

# Venture Capital and Private Equity: Calculation and Presentation of Investment Returns

BY SUSAN TRAMMELL, CFA

When AIMR formally endorsed the Global Investment Performance Standards (GIPS®) in 1999, the standards did not address in detail the calculation and reporting of venture capital and private equity.

In March 2000, AIMR formed the Venture Capital and Private Equity Subcommittee to address the unique characteristics of this asset class. The technical committee was made up of nine industry representatives from three continents. For two years, committee members reviewed various regional reporting and valuation requirements, identifying what it believed to represent global best practices.

In October 2002, the committee issued the proposed Venture Capital and Private Equity Provisions and Guidance. Following a comment period that will end 31 March 2003, the final draft will be issued later this year with a proposed effective date of 1 January 2005. The provisions apply to all venture capital and private equity investments other than open-end or evergreen funds. (Open-end or evergreen funds must follow the main GIPS standards.)

The provisions supplement all of the required and recommended elements of GIPS, *except* where they override the existing GIPS provisions for valuation, calculation methodology, fees, and presentation and reporting of returns.

## No Easy Task

"It's not been an easy task," says Ad van den Ouweland, managing partner, private equity of Robeco, and chair of the committee. "We had people from Asia, Europe, and the United States working together over a lengthy period of time to come up with valuation principles. And I'm emphasizing that it's principles, not guidelines," van den Ouweland says.

Venture capital and private equity

refer to investments in companies that are in the early stages of development and are not yet publicly traded. Investors typically invest in these assets either directly or through a limited partnership or fund of funds. These vehicles typically have a finite life (that is, they are not open-ended) and are generally illiquid. Investments usually consist of an initial commitment of capital, which is then "called," or drawn down, as the investment manager finds investment opportunities. Capital is returned to the investor via earnings distributions and liquidation of investments. The ultimate return of the investment is not known until the fund or partnership is finally liquidated.

For the performance reporting requirements of any portfolio to be meaningful, the return calculations must be based on accurate values of the underlying securities. Various regional organizations, such as the British Venture Capital Association (BVCA) and European Venture Capital Association (EVCA), have developed their own guidelines to provide member firms with standardized methods for valuing investments.

## Valuation Principles

While the regional associations provide their members with detailed valuation guidelines, GIPS restricts itself to high-level venture capital and private equity valuation principles. It should be remembered that the GIPS standards are concerned primarily with presenting a firm's performance to prospective clients rather than reporting performance to an existing client.

"We were aiming at people who are already applying existing BVCA, EVCA, or any other regional valuation guidelines," van den Ouweland says. "The goal of GIPS is to make a link to existing valuation guidelines in the world.... Wherever in the world we go — be it Singapore or Latin America — you need a standard that is catching the basics."

## PERFORMANCE REPORTING REQUIREMENTS

The proposed calculation methodology for portfolios requires that:

- The annualized *Since Inception Internal Rate of Return* (SI-IRR) must be presented.
- The annualized SI-IRR must be calculated using daily cash flows and the period-end valuation of the unliquidated remaining holdings (residual value or net asset value). Stock distributions must be valued at the time of distribution.
- Net-of-fees returns must be net of investment management fees and carried interest.
- For investment advisers, all returns must be net of partnership and/or fund fees and carried interest.

In addition to requiring the use of the Venture Capital and Private Equity Valuation Principles, GIPS requires firms to disclose if they comply with any other valuation guidelines, such as the BVCA and EVCA.

## Fair Value Recommendation

Just which metric should be used to value investments in this asset class before there is realization remains a matter of debate. The only consensus in the investment community seems to be that the concept of a "correct" answer in interim valuations does not exist.

"We try to look at fundamental principles rather than developing specific provisions," says Jonathan Boersma, AIMR vice president for professional standards. "The markets are continually evolving, so we try to come up with principles that are, in some regards, timeless."

How far afield are these performance standards from what is already

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being done in the venture capital and private equity community?

"I think the area where we're pushing the envelope a little bit is in the area of valuation," Boersma says. "We recommend a fair value methodology. We don't require it right at this point because the world, frankly, is not ready for that in some places. But we have included it as a recommendation, and I can see that, down the road, it might become a requirement for compliance with our standards."

The provisions recommend that a qualified person or entity that is independent from the valuer review venture capital or private equity valuations. //

*Susan Trammell, CFA, has a background in venture capital.*

## TRADE GUIDELINES *Continued from page 10*

investment manager's trading techniques, venues, and agents, and any actual or potential trading-related conflicts of interest. Rather than sitting back and waiting for the SEC, practitioners should embrace these guidelines as an opportunity to do something voluntarily. That brings a considerable ethical advantage."

Ultimately, Mann views the guidelines as a valuable management tool. "Charterholders often call on AIMR for assistance in making their firms' policies the best they can be, and practitioners in other markets often ask how they can move from local acceptable practices to global best practices. The Trade Management Guidelines fortify our toolbox in terms of what we can offer our members," she says.

Aronson concludes that today's management tool could one day become a regulator's checklist. "Regulators' attitudes may be, 'Here's what your peers

in the industry think you should be doing, so it's reasonable for us to expect it.' Looking ahead, I think there will be new tabs for transaction costs in managers' quarterly reports, and that would be a very positive development. Better managed trading will improve the entire investment process," he says.

You can view the AIMR Trade Management Guidelines at [www.aimr.org/standards](http://www.aimr.org/standards) and send comments or questions to [tmg@aimr.org](mailto:tmg@aimr.org). //

*Nancy Opiela, also writes for the Journal of Financial Planning and Fidelity's Investment Focus.*

### STANDARDS E-MAIL ALERT

The AIMR Professional Standards department now has a bi-monthly e-mail service detailing current events relating to the Investment Performance Standards (AIMR-PPS® and GIPS®). If you are interested in subscribing to the service, write to [standards@aimr.org](mailto:standards@aimr.org) and enter "Standards E-mail Alert" in the subject heading, with your name, postal address, and e-mail address in the body of your message.

### INVESTMENT PERFORMANCE COUNCIL

#### MEETING DATE

**6 March 2003**  
Vancouver, BC, Canada

All meetings are open to the public. To observe a meeting, notify the AIMR Professional Standards Department at least two weeks prior to the meeting via e-mail at [standardsetting@aimr.org](mailto:standardsetting@aimr.org).

### OPEN FOR PUBLIC COMMENT

#### Proposed Venture Capital and Private Equity Provisions and Valuation Principles

Open for comment  
until 31 March 2003

#### Proposed Leverage and Derivatives Provisions

Open for comment  
until 30 April 2003

Visit [www.aimr.org/standards](http://www.aimr.org/standards) or e-mail [standardsetting@aimr.org](mailto:standardsetting@aimr.org) for more information.

### IPC-ENDORSED STANDARDS

as of 15 November 2002

#### Country Version of GIPS (CVG)

AIPS (Australia)  
DVFA-PPS (Germany)\*  
IPS (Ireland)  
SAAJ-IPS (Japan)  
SPPS (Swiss)  
UKIPS (UK)  
AIMR-PPS (US & Canada)

#### Translation of GIPS (TG)

GIPS (Austria)  
GIPS (Denmark)  
GIPS (France)  
IPPS (Italy)  
GIPS (Hungary)  
GIPS (Luxembourg)\*  
VBA-PPS (Netherlands)  
GIPS (Norway)

#### GIPS (In English) New Zealand

\* Indicates submission has been received, but not yet endorsed by the IPC.

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