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

By email: contact@privateequityvaluation.com

18 November 2022

Dear Paul

**Re: Draft amendments to IPEV Guidelines**

The BVCA is the industry body and public policy advocate for the private equity and venture capital (PE/VC) industry in the UK. With a membership of over 700 firms, we represent the vast majority of all UK-based PE/VC firms, as well as their professional advisers and investors. Between 2017 and 2021, BVCA members invested over £57bn into around 3,900 UK businesses, 90% of which are small and medium enterprises. These cover sectors across the UK economy and in all nations and regions (two thirds of UK investment was outside of London).

We welcome the opportunity to provide our feedback on the draft amendments to the International Private Equity and Venture Capital Guidelines ("Guidelines"). The BVCA would once again like to emphasise its endorsement of the IPEV Guidelines as they remain a practical, pragmatic and helpful guide for our members and the private capital industry.

**BVCA comments on the draft amendments made to the Guidelines**

Overall, we were pleased to see a number of changes made to the Guidelines which will continue to assist our members in a difficult and highly judgemental area. In our response to the initial consultation, we highlighted a number of areas which we felt required amendment and/or additional guidance. We were pleased to see a new section on Environmental, Social and Governance (ESG) factors, clarity around the concept of Known or Knowable Information, and additional information on cash adjustments and net debt adjustments. We also welcome updates that have been made to the sections on surplus assets/excess liabilities, use of contemporaneous data and valuation in distressed or dislocated markets.

However, there were also a number of areas in our response that we feel were not addressed by the draft amendments. In particular, more detail could have been included on ESG as this is a very important and current topic for the industry. Further guidance on early-stage investments would also be beneficial for the venture capital industry given the potentially costly additional work required to determine fair value. Also, while we note the positive changes above to cash adjustments and net debt adjustments, there are queries around specific wording used, including "asset surplus" and the use of "recent" when referring to timelines.

**BVCA specific comments on the draft amendments made to the Guidelines**

**1. Valuing seed, start-up and early-stage investments**

Change: Section 3.10 added paragraphs at the beginning of Valuing seed, start-up and early-stage (pre-revenue/pre-earnings Investments to clarify the valuation approach for such investments.

Our previous response included a number of issues and recommendations in relation to valuing venture capital and growth stage investments and harmonisation between European and US valuation principles for early-stage investments.

We were happy to see additions in Section 3.10 including additional information on calibrating the price of a recent investment and the qualitative factors which impact value that should be considered. These factors will help firms move away from historic cost valuations for early-stage investments as they assess the current performance of such investments.

We believe complexity arises in IPEV's recommended steps if fair value is deemed to have deviated since the previous funding event. Three possible techniques are highlighted, probability weighted expected return method (PWERM), current value method (CVM) and option pricing method (OPM), with the latter being the prioritised technique. Without further guidance or illustrative examples, application of these more complex valuation techniques may be difficult to perform without external expertise. Even firms with experience of applying these methods may still need third party assistance with this approach.

The section remains silent on complex financial instruments such as those with a preferential right attached. These rights can be commonplace, particularly for less mature investments. Further clarification on valuing these types of instruments would be a welcome addition.

## 2. ESG

Change: Section 5.17, New section added to discuss ESG factors

The new section contains an acknowledgement by the board on the focus given to ESG by stakeholders and a high-level framework is included. We understand and appreciate that, ultimately, the industry will drive the approach to ESG and that it is very difficult to lay down a full set of guidelines that will consider all of the relevant ESG scenarios, industry impacts etc., however, we do believe more information is needed to assist the industry. The section as presented is quite limited, descriptive and addresses only a small number of concerns. Given the increased importance given to this area by investors, regulators and governments, we would like to see more guidance included.

The new section may not result in much practical difference for valuers but provides a useful prompt to consider such factors. Risks and opportunities which are "measurable" or "known or knowable" should already be relevant to a valuer following the 2018 guidelines.

## 3. Governance

Change; Appendix 2, Valuation Standard amended to expand discussion of good valuation governance

We were very pleased to see that the amendments include all nearly all of the points we included in our previous response. We would however recommend that the newly-added section be moved from the appendix to the main body of the Guidelines, given the importance of good governance. We think it should be included after the section on 'Known or Knowable' in Section 2.5, titled Exercising Prudent Judgement, as part of exercising prudent judgement is to have appropriate governance.

## 4. Use of investee portfolio company estimates

Change: Section 2.5, added paragraphs covering Known or Knowable concepts.

In our previous response we included a section titled "Use of investee portfolio company estimates" and highlighted common practice around producing NAV statements for LPs and the associated time lag between the measurement of management accounts of portfolio companies and the fund's measurement date when producing the NAV statements. We included an example to illustrate this, as follows; 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.

Our recommendation was that the Guidelines could note that the 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. It appears that on page 17 of the Guidelines wording has been included to address this, which is helpful.

## 5. Known or knowable information

Change: Section 2.5, added paragraphs covering Known or Knowable concepts

As noted in our introductory remarks, it was pleasing to see more information included on known or knowable information. However, we think clarity should be provided on how the known or knowable information is considered during an exit process, and where such information may not have been known at the valuation date but is clear evidence of fair value at that date. This is most common in exit scenarios where a process is started and completed in the post valuation date period but before LP accounts are prepared. In practice we see a divergence between GPs who will update their valuations and those who don't as they consider the information "not known or knowable" at the valuation date. This risks a divergence in practice and removes effective comparability.

## 6. Transactions around the period end

No change

Our response highlighted the lack of consistency around how to treat transactions at/around the period end. Unfortunately, it appears that no guidance has been included. We would like to see guidance on how to address transactions around the period end. i.e. that we can value based on a term sheet where this completes post year end but before sign off, and that applying a completion risk discount is allowed/sensible. We believe this is currently not covered and we see many approaches.

## 7. Comparable recent transactions

Change: Section 3.4, modified wording under Comparable recent transactions to clarify how to consider transaction multiples and consider market dislocation.

It was pleasing to see changes in the section to include wording around market dislocation and changes in market conditions. However, we believe the changes still do not express a practical time period where you could rely on a funding round, or other relevant transactions. For early-stage transactions we have preference for using these benchmarks as earnings are often negative and revenues unpredictable.

Secondly, we believe the following wording on page 27 at the end of the section should be changed as we believe that judgement is better than guiding people not to use transaction multiples, as in some cases they are more relevant.

"In times of market dislocation, judgement should be applied ~~it may not be appropriate to use~~ if using transaction multiples, even if very recent if the market is changing very rapidly."

| 8. Quoted Investments |
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Change: Section 3.6, numerous changes and additions.

We were pleased to see that IPEV has taken the opportunity to recertify two key positions on the valuation of quoted securities:

- That regardless of market dislocation or significant volatility, actively traded securities should be valued at P * Q (closing price on the relevant exchange at the measurement date multiplied by the quantity of shares held). This is despite the belief that in volatile markets, valuers may no longer deem the "share price" to be representative of fair value.

- Discounts can be considered in instances where restrictions are deemed to be attributable to the security, however holder specific restrictions are not deemed sufficient to deviate from a valuation at P * Q.

The amendments cover the theoretical difference between US GAAP and IFRS with regard to listed investments, however in practice this may not be a concern for practitioners or valuers.

As noted in the Guidelines, the recent June 2022 FASB Topic 820 Accounting Standards update clarifies that contractual sale restrictions (holder specific e.g. underwriter imposed lock up) should not be considered when calculating fair value whilst regulatory restrictions (security specific) should be considered. This helpfully provides comfort that the IPEV guidelines, IFRS and US GAAP are now converged on the approach to listed securities, which as noted above is in practice what was already more often seen.

Whilst the Guidelines remain clear that in an active market, quoted instruments are expected to be valued at P * Q, there is still limited guidance as to how to proceed if a market is not deemed to be active.

| 9. Distressed or dislocated markets |
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Change: Section 5.3, Distressed or Dislocated Markets amended to reflect the Boards 2020 and 2022 special guidance and to separate the concept of Distressed Markets from Distressed Transactions.

This section has been overhauled, given the experiences gained through the Covid-19 pandemic and the current global market volatility. The addition of areas of focus in periods of high volatility will be helpful to valuers.

Critically, the guidelines state that 'Fair value is determined using the market conditions which exist on the measurement date'. This is a topical area given the time it can take for market shocks priced into quoted instruments to translate into the valuation of private assets. Similar to the removal of the marketability discount (a discount to reflect the time that would be required to sell an asset) in previous iterations of the Guidelines, the current update cements the idea that an asset should be valued using the prevailing information at the measurement date.

Please do not hesitate to get in touch if you would like to discuss any of the above in more detail (please contact Ciaran Harris charris@bvca.co.uk).

Yours sincerely,

Gurpreet Manku, Deputy Director General and Director of Policy, BVCA