challenging for the human mind to envision multiple variables at once, instead of attempting to describe the entire universe, most investors rely on presenting specific scenarios or "cases" to illustrate an outcome given a set of specific inputs—the spread in outcomes among the cases serving to communicate the riskiness of the investment. The analysis then becomes a question of "what do we have to believe for this specific outcome to happen, and is that a reasonable set of assumptions" instead of "boiling the ocean" and plotting out the entire probability curve of outcomes.

A common investment memo structure is to lay out and explain three cases: (1) a "base" case, or the investment team's best guess at the "average" outcome for the investment; (2) an "upside" case, which is the team's assessment of how much better the outcome could be, within reason, if all of the identified possibilities work as planned and on time; and (3) a "downside" case, which is used as a floor to understand what happens if the business gets unlucky or the investment thesis fails (often measured against credit requirements to see what kind of leverage is appropriate).

There's nothing wrong with this standard case approach, but my personal quibble is that the selection of the cases is often arbitrary. Knocking a few percent off the revenue growth forecast and calling it a "downside case" is not instructive, nor connected to actual events that could happen in the operations of the business (like losing a major customer, failing on a product launch, or construction delays).

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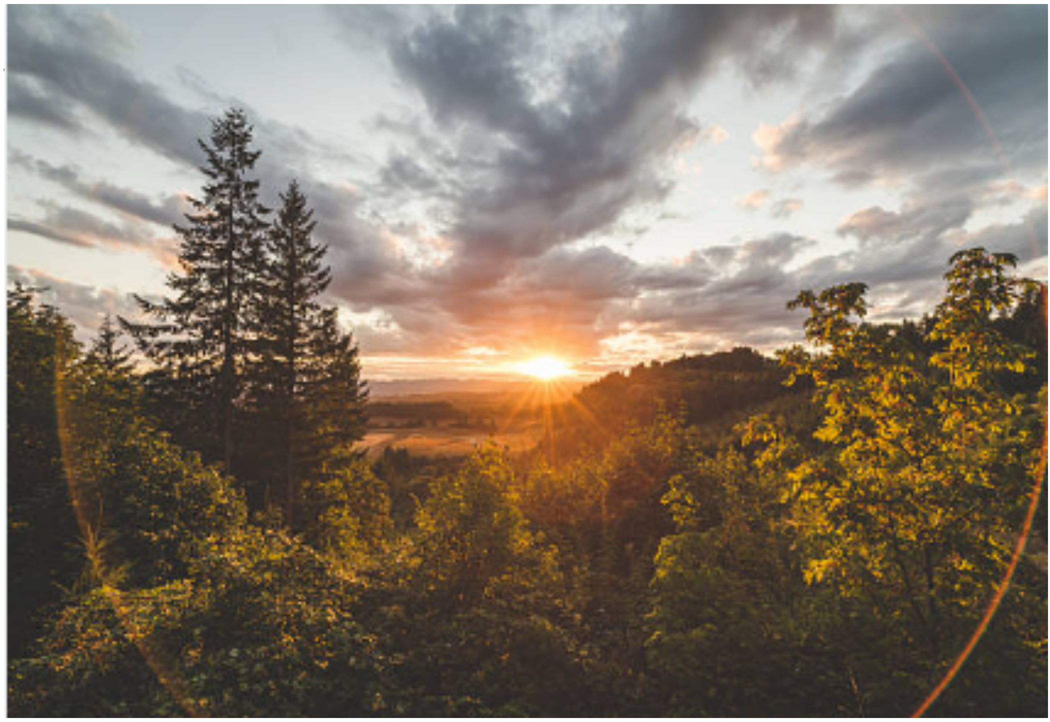
You'll also rarely find a defense of just how likely the cases are – does the downside case occur five percent of the time? Ten percent? How about the upside case – is it



of equal likelihood to the downside case? Business outcomes are often skewed or lumpy, and rarely follow a normal distribution. A cases approach can account for this reality if appropriately grounded in actual events but often is not.

Step into different investors' boardrooms and you'll find a very wide range of how deeply to characterize the riskiness of an investment. I've seen anywhere from a very basic base-case/downside-case returns comparison built from a five-line cash flow model to an intricate multivariate Monte Carlo simulation that plots a probability distribution function in much the same way that sports networks predict playoff outcomes by simulating a matchup thousands of times. It's instructive to keep in mind the oft-repeated aphorism in statistics: "all models are wrong, but some are useful." Everyone agrees that at some point there are diminishing returns to adding complexity to the characterization of an investment's risk, but opinions vary on where exactly to draw that line.

Price and Structure

As if this weren't yet complicated enough, let's build the third tier onto the wedding cake: applying price and structure to the transaction. For a long-only hedge fund manager investing in public equities, this is pretty simple, as the mechanism to buy a position is to buy common equity. In private equity, the mechanics for investing are more complex, and the use of structuring tools like earnouts, preferred equity, warrants, or liquidation preference makes the effective "price" dependent upon future performance.

It also starts to decouple the performance of the business from the performance of the investor; for instance, an intricately structured investment may trade upside (in the form of a higher price paid at close) for downside protection (in the form of a preferred interest on the assets of the business before other equity holders, in case things really go south). An investor that structures an investment advantageously can earn a solid return

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even if the business performs unspectacularly.

It will likely not surprise you that investors vary widely in their preferred use of structure in their investments. Some investors eschew complicated transaction mechanics (that can unsettle sellers in an already stressful process) in favor of simplicity, but that often means a lower price to justify the risk. Structure is a bridge; it allows an investor to justify a higher purchase price for the same opportunity because the structure adds some amount of certainty to the range of possible outcomes.

Putting It All Together

Now that an investor has put in considerable time and energy into building a return profile of an investment, it can be used to make decisions. The investor can consider if a return profile is attractive given its pursued investment style, or given other available opportunities. The investor can also consider if the investment is actionable, as even the most fantastic return profile might not overcome an unreliable seller that might pull out of the deal at the last minute. These factors and others are important to an investor’s consideration of moving an investment forward or to the graveyard, but they are impossible to consider without the evaluation analysis providing the necessary context.

Evaluation In Relation To Other Tools

Many budding private equity professionals believe this tool is the one where they’ll spend the majority of their careers: in a board room, surrounded by intricate and deeply-researched investment memos, arguing the finer points of investment structures and risk characteristics, invoking Ben Graham and Howard Marks. Or at least I did. (Heady stuff, I know.)

In truth, except for in specific niches of the investment world where outcomes are very uncertain and structure plays an outsized role in developing a return profile, there’s only marginal value in pouring additional resources into building out a market-beating evaluation tool. The benefits of precisely evaluating a deal’s merits past a basic threshold can be easily overwhelmed by other capacities, and as a result, most private equity firms’ deal evaluation is “good enough” but ultimately undifferentiated in the scope of all investment professionals. Nobody likes to hear that—I’ve never met an investor that didn’t think he was smarter than the average bear—but evaluation is rarely a source of value to the investor to the extent some of the other tools can be.

Having now looked closely at the sourcing and evaluation tools, our next installment of the Five Tools of Private Equity will look at the tool nearest and dearest to the investment banker’s heart: transaction execution.

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