

Value Preservation in the Age of COVID-19: Assessment and Conveyance

THE DUFF & PHELPS CREATED VALUE ATTRIBUTION WHITEPAPER SERIES
THIRD IN A SERIES | BY GEORGE PUSHNER, PH.D., AND P.J. VISCIO



The COVID-19 pandemic required extraordinary steps by private equity general partners (GPs) for their portfolio companies to weather the storm and survive. Such steps have included drawing down revolvers to preserve liquidity, cash burn reductions and reconfiguring, and, in some cases, even mothballing operations. The value impact of such specific measures may be difficult to quantify. However, as limited partners (LPs) seek to evaluate performance over the life of an investment, it is essential for GPs to demonstrate that what they do to create value has preserved value for their investors over the course of the pandemic.

Demonstrating the ability to create and preserve value is both a qualitative and quantitative effort. It involves documenting, over the holding periods of the portfolio company investments, the initiatives taken, before, during and after the current crisis that have built better businesses and created value for investors. And key to quantitatively measuring value creation and value preservation is benchmarking portfolio company performance against an appropriate measure of industry and sector performance.

The COVID-19 crisis has clearly impacted values and will no doubt impact returns, and performance and returns now vary more widely across industries. In this environment, benchmarking is even more critical to identify and measure value preservation. Just as a rising tide may obscure outperformance, or underperformance, industry and market headwinds can mask value preservation. As the current volatility has heightened concerns of future down markets, the ability to quantify operational and strategic value-add and value preservation assumes new significance.

While COVID-19 impacts have been overall negative, the meager or even negative returns that may have resulted do not mean that GPs have not preserved value. In these situations, a GP's value-add offsets negative macro impacts not under their control. We have seen this time and again in our value attribution studies where alpha, as a source of value creation, becomes a source of value preservation, indicating that without the contributions of the GP, performance would have been worse.

Evidencing value preservation in challenging times

Our initial beta test of our attribution framework was particularly enlightening in illustrating and evidencing value preservation. We saw pedestrian-level returns in a pre-financial crisis investment. However, that weak performance hid a substantial amount of value preservation achieved through the generation of alpha. After the appropriate benchmarking of industry and sector performance, we observed that alpha significantly exceeded the observed change in investment value. The alpha that was quantified represented evidence of outperformance and value preservation during a time of adverse economic conditions.

We have since seen a similar dynamic in many of our subsequent 70+ studies across diverse industries, geographies and sizes of portfolio companies. Utilizing portfolio company level benchmarking, our studies have shown that GPs who are able to generate operational and strategic value-add can cut through market and industry headwinds and shine during such times of economic adversity.

How different performance analytics incorporate benchmarking

There are various types of performance analytics. Yet the insight they provide into value creation and value preservation is often limited or non-existent.

Public Market Equivalent (PME) analysis incorporates benchmarking based on broad indices and can provide a good overall measure of outperformance. However, given the broad benchmarks normally employed, it is usually not helpful in isolating alpha relative to industry performance at the portfolio company level.

Quartile performance analytics relative to other private equity firms also incorporates benchmarking but again does not provide meaningful output regarding performance of portfolio companies relative to public companies with similar industry and sector exposure. It also suffers from issues with respect to IRR calculation. In practice, the majority of firms appear to claim top-quartile status.

The traditional value bridge, the industry convention for value attribution analysis, based on changes in EBITDA, multiples and net debt, does not include any benchmarking and therefore does not reflect outperformance or value preservation at all. But with enhancement as reflected in the Duff & Phelps Created Value Attribution (CVA) framework ("the Framework"), it can incorporate benchmarking and provide a measure of outperformance at the portfolio company level relative to industry peer companies.

Defining alpha and value preservation for private equity

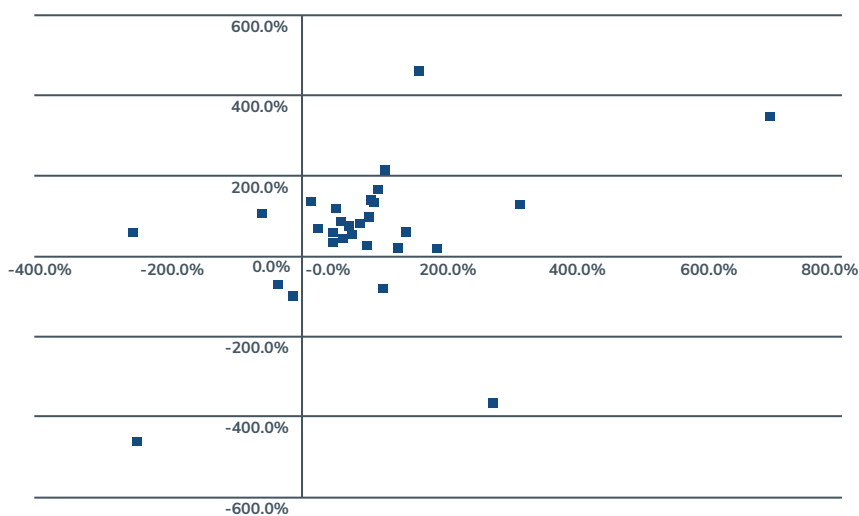
We define alpha as organic outperformance relative to an appropriate industry benchmark. The appropriate industry benchmark represents an investable alternative with similar market and sector risk as the subject portfolio company. Alpha represents performance that exceeds the benchmark. Any positive alpha generated during adverse economic conditions should therefore represent value preservation, if not value creation, as it represents outperformance relative to industry /sector averages.

Investors typically look to the traditional value bridge and the change in EBITDA as evidence of GP value-add. However,

as noted above, the traditional value bridge does not include any benchmarking and therefore cannot reflect alpha or outperformance. This inherent weakness of the value bridge has been vividly demonstrated in the CVA analyses we have performed to date. Research by Duff & Phelps, based on the application of the Framework, indicates a very weak relationship between results from the traditional value bridge and the measure of alpha or outperformance from the Framework. Based on a sample of 66 investments analyzed across several sponsors and funds, the correlation between EBITDA-driven value change and alpha is very low ($R^2 = 0.13$).¹ The distribution is plotted below, and the relationship is weak.

¹ Based on Created Value Attribution analyses completed by Duff & Phelps since 2012

Figure 1: Correlation of Alpha % of Value Creation and EBITDA % of Value Creation



As shown above, there is almost no correlation between value creation as measured by EBITDA improvement in the traditional value bridge and value creation as measured by alpha in the Framework. While the sample size of the study group is relatively small and reflects positive and negative self-selection, the poor correlation between EBITDA-driven value change and alpha provides important evidence of the importance of benchmarking in measuring performance.

What is required to accurately measure alpha and value preservation?

As defined above, the measure of alpha and value preservation must include benchmarking and separate the transactional impacts of add-on acquisitions. The Framework first goes beyond industry convention to separate revenue and margin impacts and (macro) cost of capital impacts from expected growth. The Framework then integrates benchmarking and the isolation of the initial impact of add-on acquisitions (i.e. purchased value), ultimately segregating performance into four sources: industry/sector, capital markets/beta, deleveraging and alpha.

The Framework, in our view, represents the leading candidate for an industry standard for robust created value attribution analysis and a more meaningful measurement of alpha for private equity investments. As such, the methodology behind the Framework is “open source” and has been made fully transparent and detailed in our whitepaper on the Framework.² It also has been highlighted in a recent video on private equity value creation by Steven Balaban of the University of Waterloo and the University of Toronto.³

Conclusion

Benchmarking is critical to quantifying value reservation, especially in today’s volatile markets. Weak performance can hide a substantial amount of alpha or value preservation, which can only be revealed with appropriate industry benchmarking. Most performance analytics do not incorporate benchmarking at the portfolio company level against comparable industry and sector performance, and therefore cannot accurately measure outperformance or value preservation. Measurement of alpha and value preservation must also separate the transactional impacts of add-on acquisitions, as reflected in the Framework.

² Created Value Attribution: Assessing How Value is Created in Private Equity Investments, <http://www.duffandphelps.com/expertise/publications/pages/NewslettersDetail.aspx?list=Newsletters&ItemID=154>

³ Value Creation

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