Is the convention of valuing unrealized private equity and venture holdings at cost about to become history?

Happily, for pension fund and endowment managers at least, the answer is a qualified yes. For the most part, general partners of private equity and venture capital funds are accepting the notion of fair value. New industry guidelines released March 14 may goad any laggards into line.

The Private Equity Industry Guidelines Group, an ad hoc industry panel established in 2003, issued updated rules this month following changes in accounting regulations (FASB No. 157) requiring that all accounting use fair value for any tax write-offs. Fair value, defined by generally accepted accounting principles, is the amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

After the dot-com crash and tightened accounting and corporate governance rules in the post-Enron era, many limited partners' contracts with buyout and venture capital firms began calling for GAAP accounting. Compliance still varies, though, depending on how demanding the LPs' -- and the GPs' -- auditors are.

"Over the course of time, I have definitely seen a movement by GPs to assign fair value to something [rather] than the lower of cost or market," says Henry Robin, a partner at AlpInvest Partners NV who is responsible for the Dutch pension funds ABP and PGGM's fund investments in the U.S.

Robin, a former chairman of the Institutional Limited Partners Association, says most GPs typically do not write up the value of an asset in the first year of ownership, owing to the so-called J-curve effect, when returns are usually negative. Thereafter, he adds, "they tend to come up with some view of what market value should be."

Still, even if fair value is required, there is still debate about how to measure it.

"The real issue is that there's no single way to place a value on a portfolio company after a year of ownership," says Robin. "Two GPs looking at the same business might come up with different conclusions because it involves judgment."
Some venture funds remain adamantly against writing up values in the absence of a liquidity event or an arm's-length financing round. It leaves too much room to arbitrarily inflate values, they say.

But David Larsen, a managing director at Duff & Phelps LLC's San Francisco office, argues that "volatility exists whether or not it's measured." In the long run, he says, volatility decreases with fair value accounting because, when an asset is sold, its realized value is much closer to the recorded fair value than it would be if it had been carried at cost.

Dana Callow, managing partner at Boston Millennia Partners, says the updates won't affect his VC firm, which was an early adopter of fair value. Every quarter, the firm gets an independent valuation "that's affordable" and that must be supported by factual data. Otherwise, an asset is left at cost. He says the firm would prefer to leave values at cost to have the smoothness, but that means, "de facto, you're managing the numbers."

Fair value accounting is likely to pick up momentum when FASB No. 157 comes into effect for fiscal years beginning Nov. 15 or later.

"There is still anxiety and unease among VCs, but pressure is now coming from auditors and accounting firms," says Colin Blaydon, director of the Center for Private Equity and Entrepreneurship at the Tuck School of Business at Dartmouth.

Requiring more realistic valuations has had an unintended impact on the secondary market for buyout and venture fund interests, sources say, reducing the uncertainties that led to good deals in the secondary market. "They're not getting the discounts anymore because they're all marked to market," says Callow.

That has cut into returns for secondary investors. "Back in the '90s, you saw a lot of [internal rates of return] at 25% or 30%," says one Wall Street investment banker. That's much harder to achieve today, he adds.

But as funds use figures closer to market value, he says, it could make potential sellers more comfortable unloading their stakes, which might prove to be a benefit for the secondary market overall.

"You might have arbitrage and returns coming down, but if people believe the values are credible, you might see much larger transaction volumes."