Conference on Private Equity Valuation

The private equity industry has been a remarkable engine of growth in the United States. The industry’s preference for privacy, however, has led to one of its primary challenges: the lack of consistent portfolio valuation and financial reporting. Accurate valuation is becoming more critical as public employee pension plans and other institutional investors increase their stakes in venture capital and buyout funds.

Tuck’s Center for Private Equity and Entrepreneurship is now bringing key private equity leaders together to develop solutions to this important issue.

Private equity portfolio companies are usually illiquid and can have negative or erratic cash flows, particularly in their early days. Generally accepted valuation procedures cannot be applied easily to these companies, and different evaluators may assess worth differently. Such shortcomings are overlooked in bull markets, when private equity firms simply value their portfolios based on recent investor contributions, but this convenient arrangement becomes untenable in a bear market as new financing dries up.

So can the industry agree on how private equity portfolios should be valued?

In 2002, the center conducted an unprecedented survey of more than 700 VC and buyout companies. (See Tuck Today, Winter 2003, for a report on survey results.) And in June of this year, the center hosted an invitation-only conference at Tuck that was attended by more than 50 leading private equity practitioners. At the free-flowing conference, industry players staked out their positions; comments were recorded but not attributed. “Many of the participants had heard of each other,” says center director Colin Blaydon, “but had yet to meet in a confidential environment. An informal atmosphere was vital to build trust among them,” he says, “since no consensus yet exists on how to handle the valuation issue. The respective needs of industry players do not always overlap.”

Important issues emerged at the conference:

- Private equity firms’ most important task is to focus on finding and nurturing companies to create value. These lean outfits simply do not have the resources to devote to quarterly valuations. Any solution to valuation and reporting issues cannot be so burdensome that it harms the performance of the funds.
- Institutional investors have come to depend on private equity investments for a growing share of earnings and assets while continuing to be under pressure to provide accurate financial disclosure. Quarterly valuations of private equity portfolios using mark-to-market or fair-value assessments may add considerable volatility to investor portfolios. In addition, Freedom of Information Act lawsuits have compelled public pension funds to reveal their financial performance and the performance of the venture and buyout funds in which they invest. The confidentiality clauses built into private equity limited partnership agreements have not provided legal protection from disclosure.
- Accounting firms, in the wake of scandals, can no longer simply accept that a private equity limited partnership is complying with its own valuation policies. Instead, auditors must look behind the privacy curtain to assess the accuracy of portfolio company valuations.

Some efforts have been made to develop fair market valuation standards and guidelines, including those by the European Venture Capital Association and British Venture Capital Association, as well as a coalition in the United States known as the Private Equity Industry Guidelines Group. “The key,” says Blaydon, “is whether the U.S. accounting industry will validate these methods and findings, which is why the informal exchange of ideas at the conference was so valuable. In fact, we have been urged by conference participants to host a follow-up meeting in June 2004.”

Professor Blaydon expects that some form of valuation and reporting guidelines are inevitable, perhaps in the next 12 to 18 months. And more important for Tuck, he expects that the Center for Private Equity will be a major facilitator in their development.