Thoughts on the PEIGG Guidelines

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December, 2003

The Private Equity Investors Guidelines Group has made recommendations about reporting the value of illiquid interests in private equity funds. Its goals are:

1) Consistency in reported values
2) Bringing reported values closer to market.

For venture capital, consistency already prevails. Nearly all general partners use the same approach now: all stock in each portfolio company is reported at the price of the most recent round of funding. A few report company value at cost—each round at its own price. Some write down a company prior to its shut down. In quarterly reports, one finds few other departures from most-recent-round valuation. Merits of the most-recent-round method are that it is (1) widely used, (2) obtainable through a few computations when reports are based on cost instead of most-recent round, and (3) everyone knows where the figures came from: real deals in which real investors invested real money.

But these values may not be current. Some 9,000 companies did a round of funding in the year 2000. Roughly 35 percent of these have since folded. Ten percent have received more funding. Another 5 percent have been acquired or gone public. The remaining 50 percent are still alive and operating. For these companies, 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, and encouraged GPs to use judgment. The Group proposed that each fund should establish a valuation committee to interact with valuation committees from other funds invested in the same companies. These committees are supposed to decide what they would pay for each company now.

Determining a current value for a venture company is a real challenge. Consider the resources consumed setting price for a real deal. Many possible valuation approaches are brought to bear. All may be informative. The implicit auction of negotiation sets the price. The serious commitment of money on both sides focuses their minds wonderfully. This process takes months. PEIGG wants its committees to repeat this process. Quarterly! I have not encountered a single GP or LP who is ready to abandon most-recent-round reporting.

The inherent costliness of finding a current value or price is the central problem for the Group. What would serve them well is an index of market value for venture companies.

Indexes for public equity—the S&P500, the Wilshire 5000, and Nasdaq—are built frequently from public prices, weighting companies by their relative values. The Sand Hill Index does the same for private companies using their valuation events.

We had to solve two problems to create the index. First, private companies are priced only episodically, when they raise money or exit, and second, bad news is less likely than good to make its way into available data. Sand Hill Econometrics has solved both of these problems with statistical tools and research beyond what is provided by the usual data vendors. The Index is constructed on a monthly basis to be

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

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

GPs can use the index 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 this ratio by the company's last valuation. 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 at 115 percent of the most recent round value.

Our analysis of the Sand Hill Index vs. quarterly returns reported by GPs show that the index predicts GP valuations six to nine months ahead. It can do this because the value of the index in each month is informed by the deals happening in *that month*, whereas the GP reported valuations 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
2) the value based on most-recent-round
3) the value updated (marked-to-market) by the Sand Hill Index.

Everyone has the first two numbers. The third is easy to calculate using 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 current market valuation. We avoid the staleness of most-recent-round, but no one is asked the heroic task of determining the price each company would fetch. Instead, we apply information from the recent pricing of other venture deals, in a systematic and scientific way.