The stage is set

What is my portfolio worth? Valuation guidelines remain a big topic for every LP and GP active in the asset class. As private equity investments by both venture capital and buyout funds grow increasingly complex and spread across borders, the necessary uniformity in valuation practices is becoming more of a reality, say Colin Blaydon and Fred Wainwright of the Center for Private Equity and Entrepreneurship at the Tuck School of Business at Dartmouth.

A year ago we predicted in an article in this journal that 2003 would be remembered as “The Year of Valuation Guidelines.” At the time two industry task forces were working on developing new guidelines for valuation practices for private equity funds: the British Venture Capital Association (BVCA) task force in the UK and the Private Equity Industry Guidelines Group (PEIGG), a group of 18 professionals representing most segments of the US private equity industry.

BVCA, PEIGG and others

The BVCA group arguably had the easier task in that their assignment was to update and improve on an already existing set of guidelines that were actually in use. In the US, by contrast, there were no official guidelines in existence, and there was no single private equity industry association that was the obvious entity to promulgate any such rules. Thus the PEIGG group not only had to develop the guidelines themselves, but it also needed to be recognised by the industry as a sufficiently authoritative voice to merit attention.

However, PEIGG was not writing on an entirely blank slate. US practitioners were already using valuation principals that were based on a set of guidelines that had been proposed to the National Venture Capital Association (NVCA) at the start of the 1990s. Although the NVCA never formally adopted these proposals, they had become a de facto standard in the industry. They were seen as appropriately conservative, as they emphasised carrying investments at cost unless 1) material impairment indicated a write-down in value or 2) a financing round with new investors supported a write-up in value. It was widely believed that any new PEIGG guidelines would be a fairly simple and straightforward codification and update of this widespread approach.

Nevertheless PEIGG’s was a serious task. Many thoughtful observers had come to believe that a codified and widely adopted valuation standard was important for the US industry at that time. This consensus developed in the wake of the widespread corporate financial reporting scandals as well as the difficult private equity reporting and clawback issues caused by an extremely harsh down market. Still, as we found out in an industry survey that Tuck’s Center for Private Equity and Entrepreneurship conducted in 2002, there was no agreement of what these standards should be; in fact, there even was some opposition to the development of any standards at all.
Still, most of those polled agreed that an industry association would be the appropriate body to develop guidelines, but even that presented a problem as the NVCA, the only industry association in the US, does not represent the US buyout industry. PEIGG’s foray was a solution to this particular difficulty.

In addition to the work of the BVCA and PEIGG task forces, there were related activities underway that could impact both their efforts and the industry as a whole. The Association for Investment Management Research (AIMR) was updating its Global Investment Performance Standards (GIPS), which focused on standards to be used when reporting historical fund performance. More importantly, the US accounting industry was moving toward greater emphasis on fair value assessments of assets as reflected in the Fair Value Project of the Financial Accounting Standards Board (FASB). In fact, FASB intends to issue an exposure draft of a proposed statement “Fair Value Measurements” in June of this year. All of this was also being done in the context of the development of International Accounting Standards (IAS) and the discussion of the conformance by US entities to those standards.

**NO MORE DELIBERATE UNDERSTATEMENT**

The first task force to present results in 2003 was the BVCA, which published its “Reporting and Valuation Guidelines” in June that year. The key feature of this framework was an explicit reliance on the principle of “fair value”, defined as the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm’s length transaction. This principle was viewed as an important objective to make the guidelines conform to International Accounting Standards. In particular, the guidelines relied on the draft IAS Standard 39 “Financial Instruments: Recognition and Measurement.”

At about that same time, Tuck hosted a valuation conference to bring together leading industry practitioners who were involved in the various task forces and initiatives. There were two major conclusions that emerged from the discussions at that conference.

First, there was broad consensus that valuation assessments are the responsibility of GPs and that LPs expect their GPs to exercise their best judgment in estimating values based on the valuation policies as set forth in the limited partnership agreement.

Second, it became clear that if any new guidelines were to conform to accounting standards in the future, they would have to be acceptable under the fair value principles purported by international and US accounting authorities. This meant that any new valuation standards that continued to reflect the old concepts of “conservatism” would not conform with accounting standards.

One member of an accounting body at the conference stated that accountants defined conservatism as “the deliberate and consistent understatement of assets or income or both.” There was broad agreement at the conference that care and caution should govern fair value assessments and that these assessments should be “prudent” even if they could not be explicitly conservative.

**PEIGG’S PROPOSALS**

PEIGG issued its valuation guidelines last December, acknowledging and supporting the fair value concept.

The most dramatic contrast with past practices in the US was the now infamous “Paragraph 30”, in which PEIGG would allow write-ups based on portfolio company performance rather than just a third-party financing transaction. Although this reflected the guideline’s underlying principle of fair value, some LPs and some GPs expressed a concern that such practices would lead to increased volatility in portfolio valuations as well as possible abuse. Some observers say that volatility is already present in any cost-based valuation policy. They point to the prominent example of Google, which will soon be one of the biggest IPOs ever (possibly over $10 billion), but is probably still carried on its investors’ books at early round valuations that are much lower. This IPO will introduce its own type of volatility, albeit of a very pleasant sort for some parties. In addition, there was a concern that a mark-up without a financing might be abused, particularly by GPs in fundraising mode. Some LPs are already seeing evidence of this, and hearing the PEIGG guidelines cited as justification.

PEIGG’s guidelines further encourage firms to report quarterly to LPs and to use valuation policy committees to help establish valuation practices for the fund. The GP will retain ultimate say in the actual valuation. Firms that co-invest in a single portfolio company are also encouraged to confer among each other.

Initial responses by the media were critical. Some commentators pointed to skepticism among industry players that the guidelines were insufficiently prescriptive to ever achieve the goal of consistency. Others viewed the retreat from conservatism and from reliance on cost-basis as dangerous. To date, few GP members of the NVCA have adopted the guidelines.

The industry is in the process of absorbing and understanding the PEIGG guidelines. The reactions of the major associations representing GP and LP interests are being watched carefully.

The NVCA has specifically encouraged its members to review the PEIGG guidelines when evaluating procedures or developing new approaches. NVCA also commends PEIGG for its efforts. However, endorsement has not yet
emerged. The Institutional Limited Partners Association (ILPA) on the other hand endorsed both the PEIGG efforts and the NVCA’s support of PEIGG.

COMPARING THE GUIDELINES

The table below presents a broad comparison of the major valuation guidelines being used. These are EVCA (2001), BVCA (2003), NVCA (proposed in 1989) and PEIGG (2003).

The broad and underlying theme of the EVCA, BVCA and PEIGG guidelines is fair value, defined by FASB as “the amount at which an investment that could be exchanged in a current transaction between willing parties, other than in a forced liquidation or sale.” The NVCA proposed guidelines focus on a cost-based approach. EVCA, BVCA and PEIGG mention key concepts such as prudence, disclosure, consistency and transparency. The frameworks also differ significantly between promulgating prescriptive rule-based guidelines (EVCA and BVCA), and issuing general principles (PEIGG).

With respect to valuation, there are demarcation lines concerning practices that would be appropriate for companies at three stages of maturity: early-stage private companies, mature mid-to-late stage private companies, and mid-to-late stage companies that are already listed on an exchange. For early stage companies, all guidelines allow the use of cost basis for some time. Similarly, there is consensus that independent valuation measurements will converge as a portfolio company approaches an exit.

Key issues of debate revolve around the question of when to abandon the cost basis for valuation, and quantitative prescriptions. The latter disagreements take the form of whether impairing an investment in 25 percent steps, as required by EVCA, results in systemic overvaluation or undervaluation, and similarly what the discount for restricted shares should be.

Regarding more mature mid-to-late stage private companies, the valuation methodology for all guidelines is primarily based on comparable multiples such as price earnings ratio (P/E) or enterprise value to earnings before interest, taxes, depreciation and amortisation (EV/EBITDA). Forward-looking methods such as discounted cash flow (DCF) are allowed but clearly not preferred. Recommendations for illiquidity discounts for shares in private companies vary, as do recommendations for discounts for restricted public shares, which are commonly based on the time period remaining for lock-up expiration.

As noted earlier, one common criticism of a “mark-to-market” valuation is volatility. When portfolio companies

<table>
<thead>
<tr>
<th>Category</th>
<th>EVCA</th>
<th>BVCA</th>
<th>NVCA (1989)</th>
<th>PEIGG</th>
</tr>
</thead>
<tbody>
<tr>
<td>Underlying Principles</td>
<td>Prudence, disclosure, fair value</td>
<td>Fair value, consistency</td>
<td>Cost with modifications based on circumstances</td>
<td>Fair value, GAAP, consistency, transparency, prudence</td>
</tr>
<tr>
<td>Periodicity of Valuation</td>
<td>Twice a year</td>
<td>Annually</td>
<td>Annually</td>
<td>Quarterly</td>
</tr>
<tr>
<td>Use of Cost Basis</td>
<td>As long as no profits or cash flow</td>
<td>First year</td>
<td>Ongoing</td>
<td>Cost may approximate fair value for some time</td>
</tr>
<tr>
<td>Follow-on Round / Write-ups</td>
<td>Significant investment by 3rd party</td>
<td>Sophisticated unrelated new investor (if strategic, apply 50% discount)</td>
<td>Sophisticated unrelated new investor</td>
<td></td>
</tr>
<tr>
<td>Write-downs</td>
<td>25% bands as needed</td>
<td>Impairment</td>
<td>Significant deterioration</td>
<td>Change in circumstances</td>
</tr>
<tr>
<td>Revaluation</td>
<td>After 1 year</td>
<td>3rd party investment, performance, adverse change, market conditions</td>
<td>After 2 years of self-financing and 1 year of positive cash flow</td>
<td>Change in circumstances</td>
</tr>
<tr>
<td>Methodology</td>
<td>Comparable multiples (P/E, P/CF, EV/EBIT, EV/EBITDA)</td>
<td>Comparable multiples (P/E, EV/EBIT, EV/EBITDA)</td>
<td>Comparable multiples (P/E, cash flow)</td>
<td>Comparable multiples (P/E, cash flow)</td>
</tr>
<tr>
<td>Illiquidity Discount</td>
<td>&gt;25%</td>
<td>10% to 30%</td>
<td>&gt;30%</td>
<td>Manager’s judgment, may be &gt;30%</td>
</tr>
<tr>
<td>Discount for Restricted Shares</td>
<td>Minimum 25%, increasing if lock-up period is significant</td>
<td>0% to 25% discount</td>
<td>30% discount, reduced as lock-up expiration approaches</td>
<td>0% to 30%</td>
</tr>
</tbody>
</table>

Sources: EVCA, BVCA, NVCA (Draft), PEIGG guideline documents. Comparison research by Erick DeOliveira (Tuck School of Business).
miss or achieve important milestones, it is certainly possible that GPs seeking to be accurate, in effect, introduce significant volatility to LP total asset valuations. However, public markets are volatile, and institutional investors are clearly committed to both public and private asset classes.

In Europe, disparate tax and legal jurisdictions raise the costs of cross-border transactions, which is why the EVCA and BVCA both stress the importance of harmonisation. Their leadership has indicated publicly their intent to collaborate in future versions of guidelines. Also, since a number of European private equity firms are listed, their management is subject to the same reporting requirements as other publicly held corporations. The EVCA's approach of publishing country-by-country comparison studies not only helps to promote transparency, but also contributes to a broader education of the disclosure environments in which different practitioners operate.

Some guidelines, notably those of the EVCA and PEIGG, go so far as to opine about what they see as appropriate governance structures. For example, EVCA and PEIGG propose a Valuation Policy Committee to which GPs would present and defend individual valuations and valuation methodologies.

A similar proposal would establish audit committees composed of a subset of LPs, whose review — but not necessarily approval, lest the limited partnership status of LPs be violated — would be required on an annual basis. This kind of structure might be a practical window through which LPs could see and hear about the activities of the partnership, but would not require GPs to deliver otherwise sensitive materials to the LPs that could subsequently be vulnerable to disclosure issues such as US Freedom of Information law based requests. This would balance LP needs for improved transparency with GP confidentiality requirements. In contrast, a number of GPs believe that their advisory boards serve this purpose and separate committees are not needed.

Increasingly, national organisations are harmonising their differences. The BVCA is adopting more of the EVCA practices. They are doing so not surreptitiously, but openly declaring their intent to conform more closely with Europe as they undertake periodic reviews of the guidelines that they promulgate to their membership.

There have also been guideline development initiatives in Australia and Canada. The new Australian industry guidelines are based on BVCA principles, while the Canadian guidelines borrow heavily from the EVCA.

**WHAT REMAINS TO BE DONE**

In the US, as public employee pension plans increase their allocations to private equity, accurate valuation becomes more critical to asset managers who need to report to their boards and key constituents such as employee contributors and retiree beneficiaries. This is also occurring within the context of a supratrend of globalisation and convergence of all types of laws, standards, guidelines, and practices, most notably in accounting, banking and trade. Similar pressures are facing fiduciaries around the world.

IAS is moving toward common cross-border accounting practices. There will doubtless be regional adjustments, but transparency will certainly be enhanced. FASB is integrally involved in the development of IAS.

Basel I was a 1998 agreement among the Group of 10 (G-10) central banks to apply common minimum capital standards and credit risk measurement frameworks to their banking industries by 1992. When finalised in 2004, Basel II will in essence force major banking institutions in the US and Europe to implement by 2007 more robust risk management programs and increase capital reserve requirements. Those banks in the US that have invested heavily
in private equity in the past already are reducing their exposure to the sector. The EVCA is working closely with policymakers to ensure Basel II does not reduce European competitiveness by hampering private capital funding for innovative growth companies and for the restructuring of existing industries.

The EVCA leadership has been instrumental in defining the framework for debate. In addition to advocating harmonised practices, the EVCA conducts regular reviews of its valuation and reporting guidelines, and is engaged with the ongoing development of International Accounting Standards. Upon assuming the association’s chairmanship, Jean-Bernard Schmidt went so far as to call for a single fund structure to attract new investors and increase the amount of capital available to promising innovations.

LOOKING FORWARD

It is fairly easy to envision ultimate convergence of valuation and reporting guidelines, but the timing is considerably more difficult to estimate. There are a several milestones and future developments that will continue to foster the move to international convergence on valuation practices in private equity. Among them:

- Broader acceptance of the PEIGG guidelines. Some industry acceptance will certainly be driven by the attractiveness to GPs of presenting near-term historical upside performance to current and potential LPs and citing the PEIGG guidelines as justification. The 2004-2005 fundraising season will be very busy. LPs will push for consistency between valuations used for fundraising purposes and those used for reporting. Looking further ahead, there will likely need to be a forum in which proposed revisions to the PEIGG guidelines can be fully discussed.

- PEIGG will produce its own reporting guidelines. This will complement the PEIGG valuation guidelines and will mirror the BVCA and EVCA guideline structure. This will provide the basis for continued discussion about international best practices.

- Development of new industry institutions in the US. It is notable that only the US is relying on ad-hoc guideline development while other countries and regions with significant private equity activities have established industry associations that lead best practice or convergence efforts. In the US, there are conversations among industry players about the need for a buyout association. There is speculation that the PEIGG group may have to remain as a permanent fixture, rather than dissolving after two or three major accomplishments.

- Increasing experimentation by buyout funds in accessing public markets. Any use of public vehicles such as Business Development Companies (see also I want my BDC on p. 56 of this issue) will broaden the use of guidelines for fair value assessments of portfolio holdings.

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