

TUCK SCHOOL OF BUSINESS AT DARTMOUTH



CENTER FOR
PRIVATE EQUITY
AND ENTREPRENEURSHIP

**Private Equity Valuation and Reporting Conference
Proceedings**

June 18 – 19, 2003

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Introduction

On June 17th and 18th of 2003, the Center for Private Equity and Entrepreneurship hosted 48 private equity practitioners and recognized industry thought leaders for a conference on trends and developments in valuation and reporting in the industry. Attendees offered a wide range of experiences, with representation from the following groups:

General Partners (both Venture and Buyout)

Limited Partners

Fund-of-Fund Managers

Accountants

Lawyers

Consultants and Service Providers

Industry Organizations

Association Francaise des Investisseurs en Capital (AFIC)

Association for Investment Management and Research (AIMR)

British Venture Capital Association (BVCA)

European Private Equity and Venture Capital Association (EVCA)

Financial Accounting Standards Board (FASB)

Institutional Limited Partners Association (ILPA)

National Venture Capital Association (NVCA)

Private Equity Investment Guidelines Group (PEIGG)

The purpose of the conference was to bring all of the groups together in one forum to discuss freely and anonymously the increasingly important and visible issue of valuation standards within the private equity industry. Prior to the conference, such a forum for open, face-to-face discussion had not been provided to the various parties. This discussion format was important for the different participants in the industry to achieve a common understanding of valuation issues as a basis for possible industry consensus on valuation guidelines.

Tom Franco, Chairman and CEO of Broadgate Consultants, as keynote dinner speaker drew a parallel to the situation in the late 1980's when the government regulation threatened the private equity industry in the wake of the leveraged buyout mania that was restructuring corporate America inside out. The industry was able to unite and effectively make the case that LBOs were good for the economy and regulation was successfully avoided. Franco concluded that a common industry approach avoided potentially harmful government regulation based on misunderstandings. This conference was intended to foster such collaboration in the industry efforts to avoid the next wave of regulatory pressures.

Many private equity practitioners agree that the status quo in private equity valuation is no longer adequate for the industry and that some form of formal standards or guidelines (beyond the 1990 NVCA proposed guidelines) should be created. This was confirmed by a survey conducted by the Tuck Center for Private Equity and Entrepreneurship of 368 venture and buyout managers, of which 46% stated that they would like to see industry standards. What those standards comprise and who should create them are more difficult questions, which the conference helped address. The survey also showed that 51% of respondents wanted an industry association to take the lead in forming the guidelines, but the US has significantly lagged Europe in creating official standards for valuation. The EVCA, BVCA and AFIC were all represented at the conference and have all recently published updated guidelines for valuation. The latest BVCA guidelines were released after the conference and are attached in Appendix A. While membership in these organizations is required of private equity firms (unlike in the US), none of them actually has the right or duty to enforce the valuation standards, but rather they are suggested best practices.

The NVCA proposed guidelines created in 1990 are currently the “de facto” guidelines for private equity valuation in the US, and they do not go into as much detail as their European counterparts. An ad hoc committee named Private Equity Investment Guideline Group

(PEIGG), which comprises representatives from both the GP and LP community, has recently taken up the challenge of developing a new set of guidelines. The committee is expected to publish its recommendations in the Fall of 2003. Additionally, the Association for Investment Management Research (AIMR) has been working to expand its own valuation standards to include alternative asset classes. A problem is that each organization is working independently of the other, and the concern is that without collaboration consensus will not be reached. One view of the conference participants was the possibility that PEIGG (with greater participation from AIMR), ILPA, and the major accounting firms might work together to publish a set of US valuation guidelines. However, broadly acceptable guidelines will need to incorporate input from many parties, and it was suggested that another conference be held that would again include PEIGG, ILPA, EVCA, BVCA, NVCA and AIMR in the near term.

With respect to valuation standards, key viewpoints began to emerge as the conference progressed:

1. Guidelines will need to reflect “fair value” as defined by GAAP, and portfolio investments should be marked to market on a periodic (preferably quarterly) basis.
2. Guidelines should reflect “prudence”, meaning a fair-value based approach to valuation, which is different than a cost-based approach or an approach that artificially understates value.
3. The major challenges for wide acceptability and usefulness will be valuation guidelines that are seen as GAAP compliant by the accounting industry.

One major issue that arose in the discussions was a byproduct of the preference for transparency and accuracy, the probable increase in volatility of interim valuations. While most participants favored moving closer to a “fair value” system of valuation, the assumed associated increase in volatility was unsettling to some participants who thought it would be misleading given the long term, illiquid nature of the asset class. In this light, an interesting

parallel to the real estate industry was drawn. The point was made that the real estate industry made the shift to quarterly mark-to-market valuations, and volatility did occur. However, this was part of the development of real estate as an asset class, and private equity should be prepared to go through similar growing pains.

From the LP perspective, most representatives voiced the opinion that having one rigorous methodology for valuing portfolio companies was less important than creating more transparency in describing and explaining the methodologies and judgement used. The example of differing valuations of the same company by different GPs is often brought up in discussions for the need for standardized valuation principles, and GPs often bristle at this as an attempt to remove all subjective judgement from the valuation process. In contrast, the LP representation at the conference recognized that GP subjectivity was an important component of the valuation and reporting process. Most LPs did not perceive a problem with differing valuations of the same portfolio company, *provided that each GP disclosed in detail the methodology and rationale used in presenting such a valuation*. The point was also made that if all GPs used the same guidelines, even with subjective components, the dispersion between valuations of the same company across multiple GPs could decrease. LPs believed that objective guidelines would be an important step in improving information quality and helping them manage their portfolios more effectively.

The conference participants agreed that there are two important reasons for trying to arrive at agreement on valuation standards: eventual international guidelines and building greater trust between GPs and LPs. As with accounting standards that are slowly moving toward a goal of one international accounting standard accepted by most if not all nations, it is important to note that international private equity valuation guidelines would greatly facilitate cross-border investing and performance comparisons.

The trust between LPs and GPs, which is vital to both parties, has been negatively affected due to the enormous amounts of money committed to the asset class and the subsequent losses in portfolio value in recent years. One of the significant issues that arose in the discussion was GP compensation and the effects that interim portfolio valuations have on carried interest and management fee payouts. This is becoming significantly more important as LPs are currently finding it difficult to enforce clawback provisions. Interestingly, the point was made that many LPs were compensated on the performance of their own assets under management, and the question was asked as to whether they were ready for the volatility of their own portfolios that a fair value approach would engender.

It was broadly agreed that the benefits to rebuilding the GP-LP trust reach beyond mere harmony in the private equity industry. This trust is critical to capital formation and investment in innovation and growth, and this is the foundation of a strong private equity sector of the economy.

The Tuck Center for Private Equity and Entrepreneurship gratefully acknowledges the participation of the following individuals in preparing these proceedings: Colin Blaydon, Fred Wainwright, Jeffrey Paré, Jane Penner, Theresa Sorrentino, and Gail Sweeney.



Conference Proceedings

Opening Remarks

Colin Blaydon, Director of the Center for Private Equity and Entrepreneurship, began by stating the goal of the conference: to bring together people who have been working on and talking about private equity valuation and reporting issues and to share the resulting wisdom with the wider world. Professor Blaydon went on to note the variety of players participating in the conference, including representatives from several industry groups, general partners, limited partners, and a voice speaking from the accounting oversight perspective. Finally, Professor Blaydon emphasized the quickly changing paradigms of the private equity world, and suggested that the conference could help shape these changes and help the industry determine how best to move forward.

Session 1 : Summary of Key Guideline Initiatives

Moderator:

Professor Colin Blaydon, Center for Private Equity and Entrepreneurship

Official Speakers:

1. Representative from the British Venture Capital Association (BVCA)
2. Representative from the Private Equity Investment Guidelines Group (PEIGG)
3. Representative from Institutional Limited Partners Association (ILPA)

Impromptu Speakers:

1. Representative from the Association of Investment Management and Research (AIMR)
2. Representative from the Association Francaise des Investisseurs en Capital (AFIC)

[After introducing the speakers, Professor Blaydon noted that there is one other group at work on valuation guidelines: the American Institute of Certified Public Accountants (AICPA). Its task force was meeting in Seattle on the same day as this conference, so unfortunately no one could be at this session to give a progress report.]

BVCA Presentation:

The BVCA speaker introduced himself as an executive from a publicly listed private equity firm. He was a member of the “consideration committee” which produced the BVCA valuation guidelines. The speaker went on to explore several topics in a Power Point presentation (see Appendix B)

He began by outlining the BVCA guidelines project timeline. Beginning to end, the process of creating guidelines took 18 months. The initial consultation phase began in December 2001 and continued through March 2002. At that point, the consideration committee was formed to discuss the issues raised during consultation. An exposure draft of valuation guidelines was

issued in November 2002. After soliciting and reviewing comments on that draft, the BVCA council formally approved the guidelines in June 2003. The committee is now considering responses to the published guidelines. The speaker noted that the guidelines would be published online within a week or so of the conference.

The BVCA speaker continued by discussing the relevant background of the guideline project, emphasizing two areas in particular: environment and diversity of views. The following environmental factors shaped the committee's project:

- Increased regulatory influence on the private equity sector. In the UK, all private equity firms are required to be registered and authorized.
- Increased publication of fund performance statistics under freedom of information laws in the U.S. Such statistics need to be arrived at using comparable and consistent methods.
- Developments in financial reporting (GAAP). Firms have obligations to report in accordance with GAAP. There has been a shift within GAAP in favor of principles-based rather than rule-based standards; and GAAP has moved away from cost-based measures towards value-based measures.
- Increasing demand for reliable, realistic information (driven, of course, by poor performance in recent years).
- Increasing secondary activity. Private equity investors were originally tied in for up to 10 years, so interim valuations were less important, but now there are an increasing number of liquidity options available.
- Overall attempt to assess what private equity investors expect and need -- especially investors who are new to the equity class. In general, investors want to be able to

assess their asset allocation positions as and when they wish and to compare performance across investment managers and funds.

Several conflicting views about valuation and reporting currently inform the private equity industry and make the process of coming up with common guidelines very challenging. The BVCA rep described how industry players often lock horns over the following issues:

- Prudent valuations ("conservative" valuations designed to avoid unpleasant surprises) *versus* realistic valuations (those that depict a true picture of the progress/performance).
- "Smoothed" results (the use of prudent or conservative valuation methods can serve to enhance the non-correlation benefit of private equity) *versus* more volatile results (those that reflect realistic values).
- Whether full disclosure ("transparency") is sufficient on its own. Said another way: Should GPs provide full information and let the LPs sort through it on their own? In that case, it is argued, there would be no need for guidelines. Yet even in a "full disclosure" scenario, the LPs won't get comparability and consistency, nor the benefit of the GP's judgment in estimating values.
- Standardization (of valuation and reporting) is a good idea *versus* standardization is a bad idea.
- Mechanistic/formulaic approach *versus* judgmental/qualitative approach. Said another way: Are GPs best positioned to determine value using subjective analysis or are they (as self-interested parties) inherently untrustworthy?
- Within private equity, it is possible in practice to derive reliable, up-to-date valuations *versus* it is impossible in practice to derive reliable, up-to-date valuations.

After presenting the background informing the committee's deliberations on valuation and reporting guidelines, the BVCA rep described the committee's agreed-upon goals. In their view, valuation guidelines must:

- Clearly specify the overriding basis of valuation – i.e. what exactly the carrying amount purports to represent.
- Privilege GP's judgment above prescription. In other words, valuations should not be derived from a predetermined formula. GPs, using good-faith efforts, should be able to come to a fair value.
- Use tight language, in order that compliance with the guidelines can be objectively assessed. "Should" statements and other qualitative language must be used, so as to not override GPs' judgments.
- Promote comparability of performance – one year with another, one fund with another, and one fund with another asset class. This could only be achieved by using realistic values, rather than prudent ("conservative") values.
- Be GAAP-compliant.
- Avoid procedural or corporate governance issues, such as the frequency and timing of valuations, or whether they should be audited.

The BVCA speaker went on to summarize the key points of the guidelines developed by the committee.

- The use of "fair value" as the overriding basis of valuation. Fair value is defined for the purposes of the guidelines precisely as it is for the accounting industry in IAS 39, "the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction."



- When valuing start-up and early stage investments, the committee recognized that fair value may not be capable of reliable measurement – where this is the case, the recommendation is to use the latest carrying value less any impairment.
- Discounts used should relate solely to marketability (i.e. is there to reflect the economic reality that the fund cannot cash in its investment immediately). The committee also acknowledged that marketability circumstances varied, and the amount of discount applied should therefore also vary. A majority holding is probably more marketable than a minority stake.
- Discounts from market prices should be permitted for quoted investments.

Regarding unquoted investments, the BVCA guidelines identify a number of methodologies and distinguish between primary and secondary valuation methods. Primary methods should be used unless they are demonstrably inappropriate, in which case secondary methods should be used. Primary valuation methods, according to BVCA guidelines, include the following: earnings multiple, price of recent investment and net assets. Secondary valuation methods include: discounted cash flows or earnings of underlying business, discounted cash flows from the investment (this can be a primary valuation method where realization or flotation is imminent) and industry valuation benchmarks. The speaker noted that the valuation methods for unquoted investments outlined in the BVCA guidelines are by no means comprehensive.

In conclusion, the BVCA speaker observed that developing guidelines had been a long process, involving a lot of consultation. Overall, the BVCA guidelines reflect the primacy of the GPs' judgment and realistic values over the use of prescriptive guidance and prudent values. Of course, implementation in real-life situations will be the true test of any guidelines, including the BVCA's. Finally, the speaker emphasized that international harmonization in this area is an important long-term goal and one which the BVCA wished to support.

Q&A Session

The first question followed up on the BCVA speaker's mention of providing complete disclosure of all information about holdings in lieu of guidelines. He asked where that conversation led. The BVCA rep responded that the committee ultimately decided that the degree of transparency on holdings information was a reporting issue rather than a valuation issue. Separate guidelines should be created and followed for reporting. The next question inquired whether British firms are required to be BVCA members and whether members are required to follow the BVCA guidelines. The BVCA rep responded that all PE firms are required to be in the BVCA, but the guidelines are only there for guidance. They are not required, and are not enforceable.

PEIGG Presentation:

The speaker began by commenting that PEIGG is a much younger organization than the BVCA, and subsequently is much earlier on in the process of creating guidelines. PEIGG was formed in the early part of 2002 from a group of 20 practitioners in the private equity business. It has established a number of committees on reporting PE investments to investors and has one sub-committee focused on valuation issues. That sub-committee consists of two LPs and two GPs, percentages that reflect the overall composition of PEIGG. It was set up that way in order to be able to arrive at a consensus that is in harmony with the views of the private equity industry as a whole.

When evaluating the prevailing philosophies about determining valuation, the valuation sub-committee decided that, if guidelines were to err, they should err on the conservative side. The PEIGG sub-committee wants to prevent one-time events from skewing valuations to any large degree. It also wants LPs involved and thinks reporting should be transparent, but feels that the GPs are responsible for the numbers at the end of the day. The sub-



committee reviewed the EVCA and the BVCA guidelines and drafted a proposal, which they then circulated within the whole PEIGG. After repeating this process (proposal/consultation/revision) several times, an initial draft of PEIGG valuation guidelines was created in April 2003 (this draft appears attached as an appendix to this report). The subcommittee is in the process of soliciting feedback (with the help of KPMG and a data matrix); a final draft of the guidelines is expected to appear in fall 2003. PEIGG has no authority to enforce the guidelines, but the speaker expressed the hope that associations and firms will adopt the PEIGG recommendations as “best practices.”

Q&A Session

The first question addressed the impact of PEIGG's recommendations on secondary sales: does a conservative ("no surprises") approach wind up undervaluing the assets of secondary sellers? The PEIGG representative responded that this issue had come up in the committee and been discussed at length. PEIGG's position is that secondary sales should have no effect on valuation, because most secondary sellers are distressed, trying to get out of future commitments they can't or don't want to cover. In such situations, the seller should still go through a valuation process for their own benefit in order to calculate a more accurate value than their selling price. But no buyer should then use that value to determine a price for the position. A follow-up question asked how secondary funds buying the same positions from different sellers at different values should reflect such purchases on their books. The PEIGG representative suggested that funds in that position initially record the value of the positions at cost and then write up the positions to fair value over the course of the year. In such cases, he added, secondary funds must factor in why the seller is selling. The final question addressed whether the PEIGG guidelines are GAAP-compliant. The speaker responded that there is one major discontinuity between PEIGG guidelines and GAAP, because GAAP allows no discounting for liquidity of blocks of public securities held by a fund and PEIGG disagrees with that position. The speaker noted that there will be major discussions about this issue in the future, since GPs don't want to keep two set of books -- one GAAP-compliant and one

reflecting "true value." [Editors' note: in a subsequent PEIGG meeting, the group decided to follow GAAP and not require a discount.]

AIMR Presentation (Impromptu):

An AIMR representative began by acknowledging two other conference participants who were on AIMR's private equity valuation task force. Giving a little background for those unfamiliar with AIMR (an investor advocate organization) he explained that AIMR's effort to develop performance presentation standards (for stocks and bond funds, as well as for events such as presentations to institutional investors or "road shows") is expanding to cover other asset classes, including private equity in general and private equity valuation in particular. He emphasized that AIMR is a global organization (unlike most of the other groups developing guidelines) and therefore is in a good position to marshal consensus on valuation standards. The task force hopes to develop guidelines that will be embraced by many (if not all) industry constituents and which can be applied globally. He also said that the AIMR guidelines are ideally aimed at helping orient those investors who are new to the private equity asset class.

Regarding how the AIMR guidelines might develop, the representative said that the task force recommends fair value methods (as opposed to conservative methods) for PE portfolio valuation. He also expressed the opinion that, in today's world, most parties agree that fair value is the best method -- this consensus didn't always exist. Finally, he noted that, in coming up with guidelines, the task force focused on "high-level principles" and common sector principles rather than details or specifics. Discussing AIMR's timeline, the representative said that the task force produced an exposure draft of guidelines last summer (released in the fall) and is now incorporating comments for a final proposal to be presented to the governing council in September 2003.

AFIC Presentation (Impromptu)

A conference participant was asked to speak about the development of AFIC guidelines (the guidelines are included in the conference binder). The speaker identified herself as a general partner and CFO of a French venture capital firm, as well as a member of the EVCA and the head of the AFIC valuation task force. The speaker began by saying that, when EVCA guidelines were published in March 2001, the initial effort was merely to translate them into French. However, during the translation process, AFIC members realized that the guidelines needed to be reworked and updated. According to the speaker, the French guidelines are still heavily based on the EVCA's, but there are some important differences. Namely, the French guidelines give general partners more flexibility than do the EVCA guidelines. AFIC's position is that any and all rules governing valuation must be fully described in partnership agreements. That way, LPs (or auditors) can easily determine if GPs are complying with what was agreed upon.

Speaking more generally about the European environment, the AFIC representative observed that the private equity industry in Europe has been motivated to self-regulate in a way that the U.S. private equity industry has not (yet) been. As a result, the European industry associations are working together much more closely than ever before. In response to a question, the speaker noted that, while all French companies have to be registered with AFIC, the organization's guidelines and recommendations are not enforceable.

ILPA Presentation:

The speaker introduced himself as a managing director responsible for the corporate equity portfolio at a large insurance company. He began the presentation by giving some background information on ILPA, noting that it is the only organization dedicated to the interests of institutional LPs in private equity. There are 150 member firms, with a large

international representation. The majority of ILPA's members are large investors, and, together, they represent about two-thirds of the total allocations in the global private equity industry (smaller players who are ILPA members represent a smaller percentage of PE allocations). Furthermore, 80% of all investors with \$1 billion under management are members.

ILPA members meet two times a year for three days. Its mission is to facilitate communication, and (to that end) the organization has just appointed its first-ever executive director. Networking, education and information sharing are very important goals. There are three committees within ILPA focused on best practices: reporting, valuation and performance measurement. Valuation issues in particular have been a core topic of discussion during the last two meetings. The ILPA speaker emphasized two caveats about his remarks: 1) the beliefs expressed are majority opinions (unanimity among 150 members is virtually impossible); and, 2) the beliefs expressed are ILPA's recommendations for *best practices* (i.e. they are NOT attempting to provide guidelines or standards).

The rest of the speaker's comments were divided into two sections: ILPA's response to the PEIGG guidelines and ILPA's response to the BVCA guidelines. What follows is a summary of the discussion outlined in the speaker's presentation (see Appendix C).

ILPA's Response to PEIGG Guidelines

The speaker began by saying that the majority of ILPA members take issue with PEIGG's assertion that investment cost ("cost") is an adequate proxy of fair value. He listed several reasons for this position, including the following: U.S. GAAP requires fair value (rather than cost) reporting; banks and insurance companies are required to "mark to market;" and many state pension plans have adopted fair value accounting. Instead of valuations based on cost (or impaired value), the majority of ILPA members favor accounting of valuations at fair value

estimated in a conservative manner (i.e. substantially greater evidence is required to write up the carrying value of investments than to write down those investments). The majority of ILPA members also feel that fair market values should be prepared quarterly, since quarterly reporting is required of LPs by GAAP (PEIGG guidelines are not specific about how often GPs should report valuations to LPs.)

Addressing PEIGG's criteria for write-ups and write downs, the speaker noted that the majority of ILPA members would like to see more symmetry between the criteria for writeups and the criteria for writedowns. While writeups at venture funds should require objective (transactional) evidence, writeups at buyout funds may credibly be based upon improved financial performance and/or market multiple expansion in addition to transactions. Additionally, ILPA members generally feel that writedowns at both buyout funds and venture funds should (following a conservatively implemented fair value approach to valuation) be based on subjective as well as objective criteria.

The ILPA speaker went on to discuss financial statements in light of the PEIGG guidelines. He began by reiterating that the majority of ILPA members feel that carrying value should be fair value, as required by U.S. GAAP. More generally, he expressed ILPA members' desire for an "industry-standard" valuation framework that would support specific fund policies and processes. The guidelines describing this framework should be written in careful, specific and articulate language, which, in turn, would become idiomatic within the industry. The framework should not be regulated (by external forces or professional valuers) nor should LPs expect the standard to magically produce completely consistent values. But such a standard would, if adhered to (even with predictable exceptions) by all PE firms, permit intelligible comparisons between different valuations of the same portfolio companies by different funds.

The next issue raised by the ILPA speaker dealt with the desirability of international valuation standards (as opposed to country-specific standards). Noting that there are common investors across all geographic regions as well as the fact that EVCA and BVCA guidelines are converging, the speaker said that the majority of ILPA members support U.S. private equity firms adopting European or British guidelines. Given that the U.S. lags the rest of the world in adopting valuation guidelines, the development of independent U.S. standards would also be viewed as a good first step (barring U.S. firms' embrace of international guidelines).

The next topic concerned who should be responsible for determining valuations and valuation policy. The majority of ILPA members feel that GPs are best positioned to determine valuations (the PEIGG guidelines suggest that, in certain circumstances, formula- or rules-based valuations are appropriate). External validation of GPs' valuations is not needed. LPs should always be informed of a fund's valuation policies, and an advisory committee (with LP members) should review and discuss -- but not ultimately approve -- those policies.

Finally, the ILPA speaker addressed the potential usefulness of industry-driven guidance about valuation methods. The majority of ILPA members feel that clear guidance is preferable to rules or formulae. Specifically, they think that PEIGG guidelines, in their initial draft, while a great first step, are too broad. Clarification and/or specific examples are very helpful in all industry-driven efforts to develop valuation guidelines.

ILPA's Response to BVCA Guidelines

The speaker began by outlining the expanded scope ILPA members would like to see the BVCA (or any) guidelines have. In addition to offering guidelines on investor reports, they would also like to see guidelines regarding capital calls, distribution notices and capital accounts.

Regarding the basis of valuation, the majority of ILPA members feel that fair value is the best method even though a minority are comfortable with lower of cost or impaired value. There is almost unanimous support amongst the membership for a conservative estimation of fair value, with write ups for private companies being taken only when there is clear evidence to support them, and write downs being justifiable in cases of material or significant impairment of value, not just permanent impairment. Furthermore, a majority of members believes that U.S. GAAP requires fair values.

The speaker noted that ILPA members are in general agreement with the BVCA's distinction between "primary" and "secondary" valuation methodologies. However, given that the valuation techniques assume that businesses are a "going concern," many members argue that "net assets" should be categorized as a "secondary" methodology; other members consider an assessment of the discounted cash flows of the underlying business to be a "primary" method of determining value.

ILPA members generally approve of a marketability discount for unquoted investments and thus are in agreement with BVCA guidelines on that subject. This is consistent with ILPA's majority view that methodologies employed to estimate fair value should be applied conservatively. Additionally, the speaker noted that that discounts should be applied to the equity value, not the enterprise value and that (generally speaking) businesses where cash flows have increased relative to leverage should not be carried below cost due to discounts.

Wrapping up his comments on BVCA valuation guidelines, the speaker said that ILPA members generally agree that more transparency in valuation is better than less and that more frequent (ideally quarterly) valuations are better than less frequent ones. Additionally he noted members' feeling that BVCA shouldn't shy away from billing its guidelines as "best practices"

for process, practice and procedure within the private equity industry. In particular, he noted the need for the BVCA to take a stronger stand endorsing the fair value accounting practices.

The speaker went on to discuss ILPA's response to BVCA's reporting guidelines. While the organization's recommendations are very similar to BVCA's, he noted some differences, including the following:

- ILPA recommends that GPs prepare interim reports on a quarterly rather than a semi-annual basis;
- ILPA recommends that interim reports be produced within 60 days of the end of quarter (within 90 days for Fund of Funds) and that annual reports be produced within 90 days after year-end (within 120 days for Fund of Funds);
- ILPA recommends that complete unaudited financial statements with footnotes be included in interim reports and complete audited financial statements with footnotes be included in annual reports;
- ILPA recommends that interim and annual financial statements include footnote disclosure of any guarantees made by the partnership on behalf of the investments, including debt guarantees and contingent liabilities;
- ILPA recommends that interim and annual financial statements include a note regarding the value of unrealized investments that details the carrying value and the cost basis of each investment;
- ILPA recommends disclosure of any leverage to the fund, including debt and guarantees, charges, or contingent liabilities.

Finally, the speaker had a few comments about possible guidelines for capital calls and distribution notices (BVCA guidelines do not address these subjects). In general, ILPA

members would like guidelines to recommend that GPs explain to investors what the capital call is for. Regarding distribution notices, ILPA members would like guidelines to recommend that GPs tell investors:

- The amount of the return of capital;
- The amount of gain or loss;
- From where the distribution is coming.

The speaker remarked that addressing the above issues would save GPs and LPs a lot of time and aggravation.

Q&A Session

Professor Michael Horvath began by observing that there seemed to be a unanimous position within ILPA regarding conservatism, and wondered aloud why everyone is so concerned about negative surprises in private assets, when such surprises are so common in public assets? He observed that investors shouldn't expect to avoid negative surprises if they seek the opportunity that exists in private equities and again raised the issue of whether a conservative approach winds up undervaluing the asset class as a whole. The ILPA speaker responded that the organization's stance is really that, since no one knows exact value (GPs are really guessing at the end of the day), values should be at the bottom (conservative) end of the possible range rather than at the top end of that range. (He distinguished this brand of fair value-based conservatism from the cost-based conservatism advocated by PEIGG and others.) The PEIGG speaker added that a cost-based conservative approach, combined with the use of milestones, reduces the likelihood of clawbacks.

Professor Horvath stated that given that GPs are generally optimistic, and are also afraid to put anything in their statements that smacks of a value judgment, he asked the group why LPs and/or GPs don't simply hire third party, independent valuers to make rational economic

determinations? There seems to be a large opportunity for consultants here, especially since, under Sarbanes-Oxley, auditors need to be independent. Furthermore if third-party valuers were to start keeping track of how good funds are at *reporting* (calculating interim valuations, etc.), it might provide an incentive for standardization. This would also allow the various valuation methods (cost vs. fair value) to be intelligently compared. GPs currently have all of the data necessary to make this sort of standard post mortem analysis of funds possible. Some questions were raised at this point about whether an increased focus on valuation/reporting (either by GPs or by third party valuers) might encourage lawsuits. One participant observed that no valuation methods have precision to within a factor of five, even. The values are thus "highly metaphysical" -- could stoking the desire for more accurate values lead to lawsuits? Another participant opined that there is very little risk of this, due to the time and cost required to go over individual valuation estimates.

Getting back to the possible standardization of valuation methods in private equity, one participant observed that the real estate industry is about 10 to 15 years ahead of the PE industry in thinking through these issues. As the real estate industry became increasingly institutionalized, it adopted industry standards for annual third party appraisals. This created quite a bit of volatility, because until an asset was sold, there was no real way of knowing what the building was worth. The debate over valuation methods in PE is just one of many signs of the industry's growing pains. The PEIGG speaker responded by noting a big difference between the real estate industry and PE, namely that real estate assets can be valued in a somewhat formulaic way (because they all have certain things in common) whereas early-stage companies cannot be. That said, however, he acknowledged that the concept of defining a set of variables to assess value could be done in the private equity industry as well and concluded that the trend seems inevitable. A representative from AIMR agreed that real estate information standards (RISA) are very formulaic, and noted there is an AIMR committee for real estate as well. He also commented that, within the real estate

industry, there is a lot of pressure to go back to having third party valuations done every 36 months, as opposed to yearly, in order to tame volatility.

At this point, the discussion returned to the debate over the meaning of "fair value." The BVCA speaker told the group that that his organization had debated the idea at length and determined that "fair value is incompatible with conservatism." He characterized conservatism as a way of telling not the truth, but rather a "protected truth." Other conference participants weighed in on the subject. One suggested that a fund manager should ask himself what he would pay to "jump back into" a given position all over again -- the answer to that question would be a good indicator of the position's fair value. Another participant suggested that fair value is the price for which one could auction off one's stake, and observed that very often the price you pay for a position is not what you expect to sell it for. Another participant (a senior partner at large fund of funds) opined that, rather than wrestling with accounting definitions of fair value, industry players should be thinking, "What is a fair value for *us*?" The speaker noted that the answer to this question must include a mix of quantitative and qualitative elements to earn any sort of credibility, and concluded that if industry players can't agree on a definition, regulators will take it upon themselves to do so.

Several participants discussed the ways in which the notion of fair value becomes even more complicated in secondary fund accounting. One reminded the group that assets in secondary sales are often distressed and that one must factor in the reasons why they are distressed. He asked: "Is fair market price the last price at which they cleared? Remember, in secondary markets you are not just buying the equity position; you are buying future commitments as well. You need to consider those obligations when assessing a fair value." Another participant raised the issue of when the buyer of a distressed asset in a secondary sale can mark up that position. In response, another participant argued that a buyer in that situation could credibly mark up the position the day following the sale because the buyer has the intent and ability to hold onto that asset, unlike the seller.

A managing director at an accounting firm raised the important distinction between carrying value and realization value in the whole "fair value" debate. He recounted working with a buyout fund that did quarterly valuations, and noted that the fund's volatility was enormous. It took a huge time commitment on the part of that fund to produce those quarterly valuations. Eventually, producing the valuations became so burdensome that client said, "Forget these valuations -- just go and run the money!" The lesson? For whom are fund managers going through the exercise of portfolio valuation? Is it an efficient use of time and resources? Professor Colin Blaydon then posed a version of this question to the entire group: From where is the impetus for guidelines coming? What's the driving motivation behind that impetus?

The BVCA speaker responded that his organization's motivation was to protect and benefit its members. He said that there is a fear among members of being attacked by LPs and/or the FSA. A partner at a major national accounting firm observed that trust between GPs and LPs has eroded considerably over the past decade due to more entrants in the equity class (and subsequently more money under management) and because of the bursting of the Internet bubble. He posed a basic question for the group: Why do valuations even matter? Another participant responded, saying valuations often determine who gets paid what, and when -- especially if there is some sort of a bonus program, benchmark, or job performance standard in place. Furthermore, he argued, there is a perception, if not a reality, that valuations matter because of a fundamental misalignment of interests between LPs and GPs. If we can fix the misalignment, he argued, a lot of the tension would be resolved.

The managing general partner of a large VC fund weighed in on this issue, noting that discussions with LPs get a lot calmer when they realize that the GPs' compensation never derives from interim valuations. But, he noted, the LPs are still very interested in interim valuations all the same. He went on to emphasize the importance of understanding the LP/GP relationship as a partnership. Ideally, both parties should be continually imagining what it's



like to be in the other's shoes. He went on to argue that any sort of institutionalization of the LP/GP relationship jeopardizes the quality of that partnership. LPs and GPs must have mutual trust and must be communicating with each other; a report just won't cut it. Furthermore, he argued that most GPs don't have the time to really understand the increasingly "transparent" information that they're getting ("That's the stuff they are paying *us* to interpret!") In the end, a compatible LP structure (partnership agreement) will serve all parties better than complete transparency. For the business to work, it has to revolve around trust. He went on to suggest that a lot of the pressure (i.e. lack of trust) is coming from new entrants who approach venture capital with a transactional attitude, which is inappropriate. Venture capital, in particular, is a building business -- if you haven't been around long enough to see year 12, then you really haven't lived through a cycle. He concluded by saying that now is the time to solve this contentious issue of valuation, because so little money is being raised right now. In 18 months or two years, it will be a very different world to be seen out there and the conversation will be that much more fraught.

Session 2 : The Accounting Industry

Moderator:

Professor Rick Antle, Yale School of Management

Official Speakers:

1. Representative from FASB
2. Representative from a major national accounting firm
3. Representative from a major national accounting firm

Speaker #1

After thanking the Center for the opportunity to speak, the FASB speaker read a disclaimer and informed the group that this disclaimer applied to any remark that the speaker made at any time during the conference. The speaker began by giving an overview of the five topics to be covered:

- FASB's definition of fair value for financial reporting;
- Application of the fair value measurement attribute in U.S. GAAP;
- FASB criteria for decision making, applied to fair value measurements;
- Current FASB thinking about fair value measurements, with specific attention paid to applications to private equity scenarios (the speaker developed these scenarios from reading the BVCA document);
- Current FASB fair value measurement project.

FASB's tentative definition of fair value is as follows: "the amount at which an asset or liability could be exchanged (or settled) in a current transaction between knowledgeable,

unrelated, willing parties when neither is acting under compulsion." The speaker noted that the definition is "tentative" until it is published in official FASB public documents. The speaker also clarified several terms used in the definition, noting "current transaction" means close in time, and that Statement 57 of GAAP provides a definition of "related parties." Regarding "compulsion," the speaker stated that such compulsion could be economic (i.e. a distressed sale) and therefore wouldn't be recognized as fair value. Finally, the speaker pointed out that FASB's definition doesn't require a real marketplace; the objective is to estimate the single exchange price at which *hypothetical* willing marketplace participants would agree to transact, excluding transaction costs.

The speaker went on to discuss the applicability of fair value measurements in U.S. GAAP, stating that US GAAP requires fair values in some but not all current and proposed standards. GAAP requires fair value measurements for certain assets and liabilities acquired in a business transaction; for impaired assets (including purchased goodwill); for certain derivatives; for certain performance obligations (guarantees, per FIN 45); and for some financial instruments (per FAS 115). Despite the fact that there are a few standards that require present value measures (as opposed to fair value), the trend is toward fair value measures; ideally, FASB would like one way to think about this issue.

The speaker's next topic was FASB's criteria for decision-making. Following the Conceptual Framework, reported information should be:

- Relevant: capable of affecting decisions. (Fair values are sometimes the only available measurement attribute, and they are viewed in many cases as the most relevant attribute.)
- Reliable: verifiable, neutral and representationally faithful. The accounting definition of faithfulness is when neutral, representational, independent measurements would

agree. (Fair values are viewed by some parties as inherently less reliable than other measurements.)

- Comparable: similar events and transactions are accounted for in the same way. Comparability is *very* important to FASB and the Board creates both standards and implementation guidance to enhance comparability.

The speaker explained that FASB's current thinking about fair value measures has two main thrusts. Firstly, wherever possible, funds should use observed prices for identical items, or for similar items (adjusted for dissimilarities). Some caveats: Prices are not considered reliable if the exchange is between related parties, or if the exchange includes other elements, or if there is a legal/regulatory compulsion, or if one party to the exchange is in financial difficulties. Furthermore, as the observed price becomes more distant in time, it becomes less useful as a fair value measure. Finally, transaction costs should be excluded and the midpoint of the bid-asked spread should be used. Secondly, in the absence of observable prices, the FASB speaker noted that valuers should use models and assumptions that market participants would use (an example of a "model assumption" is a multiple of net earnings or EBITDA).

The speaker moved on to discuss certain valuation practices (largely those covered in the BVCA proposal) in light of current FASB policy. The practices/proposals covered in this discussion included:

- The deliberate use of conservatism;
- The practice of using different measures for different kinds of business models (e.g. venture vs. buyout);
- The use of block discounts;
- The practice of discounting restricted securities;

- The use of numerical rules.

Regarding the deliberate use of conservatism, the speaker first defined what "conservatism" means in an accounting context: the "deliberate and consistent understatement of assets or income or both." Because FASB calls for unbiased measurements, it rejects deliberately conservative valuation practices. Regarding the practice of using different measures for different kinds of business models (as the ILPA documents suggest for VC and buyout funds), the speaker noted that some reporting standards (e.g. FAS 115) are already based on intent or on an entity-specific business model, but -- that said -- FASB's experience with intent-based standards is decidedly mixed. There can be difficulties properly describing what the intent and/or business model is; in short, such standards are problematic to apply. FASB is still wrestling with the issue of block discounts. At the moment, the Board wants to disallow block discounts because of the inability to define the circumstances for which discounts would be required, as well as for difficulties in describing how to measure/record the discount.

Regarding discounts for restricted securities (per FAS 115), FASB's tentative position closely follows the SEC's existing regulations: Adjust prices of otherwise similar assets for the effects of the restriction. The speaker added that intent is not an issue in such cases because the restrictions are contractual or legal. Finally, the speaker moved on to FASB's thinking about the use of numerical rules (as in BVCA proposals for block discounts). The speaker noted that, while some reporting standards contain numerical rules (e.g. FAS 13 and FAS 123), some accountants believe that numerical rules encourage transaction structuring. On the other side of this very heated debate are those accountants who think such rules are necessary to reduce implementation difficulties.

The final part of the speaker's presentation focused on FASB's fair value measurement project. The goal of the project is to develop a single standard for measuring fair values, to be

applied whenever the relevant reporting rules require a fair value measurement. Such a standard would apply broadly, to both nonfinancial and financial assets/liabilities, and decisions about measurement attributes would continue to be made one at a time. The development of this (unprecedented, in FASB history) standard will include some of the discussion that is currently in Concept Statement 7 (essentially a discounting approach to fair value) -- and thus the project aims to update and expand those Concept Statements that pertain to measurement.

Q&A Session

The first question came from the PEIGG speaker. He noted that the private equity industry has always had a conservative approach to valuations, and asked why the FASB "can't accept" that approach. The FASB speaker responded that the Board's mission is to provide neutral information, and that purposely biased reporting is not consistent with that mission.

The next questioner asked about the reliability of fair value measures, and asked what the FASB thinks is an acceptable level of reliability in financial reports. The FASB speaker noted the pervasiveness of estimates in financial reports and acknowledged the FASB's concern about the reliability of fair value measures. When asked whether estimates should be recorded with an uncertainty measure, the FASB speaker responded that that idea has not been considered, but also noted that fair value estimates do reflect uncertainty to some extent, because the measurement is based on probability-weighted assessments of possible outcomes.

Speaker #2

The speaker began by saying that private equity valuation guidelines aren't likely to come from industry organizations because U.S. firms can't be forced to join an industry group. He also noted that the top 25% of firms are those that "don't want to play by anyone's rules," creating a conundrum for the rest of firms. He feels that the industry as a whole needs to find stability, reliability, order and structure in capital markets.

In late 2001, his accounting firm conducted a voluntary survey to assess how venture capital firms value their portfolios. One of the key conclusions he drew from the survey results was that the so called "NVCA guidelines" are largely misunderstood. Many firms think that they are following NVCA guidelines, when in reality no one agrees on what those guidelines mean in practice. The speaker opined that the NVCA guidelines were a good place to start, but they should not be the end of the story.

The speaker then reviewed some of the questions asked and answered on the survey. One question asked whether guidelines might be a good tool to extract the truth from inherently dishonest GPs. Most respondents rejected this idea, saying that the structure of the VC market eliminates the dishonest GPs very efficiently (LPs won't reinvest in a partnership with someone they can't or won't trust.) Another question asked whether valuing the private sector is just too difficult, and can't or shouldn't be done?

Another set of questions dealt with under what circumstances GPs should write up and write down investments. In general, respondents felt that write-ups should be transaction-based, and, specifically, they felt that strategic investors have different incentives than other investors and GPs shouldn't mark up a round when it's just them investing. As for write-downs, the survey found that firms are more likely to write down than write up investments. Many respondents indicated that Q2 is a popular time for firms to write down investments.

The speaker pointed out an answer to one survey question that may be of some concern. When the question was posed whether respondents would write down a company that had a new round of funding, but wasn't meeting milestones and seemed to be in trouble, 40% of firms said that they wouldn't write down that investment. The speaker suggested that this is because VCs are inherently optimistic; no one wants to write down an investment, because it seems to be a self-fulfilling prophecy. Once you write down something to zero, it tends to fall off of a firm's radar screen. What's more, VC financial statements tend to get around; so writing a company valuation down may doom it in the eyes of other industry players.

Here, he raised the point that good business decisions at VC firms are not always good accounting decisions. Thus, not writing down in above situation can be understood as a valid business decision, but not a responsible accounting decision. What's more, the above scenario demonstrates how the FOIA creates huge issues for the industry. Because of FOIA, there have been cases of LPs receiving information from GPs about portfolio companies and then giving that information back, so the documents won't be in their files, which are public domain.

In response to questions about discounting practices, survey respondents said they took anywhere from a ten to a 50% discount, and then respondents characterized the discount as being the "industry standard." The speaker remarked that it is not surprising that discounting practices disorient LPs! The question, "After lockup, do you take block discounts?" yielded an overwhelming diverse set of responses, indicating that firms' policies are all over the map on this issue.

One survey question asked how much VC firms talk to each other (about valuation issues regarding the same portfolio companies). Less than half of the firms said that they actually talk to other firms that are co-investors in a company. Some CFOs say that's because they

think it is illegal (i.e. in violation of anti-trust laws). The speaker joked that it is time to get the word out: Discussions among VC firms are *not* illegal!

Finally, the speaker revealed that two-thirds of surveyed GPs characterized their practices as "industry consistent," noting that there seems to be an industry perception that there are de facto standards that are being followed.

Q&A

The first question asked whether valuations could be influenced by liquidation preferences. The speaker responded that, yes, firms could do this if they can represent that the preferences will be *followed* (he remarked that such preferences often are not followed in practice).

The next question inquired about the state of accounting in portfolio companies, asking whether the data received from those companies are reliable. The speaker responded that since most VC's have very professional staffs, he typically doesn't even ask for the financial statements of portfolio companies. In the case of buyout firms, the speaker indicated he didn't know but thought the process should be very different than with VCs since buyout target companies typically have more "substance" than portfolio companies at a VC. Thus buyout firms often have one of the major national accounting firms audit the companies in their portfolio.

At this point, a debate began about whether VC firms talk among themselves about the portfolio companies they have in common, and whether such conversations are a good thing or a bad thing. One managing partner at a VC fund suggested that, if the survey were taken today, more firms would say they were talking with each other. He indicated that some firms do talk amongst themselves to get a better feeling on how other VCs feel about particular

portfolio companies, and to forecast ideas for future rounds. Another participant identified the potential problem with such conversations -- syndicate risk -- and others chimed in that anti-trust concerns (i.e. collaborating on valuations) should be taken seriously. One GP at a French venture capital firm wondered if, by discussing portfolio companies amongst themselves, VCs might effectively be giving those private companies "market values." She added that too much collaboration among VCs might harm the prospects of early-stage companies.

Speaker #3

The speaker introduced himself by saying he was an auditor in a former life, and is still "in recovery." He now spends most of his time working with LPs and has observed that frustration among certain LPs is focused on inconsistency in the application of GAAP. For example, it is common to receive multiple different portfolio valuations of the same company. This forces LPs to ask a lot of questions. He feels that, while there will always be some variability between different firms' valuation of the same portfolio companies, it shouldn't be a wide gap.

He identified two broad categories of LPs: those for whom P&L matters, and those for whom the only thing that matters is how much cash is in the investment (do I get back in year 10 what's in my capital account?). The former needs to feel like they are getting reliable, relevant, industry-comparable data. The speaker opined that most of those LPs don't think they're getting that. Why? Because there are many different policies for write-downs and write-ups: namely, cost, performance and overall market in the sector, all three of which have GAAP obligations and all of which are clearly audited.

He emphasized that LPs don't want "one number" from VCs, but are looking for more consistency and reliability within a tighter range. At this point, the FASB speaker interjected that a precision-weighted average is much better than any one estimate, as long as the VCs all

have same measurement objective (she drew an analogy to the forecasting of earnings estimates by sell-side analysts). Another participant weighed in that LPs are simply going to have to start learning more about financial statements, particularly the notes -- LPs really have to read those notes. Here, the FASB speaker noted that there is an "impassioned minority" of accountants who want to get rid of the earnings per share number altogether (they feel that measure can be easily abused), and simply use financial statements with line item details.

Another debate opened up when the question was raised: How do you reconcile accounting statements versus payout arrangements? Make sure that you create explicit payout arrangements? Someone else made the point that some GPs write up more easily/quickly, while some write down more easily/quickly, thus complicating the picture. Speaker #2 advocated what he called a "free-market" approach to payouts/partnership arrangements, saying "If you let GPs and LPs talk, they will work it out. Most GPs want their current fund not to be their last one, so they are motivated to work out a solution, return management fees, etc, in order to maintain LP goodwill. Another participant responded to this comment with disbelief, arguing that such compromises must be negotiated into partnership agreements beforehand. A GP at a VC fund agreed with Speaker #2's sense that LPs and GPs could work out their differences less formally, saying that "a good LP/GP relationship is one where the LP doesn't even have to ask the question -- GPs should, under appropriate circumstances, just waive fees to earn the goodwill of their LPs." Arguing that an overemphasis on partnership agreements can backfire, Speaker #2 asked the group, "Do you want to invest in the fund with the best terms or in the fund with the best managers?"

Session 3 : Implementation – The Hard Reality

Moderator:

Professor Michael Horvath, Center for Private Equity and Entrepreneurship

Official Speakers:

1. Representative from the GP community
2. Representative from a law firm
3. Representative from the Fund-of-Funds community
4. Representative from a major national accounting firm

Speaker #1

The first panelist, a managing director at a private equity firm, began by focusing on the reporting side of the debate. He felt that one of the issues that had not yet been addressed was the communication level between General Partners and their Limited Partners and making sure the GPs were spending enough time and effort communicating with their investors. He suggested a set of best practices based his firm's reporting procedures. His firm distributes eight reports a year to its LPs (two each quarter), holds two LP meetings per year, and tries to meet one-on-one with each of its LPs at least once a year. With respect to the two quarterly reports, the first is issued about 10 days after the close of the quarter and consists solely of the financial statements. The panelist made a side comment that he would prefer not to release information solely in that format, because the financials alone, without any substantive narrative and backup figures, are not particularly valuable. This additional information is sent to the LPs 30 days later in the form of an activity report, which details the company's operating performance and profit, cash position, backlog, pipeline, and other statistics to help the investor understand the overall health of the company. This gives the investor, who generally looks briefly through a report to find the valuation of the each investment and

moves on, an idea of the momentum of each portfolio company and, in turn, the portfolio as a whole.

The panelist suggested that this is the type of information that LPs need to assess both the short-term results and the long-term potential of the fund. Issues can and do arise, however, with the disclosure of information, in terms of misinterpretation of data and loss of confidentiality. The latter can arise from state Freedom of Information Act (FOIA) issues that require access to public documents, which would include the above described activity reports if they are held by state agencies (i.e. pension funds). Obviously, most of the information described in the firm's activity reports is not meant for public eyes, and a portfolio company's competitive position would be severely compromised in the event that other industry players or investors gained access to this information. In some cases where the LPs are subject to FOIA issues, the firm has had to separate these LPs out and meet with them one-on-one to discuss the fund's performance and then take the activity report back at the end of the discussion. Clearly this is a sub optimal solution, and it becomes difficult for each side to implement when looking at larger funds, which have large numbers of LPs, and large LPs who have hundreds of fund investments.

On the valuation side, the panelist briefly discussed his firm's policies, including the concept of discounting publicly traded securities. In this respect, the firm discounts from the last trade (bid price) securities that are not freely tradable (i.e. under lockup or high ownership relative to the float or trading volume). The firm also uses a "six month rule" to discount valuations of companies that will be in need of cash during this time period. This becomes tricky, however, as it is difficult to determine a "market price" for a future follow-on round of financing, and the firm needs to be careful not to create a situation where there is a self fulfilling prophecy, whereby the price of the new round is effectively set as a result of the discount given to the valuation based on the need for the financing. The firm's valuations are reviewed by its Advisory Committee, and representatives from major audit firms are also

invited and are encouraged to speak up. Again, the panelist stressed that in the absence of the more detailed activity reports, which give an idea of the overall momentum of the portfolio, the quarterly valuations can be misleading, and they should be viewed in conjunction with and somehow linked to the financial statements of the investee company. Also with respect to valuation, the firm runs a Monte Carlo simulation on its portfolio twice a year to get a perspective on the potential performance and attempt to use more quantitative, statistical analysis and minimize the amount of subjectivity involved in the valuation process.

Speaker #2

The second panelist, a partner at leading law firm, addressed three issues: 1) valuation as it relates to compensation (carried interest and clawbacks), 2) public disclosure with respect to open record laws and LPs, and, 3) his general opinion on valuation guidelines. The compensation effects of valuation were raised earlier, when a representative of a large LP investor in private equity complained that inaccurate valuations were affecting carried interest and management fee calculations in cases where high valuations resulted in large carry payments and management fees and then the investments were written off. Adding to the frustration was the fact that clawback provisions were not forceful enough and LPs generally felt like they had to beat many GPs over the head to recover money that had been paid out. The panelist outlined the various different types of waterfall arrangements that are included in LP agreements and how they deal with two issues, namely the clawback and the time value of money:

1. No carried interest payments until all committed capital has been returned to the LPs – this eliminates issues with both the clawback and the time value of money.
2. No carried interest payments until all contributed capital has been returned to the LPs – this ameliorates (but does not completely eliminate) the issues with the clawback, and it eliminates time value of money issues.



3. The third method, which involves a calculation and distribution of carried interest prior to all capital being returned is the most prevalent in the US (more so than in Europe), and is what is causing the most heartburn with LPs today. This is particularly relevant in examples like 1999 vintage year venture funds, where the GP has received large carried interest payments based on early success, but now the fund is in danger of being underwater for good. The distribution provisions incorporate NAV in some way to determine payouts (usually with a specific test or through the return of cost plus write-offs). Some LP agreements try to govern payouts a bit more; however, even an IRR hurdle test is subject to valuation issues. Similarly, management fees are affected by valuations in the later years of a fund's life. While fees are generally calculated based on a percentage of committed capital on the front end, when the fund starts its winding down period fees are generally calculated as a percentage of the cost of the remaining investments (less writedowns). Clearly the valuations used and timing of writedowns can have a large impact on the amount of fees paid by the LPs, and the agreements often have provisions for valuation standards (GAAP and other) based on the lower of cost or market baked into them as a result.

Public disclosure of fund information has become an issue as a result of increased pressure on some LP's (most famously CalPERS and UTIMCO) from recent lawsuits (by the *San Jose Mercury News* and the *Houston Chronicle*) to reveal investment information in the LPs' records, namely portfolio company information of private equity fund investments. Federal FOIA and state open record laws were the basis for the lawsuits. While these two high-profile lawsuits were most likely driven by the newspapers' desire to get a story, other organizations have a vested interest in gaining access to this information. These parties include portfolio company competitors for obvious reasons, unions trying to find out portfolio company labor policies in an effort to influence labor-friendly policies, organizations trying to compile and sell the information, and portfolio company management trying to derive the PE firms' opinions of the company or the value of options based on valuation data.

CalPERS has settled and agreed to publish only the most basic information, namely the individual fund IRR and cash in/cash out data on a quarterly basis. Despite this, *SJMN* is still suing and there are similar issues being resolved in Illinois, Washington (Mark O'Hare), and Massachusetts (Mass PRIM vs. the Attorney General). The result has actually been counterproductive – since it is unclear where the information is ending up and what it is being used for, many GPs are starting to curtail their reporting rather than increase it. Some GPs are even resorting to reporting aggregate portfolio or industry-based valuation numbers rather than disclosing individual company valuations. This is in direct conflict with the LPs' desires for more disclosure (many of the representatives at the conference were less worried about what the actual valuations than they were about receiving detailed information about how the valuations were derived).

With respect to guidelines, the panelist suggested that the LP agreements include written valuation guidelines. Guidelines should be approved, at the very least, by a subset of the limited partners which comprise the advisory committee of the limited partnership. He noted that the guidelines should be a living document that evolves over time, and it must not be a cumbersome exercise to modify them.

Speaker # 3

The third panelist was the head of a fund-of-funds group and offered the interesting perspective of being both on the GP and the LP side of the business. He began his remarks by offering a look at the PE world as it is today and stressing the need to understand where it is going. The existence of the valuation debate and the need for conferences like this one is the result of the bursting of the bubble. He made the comment that we probably wouldn't be talking about this if returns had continued to go up.

That said, the institutionalization of private equity is the inevitable result of the growth and maturation of the asset class as more capital and players have entered the industry. As a result, there is more of a focus on regulation, oversight, and governance. LPs need quick, accurate information on which to base their investment decisions, particularly when it comes time to rebalance their portfolios, and they want more quantitative assessments of valuation and portfolio company performance. Unfortunately there appears to be a countertrend, with many GPs wanting to restrict information flow into the market. The panelist believed that most still strong sentiment in the GP community that cash is king, and that interim valuations don't really matter.

This will be a problem, however, when GPs try to come back to market for new funds in 2004-2005 (many GPs are working through their overhangs and the panelist expected a flood of fundraising in the market in the coming years). When they do come back to market, GPs are going to face skeptical LPs who are likely to be less inclined to base investment decisions on unrealized gains. It is in the GP's best interest to present accurate, defensible interim valuations in order to give its investors an idea of the direction of the portfolio, even though they are locked in for the long term. When the market was hot, funds attracted a lot of investors who did not really understand the asset class. With investment periods increasing due to the lack of exit opportunities relative to a few years ago, it's harder to simply hold things at cost given the glut of unpleasant surprises recently. If the GPs want to raise additional funds in the coming years, they need to communicate better with investors to educate them and allow them to understand where the portfolio is going. Many CIO's are now trying to shorten their J-curves and educate their LPs in order to be able to raise funds in the coming years.

While the panelist agreed that increasing the accuracy and transparency of information in interim reporting would be helpful if used correctly, he pointed out that there needs to be more work done on how this can be accomplished. An interesting analogy to the real estate



market was brought up. The panelist pointed out that, right or wrong, the real estate industry has been forced to use periodic appraisals to value investments. The two asset classes are similar in that both are long-term, privately held investments. Real estate is appraised periodically, regardless of the intention (or lack thereof) of the investor to sell in the near term. Some argued that a real estate appraisal in a depressed market didn't mean much if the holder had no intention to sell until the market rebounded. Periodic appraisals, in their minds, would result in unwarranted and misleading volatility in valuations and serve to confuse investors. However the appraisal process did become standard in the real estate industry (and volatility ensued), and the panelist cautioned that GPs should understand that the PE industry could be moving in the same direction.

There appears to be a thrust by some LPs to make the valuation process as simple as possible given their limited resources; however, the panelist believed that pushing the work on the GPs to make life easier for LPs who can't do it themselves is short sighted and would be costly (both in terms of dollars and the opportunity cost of investment professionals' time). In his opinion the LPs need to take responsibility to increase their understanding of the asset class in conjunction with GP efforts to improve reporting and valuation. While GPs need to be more transparent about their valuation and methodologies, LPs need to be able to understand the limitations of these methodologies and do the work themselves in researching and assessing those valuations.

Speaker #4

The fourth and final panelist, a valuation specialist for a major investment banking firm, expounded on the previously raised idea of the relationship between GPs and LPs in the valuation process. More attention is being given to fair value, and in order to synthesize this fair value concept, there is an increasing need for standards and guidelines, and there will be more of an emphasis on regulation. Clearly these guidelines will not get everyone to the exact same number, and there will be a fair amount of variation in reported valuations as a result.

LPs need to understand that this will happen, and GPs need to be forthright in disclosing in detail their methodologies so that investors can understand how every one got the different numbers and make their own decision with regard to the fair value of the asset. The panelist admitted that there would be increased volatility and likely increased tension as a result of any attempts to implement a mark-to-market system to determine fair value, but that can be remedied by educating the investor base and improving GP-LP communication. Once the dialogue is started and trust is built between the GPs and LPs, the panelist opined, the valuation issue would fall away.

Q&A Session

The discussion quickly turned back to the issue of compensation, in particular with respect to clawbacks and management fees. While valuation clearly does have impact on clawback issues, the lack of valuation standards did not necessarily cause the clawback issues that many LPs are now facing. The root cause was the bubble and the resulted inversion of the J-curve. Even using lower of cost or market some GPs had enormous unrealized appreciation in their funds and took hefty carried interest payments, but now some of the investors are concerned about getting out whole by the end of the fund. Enforcing clawbacks has become a troublesome endeavor for many LPs.

One panelist, a GP himself, suggested that the LP should be viewed as a customer, and if the investors are genuinely concerned about compensation, the GPs should address this. He contended the partnership responsibilities went beyond the LP agreement and that GPs should be doing everything they can to maintain the relationship, including amending clawback provisions to reflect the current environment. Clearly the market has changed, and LP agreements (which were written when investors were dying to get into these funds and accepting egregious terms to do so) have not changed accordingly. With the market where it is in terms of low valuations for new investments, GPs should be focusing on their investments and relying on consistent performance, the training and grooming the next

generation of investing professionals, and long-term capital gains for compensation rather than focusing on management fees and early distributions of carried interest for incentives.

A few counterpoints came out of the discussion. First: Amending LP agreements and trying to entice investors based on terms will result in the further bifurcation of the GP community between the “haves and the have-nots” -- here, the example of the recent Sequoia controversy was cited. This also led to a discussion once again about the GP/LP relationship, and the fact that with larger and larger funds out there, the relationship has changed from a partnership to a business transaction. One-on-one meetings with LPs works fine for smaller funds with fewer investors, but mega-funds with enormous investor bases simply cannot do this. Similarly, LPs with multiple fund investments and hundreds of underlying portfolio investments don't have the capacity either. One panelist did point out however, that the press usually highlights the negative stories and ignores the funds that have rebated fees, forgiven commitments and escrowed carried interest payments in response to LP desires. He also pointed out that while work still needs to be done, the GP community (albeit in its own self interest in light of the upcoming need for fundraising) recognizes the importance of LPs and is focusing on more than ever, as evidenced by large investments in back office staffing and technology.

Another subject that arose was the importance and value of quarterly reporting. LPs want more frequent, efficient reporting that goes beyond simple return and valuation number in order to both assess the movement of their portfolios and rebalance to make the proper asset allocations as dictated by their fiduciary duties. Some also see fair value accounting and the opportunity to write-up investments as a mechanism to bolster confidence in the market. The meat of the argument against “over-reporting” from the GP perspective came on the basis of avoiding the additional cost and distraction of reporting, avoiding the focus on short-term results, and whether fair value loses value as a measurement tool if quarterly reporting results in information overload. FOIA reared its head again when someone pointed out that the

quality of information was going down because some GPs didn't want it ending up in the hands of the press. This was lesser point, however.

The question of compensation resurfaced when an attendee pointed out that they were paying huge dollars in management fees but were not able to get the information they wanted. However, the body of the discussion was focused on what needs to be done with respect to determining the information to be reported and how best to present it. Many LP representatives cited the wide disparity in the detail and quality of reporting among different funds and stressed the need for consistency. Some GP representatives countered by noting that there was an equally wide disparity among LPs with regard to the type of information each investor wanted. Some want great detail, while others just want nothing more than a number. One GP suggested that the LPs get together and take a bottom-up approach to forming a boilerplate for reporting that lays out what they can agree upon to be an appropriate level of information and the appropriate method for presenting it consistently. This idea was not entirely embraced by the LP representatives.

In wrapping up the session, it was suggested that GPs and LPs get together and figure out a mutually agreeable solution. The opinion of most in the room was that the actual physical reporting issues should be an easy fix with the implementation of a standard reporting template that incorporated input from all constituents. While public record laws could have an impact on this, the two groups should at least try to tackle the content and structure of the reporting package before addressing FOIA issues. On the valuation side, most in the room agreed that subjectivity in GP valuations was not an entirely bad thing, and most investors are not looking for everyone to have the exact same number, but they do want a clear and detailed explanation of how each number was derived. Furthermore, they felt that if everyone uses the same valuation standards, even with GP subjectivity involved, the dispersion of the results would be minimized, and it would considerably easier for everyone to determine what really is a fair value for PE investments.

Session 4: Breakout Discussions

Session Leaders:

Professor Colin Blaydon, Center for Private Equity and Entrepreneurship

Professor Michael Horvath, Center for Private Equity and Entrepreneurship

Professor Fred Wainwright, Center for Private Equity and Entrepreneurship

Professor Rick Antle, Yale School of Management

In this session, conference participants split into four groups and went into separate conference rooms. Each group wrestled with assigned discussion questions and, when everyone reunited, a representative from each presented the conclusions.

Who really benefits from the existence of guidelines?

The group concluded that trying to decide whether LPs or GPs benefit more is moot. Rather, the real upside of having reliable guidelines is that, by removing the crisis of confidence investors (especially new entrants) have about private equity, such guidelines will strengthen the industry and drive capital formation. In short, good guidelines will make the pie bigger for everyone. The caveat here is that "we have to get it right" -- inconsistent or contradictory guidelines will simply make things worse.

Realistically, can multiple funds ever reach exactly or even approximately the same valuations for the same portfolio companies?

Group members voiced the opinion that LPs don't care all that much about getting different numbers about the same portfolio companies as long 1) the assumptions/logic behind each set of numbers is clear to them, and, 2) the discrepancy between valuations of the same assets isn't profound.

A related debate arose in this group's discussion regarding the practice of "mark-to-market" (vs. cost-driven) valuations. Some group members observed that marking-to-market will increase volatility and wondered whether the industry "is ready for that" volatility (especially since PE traditionally draws a lot of investors precisely because it is considered less volatile than public markets). But other voices in the group pointed out that "at cost" merely disguises/muffles the volatility that is there all along, so PE investors shouldn't necessarily shy away from marking-to-market.

Is personal compensation (of both GPs and LPs) driven by valuations?

The group's answer here was an unequivocal "yes."

Does "conservatism" mean always picking the low number in a range or is it about conservatively applying underlying principles (e.g. fair market value)? Is conservatism another name for earnings management?

The group defined "conservatism" as the use of cost-based valuation methods (rather than the conservative application of fair value-based methods). Regarding the debate between a "no surprises" cost-based approach and a more volatile, fair value-driven approach, the group endorsed the latter.

Can consensus be reached for defining "fair value"? Should there be fair value definitions by sub-sector within private equity?

The group concluded that GAAP (and its definition of fair value) is the accepted standard, and it should be applied to private equity.

Who are the users of this information on valuation?

The group listed the constituents it felt were the chief users of valuation information: LPs who want to rebalance their investments; shareholders in public companies that have invested in private equities; interim management and public officials.

In a related point, the FASB speaker suggested that both LPs and portfolio companies have clear incentive to deal with each other directly (a prospect that would be made substantially easier by highly standardized valuation rules). As the information broker/intermediary, VCs represent cost to both LPs and portfolio companies. Several audience members responded by remarking that VCs bring specialized investing and company building skills that are necessary for these investments.

Are there third-party rulemaking actions outside of the industry that might impact or prevent industry-driven guidelines?

The group answered this question with a question of its own: Why should a rule-making body need to implement good, transparent valuation practices when those practices can easily be assured in partnership agreements?

If guidelines should be developed, which entity should be responsible for managing the process?

The group felt that either PEIGG or a joint venture of ILPA and the major national accounting firms should be responsible for developing guidelines. Additional representation from AIMR could be added to PEIGG. Additional potential combinations of industry groups were also discussed. A standards setting body might be needed to rule on interpretations and changes.



Who should bear the costs of applying guidelines?

The group concluded that ultimately LPs will bear the costs, including increased audit fees charged to funds and increases in GP staffing.

What should be the next steps after this conference?

Publish a summary of the conference proceedings and then organize a consortium meeting of EVCA, BVCA, ILPA, NVCA, AIMR and PEIGG.

Exhibits

- A. BVCA Valuation Guidelines
- B. BVCA PowerPoint Presentation
- C. ILPA PowerPoint Presentation
- D. Keynote Presentation

For Exhibits A, B and C, go to this link:

http://mba.tuck.dartmouth.edu/pecenter/research/pdfs/conference_proceedings_exhibits.pdf

For Exhibit D, see next page.

Exhibit D: Keynote Speech

A Scary Thought: Congress May Try to Fix Private Equity and Performance Reporting

Keynote Address by Tom Franco of Broadgate Advisors

Private Equity Valuation and Performance Reporting Conference
June 2003
Tuck School of Business at Dartmouth

I was talking last week to David Carey, a senior editor of *The Deal*, about common valuation standards. David has been around a long time and is a very insightful guy. He told me that when KKR and Hicks Muse were in the market raising funds prior to the bankruptcy of Regal Cinemas, KKR was carrying its investment in the business at zero while Hicks Muse was carrying theirs at cost. I haven't verified that independently, but it does put the issue of transparency and disclosure into focus. Who's right? And who now is asking?

These are not new issues for private equity. They were there when I first started working with Clayton, Dubilier & Rice around the mid '80s. It became even more critical as pension and endowment funds started to seriously invest in the asset class -- institutions who themselves had public reporting obligations to constituencies far beyond what sponsor organizations were used to dealing with - leading to some surprisingly convoluted linkages. An example of this were articles in the Houston Chronicle and Harpers in the mid - '90s that tried to disparage UTIMCO's relationship with Hicks Muse, when Tom Hicks was on the board of regents of the University of Texas.



Today of course, issues of transparency and disclosure have been reignited by Enron, Worldcom, Healthsouth and the rest. In this scandal -- charged environment, “private” must mean “secret” which must mean “hidden” which must mean “bad.” Just ask Freddie Mac and Fannie Mae. Sounds like a prelude to the six most unsettling words that any business executive can ever hear from Capitol Hill: “Something needs to be done about...” You can fill in the blank with any number of choice catch phrases - many of which helped drive Sarbanes Oxley into law.

The situation today in private equity resembles a difficult period for the industry when Congress wanted to ‘do something about’ the wave of debt-financed buyouts and takeovers that were turning corporate America on its head in the late '80s. There may be some relevant lessons for us today from that public positioning battle, which threatened the very existence of the industry. It is far from clear that the transparency and disclosure debate confronting private equity today represents a potential threat of the same magnitude. My theme, however, is that there could be political fallout that could prove to be more significant than the merits of the case presently being argued by industry participants.

Legislation seemed almost inevitable in the wake of the legendary RJR Nabisco buyout. Politicians were already roused by a frenzy of buyout activity and fears of an explosion of leverage, massive layoffs, community dislocations, and by accounts of excessive multimillion-dollar fees.

As night follows day, the war cry echoed above the Washington monument -- “Something needs to be done....” Moreover, congressional leaders like Bob Dole, Jim Wright, John Dingell, Dan Rostenkowski, Lloyd Bentsen and Ed Markey, among others, got an earful from entrenched corporate leaders who were beginning to feel the heat from the raiders or what one senator memorably referred to as the “fourteen-karat pirates motivated by greed.”

The heat that was turned on corporations had two aspects. First, companies with depressed share prices were sitting ducks with top managers looking ripe for unemployment. Second, the so-called raiders seemed to have a financing advantage in making deals with what Ted Forstmann has called “the fake wampum of 1980s finance.” An interesting aside here is how Forstmann broke ranks with the buyout industry over the junk bonds made fashionable by Drexel’s Mike Milken.

These are days that perhaps we should remember. Congress back in the late ‘80s was determined to do something – almost anything – about the leveraged deal mania but found answers in shorter supply than indignation. The creative lobbyists for the Business Roundtable came up with an argument guaranteed to not only get Congress mad, but also give them ammunition to do something once and for all about LBOs. The argument was that the U.S. Government – at a time of huge deficits, tax hikes and program cutbacks – was providing gigantic subsidies to buyout artists through a quirk in the tax code. The answer: get rid of the tax deduction that acquirers enjoyed on the interest they paid on their borrowed funds. Yikes!

This was serious. Takeover activity ground to a halt. Any sensible private equity firm was laying low on the deal front because they did not want to throw fuel on the fire. But some of the most important firms became active on another front – government relations. Henry Kravis, Joe Rice, George Roberts, Ted Forstmann and Martin Dubilier – the most fiercely entrepreneurial and anti-political bunch you could ever imagine -- began a coordinated push to reposition the battle that pitted Main Street against Wall Street. It was the first and, perhaps, last time the industry was unified about anything.

Believe it or not, they organized. They actually funded a campaign to change public perceptions. And the industry’s top leaders were directly involved. They recognized the importance of acting in concert to tell a more positive story and provide corrective context. The repositioning involved making the case that buyouts were the driving force for

constructive change in the U.S. economy at a time when our competitiveness as a nation was in jeopardy. Remember, it was a time when Japan's star was still in its ascendancy.

Studies were commissioned. And academics like Michael Jensen made a real impact by writing about the positive reality of buyouts. Partners at private equity firms testified before Congress and used a blizzard of data that buyouts revitalized undervalued, poorly managed companies into global competitors. To refute critics, they brought along evidence that showed that their portfolio companies increased productivity and operating profits without cuts to R&D, capital spending and employment.

Importantly, they also challenged the view that buyouts hurt U.S. tax collections, arguing that the capital gains realized by their firms generated tax revenues well in excess of the tax revenue associated with an LBO company in any given year. KKR estimated that their buyouts at that time generated \$2 billion more in taxes for the U.S. government because of big capital gains.

The point is that the political debate was successfully recast away from the extreme position of Byron Dorgan, a member of the Ways and Means Committee, who famously characterized junk bonds as the "evil engine driving destructive hostile takeovers and lining the pockets of dealmakers" to a debate over the value of buyouts to the economy.

The campaign demonstrated that by changing the tax code Congress risked doing more harm than good. As one lawmaker observed about the proposed interest deduction cutback: "If you thought the problem was bad, wait till you see the solution."

It's not every day that Congress recognizes the error of its ways. At the end of the day, I believe the evidence that the buyout firms assembled was sufficiently compelling to persuade lawmakers that buyouts were facilitating the much needed corporate restructuring that would improve U.S. competitiveness.

How does this relate to the transparency and disclosure debate confronting the private equity industry today? Well, this could very well become the second threat to unify the industry.

I see some risk that those agitating for common disclosure and valuation standards could unwittingly become the catalyst for those chilling words “Something needs to be done about...” The ingredients are clearly there for a politically-driven public relations problem: broad-based concerns about corporate governance, stories of wide-spread value destruction causing pain among pensioners, lack of sophistication about the private equity life cycle, and a growing media pressure for disclosure that is fuelled, in part, by commercial interests that eagerly want to publish the information.

It is not too early to begin thinking about repositioning the transparency and valuation story or to otherwise face the consequences.

What are the elements of that repositioning? It has to recognize that: 1) private equity firms already provide an enormous amount of information about portfolio company performance to their investors; 2) comparing private equity investments to public equities is deeply flawed; and 3) interim valuations are often very poor indicators of exit values.

Public confidence about what is in the corporate closet is at an all time low. If this confidence isn't rebuilt, there will inevitably be more regulatory oversight. There are already signs of increased regulation in the private equity context– the new Patriot Act's provision on money laundering; new privacy rules; the SEC's investigation into hedge funds – all reflect incremental oversight.

The broad challenge is repositioning private equity itself. There needs to be more focus on equity and less on private. The essential difference between public and private equity is not a

matter of privacy, but a matter of control. Perhaps we would be better off talking about “control equity,” instead of "private equity."

Whatever we call it, I believe there are at least 5 compelling themes that could better define what private equity stands for and help build broader public understanding and acceptance of this poorly understood asset class.

1. Frankness. Private equity firms get all the bad news out early. One of the great advantages of a private equity firm is its willingness to address hard issues and make business decisions that can have negative short-term financial impact. Private equity firms typically insist on tough-minded reviews that can lead to shut-down costs for exiting poor businesses or geographies, writing off bad inventory, and, if necessary, incurring severance charges for layoffs.
2. Flexibility. Very often, the investment thesis underlying a private equity firm’s commitment of capital requires a change in the business model of a company. For example, in a situation I am very familiar with, CD&R’s acquisition of the Allison Engine Company from General Motors was premised on shifting production away from military and toward commercial markets. The shift required a dramatic change in Allison’s cost structure in addition to a transition away from highly arcane percent-of-completion project accounting that made Allison’s financials a nightmare in the first two years of CD&R's ownership.
3. Long-Term Perspective. Many private equity firms often find major opportunities to invest in technology to improve productivity. They are willing to accept longer payoffs. For example, at Alliant Foodservice, a broadline food distributor acquired from Kraft by CD&R, the company invested more than \$25 million dollars in Web-based technologies that enabled salesmen to see current inventory levels and confirm

sales to customers on a real-time basis. Almost all of these costs were expensed, depressing earnings.

4. Growth Focus. The days of building value from financial engineering and balance sheet restructuring alone are long gone. Private equity firms, in virtually every investment, are supporting strategies to develop new products, drive sales growth, fund acquisitions, and be catalysts of positive change for their companies. Investments in growth tend to be a drag on short term operating results, but are necessary to achieve long-term results.

5. 'We Serve No Wine Before It's Time.' This is an expression often used by Don Gogel of CD&R and it really crystallizes a key point. If a business has grown well and there is a reasonably good market for the sale of the business or a public offering, private equity firms are usually quick to capitalize on the opening. However, without a compulsion to sell, firms will hold investments through periods of low acquisition or public market multiples. As a practical matter, this means that portfolio companies now in the portfolios of most private equity firms will suffer in the current valuation environment.

These are powerful themes that are not getting the public traction and visibility they deserve. Private equity is often a very messy matter. There's no such thing as a microwavable solution. It's hard work. It's a commitment to the long-term. This should be better understood.

This is not an argument for non-disclosure. It is more a plea that we need to start shifting the argument -- not dissimilar to what happened during the interest deduction debate in the '80s -- to promote a better understanding of how the asset class really works. Otherwise, we should all steel ourselves for those immortal words: "Something needs to be done about..."