

## Thoughts on the PEIGG Guidelines

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Recently the Private Equity Investors Guidelines Group, a volunteer group of eighteen participants in private equity investing, issued a set of guidelines for valuing illiquid interests in private equity. These guidelines are the results of two years of study. The guidelines are available at [www.peigg.org](http://www.peigg.org).

The goals of the PEIGG in crafting its new guidelines were two:

- 1) To introduce consistency in the reporting of quarterly values of venture partnership holdings.
- 2) To bring quarterly venture partnership valuations closer to market values.

If consistency were paramount, we would not have much of a problem for venture capital. The overwhelming majority of general partners follow a single approach now: they value all of their stock in each portfolio company at the price established in the most recent round of funding. A small minority report company value as the cost of all stock purchased in the company, each round at its own price. A minority in either group may write down a company that is judged likely to go under, before it actually does. The most-recent-round approach to valuation has the merits that (1) it has wide use, and thus consistency; and (2) everyone knows where the figures came from. They came from real deals in which real investors invested real money.

The trouble is, these values may have been established months or even years ago. For example, some 9,000 companies did rounds of funding in the year 2000. Since then, roughly 35 percent of them have folded worthless. About 10 percent have done another round of funding since then. Another 5 percent have been acquired or gone public. The remaining 50 percent are still alive and operating, mainly on their own revenues. As the PEIGG acknowledges, the most-recent-round values could be far from current values.

But how to value them months or years after their last rounds? The Group blessed just about all known valuation approaches as appropriate in some circumstances, and emphasized that it did not intend to constrain the judgment of general partners. It is hard to see how this would ever get us to the goal of consistency. The Group did make the concrete proposal that each fund should establish a valuation committee to review values to be reported and to interact with valuation committees with other funds invested in the same portfolio companies. In essence, these committees are supposed to get together and decide what they would be willing to pay for each company now.

Determining a current value is a real challenge for a venture company. Consider the resources marshaled to set price for a real deal. Parties to the negotiation are the founders, the earlier investors, the new investors, and some others who have only warrants or options. Their interests are different. Many possible valuation approaches are brought to bear by all parties. Each approach may be informative. In the end, the implicit auction that takes place in this negotiation sets the price. The serious commitment of money and effort on both sides focuses their minds wonderfully. This process takes many months. It is costly. What the PEIGG wants its committees to do is repeat this process each quarter, and arrive at a price for the company now. This is sufficiently burdensome that I have not encountered one single GP or LP who is inspired by the Guidelines to abandon most-recent-round reporting in favor of anything else.

The inherent costliness of finding current price is the central problem for the Group. They suggest the current price of similar private companies, similar public companies, similar revenues, similar subscribers, similar numbers of internet visitors. What they really want is an index of market value, something like the S&P500 for private companies, but they don't have one. Here is where the Sand Hill Index can help them.

The Sand Hill Index was designed to function as an index for venture capital like the Wilshire5000, the S&P500, and the Nasdaq, do for public companies. For companies in the stock market, an index is straightforward to build, because nearly every stock is priced every day. All such indices are value-weighted, so that large companies have a larger influence on the index value than small companies do, and are calculated on a regular periodic basis.

For private companies we face two problems that public market indices do not present: first, the companies are not priced continuously, but instead only episodically, when they raise money or exit, and second, bad news is less likely to make its way into available data than good news. Sand Hill Econometrics has solved both of these problems with advanced statistical tools, and built an index that has all the desired properties of a true index of value: the Sand Hill Index is

periodic (monthly)  
value-weighted  
and unbiased (adjusted for under-reported bad news).

It is the *only* index of value for venture companies with these properties.

The Sand Hill Index can be used to bring each company valuation current. Take the ratio of the current value of index to its value at the time of the company's last round, multiply that by company value at the last round. The result is an approximation to the value the company would command now. For example, if a company's most recent round was ten months ago, and the index has risen 15 percent since then, report the current value (marked-to-market value) at 115 percent of the most recent round value. Sometimes adjustments will be up, and sometimes they will be down, as the market dictates. With these valuations in hand, adjustments appropriate for warrants, options, and convertible preferreds would be easier to do than they are now.

For an individual company, the result is an approximation. For a portfolio of 40 companies, it is quite robust. For a portfolio of many partnerships, with a total of a hundred or so companies among them, this adjustment is likely to be very close to the true value.

How do we know this? We have analyzed the relationship between quarterly changes in the Sand Hill Index and valuations reported by general partners of venture funds. The Sand Hill Index predicts the GP valuations six to nine months ahead. The reason is that the value of the index at each point in time (each month) is informed by the deals happening in *that month*, whereas the GP reported valuations are stale because they are based on deals some months or years in the past.

What would serve investors well and be little trouble to implement? Have GPs give the investors three numbers for the portfolio:

- 1) the cost basis for the portfolio (what was actually invested) (they know this already),
- 2) the value at the price for each company's most recent round, (they know this already too), and
- 3) the sum across companies, adjusting the value from the most recent round by the subsequent change in the Sand Hill Index.

The merit of this approach is that it would

- 1) be consistent across funds,
- 2) be based on figures that are readily available and understood, and
- 3) provide a valuation that is marked-to-market.

In other words, we achieve both of the PEIGG's central goals: consistency and market valuation. We avoid the stale pricing that results today from the tendency of GPs to seek the safe harbor of the price from the most recent round, but we do not ask anyone to accomplish the impossible task of determining on a company-by-company basis the price that a company would fetch. Instead, we apply information from the recent pricing of other venture deals, in a systematic and scientific way.