



Center for Private Equity and Entrepreneurship

Tuck School of Business at Dartmouth

Results of Survey of Valuation Practices

June 2005

Center for Private Equity and Entrepreneurship

Survey Regarding Valuation Practices

Contents	Slides
• Executive summary	3
• Additional survey results	4
• Characteristics of survey respondents	5-6
• Acceptance of an industry standard	7
• Adoption of specific guidelines	8
• Reasons for not adopting PEIGG	9-10
• Auditor oversight of valuation principles	11-15
• Side schedules	16
• Effect of "fair value" on valuation	17
• Convergence of standards	18
• About the Center	19
• Acknowledgements	20

Executive summary

The Study

- This survey is a follow-up to the first valuation survey conducted by the Center for Private Equity and Entrepreneurship in 2003. The first survey focused on the need for an industry wide valuation standard, who should develop it, and general awareness of standards already in place. This new study focuses on the formal adoption by private equity firms of certain valuation guidelines, reasons for not adopting these guidelines, auditor oversight of valuation principles, and the effect on portfolio valuations if certain guidelines were applied.
- 102 private equity funds, from both the venture and buyout perspective, completed the survey.

Key Findings

- A significant portion of GPs are formally adopting the PEIGG guidelines.
- While auditors are paying more attention to portfolio valuation this year, they are not issuing qualified opinions and consider most current valuation policies to adequately represent “fair value” principles.
- The majority of GPs that only allow write-ups based on a new financing round say that at least part of their portfolio would be written up if they were to apply fair value principles.
- According to GPs, LPs are not insisting on the application of fair value principles.
- Many GPs believe that the convergence of international and US industry valuation guidelines is not likely to occur in the near future, if ever.

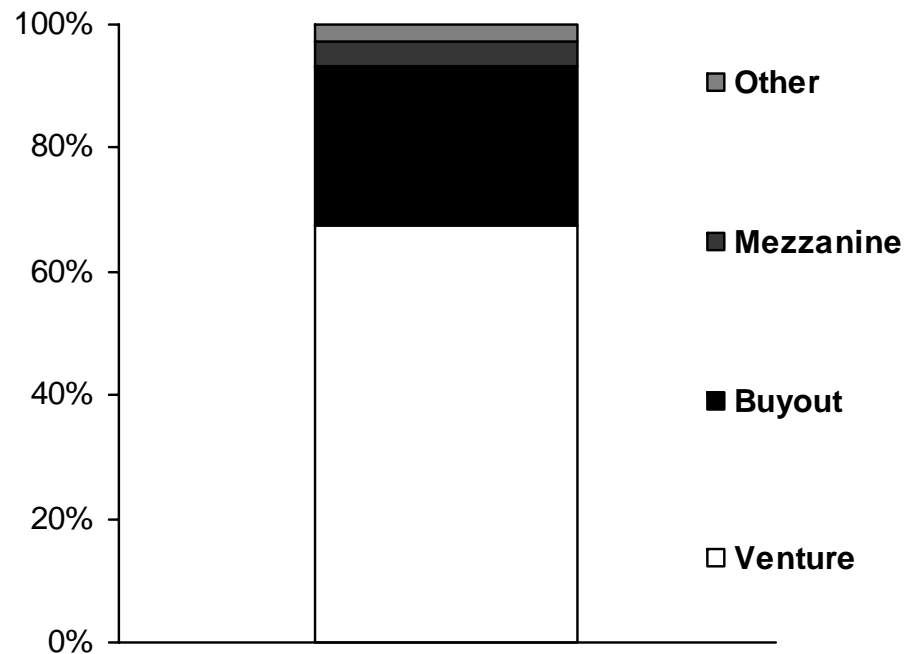
Additional survey results

- 19% of respondents have formally adopted the PEIGG guidelines.
- 68% of respondents characterized themselves as VCs, while 25% were buyout investors.
- Venture respondents who have not adopted the PEIGG guidelines cited their “preference for write-ups only if a new round of financing has occurred” as their primary reason for not implementing PEIGG (59%).
- Buyout respondents who have not adopted the PEIGG guidelines cited “little interest from LPs” as their primary reason for not implementing PEIGG (41%).
- Nearly 70% of respondents indicated that they would write up their portfolio by some percentage if they were to apply fair value principles.
- 79% of venture respondents said they would write up their portfolio if they were to apply fair value principles (versus 43% of buyout respondents).
- 46% of venture respondents indicated that convergence will never happen, and only 29% of buyout respondents agreed.

Characteristics of valuation survey respondents

- 68% of respondents characterized themselves as VCs, 25% as buyout investors, 4% as mezzanine investors, and the remaining 3% are involved in other areas of private equity.

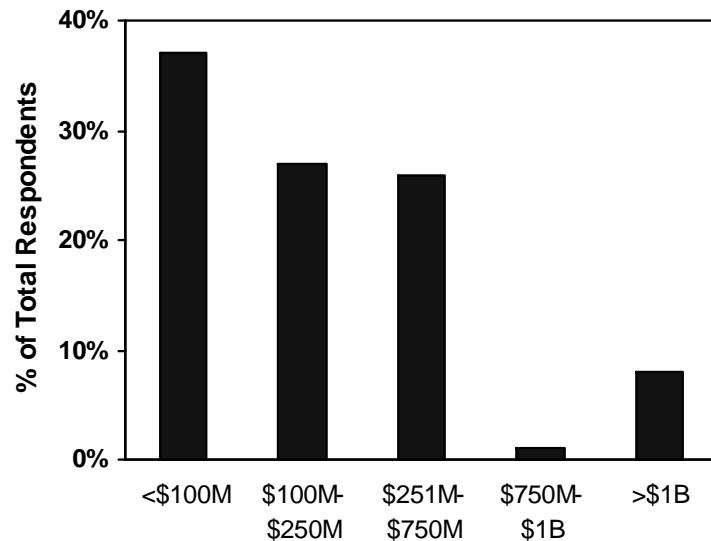
"How would you characterize the majority of your funds?" (n=102)



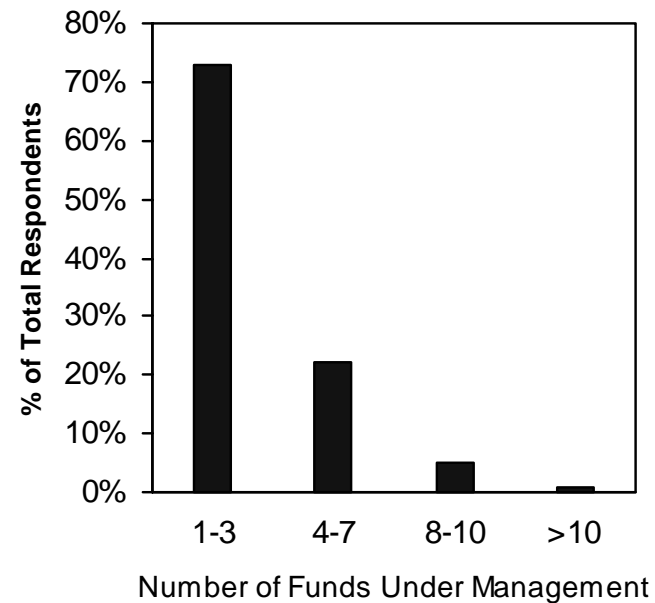
Characteristics of valuation respondents (cont'd)

- The majority of funds have less than \$750M in total committed capital, but larger funds over \$750M are also represented (9%).

"What is the committed capital of your most recent fund?" (n=102)



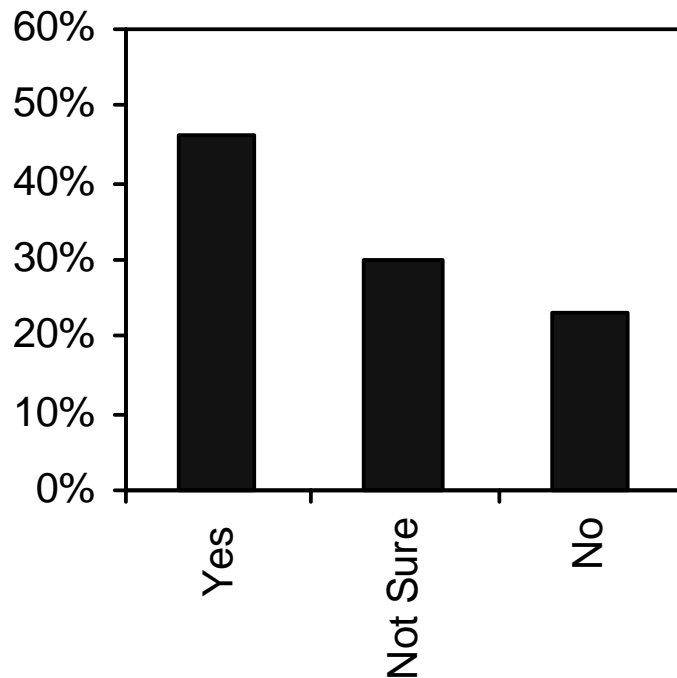
"How many total funds has your firm or partnership raised?" (n=102)



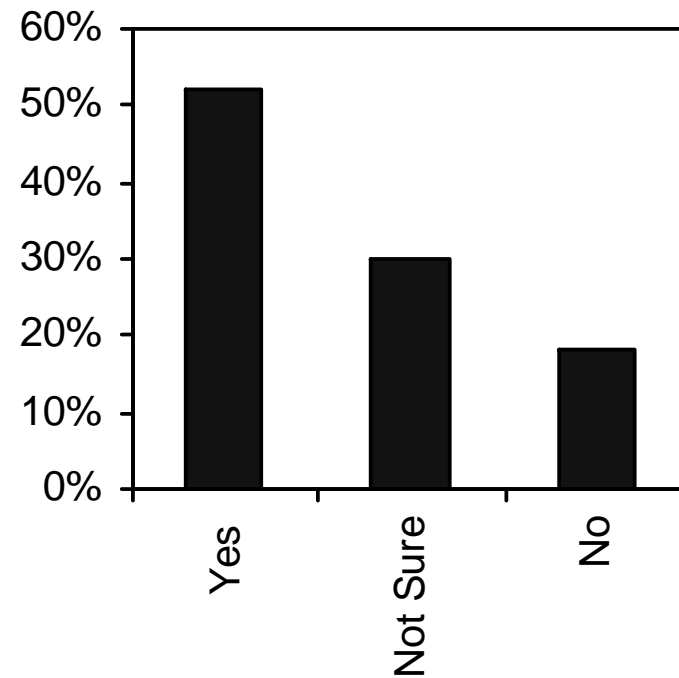
Acceptance of an industry valuation standard

- The percentage of firms that would like to see an industry valuation standard has remained at around 50% since our first valuation survey in 2003.

"Would you like to see an industry standard for valuation practices?" (n=102)



2003 Valuation Survey

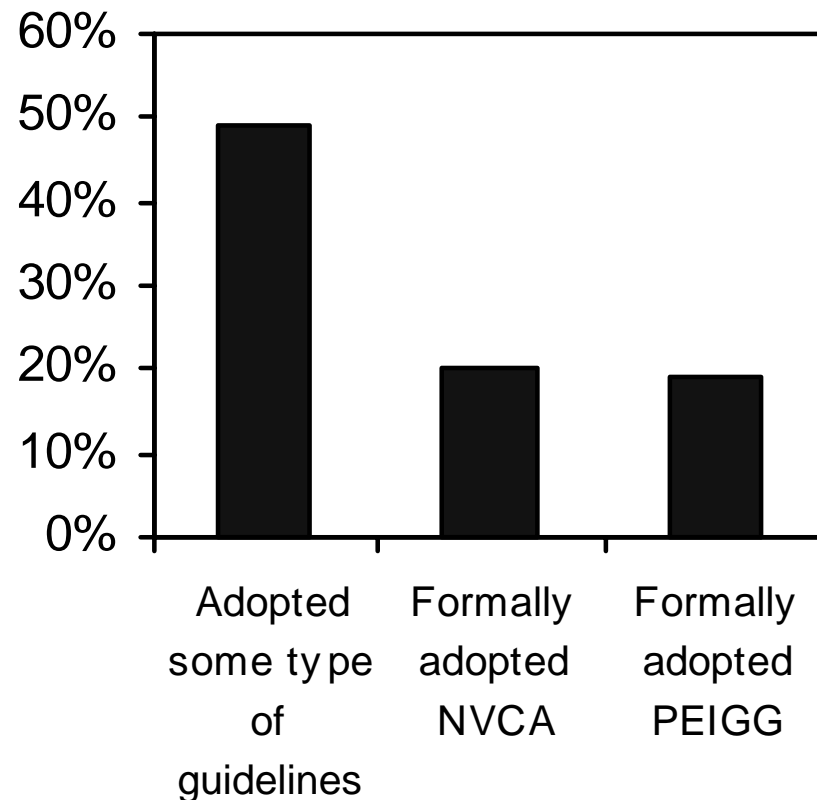


2005 Valuation Survey

Adoption of specific guidelines

- 19% of respondents have formally adopted the PEIGG guidelines.
- Over 50% of respondents have adopted some form of valuation guidelines, either NVCA, PEIGG, AFIC/BVCA/EVCA, SBIC or a modified version of these guidelines.

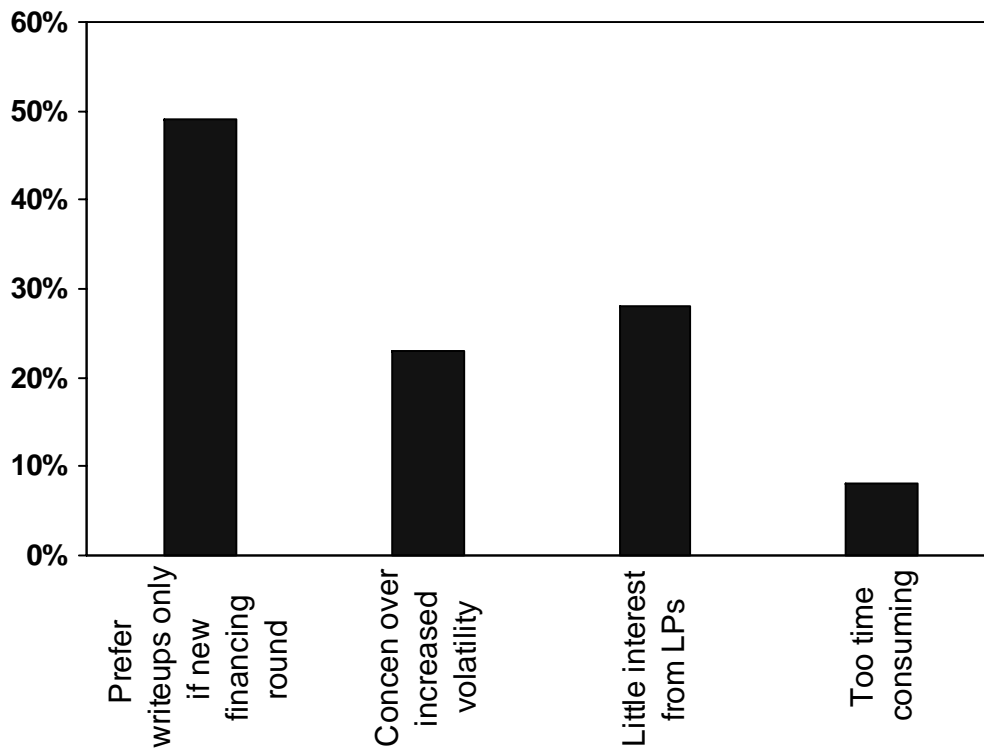
"Has your firm formally adopted any of these guidelines or proposed guidelines for valuation?" (n=62)



Reasons for not adopting PEIGG

- Nearly half of respondents that specifically had not adopted PEIGG indicated that they preferred write ups only after a new round of financing.
- “Concerns over increased volatility” and “little interest from LPs” were important factors to at least a quarter of respondents that did not adopt PEIGG (23% and 28% respectively).

“If you have not implemented the PEIGG guidelines, please explain why not?” (respondents could answer more than once)



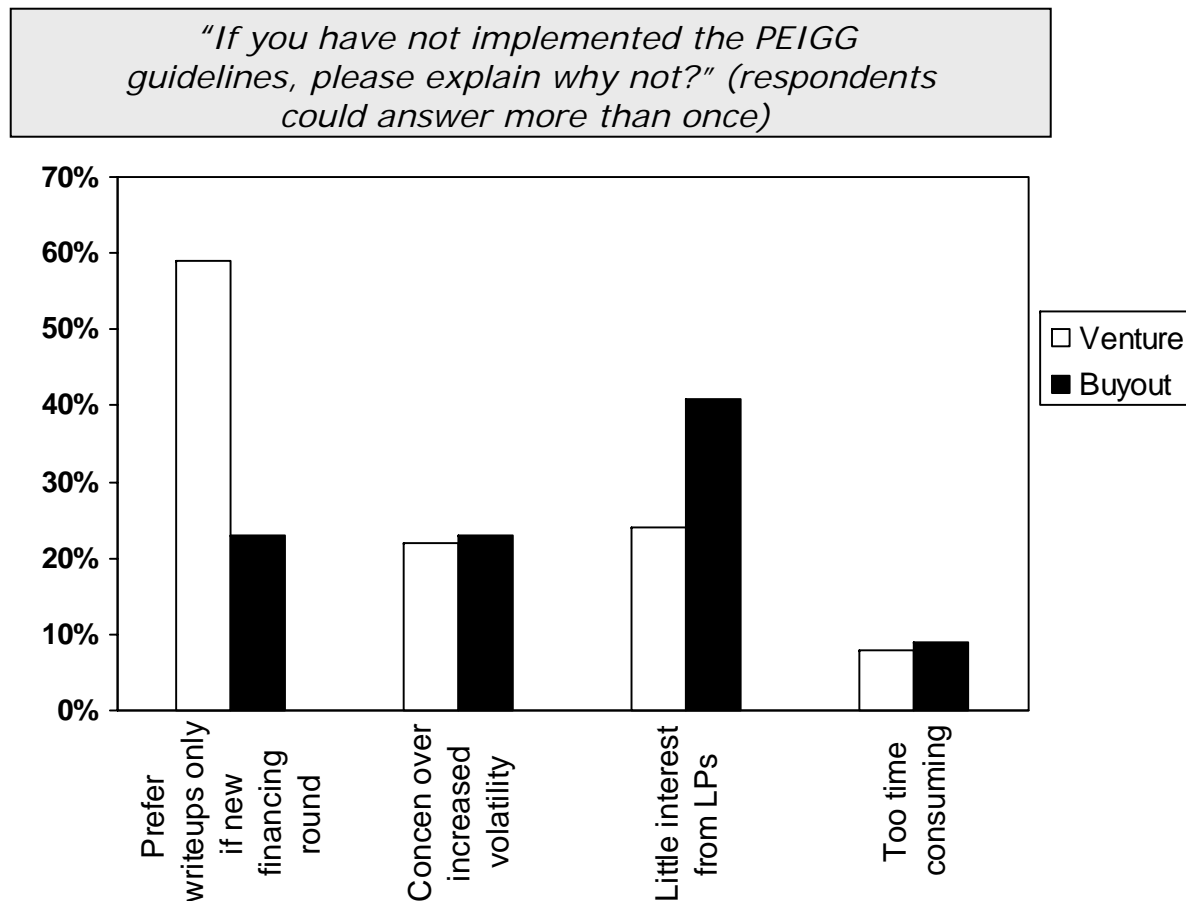
Some “fill in” responses also included:

- *Currently following SBA guidelines*
- *Write-ups/write-downs are very subjective*
- *We do not write up investments, even in an up-round*
- *Waiting for the debate to end*
- *LPs were pleased with our pre-existing policy*

Note: Percentages will not add up to 100% because respondents could check more than one answer.

Reasons for not adopting PEIGG (cont'd)

- Venture respondents who have not adopted the PEIGG guidelines cited their “preference for write-ups only if a new round of financing has occurred” as their primary reason for not implementing PEIGG (59%).
- Alternatively, buyout respondents who have not adopted the PEIGG guidelines cited “little interest from LPs” as their primary reason for not implementing PEIGG (41%).

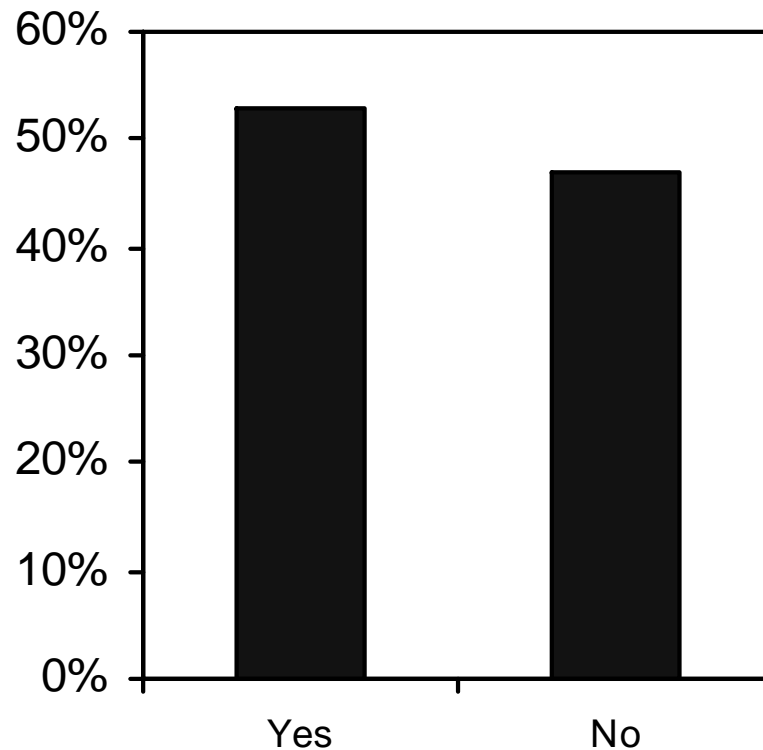


Note: Percentages will not add up to 100% because respondents could check more than one answer.

Auditors are paying more attention to portfolio valuation

- Over half of the survey respondents have received increased attention from their auditor regarding portfolio valuation in FY2004 vs. FY2003.

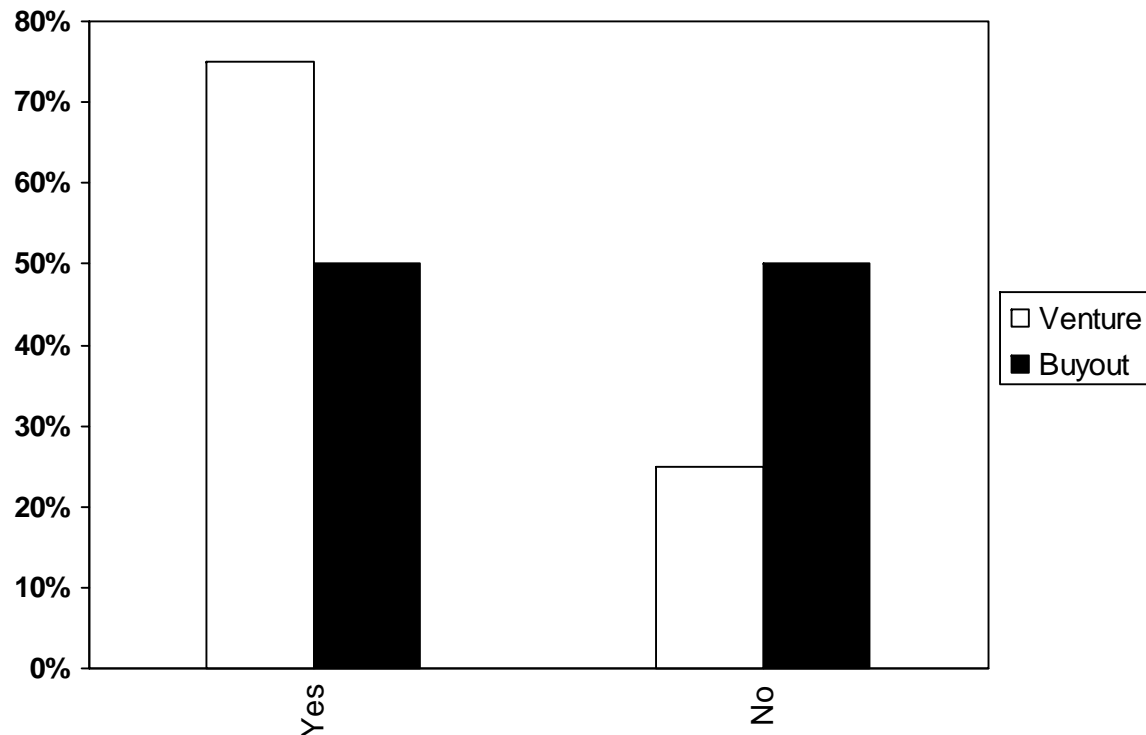
"Have you experienced increased attention or greater oversight from your auditor regarding portfolio valuation in FY2004 vs. FY2003?" (n=98)



Auditor acceptance of valuation policies

- 75% of venture respondents indicated that their auditors accept their valuation policy without qualification, even if it does not allow for non-financing round write-ups.
- Half of buyout respondents said that their auditors accept their valuation policy even if it does not allow for non-financing round write-ups, while the other half of buyout respondents say that this is not accepted.

"If your valuation policy does not allow for non-financing round write-ups, does your independent auditor accept this without qualification as GAAP 'fair value?" (n=77)



Auditor requirements regarding valuation

- Most respondents said that either their current valuation policy adequately represents “fair value” (79%), or their auditor is more concerned that the valuation policy is applied consistently, regardless of the methodology (48%). Only 2% of respondents are at risk for a qualified opinion if they don’t change their valuation policy to a “fair value” method.

“What have been your independent auditor’s requirements regarding valuation? (check any that apply)”

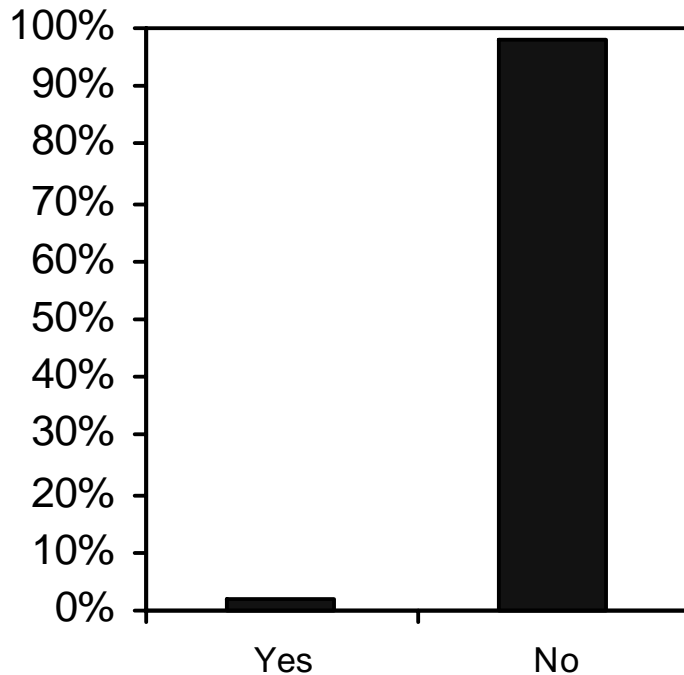
Regardless of valuation methodology, it is more important to apply your valuation policy consistently to all portfolio companies	48%
Your current valuation policy is cost based and should be transitioned to represent “fair value” within the next year or you risk receiving a qualified opinion	1%
Your current valuation policy is cost based and should be transitioned to represent “fair value” within the next two years or you risk receiving a qualified opinion	1%
Your current valuation policy adequately represents “fair value” principles	79%

Note: Percentages will not add up to 100% because respondents could check more than one answer.

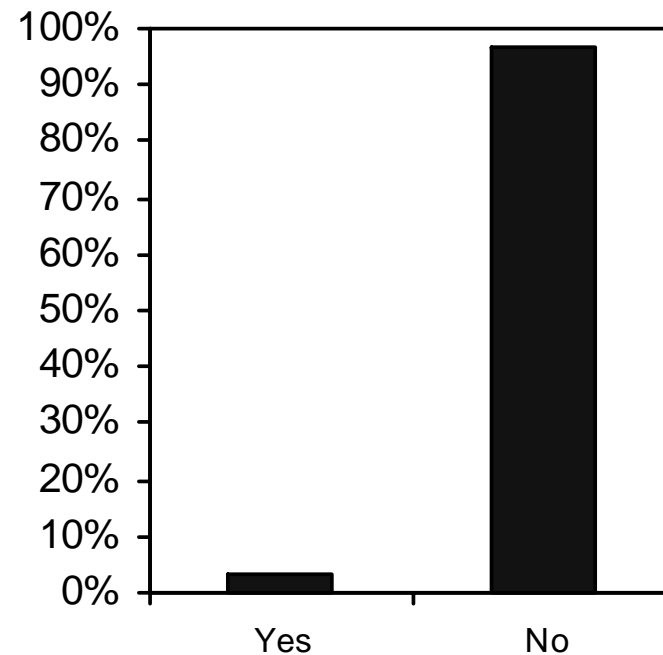
Auditor opinions

- While auditors are paying more attention to portfolio valuation this year, they are not issuing qualified opinions and consider most current valuation policies to adequately represent "fair value."

"Have you been issued a qualified audit opinion for FY2004 for not using "fair value?" (n=96)



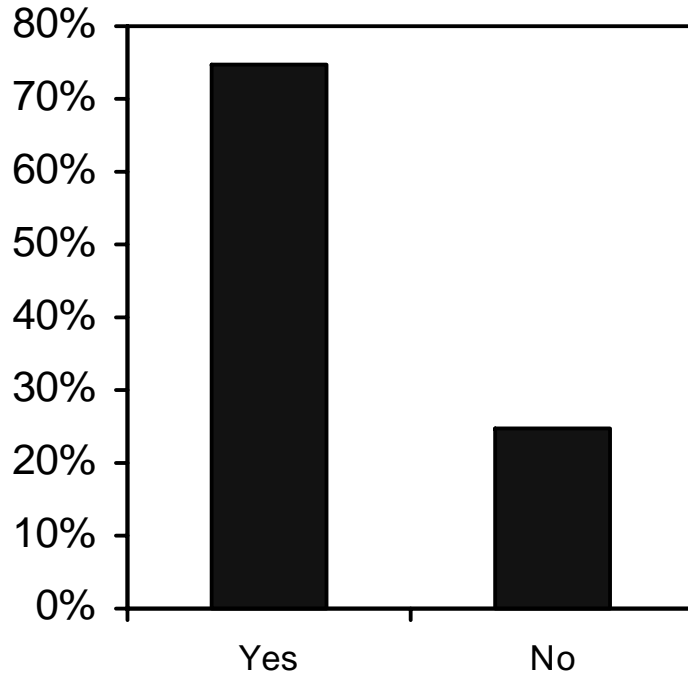
"Do you expect to be issued a qualified audit opinion For FY2005 for not using "fair value?" (n=94)



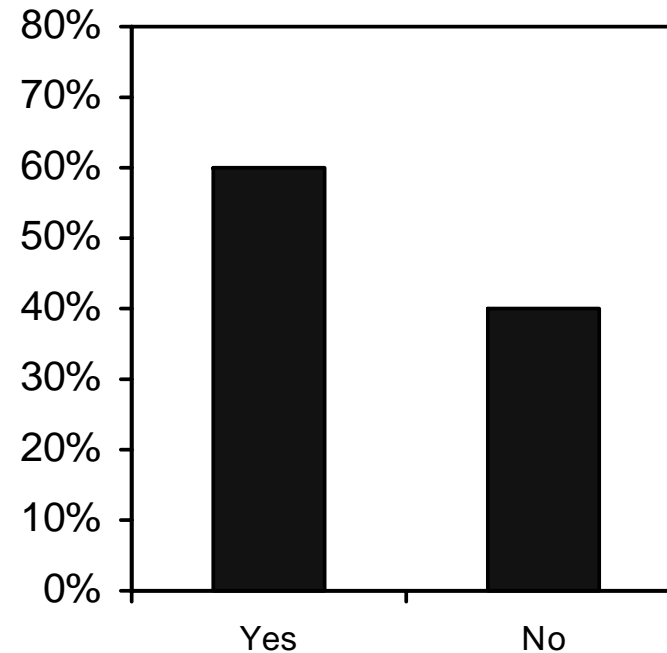
Auditor opinions (cont'd)

- 75% of respondents said that they would change their valuation policy in order to receive an unqualified audit opinion.
- 60% of respondents said that limited partners would overlook a qualified audit opinion if fund performance was satisfactory.

"Would you change your valuation policy in order to receive an unqualified opinion?" (n=96)



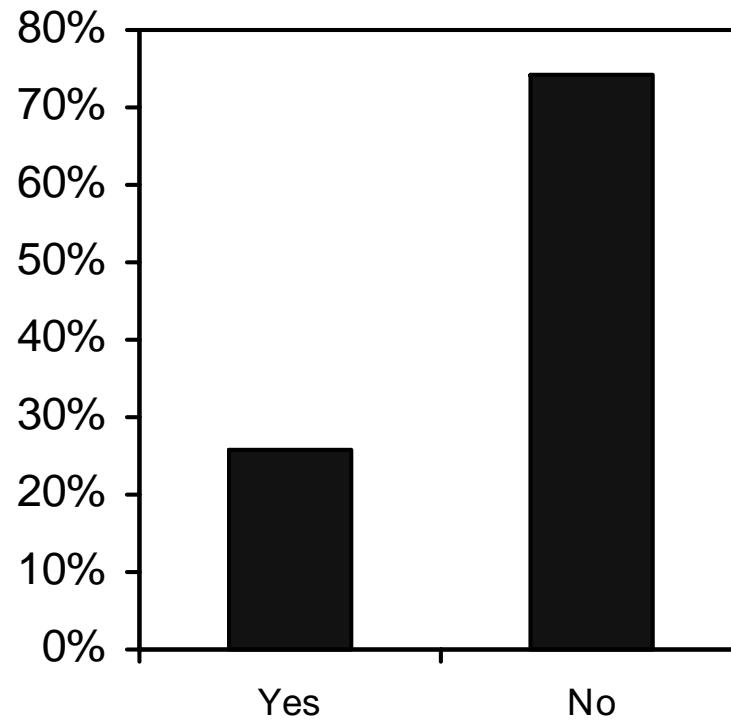
"Do you believe limited partners are willing to overlook qualified audit opinions as long as fund performance is satisfactory?" (n=97)



Use of side schedules

- 26% of respondents provide investors with “side schedules” where the valuation estimates differ from the audited financial statements.

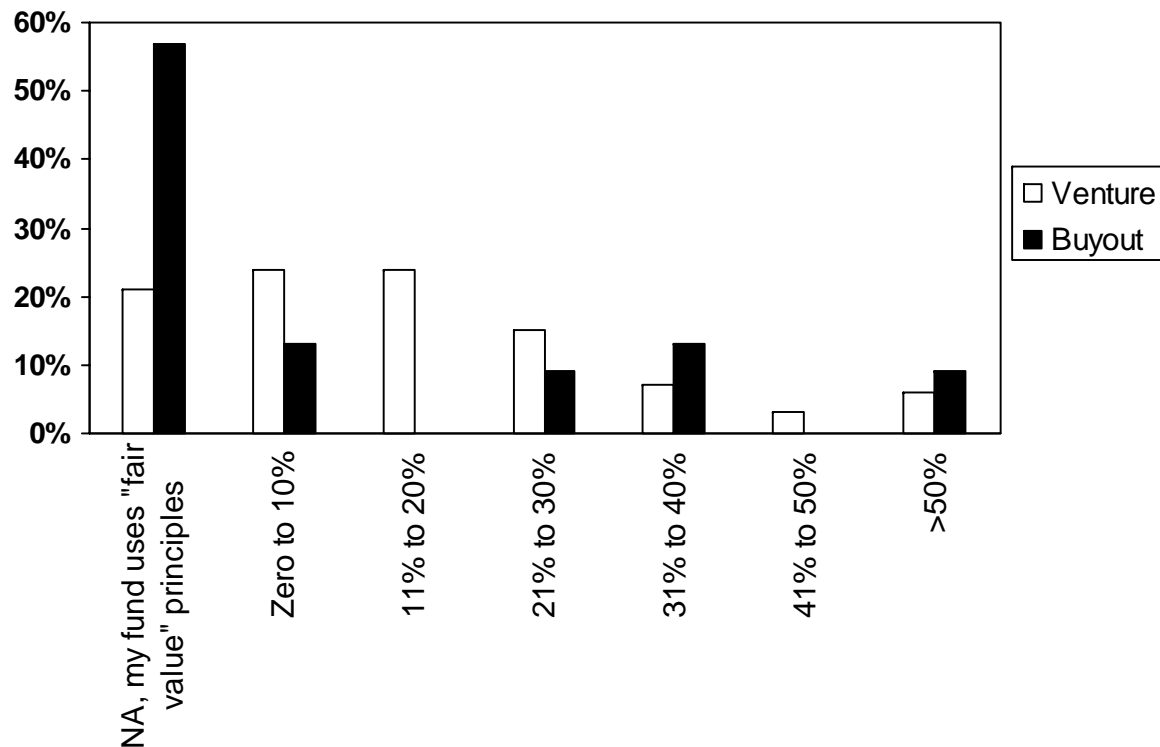
“Do you provide your investors with “side schedules” that contain up-to-date valuation estimates that differ from audited financial statements?” (n=101)



Effect of “fair value” on portfolio valuations

- The majority of GPs that only allow write-ups based on a new financing round said that at least part of their portfolio would be written up if they were to apply fair value principles.
- 79% of venture respondents said they would write up their portfolio if they were to apply fair value principles versus 43% of buyout respondents.

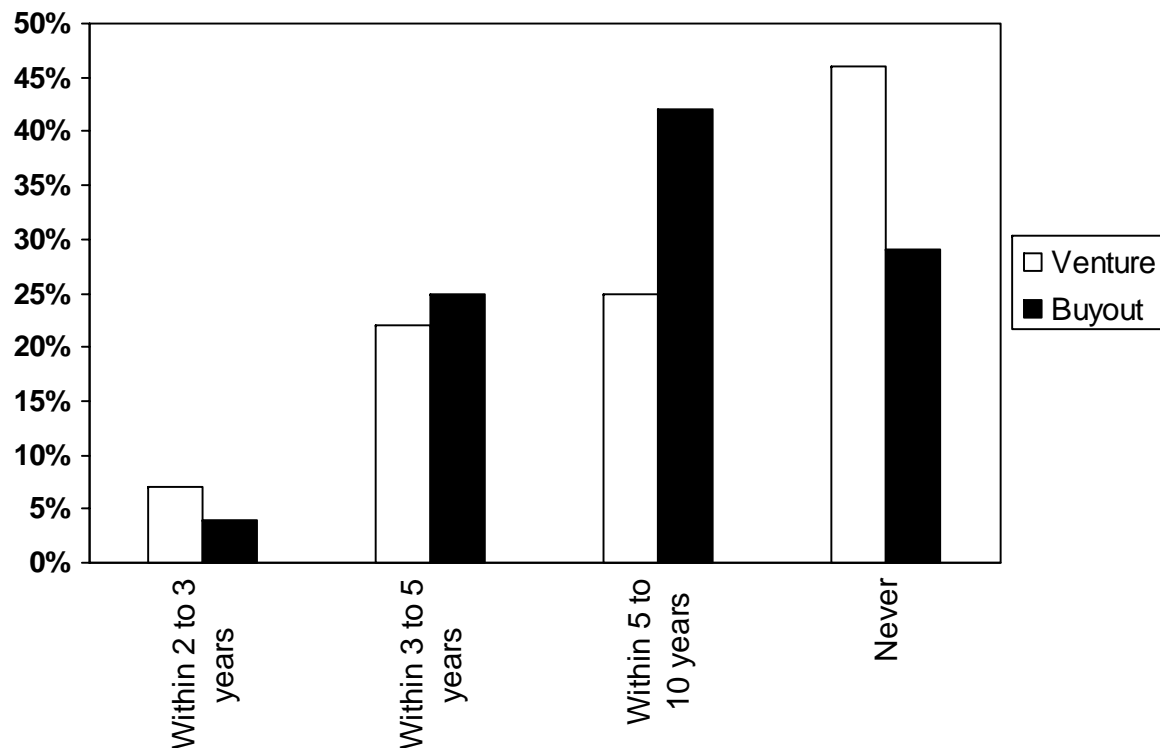
“If you only allow write-ups based on a new financing round but you were to apply fair value principles, then, on average, what percentage of your portfolio companies would likely be written up which aren’t written up now?” (n=96)



Convergence of US and international guidelines

- Many GPs think the industry is far from the convergence of US and international valuation guidelines.
- 46% of venture respondents believe that convergence will never happen, and 29% of buyout respondents agreed.

"Considering the increasing globalization of investing and the greater number of cross-border investments, will the various international and US industry valuation guidelines converge?" (n=89)



About the Center for Private Equity and Entrepreneurship

The Center for Private Equity and Entrepreneurship aims to produce practical and insightful global private equity and entrepreneurship research and education. The Center is a trusted independent source of information on best practices and trends in private equity and entrepreneurship. It covers both macro and micro issues relating to private equity in areas such as capital markets, financing structures, governance and entrepreneurship. The Center is actively involved in the practitioner communities of private equity and entrepreneurship, both to gain information about current trends and challenges and to share insights and solutions. The Center interacts with institutional investors, venture capitalists, buy-out investors, corporate venturers, angel investors, entrepreneurs, portfolio companies, industry lawyers and accountants, industry associations, and the media.

A thought leader in the field of private equity, the Center's work is represented in prestigious publications and industry conferences. The Center is a regular contributor to the *Venture Capital Journal*, the leading industry magazine, and its directors are sought out as authorities by top business publications, such as *The Wall Street Journal* and leading television media such as *CNBC*. The Center seeks to educate Tuck students in private equity investing and entrepreneurial management through such courses as Private Equity Finance, Advanced Entrepreneurship, Field Studies in Private Equity and through supporting internships, fellowships and independent studies.

For additional information on the Center for Private Equity and Entrepreneurship please visit: <http://mba.tuck.dartmouth.edu/pecenter/>

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