Surprise! Valuation Guidelines Are Being Adopted

By Colin Blaydon and Fred Wainwright

The venture industry has been under the impression that the valuation guidelines published about 18 months ago by the Private Equity Industry Guidelines Group (PEIGG) are not being adopted. However, it appears that a quiet sea change is taking place. The Center for Private Equity and Entrepreneurship at the Tuck School of Business at Dartmouth has been conducting an online survey of general partners during the past several weeks and the results are surprising.

The data indicate a significant influence of the PEIGG guidelines on valuation policies. Twenty one percent of the respondents have formally adopted PEIGG. Furthermore, 55% of respondents relied on well-known industry guidelines for their internal valuation policies, indicating a general acceptance of guidelines as a useful tool for internal policies. Comparison with a 2003 valuation survey by the center has produced an interesting fact: The growing influence of PEIGG has occurred despite unchanged industry attitudes from 2003 to present about support (from nearly 50% of respondents) and opposition (from about 20% of respondents) to an industry standard for valuation practices.

The center’s survey is ongoing, so the results described in this article are preliminary and provide an indication of current industry practices. Seventy-seven GPs completed the survey thus far. Of those respondents, 66% were venture capital fund managers and 26% were buyout fund sponsors. About one-fourth of respondents had four or more funds under management while the remainder managed up to three funds. Thirty seven percent of respondents managed $250 million or more in their current fund, including 8% of respondents that managed over $1 billion.

As indicated in Figure 1, nearly 50% of GPs indicated that they would like to see an industry standard for valuation. While a rigid set of rules cannot possibly meet the needs of all venture and buyout funds, there appears to be agreement that the industry could use guidelines. The opinion about the usefulness of guidelines was held across a range of characteristics of funds (investment focus, number of funds and fund size).

Since the PEIGG valuation guidelines were launched in December of 2003, they have been endorsed by the Institutional Limited Partners Association (ILPA) and commended by the NVCA. ILPA has over 130 members, which collectively manage more than $300 billion of private equity capital. ILPA went on the record in a press release in September of 2004 stating that the PEIGG guidelines were “endorsed after a thorough, two-year consultative process involving its membership and external associations and experts in private equity investing, accounting and valuation.” As stated in an NVCA public document from March 2004, “when evaluating current valuation procedures or developing new approaches, the NVCA suggests its members include a review of the Private Equity Industry Guidelines Group…”

As stated earlier, 21% of the survey respondents formally adopted PEIGG. Twenty three percent of respondents indicated that they used the draft NVCA guidelines developed in 1989, which previous surveys had shown to be the most common basis for internal valuation guidelines of VCs prior to PEIGG.

Hot Button

For funds explicitly choosing not to adopt PEIGG, the largest single reason is paragraph 30 of the PEIGG guidelines,
which calls for writeups to reflect fair market value even in the absence of a new round of financing. Some LPs have expressed concern over “stale” valuations that do not reflect economic reality, either on the upside or the downside. They cited examples such as a portfolio company with no recent financing rounds but preparing to conduct an IPO or a company that is currently impaired but has not yet been written down. Some GPs counter that adhering to a conservative philosophy that leads to underpromising and overdelivering to LPs when portfolio companies reach successful exits best serves the needs of both LPs and GPs. Other GPs say that continually adjusting interim evaluations, particularly for early stage companies, serves no purpose.

Over half of GP respondents that specifically had not adopted PEIGG indicated that they preferred writeups only after a new round of financing. As the NVCA stated in its March 2004 announcement, the organization “encourages diligence, prudence and caution when implementing the specific elements of any guideline, such as valuation writeups of early stage companies in the absence of market-based financing events.”

Concerns over increased volatility and little interest from LPs were important factors to at least a quarter of the respondents that didn’t adopt PEIGG (24% and 27%, respectively). As would be expected, based on data and respondent commentaries, buyout funds tended to be more likely adopters of PEIGG than VCs, while more VCs than buyout funds were insistent about not implementing PEIGG due to non-round writeups. Finally, nearly 50% of respondents believe that their current policies adequately reflect fair value.

**Auditors’ Role**

In a post-Enron world with Sarbanes-Oxley fueled transparency pressures, accounting firms are paying more attention to valuation. Over half of respondent firms indicated an increased scrutiny of portfolio valuations by outside auditors in fiscal year 2004 versus 2003. In addition, an overwhelming majority of funds (76%) would change their valuation policy in order to receive an unqualified opinion. However, despite the barking, outside auditors appear not to be biting. Sixty eight percent of respondents indicated that their auditors accepted without qualification that a policy of not allowing non-round writeups represented GAAP “fair value.” However, 41% of respondents indicated that if they applied fair value principles, 20% or more of their portfolios would be written up.

Regarding the effect of audit results on GP/LP relations, performance seems to overrule any other factor. Fifty nine percent of GPs believed LPs would be willing to overlook qualified audit opinions as long as fund performance was satisfactory. Twenty two percent of GPs provide their investors with “side schedules” that contain up-to-date valuation estimates that differ from audited financial statements.

The British, French and European industry associations have developed and refined their valuation and reporting guidelines during the past several years. In March of this year they issued joint valuation guidelines. Convergence is also occurring, albeit slowly, in overall accounting standards. Survey respondents were asked if, considering globalization and more cross-border investments, the various international and U.S. valuation guidelines would converge. As Figure 2 shows, a quarter of respondents believe convergence will occur within three to five years, another one-third of respondents believe it will take five to 10 years and nearly 40% believe it will never happen.

The development and wide adoption of a valuation guideline is challenging in an industry with independent and entrepreneurial professionals. Certainly some survey respondents expressed deep skepticism. However, there has been substantial progress toward an industry-wide guideline, and continuing efforts both in the United States and Europe indicate a move toward convergence that is of increasing interest to those LPs and GPs that invest internationally. Surprisingly, the role of independent auditors has not yet been a factor in any expanded emphasis on guidelines that urges greater emphasis on fair value.

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