Bridging the Gap

AIMR expands GIPS® standards to private equity

BY CRYSTAL DETAMORE-RODMAN

When AIMR's Venture Capital and Private Equity Subcommittee set out four years ago to address incongruities in the way private equity managers calculate and report performance, members were confronted with not only differing regulatory attitudes but also an asset class that was difficult to valuate.

"One of the biggest headaches of all is how to value a company that is not yet making profits," says Carol Kennedy, chair of the subcommittee and senior partner at Pantheon Ventures Limited in the UK. "All of the companies in the early stages of development in the venture industry, for sometimes a number of years, are not yet profitable."

The subcommittee ultimately endorsed the "fair value" reporting method over the historically popular cost-based approach. Not only does GAAP require managers and investors to record private equity investments at "fair value," but most private equity industry associations have sanctioned the practice in their valuation guidelines as well.

The "fair value" basis of valuation is a focal point of AIMR's newly adopted GIPS Private Equity Valuation Principles, which extend to the private equity sector global standards for the ethical presentation of investment performance. Input data, calculation methodology, composite construction, disclosure, and presentation and reporting are all addressed in the AIMR principles. The GIPS private equity provisions — which focus on fundraising — take effect 1 January 2005, though firms are urged to adopt them sooner.

Key disclosures include the requirements that firms document valuation practices, disclose that the procedures are available upon request, and have the actual valuations reviewed by an independent entity. From a reporting standpoint, the GIPS private equity provisions require the inclusion of both net and gross of fees performance statistics, as well as key multiples to help prospective investors gauge the overall health of the fund.

"Our standards create a checklist of types of information prospective investors should ask private equity managers for," AIMR Investment Performance Standards Associate Gregory Turk, CFA, states.

It was inevitable that greater scrutiny would follow the venture capital industry's dramatic collapse in the early 2000s. Significant growth in private equity assets was another reason to put valuation and performance reporting practices under the microscope. "In the mid '90s, for your typical pension fund, private equity was 2 to 3 percent of the fund, and now it's 5 to 8 percent," Turk explains.

Unfortunately, the industry's growth didn't yield more meaningful valuation guidelines in all parts of the world. In North America specifically, published guidelines have been available for over a decade, but unfortunately these guidelines were never fully endorsed. Currently, an attempt is being made by a US-based venture capital industry association called PEIGG (Private Equity Industry Guidelines Group) to not only create valuation guidelines for the US but also to have them fully endorsed by the venture capital community.

The British Venture Capital Association was the first regional group to develop standards, followed by the European Venture Capital Association some years later. "For well over a decade, both of those groupings have had developed guidelines, and the rest of the Europeans have followed as the industry has developed," Kennedy observes. "And because the industry around the world has developed separately, each country has its own guidelines."

"Although the GIPS private equity standards are meant to wrap around regional industry association valuation guidelines, our standards are higher level principles that should be thought of as core principles that any private equity firm should follow," says Turk. "We don't get into the very detail that a private equity industry association gets into in regard to valuation hierarchies."

Rick Hayes, senior investment officer at the California Public Employees' Retirement System (CalPERS), welcomes the heightened focus on improving reporting and valuation standards. "We have been working with all the groups focused on these issues, such as AIMR and the Institutional Limited Partners Association, to move these issues forward," he says. "In running a large portfolio, these types of issues are critical so that we can make apples-to-apples comparisons of the performance of our investments; at CalPERS, we manage over 350 private equity investments in the alternative investment management program. This is a step in the right direction."

Crystal Detamore-Rodman is a freelance journalist with a background in small business finance.

HELPFUL LINKS

Global Investment Performance Standards (GIPS), www.aimr.org

British Venture Capital Association (BVCA), www.bvca.co.uk

European Venture Capital Association
www.evca.com/html/home.asp

Private Equity Industry Guidelines Group (PEIGG)
www.peigg.org/pages/1/

Dartmouth College
http://mba.tuck.dartmouth.edu/pecenter/resources/glossary.html