FAO Paul Cunningham, Chair
International Private Equity and Venture Capital Valuation Guidelines Board

By email: contact@privateequityvaluation.com

22 February 2022

Dear Paul,

RE: BVCA response to call for feedback on IPEV Valuation Guidelines

We are writing on behalf of the British Private Equity and Venture Capital Association ("BVCA"), which is the industry body and public policy advocate for the private equity and venture capital industry in the UK. With a membership of over 750 firms, we represent the vast majority of all UK-based private equity and venture capital firms, as well as their professional advisers and investors. Between 2016 and 2020, BVCA members invested over £47bn into around 3,500 UK businesses, in sectors across the UK economy ranging from heavy infrastructure to emerging technology. Companies backed by private equity and venture capital currently employ over 1.1m people in the UK and 90% of the businesses our members invest in are small and medium-sized businesses.

We welcome the opportunity to provide our feedback on the review of the International Private Equity and Venture Capital Guidelines ("IPEV Guidelines"). The BVCA would like to emphasise its endorsement of the IPEV Guidelines as they remain a practical, pragmatic and helpful guide for our members on a difficult and highly judgemental area.

BVCA views on IPEV's proposals for incorporation

- The guidance provided during the COVID-19 pandemic.
    - We agree this guidance should be incorporated.

- Further guidance on the valuation of early-stage venture investments and the calibration to the price of recent investment/funding rounds at each measurement date; see 2019 FAQ - https://www.privateequityvaluation.com/FAQs
    - If providing explicit guidance around the use of 'forward-looking methods', it would be good to emphasise that a fair valuation needs to be at the valuation date, and give explicit reference to the key differences between using forward looking multiples/future earnings models and using a future exit value, as this is an area we feel could be better understood.
    - The FAQs on the website https://www.privateequityvaluation.com/FAQs should be incorporated into the main document. A separate section on guidance for valuing early-stage venture investments would be beneficial (we note this is currently incorporated throughout the 2018 guidelines).

- Changes made to ASC Topic 820, highlighting any differences to IFRS 13.
  - With regards to the elimination of the discount against a contractually restricted security (such as locked up listed stock), our view is that the discount does allow for a more accurate fair value. Our observation is that the price of the stock drops when the lockup comes off and the market suddenly has much more supply. Any sophisticated purchaser of this restricted stock (should it be possible to broker a deal while in lockup), would know of this and discount accordingly. The 2022 edition of the IPEV Guidelines should incorporate the feedback received on this point and the clearly explain what is required under US GAAP vs IFRS 13.

- Other feedback following the continued experience of industry practitioners applying IFRS 13 and ASC Topic 820.
  - Please see below

Specific BVCA comments

	Topic	BVCA specific comments
1	Harmonisation between European and US valuation principles for early-stage investments	**Issue:** The use of option pricing is being promoted in the US for early-stage investments whereas in Europe this is merely one of the four suggested valuation methods. More guidance around the valuation of VC/pre-revenue investments would be helpful. The 2018 edition refers to four valuation/equity waterfall techniques for such investments: scenario-based methods, option pricing method (OPM), current value method (CVM) and a hybrid method, but remain relatively silent on the most appropriate technique. In the US, the adoption of OPM is gaining traction and the AICPA has come out in favour of the theoretical underpinnings of the OPM vs CVM. **Recommendation:** It would be useful for the IPEV Board to provide further guidelines on the appropriate techniques for valuing companies at series A, series B funding rounds when the company has no/limited revenue or profit as the subjectivity between methods is very high, perhaps suggesting OPM for investments where the impact is greatest (e.g., for early investors in down-rounds). Further, as part of the process to calibrate valuations to supporting evidence, we would recommend that explicit reference to the last funding round is re-introduced to the guidelines albeit with clear guidance that this is not, on its own, the only data point that should be used in the valuation of venture investments. There would be merit in also providing guidance/referencing a further harmonisation between US and UK practice when nearing IPO, namely the tendency in the US to assume all share classes are pari passu (given they will be once the business IPOs), which is standard practice in the US and we are increasingly seeing in the UK.

2	Probability weighted expected return method (PWERM)	**Issue:** How should PWERM be used in the valuation of early stage investments, particularly where there are other data points such as recent funding rounds and revenue forecasts available? We have noted that the level of detail involved in such valuations and the inherent subjectivity of the range of assumptions used, results in significant potential valuation ranges. **Recommendation:** Given the estimation uncertainty of the PWERM approach and the “highly subjective” nature of the output as currently noted in IPEV section 5.11, we would recommend that to ensure the clarity and usability of venture valuations, usage of the PWERM approach should also be calibrated to other data points including, where applicable, cost of recent funding round, and a revenue multiple approach. In addition, whilst not directly within the remit of the IPEV Guidelines, we would suggest that section 5.11 includes advice to include enhanced documentation and disclosure of the valuation range and assumptions when a PWERM model is used.
3	Price of Recent Investment	**Issue:** When a fund acquires an asset, how long is “price of recent investment” a relative metric albeit not a valuation methodology. **Recommendation:** The guidance is clear that price of recent investment alone is not a standalone valuation technique. However further clarity could be introduced to note that in instances where a transaction completes close to or on the reporting date then the price of recent investment in all likelihood is the most applicable valuation point that represents fair value and therefore may potentially be a standalone valuation technique, whilst also noting that the fair value assessment should remain at this date i.e. has anything come to the valuer’s attention that would suggest otherwise that price of recent investment is an accurate reflection of fair value at that reporting date.
4	Valuation of VC/growth-stage investments	**Current wording**: IPEV (2018) Section 3.1 – Calibration to PORI *Where the Investment being valued was itself made recently, its cost may provide a good starting point for estimating Fair Value. Where there has been any recent Investment in the Investee Company, the price of that Investment may provide a basis for recalibrating inputs to the valuation model.* *[…] which tie to the fully-diluted (“post-money”) equity value […]* *IPEV FAQs* *The Price of Recent Investment methodology requires the use of the post money valuation.* **Issue**: The above guidance has been interpreted by some UK GPs to mean that the Price of Recent Investment, to be used for calibration purposes, is equal to the “headline” post-money valuation. i.e. using the headline value as the starting equity value when applying the valuation techniques. We often see this used as a default position, which is a challenge when there are other share classes with differing rights and preferences in the share structure. We acknowledge that in some cases it may be reasonable to consider the post-money valuation as equal to the headline valuation, and flexibility in wording is required for this. However, in our view this should not be taken automatically as the appropriate application.

<table>
<tr><td></td><td></td><td>Recommendation: It would be helpful for the IPEV guidelines to provide clarification of the terms “post-money”, and “headline value”

Recommended wording: Where the Investment being valued was itself made recently, its cost may provide a good starting point for estimating Fair Value. Where there has been any recent Investment in the Investee Company, the price of that Investment may provide a basis for recalibrating inputs to the valuation model.

When calibrating to the price of a recent Investment, care should be taken not to automatically apply the “headline value” of a round of financing to other share classes which have different rights and preferences. [From IPEV FAQs]

The headline value assumes that all shares in the company have the same price as the shares transacted.

When such differences in rights and preferences exist, the other share classes may be subject to different risks and return expectations, impacting the value of those share classes relative to the Investment. In such cases, the post-money equity value may not be equal to the headline value of a round of financing and it may be necessary to estimate the post-money value using a valuation technique.</td></tr>
<tr><td>5</td><td>Valuation of VC/growth-stage investments</td><td>Current wording: <u>IPEV (2018) Section 3.10 – Calibration to PORI</u>

[…] The following valuation techniques may be helpful in estimating Fair Value:

• scenario-based methods, a forward-looking method that considers one or more possible future scenarios. These methods include simplified scenario analysis and relative value scenario analysis, which tie to the fully-diluted (“post-money”) equity value, as well as full scenario analysis, also known as the probability-weighted expected return method (PWERM);
• the option pricing method (OPM), a forward-looking method that considers the current equity value and then allocates that value to the various classes of equity considering a continuous distribution of outcomes, rather than focusing on distinct future scenarios;
• the current value method (CVM), which allocates the equity value to the various equity interests in a business as though the business were to be sold on the Measurement Date; and
• the hybrid method, a hybrid of scenario-based methods and OPM.

Issue: The guidelines mention the 4 techniques but do not explain when each method may be appropriate. Some GPs have used the reference to CVM as a basis for applying the same share price to all share classes, using the headline valuation as the exit price for the whole business, without consideration of the risks of various underlying share classes. Additionally, the reference to the “post-money” valuation as the basis of the PWERM has caused challenges when considering the Unit of Account for calibration purposes. GPs have used this as support that the post-money valuation is the appropriate calibration point for the PWERM rather than the instrument transacted in the funding round.</td></tr>
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		On the other hand, feedback from GPs is that the forward-looking methods of valuing early-stage businesses are "too subjective" and they are concerned that these approaches should not be mandatory for pre-revenue companies. **Recommendation:** It would be helpful for the IPEV Guidelines to provide clarification on the following: • Further guidance on when it may or may not be appropriate to apply each technique, depending on the investments/situations. • Clarification that no technique should be used as a default, and due consideration should be given to the situation and risk/return in each case. • Further guidance on the appropriate techniques for valuing companies at series A, series B funding rounds when the company has no/limited revenue or profit as the subjectivity between methods is very high, and particular focus for investments where the impact is greatest (e.g., for early investors in down-rounds) **Recommended wording***:* In applying the valuation techniques, care should be taken to ensure that any allocation reflects market participant expectations for each share class, and appropriately considers the risks and returns of the different share classes. The CVM may be most appropriate in circumstances where a liquidity event for the whole business is anticipated in the near future and therefore an allocation of the equity value to the equity interests can be conducted with relative certainty of a market participants expectations. Where there is expected to be a longer holding period prior to a sale or IPO (i.e seed stage and early growth stage), share classes may be subject to different levels of risk and return expectations. In such cases, scenario analysis, OPM, or the hybrid method may help to determine the relative value of each share class, while the CVM may not be reflective of a market participant's perspective.
6	Transactions around the period end	1. **Issue:** In the past, our members have taken the approach of discounting for uncertainty for rounds where a term sheet is signed, but the round has not yet closed. **Recommendation:** It would be helpful for the "Indicative Offers" section to be expanded to include guidance for the rest of the offer/sale process, and how valuation methods and cross-checks may change as the company receives more formal offers and goes through the process prior to signing. 2. **Issue:** There is no consistency around how to treat transactions at/around the period end. When a transaction completes around the period end, the valuer must assess what information was available at the date of the valuation. In making this assessment, they should consider that an investment completing shortly after the period end, where negotiations were materially advanced at the period end are adjusting events. The valuer should consider whether it is appropriate to apply a discount to the transaction price where there is a risk of default, for example where the transaction completion is dependent on factors such as merger panel clearance, or supplementary due diligence

		steps. Where proceeds are placed into escrow accounts, the same considerations should be made. Where the proceeds are in escrow for a substantial period it may be appropriate to discount the value at the fund's cost of capital. **Recommendation:** It would be helpful if IPEV could add an explicit sentence saying it is expected that some element of risk around exit remains in most circumstances and therefore an adjustment for this risk would be expected in the fair value assessment.
7	Transaction comparables	1. **Issue:** The length of time transaction comparables are used to triangulate a valuation is relevant. **Recommendation:** The guidance is clear what can undermine the appropriateness of a comparable recent transaction. A potential point to further consider is the market backdrop in which the transaction was completed. For example, transaction that took place before a market turbulent event (such as the pandemic), may be more relevant than a transaction that occurred during the market turbulent event, even though the prior transaction was a longer time ago. This view would depend on the nature of the market turbulent event. The valuer would need to satisfy themselves that the market is comparable pre and post the turbulent event, otherwise if there has been a fundamental shift in the market dynamics after the turbulent event, the transaction multiples before the market turbulent event may not be relevant as they do not consider this market shift. This is an important consideration when considering if to introduce a timing element to the relevance of comparable transactions. Ultimately whether a transaction is relevant should be based on the judgement of the valuer and should consider all the points set out in the IPEV guidelines as well as the market backdrop/dynamics. A caveat should be included here to reiterate that there is no period of time for which cost is automatically a proxy for fair value. 2. **Issue:** Transaction comps from the last 5 years may demonstrate the best reference point for the valuation of companies that are in niche industries with few traded peers. As such should it be appropriate to consider an average of transaction comp multiples in the relevant industry despite IPEV saying that price of recent transaction is not a fair valuation indicator. **Recommendation:** While the price of recent transaction for the investment itself is not an indicator of the current fair value, the average multiple of a basket of recent, relevant market transactions can be considered when determining fair value. For this purpose, it may be acceptable to consider transactions that occurred in excess of one year ago where these are more relevant to the specific industry than quoted company peer multiples. The valuer must still consider how this method remains current (i.e. whether there are transactions during the period under review that should be added). 3. **Issue:** The IPEV Guidelines currently state "the amount of time that has passed since the transaction was negotiated/consummated" should be considered. What in practice does this mean? (i.e. 6 months, 3 years, 5 years, etc). We have seen a variety of approaches used.

		Recommendation: We would add to the paragraph on page 26 starting "It is a matter of judgement for the Valuer" with some expanded guidance suggesting that it is also a matter of judgement for the valuer as to whether a range of transaction multiples is more appropriate than a listed comp set. This could be augmented with a sentence such as "it would be unusual for a transaction comp more than 5 years old to be appropriate due to…"
8	Secondary fund transactions	1. **Issue:** If a manager has the intention to pursue a disposal via a secondary sale, for example because the life of its own fund holding the asset has ended, is it appropriate to apply a discount to the lead GP NAV to reflect a likely exit price? **Recommendation:** If a limited partner is looking to dispose of its investment through a secondary sale, a discount to the general partner's NAV should only be applied once the limited partner is contractually obliged to proceed with a sale. 2. **Issue:** How should discounts be unwound when completing valuations for assets bought in a secondary sale? **Recommendation:** If a limited partner has purchased an investment at a discount from an exiting LP as part of an arm's length transaction, then, when valuing the investment for the first time, the new limited partner/Valuer should consider whether it is appropriate to reflect the lead general partner's NAV immediately or whether a price closer to the transaction price was relevant where there is a deep discount. It may be appropriate to unwind the discount between the transaction price and NAV over a period of time (i.e. fund life, remaining investment period) rather than reflect a day one gain of the full amount.
9	Considerations for limited partners in pooled funds and co-investment funds	**Issue:** Limited partners in co-investment or pooled funds are guided to use the NAV of the fund(s). However, in certain circumstances the NAV may not be deemed to be IPEV-compliant E.g. where the LP considers that valuations may have been held at cost for too long or marked up aggressively. **Recommendation:** As a limited partner, consideration should be given as to whether the fund's NAV is reasonable, for example through benchmarking the implied valuation multiple against relevant industry peers or by considering transactions around the period end, if adjusting events. If the limited partner believes the general partner is not valuing investments in line with the IPEV Guidelines, they should prepare their own valuation or adjust the NAV using relevant, observable data points in line with the guidelines for investments in direct majority investments. This is likely to only occur in limited instances as the general partner will typically have more detailed information available to value the investment.
10	Environmental, social & governance factors	**Issue:** The consideration of the impact of climate change as part of a Valuer's assessment of fair value is becoming increasingly important for many stakeholders, including auditors. Currently analysis of the impact is mainly qualitative in nature and centred around climate change risks that are considered at the portfolio company level as part of ongoing monitoring. These discussions should ultimately feed into whether a company is well positioned/ already managing the climate change transition risk and adaptation, therefore potentially reflecting this

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<tr><td></td><td></td><td>qualitative assessment as a factor in determining how valuable this is in the current market and whether the valuation multiple captures this upside against the market (or downside if not well positioned).

Recommendation: Whilst noting that the 2018 IPEV Guidelines conceptually consider only the financial impact of ESG factors, given the new reporting requirements under TCFD in the UK (and broader agreement by the G20 to implement requirements on this area) and the potential accessibility of data that may allow for more quantitative analysis, further guidance on accepted principles for considering climate change in the assessment of fair value would be helpful. This includes whether a qualitative assessment would suffice at this stage and would reflecting the impact through the multiple be the best mechanism to capture the value upside or downside. The guidance at this stage should potentially remain broad until there is general consensus on how climate change is viewed across industries and markets when pricing in its impacts and risks. The guidance should allow for qualitative analysis and where applicable, based on the valuer's judgement and access to relevant data, quantitative analysis.</td></tr>
<tr><td>11</td><td>Calculation of net debt</td><td>Issue: Market practice with regard to the calculation of surplus assets included in the calculation of the Adjusted Enterprise Value varies and in particular there is considerable variation in the assessment of "free" and/or "restricted" cash. Some market participants will take the cash balance as at the balance sheet date with little or no further assessment. Some participants will consider specific one-off items such as deferred consideration or tax liabilities to settle, and some will make an assessment of "normalised" cash throughout the period to avoid one-off deviations as at the period end.

This issue is exacerbated for portfolio companies where cash flows are heavily focussed on certain periods of the year and therefore the valuation can be significantly different depending on how the "surplus cash" is assessed.

Recommendation: We would recommend that there is further guidance in the definition of "Adjusted Enterprise Value" and also a new section within 3.4 ii that highlights the following key aspects of potential "surplus assets" that valuers should take into account:
• is the surplus asset "free" and therefore the removal of this from the investment does not result in additional financing requirements?
• has the surplus asset been assessed over a period of time, rather than only at a point in time?
• consideration of factors that could indicate the "surplus asset" is actually part of the working capital requirements of the business.</td></tr>
<tr><td>12</td><td>Transaction/exit costs</td><td>Issue: Valuations will often include deemed exit costs for the investment which are not part of the unit of account and therefore do not form part of the underlying fair value of the investment. Typically, these costs will be included at a point in time when the GP is looking to exit the investment in the next 12-24 months. IFRS 13 and US GAAP indicate clearly that this should not be considered in the fair value however there is no current mechanism to ensure that investors are able to assess the expected net returns from the investment.

Recommendation: Whilst exit costs should not be explicitly, or implicitly (e.g. through modifying the multiple applied to maintainable earnings) included in the valuation, we would recommend that there is guidance on disclosures regarding the nature of the expected exit</td></tr>
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		costs in fund reports. Whilst this is outside of the remit of IPEV, we believe that such a statement would add clarity to the valuation process and ensure a level of consistency in investor reporting.
13	“Known and knowable”	We are seeing this in use more regarding post year end transactions and what was “known or knowable” at year end. Clarity and/or guidance would be of great help.
14	Use of investee portfolio company estimates	**Issue:** Private capital funds, whose underlying investments are typically debt and equity instruments in private portfolio companies, will typically produce NAV statements for their LPs with a quarterly frequency, for a given measurement date (usually a calendar quarter end), and will commit to send those NAV statements to their LPs within 60 days of that measurement date. The managers of these funds will use established techniques such as earnings multiple and DCF to value their portfolio company investment(s). The financial management accounts of the portfolio companies are a key input to these valuations. As a practical matter, those management accounts will often not be of the fund’s measurement date, but rather they’ll lag it, typically 3 months. So, for a given portfolio company, by way of example, the fund will receive that company’s 31 March management accounts at some point in (say) May/June, and it is these 31 March management accounts that the fund will use when calculating its 30 June Fund NAV statement. **Recommendation:** The IPEV Guidelines could note that the above approach is acceptable common practice, particularly where the fund’s quarterly “close” process for a given measurement date is relatively tight, and therefore doesn’t have sufficient buffer to wait for the underlying portfolio companies’ management accounts pertaining to the measurement date.
15	Governance	**Issue:** The current IPEV Guidelines do not cover any considerations for investment valuation governance that firms can implement. Strong governance over the valuations process is essential and should be on the agenda of all GPs. Focus should be applied over the controls that are associated with the critical judgments and estimates which represent material drivers of valuations. Strong governance: • Holds management teams to account to provide accurate reflections of the portfolio company valuations; • Reduces the risk that valuations are manipulated; • Allows better decision making on strategic direction of a portfolio company either if values are increasing or decreasing; • Allows for a more effective plan to exit; and • Increases investor confidence. **Recommendation:** The IPEV Guidelines could include some principles of good valuation governance. Whilst the exact nature and form of the governance framework will likely have a lot of differences between different firms, the principles of good governance will be consistent between those frameworks.

		Elements of a good control framework which the guidelines should highlight are: • *Challenge* – Appropriate processes to challenge the key assumptions at various stages of the valuation process, from methodology used, to the validity of the inputs, and the reasonableness of material judgements used to determine valuations. Providing appropriate challenge requires the right level of seniority and expertise. In addition, processes such as back-testing/retrospective reviews serve as a basis for measuring the effectiveness of the reviewer's challenge. • *Independence* – this is key to achieving a good governance framework. This will mean that the challenge provided in the valuation process is performed independently and avoids issues with respect to conflict of interest. This independence can be achieved either by having individuals from outside the deal team being part of the governance framework or bringing in external independence (either through independent non-executives or a third party valuation specialist). • *Valuation policy* - a well-thought out and detailed valuation approach approved by those charged with governance facilitates a consistent approach in determining fair value and defining processes and controls covering for example: a. the accuracy and completeness of information and data used in the valuation; b. how to manage conflicts of interests; and c. compliance, and effective application of the valuation policy.

We would be happy to discuss the contents of this response with you. Please do not hesitate to contact the BVCA if you have any questions.

Yours sincerely,

Victoria Sigeti

Chair, BVCA Legal and Accounting Committee