

**INVESTMENT PERFORMANCE COUNCIL
ADOPTION OF PRIVATE EQUITY PROVISIONS
FOR THE GIPS® STANDARDS**

SUMMARY: The Venture Capital and Private Equity Subcommittee of the Investment Performance Council (IPC) was created in March 2000 to develop new provisions for the Global Investment Performance Standards (GIPS®) to address the impact of Venture Capital (VC) and Private Equity PE performance reporting. The Subcommittee established a process to identify current practices in several markets with the goal of producing a comprehensive set of globally applicable provisions that would promote the comparability of returns and increase transparency to investors.

In October 2002, the IPC released the initial draft of the prospective provisions and interpretive guidance out for public comment. During this six-month period, the IPC received twenty-eight comment letters from individuals, country sponsors, and organizations from various countries. Below is a summary of the modifications to the PE provisions as well as a discussion of the treatment of the comments received during the public comment period.

ADDITIONAL INFORMATION: For further information on this Guidance Statement and the GIPS standards, contact AIMR's Professional Standards and Advocacy department via facsimile at 434-951-5320, via e-mail at gips@aimr.org, or at 560 Ray C. Hunt Drive, P.O. Box 3668, Charlottesville, VA 22903-3668.

SUMMARY OF COMMENTS

Below is a summary of the comments received during the public comment period. The firm or individual making each comment is indicated using the following abbreviations:

ASP:	Adams Street Partners, LLC
A:	Anonymous
BVCA:	British VC Association
BAI:	Bundesverb and Alternative Investments
CAPS:	CAPS, Inc.
CPDC:	CPD Capital
EH:	Ed Hirs, CFA
EMWG:	Emerging Market Working Group
EY:	Ernst & Young
EYSA:	Ernst & Young (South Africa)
EVCA:	European PE & VC Association (EVCA)
GS:	Goldman Sachs PE Group
JG:	Jason Gull, CFA
HSBC:	HSBC
HL:	Hubertus Leonhardt, CFA
IAIM/SIAI:	The Joint (IAIM/SIAI) Committee on Performance Measurement
RL:	Rebecca Lyons
NTF:	Nazar Technology Finance BV

NFF:	Norwegian Society of Financial Analysts
PCM:	Pathway Capital Management, LLC
PG:	P Group – Australia and the Australian Investment Performance Standards Editorial Committee (AIPS-EC)
PWC:	PricewaterhouseCoopers
DS:	David Spaulding
SAAJ:	Security Analysts Association of Japan
SBA:	Swiss Bankers Association
UKIPC:	UK Investment Performance Council
VBA-PPS:	VBA GIPS Committee
ZI:	Ziel Invest GmbH

1. Definitions

PE/VC Definition

The original proposal stated that the GIPS Venture Capital (VC) and Private Equity (PE) provisions were applicable for the calculation and presentation of VC and PE investments other than open-end or evergreen funds. VC and PE refer to investments in companies that are in the early stages of development and are not yet publicly traded. Open-end or evergreen funds should follow the main GIPS provisions.

Comment: It is not always obvious if a PE/VC portfolio is an opened ended or closed ended vehicle. The guidance should provide more definitive criteria for determining the scope of the PE provisions. (NFF, EVCA)

Comment: It seems that the interpretive guidance section does not consider buyout funds as part of the universe covered by the provisions. We suggest clarifying this because in other sections of the document it clearly appears that buyout houses are covered by these standards. (EVCA)

Comment: We suggest the proposal be changed to indicate that PE is considered equity investments in unquoted companies often accompanied by the provision of loans and other capital bearing an equity type risk. Further it should clarify that VC is a subcategory of PE covering the start-up to expansion stages of investment. (PWC)

Comment: Separate account portfolios, which are essentially evergreen or open-ended, have some unique aspects that we feel should be addressed in the document. It is suggested that they follow the main GIPS provisions; however, they cannot follow these provisions as recommended due to the necessity to use a dollar-weighted measure of performance like IRR. Additionally, recycling distributions and the possibility of separate account clients adding to their allocation over time raises questions for composite construction. (ASP)

Comment: The current draft does not cover vehicles with one investor (captive vehicles) or a variable number of investors and/or a variable lifetime. It is arguable that the performance of such vehicles must be comparable with other PE funds; therefore, the EVCA recommends including these vehicles within the scope of the draft and to use at least the gross IRR since inception as a performance measurement. (EVCA)

The definition of PE has been modified to include buyouts and funds-of-funds as well as by deleting the reference to “early stage.” The IPC agrees that VC is a subset of PE and has clarified this in the Interpretive Guidance.

Instead of discussing the specific differences between a closed end and open end fund, the GIPS PE Provisions are applicable to investments that meet the following criteria.

- manager control of cash flows,
- fixed number of investors, and
- finite fund life

While it is recommended that open-end funds use the Provisions as a guideline, firms must determine whether a separate portfolio account should or must follow this PE provisions.

Revision: Revise definition of PE to include buyouts and funds-of-funds. Clarify the scope of the PE Provisions.

Comment: We recommend that the definition of PE include organizations devoted to VC, leveraged buyouts, expansion, rescue, turnaround, secondary, replacement capital, consolidations, mezzanine and distressed debt investments, and a variety of hybrids such as venture leasing and venture factoring. We also suggest the following wording for the definition of VC: Risk capital in the form of equity and/or loan capital that is provided by private capital (institution / high net worth individual) to back a business venture which is expected to grow in value. (PWC)

The IPC determined to keep examples of the types of PE at a broad level and only identify “venture, buyout, generalist, mezzanine, fund of funds, other PE” and that the current definition of VC was sufficient.

Revision: None.

Other General Definitions

The public comment document stated, “For investment advisors, all returns must be net of partnership and/or fund fees and carried interest.”

Comment: The term “investment advisors” is too imprecise and its meaning unclear. (BVCA, UKIPC)

In order to make the use of this term more clear, the IPC has included a definition of Investment Advisor in the PE Glossary which indicates an Investment Advisor is any individual or institution that supplies investment advice to clients on a per fee basis. The investment advisor inherently has no role in the management of the underlying portfolio companies of a partnership/fund.

Revision: Define “Investment Advisor”

2. Calculation Methods

Since-Inception Internal Rate of Return (SI-IRR)

The original proposal advocates for the presentation of a SI-IRR for every year of the fund's existence.

Comment: It is arguable that IRRs are not meaningful in the early years (say, the first 3 years) of a fund, since year-by-year since inception IRRs will most likely be sequentially negative (the J-curve effect) and may mislead rather than explain the performance of the fund. (BVCA, JG, EVCA)

Comment: The SI-IRR is a useful and relevant way of evaluating PE fund and/or composite performance and should be presented as of the latest year or quarter end. Reporting the SI-IRR for each prior year, other than the most recent year or quarter end, should only be a recommendation. (CAPS, PCM)

Although the commentators felt that SI-IRRs are not meaningful in the initial years of a fund and may even be misleading to an investor, the IPC continues to believe that, for purposes of comparability, all existing funds must have track records. Investors in PE understand the typical “j-curve” characteristic of returns in this asset class. SI-IRRs must be presented every year of the fund, but not annualized for any periods shorter than a year.

Revision: None.

TWRR Versus IRR

The original proposal stated an Internal Rate of Return (IRR) reflects the effects of the timing of cash flows in a portfolio, whereas a time-weighted rate of return (TWRR) removes the effects of cash flows. The IRR is required for PE assets because the firm controls the cash flows into and out of the portfolio and it is difficult to develop objective valuations for PE investments.

Comment: I support the presentation of an IRR for this asset class, as the firm controls the cash flows and believe that it should be broadened to permit the use of an IRR in any situation where the firm controls the cash flows into and out of the portfolio. The TWRR has developed as the standard return calculation because, in most cases, the client controls cash flows. (DS)

Comment: We are aware that investing in these types of funds is a long-term investment and in our opinion investors that invest in this asset-category have this long-term view. However in order to combine the performance of these funds with the performance of other asset-categories in a composite (pension funds, balanced mandates, etc.) a “short” period money-weighted return (maximum at least once a quarter) is essential.

Further we believe the traditional MWR methodologies (e.g., Simple Dietz, Modified Dietz) should be allowed. (VBA-PPS)

Comment: In terms of the calculation methodology there will almost certainly be an inconsistency between the IRR methodology used to calculate the account and composite results and the return shown in a client report where the investor holds a closed-end PE fund as part of a multi-asset portfolio. In our experience performance systems generally apply the same

calculation methodology to all assets within a portfolio. Consequently it is virtually certain that client reports will show closed-end PE results calculated on a TWRR basis. (HSBC)

Both manager control over cash flows and difficulty obtaining accurate values have been specified as by the IPC as the criteria firms must satisfy in order to justify the use of an IRR over a TWRR. The PE provisions are directed to the PE fund manager and not at the pension fund manager level. At the pension fund manager level, for comparative purposes across all asset classes, a TWRR may be more prudent to measure returns across all asset classes. However, it would not correctly capture the PE manager's performance.

Revision: *Added a section to explain why the IRR is required and TWRR is not relevant at this level.*

"Since Inception" IRR

Comment: I am concerned with the use of the term "Since Inception IRR" as I believe that this is a new industry term. In my research, it appears that most firms mean "since inception" when they report IRR. To show a since inception or "SI" prefix suggests that there may be cases when the IRR would not be since the inception of the fund. I propose dropping the "Since Inception" and "SI-" modifiers. (DS)

The IPC believes that the Since Inception and "SI" prefixes provide additional reporting and presentation emphasis.

Revision: *None.*

Calculation Methodology Formula

The original proposal contained the sub-period IRR calculation method:

$$0 = \sum_{i=0}^n CF_i \left(1 + \frac{r}{c}\right)^{-(ic)}$$

Comment: We agree that IRR is the appropriate measure for VC and PE investments where the manager controls the cash flow. We believe the IRR calculation should be written as follows:

If r represents the sub-period IRR, then the definition should be:

$$\sum_{i=0}^n CF_i (1+r)^{-(i)}$$

where i is the period of the cash flow, e.g., 1, 2,... and r is the sub-period IRR, as they are defined in the proposed standard.

The IRR calculation in the proposal is correct as written. It assumes that we are performing an IRR based on the actual dates of cash flows. The IRR formula provided is a generalized formula and allows for the flexibility of compounding periods other than daily.

Revision: *None.*

Daily Versus Monthly Cash Flow Aggregations

The original provision ONLY allowed for daily cash flows in the calculation of the IRR figure.

Comment: It would not be efficient to determine and check the cash flows to be included in the calculation for a large number of investments over a multiple-year period on a daily basis. A calculation on a monthly basis would be more feasible. (BAI, CAPS, EY)

Comment: Para 7.A.3 states that the SI-IRR should be calculated using daily cash flows and paragraph 7.A.15 refers to monthly cash flows. The standard should be clear that daily cash flows are appropriate for all calculations whether fund or benchmark. We strongly recommend that daily cash flows be the standard. (UKIPC)

The IPC decided that both daily and monthly cash flow aggregations are permitted. Daily cash flows will attain a more precise IRR measure, but the increased costs for firms to capture daily cash flows leads the IPC to allow both monthly and daily.

Revision: ***Allow daily or monthly aggregation of cash flows.***

3. PE Valuation Principles

Fair Value Basis

Advocating fair value is a core principle of GIPS, and stressing that firms must comply with fair value has been a major thesis of the PE work. Almost all comments supported the use of fair value but most also had specific examples where fair value may not provide the appropriate value.

Comment: We agree that a fair value methodology should be a recommendation until full discussion and examination have been conducted by the industry and related parties (such as accounting standards setters, etc.). (SAAJ)

Comment: The use of fair value methodology should only be required when this methodology is in line with other generally accepted valuation guidelines. Otherwise a recommendation is sufficient. (PG, SBA)

Revision: ***None.***

Fair Value Versus Cost

The original proposal advocated Fair Value as the best method to use when valuing PE investments. Cost bases were not mentioned in the proposal as the IPC believed that non-Fair Value bases were misleading.

Comment: The "Fair Value" standard of valuation seems to be equivalent to Fair Market Value, which is more rigorous and better known throughout the industry and legal system. "Fair Value" is ordinarily used in circumstances relating to forced sales and dissenting shareholder actions. I have seen evidence that such valuations are subject to manipulation by VC firms.

Consider the choice of valuation methodology before defining something new. I recommend the simplistic method of using the lower of cost or fair market value. (EH)

Comment: Cost and Cost minus impairment methods are important in view of the emerging market problems (e.g., lack of market data and useful comparables, underdeveloped stock markets with low trading volume, and other non-market constraints). We suggest that Cost/Previous Carrying Value and Cost/Previous Carrying Value minus impairment be explicitly allowed when solid data for performing other valuation bases are not available. (EMWG)

Comment: The use of fair value should be promoted but with a certain degree of flexibility in its application that would take into account the particularities of the PE and VC industry. We suggest that the IPC consider including the ability to value a recent investment (say for up to twelve months) at cost. Apart from this, we consider the use of fair value methodology to be appropriate and should be a requirement as soon as possible. (EY, EYSA)

Comment: We felt that the draft Guidelines are later-stage investment focused and do not fully reflect the many stages of investment in evidence to different degrees worldwide. This guidance should include some discussion of the application to different stage companies and the likely application of each primary and secondary methodology for companies in the three main investment stages identified. (PG)

The IPC continues to strongly advocate that a Fair Value Basis be used. However, the IPC also acknowledges the challenges in valuing early stage investments. Therefore, the IPC fully recognizes this reality and permits the use of cost as a basis of valuation in specific, defined circumstances. To protect potential investors, the IPC added several disclosures that must be provided when valuing PE investments using a non-Fair Value basis, including if a non-Fair Value basis is applied, firms must justify why Fair Value was not used.

Revision: ***Add disclosure requirements as well as a discussion on the use of “cost” as a recent transaction and basis within the Fair Value framework.***

Investment Diminutions

In the original proposal the IPC provided examples of when investments should be “written-down” in value or subject to a Material Diminution.

Comment: Firms should be required to disclose how exchange rates movements will impact cash flows (i.e. whether cash flows are kept in their original currency or translated at the rate applicable at the time of the transaction). (EMWG, PWC)

Comment: We would like to specifically include the impact of devaluations as one of the reasons for impairment. (EMWG)

Comment: Please provide further guidelines for writing down companies when last round valuations may be significantly different than a theoretical current round valuation done by a non-strategic, unaffiliated third-party in an arms length transaction. (JG)

The IPC decided to add material devaluations as another example of a diminution of investment. The IPC also added that firms should have policies in place to inform clients/prospects on a timely basis when a material diminution has taken place in the portfolio.

Revision: *Add devaluations as an example of diminution. Also add statement that firms should have policies in place for informing material diminutions.*

International Accounting Definitions of Fair Value

Comment: To avoid a proliferation of methodologies, and to minimize the cost and complexity of complying with the new provisions, we suggest the valuation section be changed so that valuations must be calculated according to the relevant principles and guidelines laid out in international accounting principles. (BVCA, HSBC)

Comment: As there are different definitions of fair value, the guidance should indicate that fair value would be required in the future and further research should be done to harmonize fair value definitions. (PWC, UKIPC)

Comment: The reference to “international accounting principles” made in the valuation section regarding the use of fair value may not necessarily be coherent with the other internationally accepted VC valuation guidelines. (SBA)

The IPC believes that on a high level the PE provisions are consistent with current accounting definitions of Fair Value. As there are differences among standard setters on the definition of Fair Value, the IPC and AIMR will investigate what role they can play in creating a globally-accepted definition.

Revision: *None.*

Fund-Of-Funds Valuation

Comment: Our principal concern is whether the fund-of-funds manager should accept and pass through the valuations that are reported by the managers of the underlying PE funds/partnership investments. We think that it would be useful to investors to augment the proposed valuation hierarchy for funds-of-funds, so that it includes valuations reported by partnership managers as the default valuation. (GS)

Firms may choose to place reliance on the performance calculated and reported by others, provided the firm takes the necessary steps to satisfy that the information provided meets the requirements of the Standards. The fund-of-funds manager is ultimately responsible for their claim of compliance and is responsible for reporting compliant information to prospective clients.

Revision: *None.*

Illiquidity/Marketability Discounts:

The original proposal stated that practical considerations should remain where there are trading restrictions or volumes are low.

Comment: In practice, public securities (particularly in the case of lock-ups, escrows, board seats, very low trading volume, high ownership relative to public float) would be valued at some discount to their public value. (NFF)

Comment: It is generally accepted that an appropriate discount should be applied to quoted shares. Whilst we appreciate that this methodology is contrary to that recommended by the International Accounting Standards Board. However, we believe that AIMR should make a submission permitting the use of discounts in certain circumstances. (UKIPC)

Although discounts are valid concerns when dealing with illiquid investments, the IPC believes these provisions and guidelines must stay at a high level and not prescribe how firms go about calculating a marketability/illiquidity discount for their investments.

Revision: *None.*

Changes in Valuation Methodology:

The guidance section of the original proposal indicated firms must disclose the effect of a change in valuation principles or methodology when the change gave rise to a material fluctuation in value. However, it did not include a formal disclosure requirement.

Comment: Alterations in valuation methodology and consequences of the alteration should be disclosed. (NFF)

As this was the original intent of the IPC, a disclosure requirement is now part of the formal disclosure requirements.

Revision: *Add disclosure requirement to provide the effect of a change in valuation principles or methodology when the change gave rise to a material fluctuation in value*

Valuation Frequency:

The original proposal required at least annual valuations and recommended moving towards more frequently quarterly valuations.

Comment: Valuing PE investments quarterly may be too frequent. Irish Investment Managers may only get VC investment valuations at half yearly intervals. (IAIM/SIAI)

Comment: A formal valuation exercise should be performed on a quarterly basis. Failing that, where valuations are merely reviewed for obvious impairment on a quarterly basis, disclosure of the latest formal valuation date should be required. (PWC)

Comment: We suggest that valuations be prepared at least quarterly and audited annually. Quarterly valuations are essential if being used for the basis of Management Fees. It is also

recommended that the quarterly and annual reports be provided within 60 days of the period end and 90 days for fund of funds. (UKIPC)

The IPC believes that annual valuations should still remain the requirement in the interim. However, we hope to move valuations to a more frequent basis in the future.

Revision: *None.*

Valuation Methodology Disclosure

Within the guidance section, the original proposal required firms to disclose valuation methods and any key assumptions; however this was not listed as a formal required provision.

Comment: We believe that disclosure should be given of the valuation basis and the methodologies used with an indication of the percentage of the portfolio valued under each method. (PWC)

Comment: The Provisions should be more specific on how to document valuation principles. Simply stating "Fair Value Methodology is being applied" is not enough. Instead, a partnership should disclose in some detail the steps taken to value its investments. (SBA)

Although additional suggestions on how firms should disclose valuation methodologies are welcome, the IPC believes it is best to allow firms to develop these on an individual basis.

Revision: *Added a requirement to disclose valuation methodology used.*

More Precision on Valuation Methodologies:

As stated in the interpretive guidance, the PE provisions were intended to apply at a high, broad level.

Comment: We would prefer a more precise definition for the period-end valuation of the individual investments in order to provide a better assessment of the return on the unliquidated, remaining holdings. A precise definition of the individual financing phases (seed, start-up, first stage, expansion stage, and later stage) would also be useful. (EY)

Comment: The AIMR's Interpretative Guidance to its VC/PE standards states that the detailed valuation guidelines of the EVCA or the BVCA may be used in addition. However, this option lacks feasibility. Rather than implementing different standards, a VC/PE firm will decide on one standard and will only have the application of this one standard verified by its auditor. We feel that AIMR should include detailed requirements and recommendations on valuation in order to make GIPS truly global. (EY)

Comment: We would like clarification on the exact valuation methodology that should be used to value stock at the time of distribution. (PCM)

Comment: The proposed methodology lacks precision and can be subjectively managed by the PE community. Consequently, the desired goal of AIMR to standardize reporting that can

enable comparison of funds will not be achieved. We encourage the IPC to consider a more restrictive, comprehensive, and quantitative approach. (NTF)

Comment: Care should be taken to ensure that the Principles do not become too specific and contradict with local regulations/guidelines. Given the evolving nature of regulation in this area, it is suggested that it might be more appropriate at this stage to classify the principles as “strongly recommended as global best practice”. (PG)

The GIPS standards are based on fundamental principles rather than becoming overly prescriptive in nature. Because many regional associations have developed their own guidelines to provide member firms with standardized methods for valuing investments, the goal of the PE Valuation Principles is to serve as a link between the existing guidelines that exist throughout the world. The IPC has always stated that the GIPS PE Provisions should complement regional Valuation Guidelines and thus has kept the guidance at a higher level.

Revisions: *None.*

“Market Transaction”

Comment: Why use the term “market transaction”, when the transaction to which you refer clearly has not taken place on a market (in its conventional sense)? We are unclear what you mean by the term “market-based model”. The one example you provide (free cash flow) does not really make the meaning clear. Also, since the DCF model often refers to market rates of return in deriving an appropriate discount rate, it could be argued that DCF is a “market-based model”. (BVCA)

The term market transaction specifically refers to the most recent transaction in a market. Instead of using the term ending market value to denote the unrealized portion of a portfolio at the end of a period, the IPC will use term “residual value”.

Revision: *Define “market transaction” more clearly. Replace “ending market value” with “residual value.”*

One Globally-Accepted Valuation Guideline

Comment: There should be one international standard for the PE industry. The AIMR should review the regional guidelines with the view of producing one internationally accepted standard. We note that the GIPS proposal seeks only to establish broad valuation principles. The risk with such a broad approach is that it provides PE managers with too much flexibility so that potential investors will continue to see different GP’s valuing holdings in common investments at differing valuations. Where appropriate these proposals should be applied retrospectively to all prior funds and that where historic information cannot be verified the reasons should be stated. (UKIPC)

As there are differences among standard setters on the definition of Fair Value, the IPC and AIMR may investigate what role they can play in creating a globally-accepted definition (at some point in the future).

4. Composites

Construction Across Vintage Years and Strategies

Comment: The proposed standards seem to imply that the manager of a closed-end fund containing PE investments would, at the least, have separate composites for each vintage year of investments within that fund. Is the intention that there would be no combined measure of performance for such a fund? (RL)

Comment: Although not envisioned in the current proposed requirements, an additional disclosure PE firms can provide is a firm-level return composite across vintage years but within the same investment strategy. This number provides explanation for firm performance over many economic cycles. (JG)

Comment: The use of the phrase “Vintage Year” should be reduced. Funds started in a different years are not per definition in a different composite, neither are funds that started in the same year in the same composite. The decision of whether funds should be included in a composite should be based on the GIPS criteria as defined in GIPS and the Composite Definition Guidance Statement, namely by investment objectives and/or strategies. (VBA-PPS)

The IPC believes prospective investors should be presented composite returns. Showing an “average” return across vintage years and/or strategies may not be appropriate or applicable. However, while not explicitly stated in the PE provisions, a firm may aggregate composite returns into a firm-wide number and present it as supplemental information.

Revision: *None.*

“Composite” Versus “Fund”

The original proposal focused on “composites” as the vehicle used to convey performance instead of “funds” or “partnerships.”

Comment: In practice for a PE or VC firm, it is unusual to raise two funds in the same year with the same investment strategy. So as not to confuse PE firms, you should use the term Fund Performance (for a single fund in a single year). This is something that should either be reconsidered or clarified. (BVCA, EVCA, JG, UKIPC)

Comment: We propose that more emphasis is given to the role of the composite in this Guidance Statement instead of the term fund. We understand that in the PE industry, each fund will often be a separate composite. However instead of one paragraph explaining the link between funds and composites (page 10 Fund/Partnerships vs. Composite) we propose that the term “composite” replaces the term “fund” as the central theme of this Guidance Statement. (VBA-PPS)

In order to keep the PE asset class consistent with overall the GIPS standards, the IPC will continue the use of “composite” and clarify the application of composites in PE.

Revision: *Clarify the notion of composites within the PE framework.*

Fund-of-Funds

Guidance on fund-of-funds was not specifically addressed in the composite construction section of the original proposed guidance.

Comment: We are proponents of constructing composites by grouping discretionary vintage year commitments to the underlying partnerships is comparable to industry benchmarks and between competitors (via comparison between different fund-of-fund managers' discretionary vintage year returns). This approach would enable a deconstruction of the composite into the many subclasses (venture, buyout, mezzanine, etc.) for attribution purposes as well. (ASP)

The PE provisions now discuss carve-outs in relation to fund-of-funds vehicles. Specifically, they state breaking-out sub-strategies and presenting them as stand-alone composites is misleading because a prospective investor cannot invest in the individual sub-strategies. Furthermore, the value added by a fund-of-funds manager is to aggregate across various fund strategies.

Revision: ***Indicate that Fund-of-funds will not be treated differently than other PE investments.***

Investment Advisors (IA) must use the net-of-fees return received from the underlying PE firm prior to calculating the IA net- and gross-of-fees returns.

Comment: For Fund-of-Funds, performance should be reported net of the underlying partnerships' fee and carry and gross of the fund-of-fund manager's fee. Venture Economics publishes partnership performance net of the underlying General Partner fees, which flows through to the fund-of-funds manager's gross of fee return. However, it would not be possible to allocate the fund-of-fund manager's fee across the underlying partnerships (to compute a net IRR) as the investments could be made from several separate accounts and/or commingled funds. (ASP)

Since the fund-of-fund manager will not be "carving-out" any of its fund into narrower mandates, there will be no need to allocate its fee to specific sub-funds. The fund-of-funds that is making the investment in the underlying PE fund should be able to include its fees into a net number.

Revision: none

5. Fees

Comment: We believe the nature of PE investments involves more Administrative Fees than ordinary open-ended vehicles. We also believe some of the Administrative Fees in a PE or VC portfolio are inside the control of the investment manager. We would welcome an inclusion of the treatment of fees in the Guidance. (NFF)

Revision: *Add to guidance “...in cases where an investor is not able to negotiate the investment management and/or administrative fees, it may be most appropriate to present performance returns net of the non-negotiable fees.”*

Net- Versus Gross-of-Fee Returns

Comment: In Japan, gross-of-fees annualized SI-IRR is not usually calculated and presented to clients although there are cases where gross-of-carried interest annualized SI-IRR is presented. Accordingly, if gross-of-fees annualized SI-IRR is required to be presented together with net-of-fees annualized SI-IRR, it may be difficult for firms to be in compliance with the GIPS standards that require firms to present a five-year compliant performance record. Hence, we recommend that the presentation of gross-of-fees annualized SI-IRR should be a recommendation and that the framework of the calculation methodology regarding how such fees are grossed should be explained. (SAAJ)

Comment: The required presentation of both Net -of-Fee and Gross-of-Fee returns is not consistent with GIPS requirements which allow firms to choose between a Net-of-Fee and Gross-of-Fee return presentation. (SBA)

Comment: The Draft Provisions currently require that both the net and gross IRRs be presented. While we agree that both results should be presented, we believe that many firms may not have the ability to calculate a gross IRR. We believe that the net-of-fees IRR should be required, but the gross IRR should be recommended only. (CAPS)

Due to the potentially wide spreads between gross and net returns, the IPC will continue to require both returns.

Revision: *None.*

Calculating Net-Of-Fees Returns

Throughout the original provisions as well as GIPS, it is implied that the net-of-fees return is “net to the investor/funder.” Within the PE industry a net-of-fees to fund return can be used (which measures cash flows between the fund and the underlying investments).

Comment: We recommend including the net-of-fees return to the funder as a requirement in the provisions to improve clarity for the investor. This return is based on the cash flows between the funder (investor) and the fund, and not between the fund and the investment. (BAI, BVCA, EY)

Revision: *Clarify that net-of-fees returns are net to the investor.*

Definition of Carried Interest:

Comment: It should be made explicit that the net asset value or residual value of a partnership used in calculating investment performance should be net of carried interest even on unrealized gains. (PCM)

Revision: Clarify the glossary definition of carried interest to reflect it should be net any unrealized partnership gains.

Fees Paid From Outside The Partnership:

Comment: Firms should disclose if investment management fees are paid inside or outside of the fund vehicle. If management fees are paid outside the fund vehicle, firms should include these management fees as a part of paid-in capital in the presentation of the fund's realization ratios: DPI, RVPI, and TVPI. (PCM)

Revision: Clarify that management fees that are paid outside of the fund must still be included in the net-of-fees return.

6. Risk Measures, Ratios and Multiples

Required Multiples

The IPC originally required six multiples that in total would provide additional fund transparency in conjunction with the IRR measure. All of these multiples were recognized industry-wide.

Comment: We feel that the additional information provided by the different ratios should help the reader in determining the quality of the valuation and/or the possibility of valuation mistakes or manipulations. Requiring one specific method of valuation would be a hurdle for any PE portfolio of relative importance, with no real added value. The added-value comes from the numerous ratios (PIC, DPI, RVPI, etc.). (CPDC)

Comment: The Investment Multiple is the exact same thing as the TVPI and the Realization Multiple is basically the same thing as the DPI. Stick with four multiples: PIC, DPI, RVPI, and TVPI. These are multiples used in practice and are helpful when trying to understand returns for a fund. (ASP, BVCA, CAPS, JG, PWC)

The IPC revised the multiples in order to clarify the calculations. This resulted in a decrease from six to four. Going forward a firm will need to calculate these four multiples once a year for each composite. If a firm is going to retroactively comply with GIPS, they will have to retroactively calculate these multiples. But without them, a prospect would not be able to adequately compare funds. The four multiples are:

- a. Total value to paid-in capital (TVPI or Investment Multiple)
- b. Cumulative distributions to paid-in capital (DPI or Realization Multiple)
- c. Paid-in capital to committed capital (PIC)
- d. Residual value to paid-in capital (RVPI)

Revision: Correct inconsistencies in definitions and delete unnecessary multiples.

Risk Measures

Comment: AIMR should expand the recommended disclosures to include an indication of significant concentration of risk which may include industry, geography, etc. as well as any additional sources of finance (besides money drawn down from limited partners). (PWC)

Comment: We feel that there is a lack of credit risk disclosures, as credit risk is relatively important with PE. An easy disclosure would be to ventilate composites to show the different credit ratings and their proportions inside each composite. (CPDC)

Comment: A VC-adequate risk measure should be included because the associated risk is a critical investment criterion alongside the expected return. VC/PE firms use simple win-loss ratios and the dominant scoring models to determine the risks of an investment, while more sophisticated value-at-risk analyses are not widely used. (BAI)

Comment: There should be additional columns labeled “money at risk” and “return on money at risk.” (HL)

The IPC determined not to include any additional disclosures relating to PE risk at this time.

“Ending Market Value”

In the original proposal ending market value was used most often to denote the unrealized portion of the portfolio.

Comment: The document should specify that multiples are to be understood at the fund level. The term “ending market value” can be misleading. We understand this term to refer to the net asset value at the end of each specific period. (BVCA, EVCA)

Revision: *Replace ending market value with residual value.*

7. Benchmarks

Use of Public Market Benchmarks:

In the original proposal, the IPC did not go into detail on the types of benchmarks required/recommended to be used in conjunction with PE composites.

Comment: There is value in using a public market index as a benchmark for a fund-of-funds or secondary fund, etc. Using a public market benchmark also provides data on the opportunity cost of not being invested in the public markets as well as data on the risk premia associated with the private markets. The obvious problem with using a public market index as a benchmark is reconciling dollar-weighted return calculations for PE and time-weighted calculations for public benchmarks. One is forced to either compare time-weighted returns to dollar-weighted returns, or restate one or the other return series to compare like to like. (JG)

Comment: In Japan there are not yet sufficient reliable performance data available regarding VC/PE investments to construct benchmarks. Until infrastructure to provide reliable meaningful benchmarks is well organized, we recommend that disclosure of the calculation methodology used for the benchmark (7.A.14) and presentation of cumulative annualized SI-IRR for a representative benchmark (7.A.19) should be recommendations not requirements. (EY, SAAJ)

Comment: We agree with the proposed provisions with the exception of the Benchmark disclosure. VC is measured in absolute terms and the presence of a formal benchmark is rare. (IAIM/SIAI)

Comment: We propose that more information be provided regarding the benchmark “problems” in this asset-class. Peer group comparison best describes the current available benchmarks in the market. (VBA-PPS)

Comment: The notion of “the benchmark” in the context of PE is less than intuitive, especially in the context of real-time reporting. We believe some explanation is required of what is envisaged here. (BVCA)

The IPC does not dictate the type of benchmark that should be used with regards to the PE asset class. As a recognized public market benchmark is not currently available, most of the industry uses peer-group universes. The GIPS standards indicate firms must either present a benchmark or provide a reason why no benchmark is shown.

Revision: ***Remove requirement for firms to use benchmarks. Restate the provisions to say, “If a benchmark is used.....”***

8. Additional Comments

Extensions to Fund Close Date

Comment: We recommend the following wording: For all closed (discontinued) composites, firms must disclose the final realization (liquidation) date of the composite together with terms and condition of any extension as allowed by the fund documents (and/or the limited partnership agreement). (PWC)

Firms should disclose when a fund does not close on time; however, at this time, the IPC feels that this disclosure is not necessary to include as a requirement.

Revision: ***None.***

Raising Capital and Making New Investments

Comment: We believe that a recommendation should be made that disclosure should also cover time frame and deadline for raising capital and making new investments. (PWC)

The IPC feels this disclosure is too prescriptive.

Revision: ***None.***

Horizon Returns:

Comment: You have obviously decided not to use horizon returns (e.g., performance over the last 3, 5, 10 years). In a Fair Value environment, we believe that, in addition to IRRs, horizon returns would be useful to investors and potential investors, since they would allow comparison

with the performance of other assets and relate more to the current state of affairs than since-inception figures. (BVCA)

While the IPC agrees that this information could be beneficial to prospective clients, it has determined not to specify the use of horizon returns at this time.

Revision: *None.*

PE Standards are out of context with the rest of GIPS

Comment: We are disappointed by the approach taken by the subcommittee in writing this Guidance Statement. Instead of matching the current practises with the GIPS standards, in this way really integrating the VC/PE asset-category with GIPS, it seems that the Guidance Statement is only a summary of already established market practises. If the Guidance Statement is judged as a single document it would be a useful abstract of current market practises, however it is not a stand alone document but part of the wider GIPS framework. VC/PE are set apart from other asset categories. (VBA-PPS)

Due to the nature of this asset class, the Committee felt compelled to provide the provisions and guidance as presented, with some additional language to clarify that the PE Provisions supplement the GIPS standards.

Comment: We recommend the revision of the current document to align future standards more closely with common practice within the PE and VC industry. Although these provisions concern documents primarily dedicated to prospective clients, EVCA would argue that the current draft does not contain a level of disclosure that is sufficient for potential investors involved in the due diligence process. (EVCA)

The PE provisions were created at a “higher level” intentionally to work in conjunction with more specific regional valuation guidelines. As is consistent with the GIPS standards, the PE provisions are designed for prospective client reporting, not for existing client reporting.

9. Effective Date

There was a lack of comments on whether or not the proposed effective date of 1 January 2005 was achievable for most firms.

Comment: Except for the points indicated under item 1 (see SAAJ comments under 6 and 10), we think firms in Japan will be able to meet the requirements beginning 1 January 2005. (SAAJ)

Comment: This will depend on how much information the underlying VC Managers are willing to provide and whether or not they comply to all of the GIPS requirements. (IAIM/SIAI)

Comment: We feel that January 1st 2005 isn't, ideally, enough time for us. To calculate the different ratios on a systematic basis will require adjustments and changes to our performance calculation applications. By the time these guidelines are officially accepted, we'll only have a year to be ready. We consider, given the magnitude of our accounting and performance systems that the timeframe would be constraining. (CPDC)

The IPC stands with 1 January 2005 as the effective date; however, these provisions are not retroactive. ***Note: Since the publication of this document, the IPC and AIMR Board of Governors have moved the effective date of the GIPS Private Equity Provisions to coincide with the effective date of the “gold” GIPS standards – 1 January 2006.***

Revision: None.

Adoption Date: 1 December 2003
Revised Effective Date: 1 January 2006
Effective Date: 1 January 2005
Retroactive Application: No
Public Comment Period: Oct 2002 – Mar 2003

**INVESTMENT PERFORMANCE COUNCIL
Venture Capital and Private Equity Subcommittee**

Private Equity Provisions for the GIPS Standards

7.A. Requirements

Following are provisions that apply to the calculation and presentation of Private Equity investments other than open-end or Evergreen Funds (which must follow the main GIPS provisions). The Private Equity provisions supplement all of the required and recommended elements of GIPS (outlined in Section II.1. through Section II.5.), except where the Private Equity provisions override the existing GIPS provisions for valuation (7.A.1. and 7.B.1.), calculation methodology (7.A.2. and 7.A.3.), fees (7.A.4. and 7.A.5.), and presentation and reporting of returns (7.A.20.).

Input Data Requirements

- 7.A.1. Private Equity investments must be valued according to the GIPS Private Equity Valuation Principles.

Calculation Methodology Requirements

- 7.A.2. Firms must calculate the annualized Since Inception Internal Rate of Return (SI-IRR).
- 7.A.3. The annualized SI-IRR must be calculated using either daily or monthly cash flows and the period-end valuation of the unliquidated remaining holdings. Stock Distributions must be valued at the time of Distribution.
- 7.A.4. Net-of-fees returns must be net of investment management fees, Carried Interest, and transaction expenses.
- 7.A.5. For Investment Advisors, returns must be net of all underlying partnership and/or fund fees and Carried Interest. Net-of-fees returns must, in addition, be net of all the Investment Advisor's fees, expenses, and Carried Interest.

Composite Construction Requirements *

- 7.A.6. All closed-end Private Equity investments, including, but not limited to fund-of-funds, partnerships, or Direct Investments must be included in a composite defined by strategy and Vintage Year.
- 7.A.7. Partnership/fund investments, Direct Investments, and open-end Private Equity investments (e.g., Evergreen Funds) must be in separate composites.

Disclosures Requirements

- 7.A.8. Firms must disclose the Vintage Year of the composite.
- 7.A.9. For all closed (discontinued) composites, firms must disclose the final realization (liquidation) date of the composite.
- 7.A.10. Firms must disclose the unrealized appreciation/depreciation of the composite for the most recent period.
- 7.A.11. Firms must disclose the total Committed Capital of the composite for the most recent period.
- 7.A.12. For the most recent period, firms must disclose the valuation methodologies used to value their Private Equity investments. If any change occurs in either valuation basis or methodology from the prior period, the change must be disclosed.
- 7.A.13. If the presentation complies with any local or regional valuation guidelines in addition to the GIPS Private Equity Valuation Principles, firms must disclose which local or regional guidelines have been used.
- 7.A.14. Firms must document the firm's valuation review procedures and disclose that the procedures are available upon request.
- 7.A.15. Firms must disclose the definition of the composite investment strategy (e.g., early stage, development, buy-outs, generalist, turnaround, mezzanine, geography, middle market, large transaction).
- 7.A.16. If a benchmark is used, firms must disclose the calculation methodology used for the benchmark.
- 7.A.17. If a valuation basis other than Fair Value is used to value investments within the composite, the firm must disclose for the most recent period presented their

* For a complete definition of composite, please see page 6.

justification for why Fair Value is not applicable. Additionally the firm must disclose the following:

- a. the carrying value of non-Fair Value basis investments relative to total fund.
- b. the number of holdings valued on a non-Fair Value basis.
- c. the absolute value of the non-Fair Value basis investments.

7.A.18 Firms must disclose whether they are using daily or monthly cash flows in the SI-IRR calculation.

7.A.19 If a firm does not use a calendar year period-end, a disclosure must be made indicating the period-end used.

Presentation & Reporting Requirements

7.A.20. Firms must present both the Net-of-fees and Gross-of-fees annualized SI-IRR of the composite for each year since inception.

7.A.21. For each period presented, firms must report:
a. Paid-In Capital to date (drawn down);
b. Total current Invested Capital; and
c. Cumulative Distributions to date.

7.A.22. For each period presented, firms must report the following multiples:
a. Total Value to Paid-In Capital (Investment Multiple or TVPI)
b. Cumulative Distributions to Paid-In Capital (Realization Multiple or DPI)
c. Paid-In Capital to Committed Capital (PIC)
d. Residual Value to Paid-In Capital (RVPI)

7.A.23. If a benchmark is used, the cumulative annualized SI-IRR for the benchmark that reflects the same strategy and Vintage Year of the composite must be presented for the same periods for which the composite is presented. If no benchmark is shown, the presentation must explain why no benchmark is disclosed.

7.B. Recommendations

Input Data Recommendations

7.B.1. Private Equity investments should be valued quarterly.

Presentation and Reporting Recommendation

7.B.2. Firms should present the average holding period of the investments (portfolio companies) over the life of the composite.

INTERPRETIVE GUIDANCE

Introduction

Private Equity has become an increasingly important part of mainstream investor portfolios. Private Equity refers to investments in non-public companies that are in various stages of development and encompasses venture investing, buyout investing, and mezzanine investing. Fund-of-fund investing as well as secondary investing are also included in Private Equity. Investors typically invest in Private Equity assets either directly or through a fund-of-funds or Limited Partnership. Private Equity investments generally 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. Fund of fund and partnership investment vehicles typically have a finite life (i.e., they are not open-ended) and are generally illiquid. The ultimate return of the investment is not known until the fund or partnership is finally liquidated. Because of the unique characteristics of this asset class, additional performance reporting requirements are needed. The GIPS standards, which are based on the principles of fair representation and full disclosure, seek to provide prospective clients with the critical pieces of information needed to evaluate the firm’s performance.

In order for any performance reporting requirements to be meaningful, the return calculations must be based on accurate values of the underlying securities. Unlike investments in publicly traded securities where there are well-defined prices, it is difficult to find an objective valuation of Private Equity investments. This has led various organizations (e.g., the British Venture Capital Association, European Venture Capital Association) to develop valuation guidelines in an attempt to standardize the methods used for valuing these assets. *The GIPS Private Equity Valuation Principles outline high-level guidelines for valuation, while the various regional guidelines provide the supporting detail.*

Effective Date

The effective date for the GIPS Private Equity Provisions is **1 January 2006**. While firms are encouraged to adopt them earlier than **2006**, these Provisions are not required to be retroactively applied.

Investment Structures

Limited Partnerships

The predominant vehicle in the global Private Equity industry is the independent, private, fixed-life, Closed-End Fund, usually organized as a Limited Partnership. These funds typically have a fixed life of ten years that can be extended upon agreement of the investors. It is termed a Closed-End Fund in that the number of investors/shares is fixed for the life of the fund and closed to new investors.

The Limited Partnership is a fund of pooled interests managed by a General Partner who raises capital (i.e., Committed Capital or commitments) from outside investors (Limited Partners). The General Partner charges an investment management fee, typically from one to three percent per annum on the total commitments raised. Until the mid 1980’s, it was usual that a General Partner did not invest any of its own capital into the partnership, but that the Limited Partners

“carried” the interest of the General Partner on their own. Most funds now require at least a nominal one percent investment by the General Partner. In addition the General Partner will take a profit split (known as the Carried Interest as described above, or simply the “carry”) of usually twenty percent of profits. The capital is commonly deployed in tranches during which the General Partner will “call” the capital from its investors as needed for investment. These capital calls are also termed “Drawdowns”. Another unique feature of these types of vehicles is that any proceeds from investments must be distributed to investors; reinvestment is only acceptable if pre-defined terms appear in the contract between the General Partner and the Limited Partners.

In this type of structure the cash flows are fairly easy to enumerate as the performance is calculated on the basis of the cash flows between the Limited Partner investor and the partnership. The investment management fee is typically charged on the total assets committed to the fund rather than on the value of the Invested Capital of the portfolio. Because of the straightforward nature of the cash flows of commitment, Drawdown, and Distribution, cash flow stream and calculation of the cost basis of investments is relatively easy.

Captive Funds

The private Limited Partnership (and its variations) is not the only investment vehicle that makes Private Equity investments. Some vehicles are organized as captive vehicles or semi-captive vehicles rather than independent. Captive refers to a fund that only invests for the interest of its parent organization. This parent may be a regular corporation, a financial corporation, insurance company, university, etc. The salient feature is that the fund only invests its parent’s capital — there are no other outside investors. Corporate venture groups of technology companies are examples of this type of vehicle, while several insurance companies and investment banks also have similar vehicles.

The notable feature of this type of vehicle is that typically the vehicle is not a fixed-life investment pool – it is “evergreen”, i.e. a fund with no fixed cost basis as the parent can ostensibly contribute additional capital or withdraw capital from the vehicle whenever it chooses. This complicates the cash flow calculations since the cost basis fluctuates as the capital managed increases and decreases. The other problem is that a fund of this type charges no management fee to its parent and does not really have a “Carried Interest” profit split, although a few creative groups have compensation schemes for the investment officers that work similar to a “Carried Interest calculation”. The result is that captive and semi-captive structures are not comparable to private fixed-life Limited Partnerships on a net-of-fees basis. Therefore the scope of these provisions is in no way directed toward captive or Evergreen Funds within this industry.

Semi-Captive Funds

There is another type of hybrid vehicle called a semi-captive fund that mixes capital from both outside investors and the parent organization. These funds typically charge a management fee and Carried Interest similar to the independent funds, but they are usually evergreen (i.e., not fixed life), and are not independent, but may be closed-end as the number of investors is fixed.

Open-End Funds

Another investment structure is an open-end public entity that acts much like a publicly quoted mutual fund. The fund is a public investment vehicle traded on an exchange and priced daily.

These vehicles typically operate much like a mutual fund or publicly traded company so no other clarification is warranted. These funds are not required to follow the Private Equity provisions in Section 7, but rather should follow the general provisions of the GIPS standards in Sections 1-5.

Direct Investments

Finally, investments can be made in Private Equity assets directly, rather than via a fund or partnership. The Direct Investments are typically made by institutions or very wealthy individuals.

Funds/Partnerships vs. Composite

While most Private Equity investment vehicles are structured as Limited Partnerships or closed-end pooled funds, the GIPS standards are structured around the concept of composites. A composite is an aggregation of portfolios with a similar investment style or strategy. In relation to Private Equity, the composite is an aggregation of funds/partnerships with the same strategy and Vintage Year. In most cases this means that a composite will contain only one fund/partnership. If a firm has multiple funds/partnerships with the same Vintage Year and strategy, they must be combined into a single composite. A co-investment fund will most likely be placed in a separate composite from the underlying linked fund. Accordingly, firms should realize that all provisions and guidance related to composites apply to funds and partnerships. For example, when the Standards state that the cumulative annualized SI-IRR (Since Inception – Internal Rate of Return) must be presented for the composite, because each composite will typically contain only one fund or partnership, this will be the same as the annualized SI-IRR for the fund or partnership. It is important to remember that the GIPS standards are primarily designed for presenting the firm’s performance to prospective clients rather than reporting performance to an existing client.

It is also important for firms to realize that GIPS states that “All actual fee-paying discretionary portfolios must be included in at least one composite” (Standard 3.A.1). Firms must understand that GIPS is aimed at a “firm wide” level of compliance and not just selected composites/funds.

Within the Private Equity asset class, the GIPS concept of “carve-outs” is not applicable. A carve-out is a subset of a portfolio’s assets used to create a track record that reflects a narrow segment of a broader mandate. In particular it could be argued that a fund-of-funds composite is invested across many separate strategies. Breaking-out and showing the sub-strategies as stand-alone composites would be misleading because a prospective investor could not solely invest in the sub-strategies. Furthermore, the value added of a fund-of-funds manager is to aggregate across various fund strategies. For comparison purposes, if a fund-of-funds manager would like to separately disclose the sub-strategies, this information must be presented as Supplemental Information.

Input Data

As mentioned above, performance reporting is of little value unless the underlying valuations are based on sound valuation principles. The GIPS Private Equity Valuation Principles establish a broad foundation for valuing Private Equity assets. These broad principles can be supplemented with more detailed valuation guidelines such as those from the British Venture Capital Association (BVCA), the European Venture Capital Association (EVCA), or others. One of the

goals of the GIPS standards is to improve comparability between firms. The GIPS Private Equity Valuation Principles helps to achieve that goal by requiring that firms use the same fundamental principles as the core of their valuation methodology.

The GIPS standards require that portfolios be valued monthly beginning 1 January 2001 and it is expected that portfolios will be required to be valued at the time of any external cash flow beginning 1 January 2010. However, because the Standards require a SI-IRR for Private Equity assets, increased frequency in valuations will not result in increased accuracy of the return calculation. The Standards only require that annual returns be presented and therefore the only valuation that is needed is at the year-end. More frequent valuations are generally required for client reporting purposes and are considered good business practice. The Standards recommend quarterly valuations because this will allow firms to report performance on a more frequent basis. Firms that do not value on at least a quarterly basis can only present performance through the prior year end.

Calculation Methodology

An Internal Rate of Return (IRR) reflects the effects of the timing of cash flows in a portfolio. The IRR is required for Private Equity assets because the firm controls the cash flows into and out of the portfolio. A time-weighted rate of return (TWR) will not offer the best measure for an investor to compare returns between Private Equity funds because the TWR will not capture the critical effects of cash flow management within the control of the Private Equity manager. While the GIPS Private Equity Standards advocate that the IRR is the most accurate measure of performance for an individual Private Equity manager, it may not be so at higher levels of aggregation. In the case where an investor, e.g. a Limited Partner, is trying to calculate the return at a wider portfolio level, including a number of Private Equity funds, that investor has no control over the timing of any cash flows. In this situation of a wider portfolio, a TWR is more applicable and will provide a comparability measure at a portfolio level with other Private Equity portfolios as well as other asset classes. It is inappropriate to directly compare IRR and TWR figures to each other. This clarification is provided in recognition that the main purpose for the GIPS Private Equity Standards is to provide comparability between Private Equity firms and not necessarily to standardize the performance presentation of the investors.

The IRR is the annualized implied discount rate (effective compounded rate) which equates the present value of all of the appropriate cash inflows (Paid-In Capital such as draw downs for net investments) associated with an investment with the sum of the present value of all the appropriate cash outflows (such as Distributions) accruing from it and the present value of the unrealized residual portfolio (unliquidated holdings). For interim cumulative return measurement, any IRR depends upon the valuation of the residual assets. The sub-period IRR, r , is calculated as follows:

$$0 = \sum_{i=0}^n CF_i \left(1 + \frac{r}{c} \right)^{-ic}$$

where CF is the cash flow for period i , n is the total number of cash flows, i is the period of the cash flow, c is number of annual cash flow sub-periods (e.g., $c = 365$ for daily cash flows), and r is the sub-period IRR. The sub-period IRR is converted to the annualized IRR, R , as follows:

$$R = (1 + r)^c - 1$$

As discussed in the section on investment structures, the predominant Private Equity investment vehicle is the independent private fixed-life fund. The cash flows are easily identified and enumerated as the fund has a fixed cost basis of investment. It is reasonable to assume that since this type of fund has a fixed life, the return on investment is fairly easy to calculate. Because of the straightforward nature of the cash flows and closed-end basis of the fund, there are rarely any intractable or mathematical problems such as multiple IRR's or unbounded solutions which often arise from complicated cash flow streams.

One of the reasons IRR is preferred is that this type of partnership generally has a fixed number of investors and a fixed commitment basis and proceeds cannot be reinvested so the cost basis of investment does not increase and decrease as it would with an evergreen or Open-End Fund. An Open-End Fund can find its investment pool increased (decreased) as investors invest (withdraw) more capital or by the addition (withdrawal) of investors.

One of the basic tenets of performance attribution is that the manager not be rewarded or penalized by decisions outside of their control. In an Open-End Fund as mentioned previously, the timing of cash flows in and out of the fund is totally at the discretion of the investors. As a result a time-weighted return will (paradoxically) remove timing of the cash flows out of the performance calculation. Accordingly, Open-End Funds must follow the provisions of the general GIPS standards and report a time-weighted rate of return.

In a Private Equity independent, fixed life fund, the decision to raise money, take money in the form of capital calls, and distribute proceeds is totally at the discretion of the Private Equity fund manager. Thus timing is part of the investment decision process and thus the manager should be rewarded or penalized by those timing decisions—thus the need for a time-value of money measurement such as the IRR.

Firms are required to deduct Carried Interest, the investment management fee and any transaction expenses when calculating net-of-fees returns. As noted above, the Carried Interest can often have a greater impact than the actual investment management fees. In the case of Investment Advisors that have discretion over the selection of Venture Capital or Private Equity funds or partnerships for their clients, the Investment Advisor must calculate all returns net of all the fund or partnership investment management fees and Carried Interest. Investment Advisor net-of-fees returns must, in addition, be net of all the Investment Advisor's fees, expenses, and Carried Interest.

Composite Construction

It is only appropriate to create composites that show a firm's capabilities or past performance with regard to a particular investment strategy. Firms must also separate funds with different Vintage Years into different composites. The following hierarchy may be helpful as firms consider how to define Private Equity composites:

Vintage Year

Strategy: (venture, buyout, generalist, mezzanine, fund-of-funds, other Private Equity)

Sub-Strategy: (size of fund, stage, etc.)

Geography

Firms must remember that GIPS has formal requirements in place regarding composite construction which can be found in Section 3 of the GIPS Standards. (In order to fully understand composite construction topics one should also read the *Guidance Statement on Composite Definition*). Of most importance, “firms are required to include **all** discretionary fee-paying portfolios (funds/partnerships) in at least one composite that is managed according to a particular strategy or style”. Creating meaningful composites is critical to the fair representation, consistency, and comparability of performance results over time and among firms.

Disclosures

Firms are required to disclose the Vintage Year of each composite. The Vintage Year is the year in which the Private Equity fund or partnership first draws down or calls capital from its investors. The disclosure of the Vintage Year increases comparability by allowing prospective clients to understand the time frame when the fund was initiated. In addition, firms are required to disclose the Final Realization Date of a composite for all closed (discontinued) Private Equity composites. Similar to the Vintage Year statistic, the Final Realization Date also aids in determining the time frame that the partnership was in existence in order to determine the appropriate comparability of one investment to another. Firms are also required to disclose the investment strategy of the composite.

Firms are required to disclose the composite’s unrealized appreciation or depreciation. This disclosure helps prospective clients determine the potential for returns to change in the future based on the potential changes in the valuation of the investments within the composite. Firms must also disclose the total Committed Capital (or capitalization). Total Committed Capital is the Total Value of capital that investors have agreed to invest.

In addition to requiring the use of the GIPS Private Equity Valuation Principles, the Standards require the firm to disclose if it complies with any other valuation guidelines (e.g., BVCA, EVCA). The valuation methodology disclosure is important to determine the comparability of different returns and other important statistical information. If valuation methodologies are substantially different, certain investments may not be able to be compared to one another without very precise and appropriate valuation adjustments.

An additional disclosure is required in situations where a firm uses a non-Fair Value basis to value investments within a fund. Prospective investors must be aware of situations where the fund manager believes a non-Fair Value basis is better and more importantly must understand why a Fair Value Basis is not applicable. Knowing how valuation methodologies differ is important to making the initial comparability determination as well as any required adjustments. Firms are required to document their procedures for reviewing valuations and must disclose that those procedures are available upon request.

Presentation and Reporting

Firms are required to present the annualized Since Inception IRR (SI-IRR) for Private Equity composites. The firm is required to present an annualized SI-IRR for each year since the Vintage Year. Unless disclosed, calendar year period-ends are assumed. For example, assume a composite has a Vintage Year date of 1 January 1999. As shown in the table below, the firm would present the SI-IRR for 1999, the annualized SI-IRR (covering 1999 and 2000) for 2000, the annualized SI-IRR (covering 1999-2001) for 2001, and the annualized SI-IRR (covering 1999-2002) for 2002. Periods less than one year must not be annualized.

Year	Annualized Gross-of-fees SI-IRR (%)	Annualized Net-of-fees SI-IRR (%)
1999	-5.2	-8.2
2000	10.3	7.3
2001	29.6	25.6
2002	22.4	18.3

When presenting Private Equity performance, firms are required to present both gross-of-fees and net-of-fees returns. Net-of-fees returns must be net of the Investment Management Fee, Carried Interest (the management firm's portion of any realized gains as well as the implied Carried Interest component of any unrealized gains in the portfolio), Transaction Expenses, and any other Fees. In general, in cases where an investor is not able to negotiate the investment management and/or administrative fees, it may be most appropriate to present performance returns net of the non-negotiable fees. In addition, if any fees are paid outside of the fund vehicle, they still must be incorporated in the net-of-fees return. Firms must disclose when fees are paid outside of the fund vehicle.

For each year presented, firms are required to report Paid-In Capital to date, total current Invested Capital, and cumulative Distributions to date. The Paid-In Capital to date is the amount of the total Committed Capital that the firm has drawn down (called) from investors. The total current Invested Capital is the amount of the Paid-In Capital that is actually invested in Private Equity assets. The total Distributions is the total amount of capital or income that has been returned to investors. This measure gives prospective clients an understanding of the amount of initial Invested Capital returned to investors relative to other composites with similar Vintage Years and strategies.

The Internal Rate of Return is not the only useful metric used to gauge performance. It assumes, for example, that the Residual Value of a composite is totally liquid while in reality the Residual Value is the unrealized (and often illiquid) portion of the composite. For performance calculation there is one non-cash flow item, Residual Value (net of investment management fees and Carried Interest) and two cash flow items, 1) Drawdowns from Limited Partners (also referred to as capital calls or Paid-In Capital), and 2) Distributions (cash and/or stock) to Limited Partners.

These three components can be used to calculate the internal rate of return assuming the Residual Value is taken as a terminal cash flow value. Only part of the return, however, is actually

realized – i.e. the Distributions. Accordingly, Realization Multiples (such as the DPI) provide additional information as to how much of the return has actually been realized and how much is still unrealized.

The Standards require firms to report the Investment Multiple (TVPI) and the Realization Multiple (DPI) for each year presented. The Investment Multiple is calculated by dividing the Residual Value plus distributed capital by the Paid-In Capital. The Investment Multiple gives prospective clients information regarding the value of the composite relative to its cost basis. The Realization Multiple (DPI) is calculated by dividing the cumulative Distributions by the paid-in-capital. The DPI is a measure of how much of the return has actually been returned to investors. In the early life of an independent fixed life fund, the DPI will be zero until Distributions are made. As the fund matures, the DPI will increase. Once the DPI is greater than one, the fund has broken even, and a DPI greater than one means that the fund has generated capital gains. In addition, firms must present the ratio of Paid-In Capital to Committed Capital (PIC). This ratio gives prospective clients information regarding how much of the total commitments have been drawn down.

The Standards also require the presentation of the Residual Value to Paid-In Capital (RVPI). The RVPI is calculated as the Residual Value divided by Paid-In Capital. RVPI is a measure of how much of the return is unrealized. As a fund matures, the RVPI will increase to a peak and then decrease as the fund matures and eventually liquidates to a residual market value of zero. At that point the entire return of the fund has been distributed.

If a benchmark is used, the Standards require the presentation of a cumulative annualized SI-IRR for that benchmark which reflects the same strategy and Vintage Year as the composite. Firms must disclose the calculation methodology of the benchmark (e.g., monthly cash flows) and if a custom benchmark is used, how that benchmark is constructed. If no benchmark is presented, then the firm must disclose why no benchmark is appropriate. If a custom benchmark is used, then the firm must describe the benchmark creation and rebalancing process.

Appendix A

Private Equity Valuation Principles

Introduction

There are many differing opinions among Investment Advisors, practitioners, and investors regarding the valuation of Private Equity assets. The margin of error for a particular valuation methodology may often be greater than the difference between alternative methodologies. The volatility of asset values is also often high, increasing the perception that an historic valuation was 'wrong'. Although cash to cash returns are the principal metric, Private Equity funds raise capital in part based on unrealized interim returns. The valuation of unrealized assets underpinning these interim returns is critical to this analysis

Although many points are contested, some common ground exists.

The Private Equity industry must strive to promote integrity and professionalism in order to improve investor confidence and self-regulation.

Consistency and comparability are important in reporting to investors and many aspects of valuation should be transparent. More information, however, does not always equate to greater transparency and there are legal and practical constraints on the dissemination of information.

Each Private Equity investment is based on a set of assumptions. It is reasonable for investors to expect interim valuations to reflect factors which, at a minimum, adversely impact these assumptions.

When a Private Equity asset becomes publicly traded, arguments against interim valuations fall away, although practical considerations may remain where there are restrictions on trading or trading volumes are low.

Beyond these issues are the debates on valuation basis and methodology. The move towards a Fair Value basis has been gathering momentum in most areas of financial reporting. Particularly for early stage venture investments which may not achieve profitability for a number of years, practical problems remain and the utility of the Fair Value basis must win over greater support before a consensus on detailed guidelines is likely to be possible.

Guidelines for Valuation

The following must be applied to all forms of investment vehicles making Private Equity investments. These principles do not apply to open-end or Evergreen Funds.

1. Valuations must be prepared with integrity and professionalism by individuals with appropriate experience and ability under the direction of senior management.
2. Firms must document their valuation review procedures.

3. Firms must create as much transparency as deemed possible in relation to the valuation basis used to value fund investments. For the latest period presented, the valuation methodologies used to value Private Equity investments must be clearly disclosed, including all key assumptions.
4. The basis of valuation must be logically cohesive and applied rigorously. Although a Fair Value basis is recommended, all valuations must, at a minimum, recognize when assets have suffered a diminution in value. (Please see *Additional Considerations* section for further guidance on diminution circumstances.)
5. Valuations must be prepared on a consistent and comparable basis from one reporting period to the next. If any change is deemed appropriate in either valuation basis or method, the change must be explained. When such a change gives rise to a material alteration in the valuation of the investments, then the effect of the change should also be disclosed.
6. Valuations must be prepared at least annually. (Quarterly valuations are recommended.)

Fair Value Recommendation

It is recommended that the Fair Value basis, which is consistent with international financial reporting principles, be used to value Private Equity investments. This valuation should represent the amount at which an asset could be acquired or sold in a current transaction between willing parties in which the parties each acted knowledgeably, prudently, and without compulsion.

The accuracy with which the value of an individual Private Equity asset can be determined will generally have substantial uncertainty. Consequently, it is recommended that a valuation method, which involves the least number of estimates, is preferred over another method that introduces additional subjective assumptions. However, if the latter method results in more accurate and meaningful valuation, then it should be used instead of the former method.

Valuation Hierarchy

The following hierarchy of Fair Value methodologies should be followed when valuing Private Equity investments:

1. Market Transaction

Where a recent independent third party transaction has occurred involving a material investment as part of a new round of financing or sale of equity, this would provide the most appropriate indication of Fair Value.

2. Market Based Multiples

In the absence of any such third party transactions continuing to have relevance, the Fair Value of an investment may be calculated using earnings or other market based multiples. The particular multiple used should be appropriate for the business being valued. Market based multiples include but are not limited to the following: Price to Earnings, Enterprise Value to EBIT, Enterprise Value to EBITDA, etc.

3. Discounted Expected Future Cash Flows

This method should represent the present value of risk adjusted expected cash flows, discounted at the risk free rate.

Additional Considerations

1. Where a third party transaction has taken place other than at arm's length, or where the new investor's objectives in making the investment are largely strategic in nature (i.e. the new investor was not acting solely as a financial investor), the manager should consider ignoring the valuation or applying an appropriate discount to it.
2. A material diminution in the value of an investment may result from, among other things, a breach of covenant, failure to service debt, a filing for creditor protection or bankruptcy, major lawsuit (particularly concerning intellectual property rights), or a loss or change of management. Other events may include fraud within the company, a material devaluation in an investment currency that is different from the fund currency, substantial changes in quoted market conditions, or any event resulting in profitability falling significantly below the levels at the time of investment or the company performing substantially and consistently behind plan. Estimating the extent of the diminution in most cases will generally involve both quantitative and qualitative analysis and should be performed with as much diligence as possible.
3. The firm should have policies in place for informing clients/prospects when a material diminution has taken place within the portfolio. Waiting until a quarterly update may often not provide the prospective investor with this critical information soon enough to make an informed decision.
4. Within the Valuation Hierarchy there will be certain industries where very specific valuation methodologies become applicable. Within the correct industry either of these methods could be considered the primary valuation methodology in the absence of an applicable third party transaction. Whenever one of these methods is used, the firm must justify the measure as representing the most appropriate and accurate method for calculating a Fair Value.
 - a) Net Assets: For firms that derive a majority of their value from their underlying assets rather than the company's earnings, this method may be preferred.
 - b) Industry Benchmarks: In particular industries there are metrics such as "price per subscriber" that can be used to derive the value of a firm. These measures are very specialized to the industries they represent and must be careful not to be carried over to more diversified firms.
5. It is recommended that valuations be reviewed by a qualified person or entity that is independent from the valuer. Such parties would include third party experts, an independent advisory board, or a committee independent of the executives responsible for the valuations.
6. As stated in the *Valuation Hierarchy* section of this document, Fair Value allows for the use of a recent transaction as the primary methodology for valuation. Accordingly, when an investment is first made, this "cost" represents the most recent transaction, and therefore the

Fair Value. In this case, the cost is permitted to be used, not because it represents the cost of the investment, but rather because it represents the value of the most recent transaction.

Cost as a BASIS of valuation is only permitted when an estimate of Fair Value cannot be reliably determined. Although a Fair Value basis should always be attempted, the Private Equity Provisions do recognize that there may be situations when a non-Fair Value basis is necessary. Ultimately, firms must keep in mind that investors make decisions based upon Fair Values, not out-of-date historical cost based measures.

In any case when a non-Fair Value basis is used, the firm must disclose their justification for why a Fair Value basis cannot be applied. In addition, for each composite the firm must disclose the number of holdings to which a non-Fair Value basis is applied, the Total Value of those holdings and the value of those holdings as a percentage of the total composite/fund assets.

7. Where companies have activities which span more than one sector, making it impractical to find comparable companies or sectors, each earnings stream may be valued independently. Sector average multiples, based on companies of comparable size, can be used where it is not practical or possible to identify a sufficient number of directly comparable companies.
8. The entry multiple(s) for an investment should only be used as a last resort when comparable quoted companies are not available.
9. All quasi-equity investments should be valued as equity unless their realizable value can be demonstrated to be other than the equity value.
10. When a Private Equity firm has invested in loan stock and preference shares alongside an equity investment, these instruments should not generally be valued on the basis of their yield. They should be valued at cost, plus any premium or rolled up interest only to the extent it has fully accrued, less any provision/discount where appropriate.

Appendix B

Private Equity Glossary

Carried Interest (“Carry”) – The percentage of profits (generally 20-25%) that General Partners receive out of the profits of the investments made by the fund. For instance, a \$100 million fund raised from Limited Partners is invested into a portfolio of investments now worth \$500 million. Assume that there have been profits from proceeds of \$50 million. Limited Partners would receive \$40 million and the other \$10 million would accrue to the General Partners as their Carried Interest. Typically, Carried Interest is only paid after Limited Partners receive their original investment back. Throughout the life of the fund, Carried Interest accrues based on both realized and unrealized gains on investments in the fund.

Closed-End Fund – A type of investment fund where the number of investors and the total Committed Capital is fixed (i.e., not open for subscriptions and/or redemptions).

Committed Capital (“Commitments”) – Pledges of capital to a Venture Capital fund. This money is typically not received at once, but drawn down over three to five years, starting in the year the fund is formed.

Direct Investments – An investment made directly in Venture Capital or Private Equity assets (i.e., not via a partnership or fund).

Distribution – Cash or the value of stock disbursed to the Limited Partners of a venture fund.

Drawdown – After the total Committed Capital has been agreed upon between the General Partner and the Limited Partners, the actual transfer of funds from the Limited Partners' to the General Partners' control in as many stages as deemed necessary by the General Partner is referred to as the draw down.

Ending Market Value – The remaining equity that a Limited Partner has in a fund. Also referred to as net asset value or Residual Value.

Evergreen Fund – An Open-End Fund that allows for on-going investment and redemption by investors. Some Evergreen Funds reinvest profits in order to ensure the availability of capital for future investments.

Fair Value – The amount at which an asset could be acquired or sold in a current transaction between willing parties in which the parties each acted knowledgeably, prudently, and without compulsion

Final Realization Date – the date at which a composite is fully distributed.

General Partner (“GP”) – a class of partner in a partnership. The General Partner retains liability for the actions of the partnership. In the Private Equity world, the GP is the fund

manager while the Limited Partners (LPs) are the institutional and high net worth investors in the partnership. The GP earns a management fee and a percentage of profits (See Carried Interest).

Invested Capital – The amount of Paid-In Capital that has been invested in portfolio companies.

Investment Advisor – Any individual or institution that supplies investment advice to clients on a per fee basis. The Investment Advisor inherently has no role in the management of the underlying portfolio companies of a partnership/fund.

Investment Multiple (TVPI Multiple) – The ratio of Total Value to paid-in-capital. It represents the total return of the investment to the original investment not taking into consideration the time invested. Total Value can be found by adding the Residual Value and distributed capital together.

Limited Partner (“LP”) – an investor in a Limited Partnership. The General Partner is liable for the actions of the partnership while the Limited Partners are generally protected from legal actions and any losses beyond their original investment. The Limited Partner receives income, capital gains, and tax benefits.

Limited Partnerships – The legal structure used by most venture and Private Equity funds. Usually fixed life investment vehicles. The General Partner or management firm manages the partnership using policy laid down in a Partnership Agreement. The Agreement also covers, terms, fees, structures and other items agreed between the Limited Partners and the General Partner.

Open-End Fund – A type of investment fund where the number of investors and the total Committed Capital is not fixed (i.e., open for subscriptions and/or redemptions). (See, Evergreen Fund)

Paid-In Capital – The amount of Committed Capital a Limited Partner has actually transferred to a venture fund. Also known as the cumulative Drawdown amount.

PIC Multiple – The ratio of Paid-in-capital to Committed Capital. This ratio gives prospective clients information regarding how much of the total commitments have been drawn down.

Private Equity – Private Equity includes but is not limited to organizations devoted to Venture Capital, leveraged buyouts, consolidations, mezzanine and distressed debt investments, and a variety of hybrids such as venture leasing and venture factoring.

Realization Multiple – The Realization Multiple (DPI) is calculated by dividing the cumulative Distributions by the paid-in-capital.

Residual Value (“Net Asset Value”) – The remaining equity that a Limited Partner has in the fund. (The value of the investments within the fund). Also can be referred to as Ending Market Value.

Residual Value to Paid-in-Capital (RVPI) – Residual Value divided by the paid-in-capital.

Total Value – Residual Value of the portfolio plus distributed capital.

Venture Capital – Risk capital in the form of equity and/or loan capital that is provided by an investment institution to back a business venture which is expected to grow in value.

Vintage Year – The year that the Venture Capital or Private Equity fund or partnership first draws down or calls capital from its investors.

Appendix C

Sample Presentation

ABC Private Equity Partners Buy-Out Composite 1 January 1995 through 31 December 2002

Year	Annualized SI-IRR Gross-of-Fees (%)	Annualized SI-IRR Net-of-Fees (%)	Bench- mark Return (%)	Composite Assets (US\$ millions)	% of Firm Assets	Total Firm Assets (US \$ millions)
1995	(7.52)	(11.07)	(9.42)	4.31	1.2	357.36
1996	6.23	4.53	2.83	10.04	2.5	402.78
1997	13.86	10.10	14.94	14.25	2.7	530.51
1998	13.12	9.28	14.22	25.21	4.1	613.73
1999	53.29	44.53	37.43	54.00	6.2	871.75
2000	40.60	26.47	32.97	24.25	2.1	1,153.62
2001	29.91	21.86	27.42	8.25	0.7	1,175.69
2002	25.33	17.55	25.24	10.25	0.6	1,150.78

Year	Paid-In Capital (US \$ millions)	Invested Capital (US \$ millions)	Cumulative Distributions (US \$ millions)	Investment Multiple (TVPI)	Realization Multiple (DPI)	PIC	RVPI
1995	4.68	4.68	0	0.92	0.00	0.19	0.92
1996	9.56	9.56	0	1.05	0.00	0.38	1.05
1997	14.54	12.91	2.55	1.16	0.18	0.58	0.98
1998	23.79	22.15	2.55	1.17	0.11	0.95	1.06
1999	25.00	19.08	15.78	2.79	0.63	1.00	2.16
2000	25.00	17.46	27.44	2.07	1.10	1.00	0.97
2001	25.00	14.89	39.10	1.89	1.56	1.00	0.33
2002	25.00	13.73	41.25	2.06	1.65	1.00	0.41

TVPI = Total Value to Paid-In Capital

DPI = Distributed Capital to Paid-In Capital

PIC = Paid-In Capital to Committed Capital

RVPI = Residual Value to Paid-In Capital

ABC Private Equity Partners has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®).

ABC Private Equity Partners is an independent Private Equity investment firm, having offices in London, New York, and San Francisco. The ABC Buy-Out Composite invests in Private Equity buy outs and was created in January 1995.

The ABC Buy-Out Composite complies with the XYZ Venture Capital Association's valuation guidelines. Valuations are prepared by ABC's valuations committee and reviewed by an

independent advisory board. ABC follows the Fair Value Basis of Valuation as recommended in the GIPS Private Equity Valuation Principles. All investments within the ABC Buy-Out Composite are valued in US dollars either using a most recent transaction or an earnings multiple. ABC's valuation review procedures are available upon request.

The GP-BO index is used as the benchmark and is constructed as the QRS index return plus 500 basis points. The benchmark return is calculated using monthly cash flows. There is only one fund in the composite for all time periods and the dispersion of portfolio returns within the composite therefore is zero for all years.

The Vintage Year of the ABC Buy-Out Fund is 1995 and total Committed Capital is \$25 million. The total composite assets (unrealized gains) are \$10.25 million as of 31 December 2002.

The fund's SI-IRR calculation incorporates monthly cash flows.

A complete list of firm composites and composite performance results is available upon request.