To Standardize or Not to Standardize: Recent Developments in the Private Equity Valuation Debate

Although the idea of a uniform, industry-wide standard for private equity valuations has been discussed for years, the topic has received a great deal of attention in the past six months, with some groups issuing, reviewing or updating proposed and existing valuation guidelines.

While uniform (but different) valuation standards are generally followed in the UK and Europe, there is no accepted uniform set of valuation standards for private equity funds in the U.S. Even though almost all U.S. private equity funds prepare their financial statements in accordance with U.S. generally accepted accounting principles (U.S. GAAP) – which require that private funds report the “fair value” of their investments – U.S. GAAP currently provides little guidance in determining fair value. U.S. private equity firms use a number of different approaches to valuing their holdings. Thus, two or more private equity firms with investments in the same portfolio company may assign dramatically different values to those investments.

In the first part of this article, we review some of the views expressed by proponents and opponents of the use of industry-wide valuation standards. In the second part of this article, we review some of the different views on the use of a “fair-value” standard for valuing private equity investments. Finally, in the third part of this article – and in the accompanying chart – we review and compare existing valuation standards and recent proposals for new, uniform valuation standards.

The Standardization Debate

Valuation of private equity holdings has always been an important issue for investors. Valuations are relevant not only in the reporting context, but also (1) when calculating the amount of carried interest distributions when funds make “in-kind” distributions of securities and (2) for funds that pay out carried interest on a “deals realized to date” basis, when determining whether a fund has unrealized losses that should reduce carried interest payments (as is common in buyout funds) or has satisfied a fair value cushion condition to carried-interest payouts (as is seen in many venture funds).

Still, pressure to adopt uniform valuation standards was not significant during the boom years of the late 1990s, what with valuations and IRRs generally rising. However, after the technology bubble burst, valuations of public tech companies fell while private equity tech investments were not always marked down promptly or at all. This led many private equity investors (and fund sponsors) to focus on valuation issues. In addition, the trend toward greater transparency in the private equity industry, including increasing disclosure of fund performance in response to Freedom of Information Act requests, generally has led some industry participants and observers to focus on valuation issues.

Despite a growing concern over valuations, neither investors nor fund sponsors in the U.S. agree on whether a single valuation standard should be developed for use by U.S. private equity firms. Summarized below are some of the various arguments that have been articulated both in support of and against the creation of a uniform U.S. private equity valuation standard:

Proponents of Valuation Standards

Proponents of a more uniform approach to private equity valuation cite a number of reasons for standardization:

Harmony with international standards. A single U.S. standard for valuation, consistent with international guidelines such as those of the British Venture Capital Association (BVCA) and the European Private Equity and Venture Capital Association (EVCA), would facilitate greater cross-border investing and cross-border performance comparisons.

Limited partner (LP) confidence in valuations. Consistent valuations across funds, which can only be achieved through application of a single standard, foster greater confidence among LPs in their funds’ general partners (GPs), particularly important at a time when GP-LP relationships are under stress.

Preempt regulatory interference with valuations. Valuation standards may preempt potential demands for greater transparency and uniformity from regulators. With various corporate and hedge fund scandals and ensuing changes in the regulatory climate, some are concerned that regulators such as the SEC may eventually extend their focus beyond hedge fund valuations to private equity fund valuations.

Greater comparability of performance among funds. Standardization of private equity valuations enables institutional investors to compare more readily the
Valuing GPs’ subjectivity. Many investors choose a particular fund manager because of their confidence in such manager’s unique judgment in respect of market investment opportunities as well as valuation, i.e., a manager’s subjective view of the value of a portfolio company is an element of the expertise for which such manager has been selected. Following a uniform standard might fetter such manager’s ability to exercise its discretionary judgment.

Others have approached the valuation debate from a different perspective, by questioning whether the more standardized approach to valuation used in public markets really produces more accurate or reliable valuations. Jesse Reyes, vice president of Venture Economics, questioned:

At one point, Amazon shares were priced at $175 dollars. Was that a good valuation? Probably not. But it was a real price. The idea of a good valuation is a slippery notion whatever you’re talking about. People say that private equity valuations must be bogus because they aren’t based on reality. But there have been plenty of things based on reality that turned out to be pretty bogus.  

Instead, he suggests, investors need to accept that valuing private equity necessarily involves guesswork.  

The Fair-Value Debate
The debate over standardization has been accompanied by an equally intense debate over the use of “fair value” in valuation standards. U.S. GAAP and many existing and proposed valuation standards require that private equity funds “fair value” their holdings. Harmonization of valuation standards is not likely to be achieved before a consensus is reached on the meaning of, and the appropriate techniques to determine, fair value.

Fair value is generally defined as the amount at which an investment can be sold in a current transaction between willing parties, other than in a forced liquidation or sale, although the exact definition may vary depending on the source. Some private equity funds have historically taken the view that private equity holdings should be carried at cost for as long as possible, arguing that, in light of the illiquid nature of private equity investments and principles of conservatism, cost is the best measure of “fair value” absent almost any event short of a complete or partial sale. (In this article we refer to this as a “conservative” valuation standard).

Others have taken the view that a less conservative fair-value standard should be applied. They argue that a variety of techniques (e.g., valuing by looking at earnings multiples, discounted cash flows) should be applied to arrive at what they believe will be a more “accurate” fair value. (In this article we refer to this as a “more rigorous” fair-value standard.)

Proponents of a “More Rigorous” Fair-value Standard
Proponents of a move away from carrying investments at cost to more rigorous fair valuing cite a number of reasons for standardization:

LPs want to measure performance. Investors want to understand how their portfolios are performing, and cost-based conservative valuations do not reflect current performance adequately.

Fund sponsors market their funds based on interim performance. A private equity firm marketing a new fund may use a “more rigorous” standard to value predecessor fund holdings at their “true” values, and not at cost, even if
**Comparison of Valuation Methodologies**

<table>
<thead>
<tr>
<th>Measure of Value</th>
<th>NVCA</th>
<th>BVCA</th>
<th>AIMR</th>
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<tbody>
<tr>
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**Valuation Methodology**

- Methodology Hierarchy for “Unquoted Instruments”
  - Earnings Multiple: Primary
  - Price of Recent Investment: Primary
  - Net Assets: Primary
  - Discounted cash flows or earnings (of underlying business): Secondary
  - Discounted cash flows (from investment): Secondary
  - Industry valuation benchmarks: Secondary
  - “Quoted Instruments” are valued at market price.

- Methodology Hierarchy
  - Market transaction: most recent independent third-party transaction involving a material investment.
  - Market-based model: in the absence of such market transaction, may calculate using market-based model (e.g., free cash flow) and market-based assumptions; the method that involves the least number of estimates is preferred.
  - Discounted expected future cash flows: the present value of expected cash flows (incorporating risk uncertainty), discounted at the risk-free rate adjusted for credit-worthiness.

**Impaired Investments**

- Value should be reduced if a company’s performance and potential have significantly deteriorated.
- Fair Value: If at-cost value is used, it should be reduced to reflect estimated extent of impairment. Examples: failure to meet significant milestones or service financial instruments; breach of covenant; deterioration in forecast performance; significant adverse changes in company’s technological, market, economic, legal or regulatory environment; market conditions deteriorate generally.
- “All valuations must, at a minimum, recognize when assets have suffered a diminution in value.” Examples: breach of covenant, failure to service debt, filing for bankruptcy, major lawsuit or loss/change of management.

**Liquidity Discount for Publicly Traded Stock**

- Yes. 10% discount recommended if a high number of shares is held; 30% discount recommended for public securities that are restricted.
- Yes. Recommended range of 10-30% in increments of 5%. Discount required if there is a risk holding might not be sold immediately or there is a formal restriction on trading.
- No.

**Additional Notes**

- GAAP-compliant with exceptions; advises against overly conservative valuation.
- Methodologies should be applied consistently from period to period, except where a change would result in better estimates of Fair Value.
- Basis of valuation must be logically consistent and applied rigorously.
- Any change in valuation principle or methodology from one period to the next must be explained.
### EVCA

Two types of valuation:

1. **Conservative Value:**
   - Value at-cost unless (a) a new financing round or partial sale (“arm’s-length”) has taken place in which case value should be based on transaction price or (b) there has been a material and permanent diminution in value (see “Impaired Investments” column).

2. **Fair-Market Value:**
   - The estimated amount for which an asset should exchange on the date of valuation between a willing buyer and a willing seller in an arm’s-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion.

#### Methodology for “Unquoted Investments” (two valuations are recommended)

- **Conservative Value:** See “Measure of Value” column
- **Fair-Market Value:** Market-based model or Earnings Multiple approach may also be applied where no transaction has occurred and where the investment has revenues and either profits or positive cash-flow

#### “Quoted Investments:”

- Market price.

Written down only in increments of 25% once there has been a “material and permanent” diminution in value below cost. Such material and permanent diminution in value may result from: a breach of covenant, failure to service debt, a filing for creditor protection or bankruptcy, a major lawsuit (particularly concerning intellectual property rights), loss or change of management, fraud within the company, substantial changes in market conditions, significant lowering of profitability margin, performance substantially below expectations.

### PEIGG

**Fair Value:** “The amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.”

#### Methodology should be used consistently until a new methodology will provide a better approximation of value.

- At-cost/latest round of financing may be appropriate. However, if manager’s review indicates circumstances such that a “material change in value” has occurred, fair value should be approximated. Examples of changes in circumstances:
  - The current performance of the company is significantly above or below expectations at the time of the original investment;
  - Market, economic or company-specific conditions have significantly improved or deteriorated since the time of the original investment; or
  - Substantial decreases in the value of public debt, defaults on any obligations of the company, a bankruptcy filing, significant ownership dilution caused by recapitalization or long term liquidity concerns.

**Fair value should be approximated using the following methodology hierarchy:**

- Comparable Company Transactions: examination of third-party investments/transactions in comparable equity securities
- Performance Multiple: application of most appropriate and reasonable multiple derived from market-based conditions or recent private transactions
- Other Valuation Methodologies: Discounted Cash Flow, Net Asset Value and Industry Specific Benchmark methodologies may also be appropriate in certain circumstances.

**Fair value/GAAP compliant methodology.**

Yes. Value adjusted for lack of marketability when quoted investments are restricted.

Yes. A marketability discount of 0-30% may be taken only when a restriction (within meaning of GAAP) on sale exists.

- Guidelines emphasize transparency and disclosure.
- Any changes in valuation method from period to period, and the effect of such change, should be clearly stated.
- All valuations should be calculated to account for the dilution resulting from the exercise of ratchets, options or other incentive schemes.

Valuation adjustments should be based on actual positive and negative events, not upon expectations.

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they use cost for financial reporting and purposes other than marketing. Some feel this phenomenon shows that these private equity firms believe that cost in fact does not reflect the fair value of those holdings. Proponents of a "more rigorous" fair value argue that firms should be able to use these more "accurate" valuations without creating inconsistencies with reporting conventions typically followed.

**Harmony with UK and European standards.** A more rigorous fair value approach enables investors to compare the performance of a U.S.-based fund more readily with European and U.K. funds.

**Secondary market reliance on valuations.** Both buyers and sellers in the growing secondary market, many of which are not distressed, need a more accurate and current valuation than a conservative cost-based valuation.

**Critics of a "More Rigorous" Fair-value Standard**
Proponents of a more conservative, cost-based approach to fair value cite a number of concerns over proposals to adopt more rigorous fair-value standards:

**Volatility.** More rigorous quarterly fair values for investments may lead to more volatility in carrying values and may prove misleading when a write-up does not prove substantiated upon disposition of an investment.

**Impracticality for early-stage investments.** A more rigorous fair-value approach may not be practical for some venture capital firms because identifying public company comparables for an early stage company with little operating history may be too difficult, if not impossible.

**Impracticality for minority investments.** More rigorous fair valuation methodologies may not be practical for a venture capital fund or a private equity fund with a large number of minority investments for which the fund has few or no board seats and, as a result, only very limited information on which to base its valuations.

**Incentive to overvalue.** A more rigorous fair value approach is dangerous because firms are encouraged to write up, even in the absence of a third-party valuation event to validate the write-up. Such write-ups can affect carried interest payouts, which can be problematic, as many LPs have faced difficulties in recent years enforcing GP clawback provisions.

**Conservative is better.** A conservative, cost-based approach to valuation can lead to fewer negative surprises to investors and reduce the likelihood of needing to rely on GP clawback provisions – if one assumes that a conservative approach to valuation discourages write-ups but does not discourage write-downs (which may not be the case). This is not a problem faced in the U.K. and European markets where fund terms historically have required repayment of all invested capital before any carried interest payments can be made.

**Cost and effort.** More rigorous fair value determinations, especially if done on a quarterly basis, can be costly and time-consuming and still not lead to more accurate determinations of fair value. Not every firm can afford to undertake such an exercise, and even those who may be diverting resources away from other more important investment activities.
entrepreneurs. The EVCA currently has over 950 members. The EVCA published its first valuation guidelines in 1993, which were later updated by the EVCA’s Task Force on Valuation in 2000 and adopted in 2001.

The EVCA’s valuation principles are based on surveys indicating that investors wish to see two separate valuations: (1) a conservative valuation (based on cost or the last round of financing), to be used for capital account purposes and (2) a more rigorous fair value determination, to be used to determine the future value and prospects of an investment. In determining fair value, the EVCA recommends (in the absence of any third-party transaction) using (1) comparable companies with established valuations and (2) earnings multiples with an illiquidity discount of at least 25%. The EVCA also recommends discounts for publicly traded instruments, regardless of whether the instruments are subject to restrictions. The EVCA guidelines have served as the base for other regional guidelines within Europe, such as those of the Association Française des Investisseurs en Capital (AFIC) in France.

United States
The majority of U.S. private equity funds tend to use conservative cost-based valuation principles. Some argue that cost-based valuations are not always consistent with a fund’s obligation under GAAP to report the fair value of an investment because, at a certain point, cost may be a stale measure of a portfolio company’s worth. Still, many U.S. firms take the view that in light of the illiquidity of private equity holdings and principles of conservatism, private equity investments should be carried at cost until a disposition or third party investment. They take this view in an environment where the accounting profession and GAAP have not yet provided sufficient guidance for U.S. firms on how to determine fair value in the private equity context. However, the Financial Accounting Standards Board (FASB) is now in the midst of a fair-value project from which more detailed guidance on fair-value methodologies is expected to emerge.

Attempts at standardization. Efforts to standardize private equity firms’ approaches to valuation in the U.S. began in the late 1980s when an Ad Hoc Committee of the National Venture Capital Association (NVCA) proposed the first private equity valuation standards in the U.S. In 1989, the NVCA presented these standards in an all-member forum but after a heated debate chose not to take a position on the standards or to adopt them formally. Ironically, the guidelines considered by the NVCA – which it refers to only as the “Proposed Venture Capital Portfolio Valuation Guidelines” (NVCA Guidelines) – have been the most widely followed valuation guidelines among U.S. private equity firms over the last 15 years.

Not long after the NVCA Guidelines were drawn up, Venture Economics introduced the first systematic performance measurement report with long-term statistics on private equity, leading to greater transparency among private equity firms. In 1994, the Subcommittee on Private Equity Presentation Standards of the Association of Investment Management Research (AIMR), a global industry association comprising both investment professionals and financial analysts, recommended that standard guidelines be used for private equity valuation and, in 1999, adopted its first version of the Global Investment Performance Standards (AIMR GIPS). In January 2004, the Subcommittee published amended AIMR GIPS guidelines to become effective in January 2005. Meanwhile, in late 2003, the Private Equity Industry Guidelines Group (PEIGG), a voluntary group of industry representatives formed in 2002, issued guidelines with a marked emphasis on “more rigorous” fair value. (These amended AIMR GIPS guidelines and PEIGG Guidelines are discussed below.)

AIMR’s new GIPS principles. The AIMR GIPS Principles introduce a hierarchy of fair-value methodologies to enable firms to derive fair values. At the top of the hierarchy is the use of relevant public data, such as comparable public company transactions, followed by market-based multiples (e.g., price to earnings, enterprise value to EBIT and enterprise value to EBITDA) in the middle tier and then discounted expected future cash flows at the bottom of the hierarchy. AIMR recommends that valuations be reviewed by an independent party, such as an independent advisory board.

The new AIMR GIPS Principles offer a bit more detail than PEIGG’s guide-

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Although the traditional assumption in the U.S. has been that conservative valuation is good, PEIGG now aims to replace the concept of conservatism with that of prudence... The valuation guidelines are intended to comply with U.S. GAAP, which requires that private equity investments be carried at fair value.
lines, although they fall short of the level of detail offered by their UK and European counterparts. While AIMR is considered by most to be the leading U.S. industry association for buy side and sell side equity analysts and mutual fund managers, AIMR is generally considered a less influential voice in the private equity world.

The new PEIGG valuation guidelines. Although the traditional assumption in the U.S. has been that conservative valuation is good, PEIGG now aims to replace the concept of conservatism with that of prudence. Thus, the new PEIGG valuation guidelines released in late 2003 recommend that investments be fairly valued on a “prudent and consistent” basis. The valuation guidelines are intended to comply with U.S. GAAP, which requires that private equity investments be carried at fair value.

PEIGG recommends updating valuations when a “material change in value” has occurred in a portfolio company. Examples of changes might be a company’s success or failure to achieve certain milestones or technology breakthroughs or materially exceeding or failing to meet budget limits. In addition to company-specific events, the PEIGG Guidelines also suggest that private equity firms take into consideration the improvement or deterioration of general market, economic or industry conditions as compared with the date of the original investment. The Guidelines also recommend that valuations be updated quarterly.

Among the valuation methodologies recommended are comparable public company transactions or earnings multiple methodologies. Different firms co-investing in a single portfolio company are encouraged to consult each other to establish a single valuation for that company. (Some suggest these conversations occur infrequently because of misplaced fears of consequences under anti-trust laws.) In addition, the PEIGG Guidelines suggest that private equity firms organize semi-independent valuation committees to establish valuation standards to be followed by a fund’s GP. However, the GP of a fund retains the discretion as the ultimate judge of a portfolio company’s valuation.

Fund managers are entitled to retain their existing valuation methods for “some period of time” before switching to the fair value method. Establishing an exact period of time for transition was a contentious issue among PEIGG members, as a venture fund might consider six months to be a long period whereas a buy-out fund might consider two years as a long period.

The PEIGG Guidelines eliminate the liquidity discount taken on the stock price of a portfolio company taken public. Typically, private equity firms discount the price of publicly held stock during any mandatory hold or lock-up period or when the firm holds a large block of such stock. Note that the FASB currently prohibits a liquidity discount for publicly traded stock unless the stock is restricted by a governmental or contractual limitation exceeding one year in duration.

Reception of the new PEIGG Guidelines has been mixed, with three member firms of PEIGG indicating they would not be adopting the guidelines. In his initial reaction to the PEIGG Guidelines, NVCA chairman Jim Breyer echoed this concern: “The troubling issue is the suggestion that, on a quarterly basis or an annual basis, there should be write-ups of portfolio-company valuations without third-party validation. That’s a slippery slope because it just leads to more arbitrary valuations when it comes to write-ups” (emphasis added).

The NVCA has maintained its neutral position in the private equity valuation debate by declining to endorse the new PEIGG Guidelines. Instead, the NVCA recommended that its members “create, follow and communicate clearly the specific procedures and methodologies used for valuing their portfolios.” This recommendation is consistent with findings of the Center for Private Equity and Entrepreneurship of the Tuck School at Dartmouth, which suggest that for most investors clearer and more detailed explanations of the valuation methodology used is more important than consistency of valuations.

Conclusion

Although reception of the new PEIGG and AIMR guidelines has been mixed, they have focused and enlivened the debate over standardized valuation and the techniques to be used to determine fair value. We hope to apprise you of future developments in the continuing debate over private equity valuation, including reporting on the results of the FASB’s fair value project later this year.

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