The Private Equity Annual Review 2002

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The year of valuation guidelines

2002 was the year when the issue of private equity valuation reporting became unavoidable for both venture capital and buyout funds in the US. 2003 is the year that the industry will finally have to take action to resolve the issue says Colin Blaydon, Michael Horvath and Fred Wainwright of the Foster Center for Private Equity at the Tuck School of Business at Dartmouth College.

Over ten years ago, a set of guidelines was proposed at a meeting of the National Venture Capital Association (NVCA). Opposition from members though was loud and clear, and the organization never officially adopted the proposal. However, the proposed guidelines turned out to have a life of their own. In subsequent years, the “NVCA guidelines,” although unofficial, became widely used.

As part of a major research initiative at the Foster Center for Private Equity at the Tuck School of Business at Dartmouth College we completed a survey of 288 venture firms in the autumn of 2002. The survey indicated that approximately one third of US venture firms use the NVCA proposed guidelines and even more use them as a basis for their valuation principles. The guidelines of the European Private Equity and Venture Capital Association (EVCA) and the British Venture Capital Association (BVCA) were also used in the US, but to a much lesser degree (see Chart 1). We expect that our current survey of US buyout funds, which will be completed within several weeks, will reveal similar results.

The NVCA proposal basically prescribed that an investment in a portfolio company should be carried in a fund: at cost, or at the value set by the last round of financing (as long as the financing included a new outside investor), or at some other appropriate value if the company had experienced a material change.

These proposed guidelines and their individually customized variations were historically viewed by fund managers as comfortably conservative when most portfolio companies had generally positive outlooks. It was

The 1990 proposed NVCA guideline is the most widely used standard for US firms

Table showing the 1990 NVCA guidelines, EVCA Guidelines, and BVCA Guidelines with bars for different fund sizes ($251M to $750M, <$250M, >$750M) and percentages for each category. The chart illustrates the percentage of respondents using each guideline for each fund size category.
always recognized that these valuations could become “stale” if no financing event or material change resulted in a new valuation for some period of time. Throughout the 1990s this was not an issue. Limited partners (LPs) were not complaining since private equity funds were performing well and fund values were generally rising.

It is not surprising that the NVCA proposed guidelines became widely used in the industry. They were simple, easy to follow, and they were not too time consuming to apply. LPs generally endorsed them without question.

In more recent times, in markets where “material adverse changes” were dismaying frequent, these conventional valuation practices were seen to leave much to be desired. Even when there were financing events including new outside investors, the aggressive non-price terms often negotiated in downround and follow-on deals meant that a valuation based on the price per share of the company often did not reflect a reasonable assessment of the company’s value or of the net proceeds to individual funds upon exit.

Since private equity fund managers had so much discretion in setting valuation, one fund could write down an investment while another might continue to value the same company at cost and a third might value it at the last financing round value. If an LP was an investor in all three funds, the LP would receive reports with a wide variation in value for the same company. This increasingly common situation unsurprisingly caused both distress and dissatisfaction among LPs.

2002: tensions rise while markets suffer

The difficulties presented by the inadequacies of the existing guidelines and how they were used became pervasive and the frustration of LP investors increased as portfolio values continued to decline. In addition, with over $185 billion committed to the industry in 2000 alone [according to VentureEconomics / NVCA data], the sheer volume of new LPs and capital in the sector was generating calls for greater transparency of information. The result in 2002 was a series of initiatives to develop guidelines that would better address these issues.

In Europe, the British Venture Capital Association (BVCA) conducted an extensive assessment of valuation methodologies and practices and issued a discussion draft for updated guidelines. In contrast to the NVCA proposal, the BVCA draft states that the basis of valuation should be “Fair Value except in rare occasions when Fair Value cannot be reliably determined.” If Fair Value cannot be determined, then the company should be valued at its latest reported value except when impairment has occurred. If there is impairment, it must be reflected in the valuation.

In the US, the Private Equity Industry Guidelines Group (PEIGG), an ad hoc volunteer group, announced in November 2002 that it was formulating recommendations for industry-wide guidelines for valuation and reporting. Its members represent national and international venture capital funds, buyout funds, limited partners and service providers. The Association of Investment Management and Research (AIMR) has also publicized a discussion draft of performance presentation standards for the venture capital and buyout industries. In essence, this draft supports the Fair Value method that has gained support in international accounting principles and with the BVCA. The American Institute of Certified Public Accountants (AICPA) and the Institutional Limited Partners Association (ILPA) also have committees and task forces reviewing valuation reporting standards.

The work of these task forces gained added urgency from the debate that erupted over the public reporting of internal rates of return (IRRs) when newspapers brought lawsuits against the University of Texas Investment Management Company, which manages the university’s endowment, and the California Public Employee Retirement System obliging them to disclose performance
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data on their private equity portfolios. The resultant furor focused on the private equity funds’ IRRs. However there was little recognition in this public debate that these return calculations were “only as good as the underlying valuations,” as was pointed out in an article on IRRs in the December 2002 / January 2003 issue of Private Equity International. As a result of these very public disclosures 2002 ended with arguments over IRRs and the industry awaiting the results of the various task forces and comments about proposed guideline updates.

2003: the reckoning

This is the year in which the private equity industry is going to have to come to terms in some way with the current valuation challenge. There is clear evidence of this. Nearly 50 per cent of the respondents in our survey of US venture capitalists say they would like to see an industry standard (see second chart). As shown in the third chart, the respondents to our survey agreed that two of the main challenges to developing a standard would be the remote likelihood of agreement among industry players and the difficulty in designing the components of a single standard. To a lesser degree, concerns about the confidentiality of individual company valuations were also important. If a fund were to write down the value of a company and this information were to leak into the marketplace or somehow be discovered by the company employees, there would be a potential for difficulties in raising additional capital or retaining key employees.

If valuation guidelines are to be useful and broadly serve all players in the industry, certain simple criteria should be met. These are: agreement on the basic goal to be sought in any valuation calculation; guidelines that endorse accuracy, not conservatism, and recognition that specific methodologies should be applied in the service of the basic goal and not be used simply as an approved prescriptive list.

In any discussion of valuation, the goal that is being sought is generally implicitly assumed to be that a valuation should be an assessment of fair market value. However, the discussion often quickly moves to specific approaches and the debate quickly revolves around which specific approaches are reasonable and acceptable. The goal of fair market value as a standard against which to judge the suitability of any particular method in a particular set of circumstances needs to be paramount.

In most discussions relating to private company valuation, another implicit assumption is that being “conservative” in a valuation calculation is desirable. While this seems reasonable at first, it presents a problem because the degree of conservatism is generally not specified. Thus all that an LP knows is that the “conservative” GP believes that the true value is greater than the value being reported, but not by how much. The desire to report conservatively is understandable for several reasons. The GP does not want to report disappointing news in the future, nor does the LP want to be disappointed. A current estimate that is low should make such future disappointments less likely. Also, the future outcome is highly uncertain and a conservative approach represents a degree of risk aversion in the value assessment.

A key issue is that unless the conservative valuation report includes enough additional information for an LP investor to have some sense of the true situation, such conservatism can mask a wide range of circumstances and not provide the LP with the benefit of the GP’s full judgment in each case. While conservatism is often cited as desirable in financial reporting, it is accuracy that is the basic
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The underlying principle in accounting standards and funds will be increasingly urged to apply such a valuation standard in their audited financial reports.

Often people think of guidelines as a list of approved approaches to a problem. This is apparent in much of the private equity industry discourse about valuation guidelines. Many industry participants would still like to see a prescription that could be easily followed. However, keen and industrious GPs see their jobs as making good investments and working to make their investments succeed. Spending significant amounts of time and effort to better assess interim valuations is seen as a potentially large drain on resources that will not improve the final results of the fund.

While understandable, the search for simple valuation prescriptions is counterproductive if a standard and agreed-upon measure of accuracy is the goal. There are many valuation methodologies that can be applied but no one methodology will fit every set of circumstances. Instead, what is needed is a clear understanding that any methodology that is used should be judged by how accurately it reflects market value. If there is such a clear understanding of the objective, then an LP who receives different valuations of the same company from different GPs can explore why the GPs’ judgments differ about value, rather than be concerned that the differences may only reflect the application of different “approved” methodologies.

Although there will be challenges in the process, the private equity industry will be best served by developing new valuation guidelines that emphasize the goal of market value assessments. These assessments should reflect the best judgment of fund managers and provide guidance regarding best practices about the application of specific valuation methodologies.

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