UPDATED U.S. PRIVATE EQUITY VALUATION GUIDELINES

Private Equity Industry Guidelines Group

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PEIGG – UPDATED U.S. PRIVATE EQUITY VALUATION GUIDELINES

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I. OVERVIEW

Introduction

1. As the U.S. private equity industry (defined as venture, buyout, mezzanine, and other investments in private companies) has grown and matured, its participants have become increasingly interested in the appropriate reporting of fund values. The interest stems from a number of sources, such as an investor's desire to measure interim performance, investor's need for fair value data to report investments in their own financial statements, a manager's need to report and measure valuations in accordance with fund agreements, and the need to determine the allocation of distributions of fund realizations. This has led to increased scrutiny of portfolio company values and the need for greater consistency of valuation methodologies employed by managers of private equity funds. However, by its very nature private equity is an asset class in which judgment plays a significant role. Accordingly, investors in the same company may have different, but supportable, views on valuation.

2. The objective of the Updated U.S. Private Equity Valuation Guidelines ("Guidelines") is to provide managers a framework for valuing investments in portfolio companies at fair value and to provide greater consistency within the private equity industry with regard to valuations. Historically there were few authoritative guidelines compliant with U.S. generally accepted accounting principles (GAAP) that required specific procedures for estimating fair value of investments in portfolio companies held by private equity investors. In September, 2006, the Financial Accounting Standards Board released Statement of Financial Accounting Standards No. 157, *Fair Value Measurements.* The Updated U.S. Private Equity Valuation Guidelines are intended to assist managers in their estimation of fair value and are intended to be consistent with GAAP (FASB Statement No. 157) and the AICPA *Audit and Accounting Guide - Audits of Investment Companies*. The AICPA Guide's definition of Investment Companies includes Private Equity Investors (paragraph 1.03) and requires investments to be reported at fair value (paragraph 1.32).

3. These Guidelines were created jointly by managers (i.e., general partners) and investors (i.e., limited partners) incorporating feedback from a wide number of industry participants. The Guidelines are not intended to be all encompassing, nor are they intended to eliminate all subjectivity. Rather, they are to be a guide to assist managers and investors in agreeing to a valuation framework while allowing a manager to exercise its best judgment in applying the Guidelines.

4. Included in these Guidelines are terms that are subjective in nature, such as materiality, and could have different meanings in various factual situations. While it is outside the scope of these Guidelines to force specific definitions upon its users, the manager, in consultation with the Valuation Policy Committee (as discussed below) may develop and document appropriate definitions of these subjective terms.

5. The Guidelines are not intended in any way to modify the provisions of the fund agreement relating to the subject matter hereof. To the extent the Guidelines are adopted by a manager and a Valuation Policy Committee and in one or more respects the Guidelines are inconsistent with the fund agreement, the fund agreement would govern (absent a specific amendment thereto).

Fair Value Concept

6. The Guidelines seek to have all investments in portfolio companies reported at fair value on a consistent, transparent and prudent basis. Fair value as defined in accordance with GAAP is "**the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date"** (FASB Statement No. 157, paragraph 5). The objective is to estimate the exchange price at which hypothetical willing marketplace participants would agree to transact in the principal market, or lacking a principal market, the most advantageous market. No matter which market is deemed most appropriate, fair value is the estimated "exit price" in that market.

7. Securities of private companies, by definition, will not have quoted market prices available. However, private companies at times engage in arm's-length transactions for issuances of their equity or debt securities. The value of these transactions could serve as an observable market price similar to a quoted market price if the transaction is both recent and between willing parties for the same securities as those for which the fair value determination is being made (deemed a level 2 input by FASB Statement No. 157), and could therefore be used as an estimate of the theoretical exit price.

8. When quoted market prices or arm's-length transaction prices as described above are not available, the estimate of fair value should incorporate all reasonably available information about the business and utilize assumptions that market participants would normally use in their estimates of value. The estimate of fair value should seek to best replicate the amount at which the investment could be sold in a current transaction between willing parties.

9. In determining the fair value of individual investments using these Guidelines, managers are expected to use their judgment. In utilizing judgment, substance takes precedence over form. For example, when a manager's past experience indicates that liquidation preferences will likely be renegotiated or may not be fully enforced at the time of liquidation, the manager is strongly encouraged to use the expected results rather than the form of the agreement.

10. Valuations should be updated on each measurement date, generally on a quarterly basis. Of course, valuations used for annual and quarterly performance reporting should be used in private placement memorandums and other marketing materials.

Valuation Policy Committee

11. These Guidelines acknowledge the perception that bias exists or has the potential to exist in a non-independent (versus independent) valuation performed by a fund's manager. As a result, it is recommended that the manager of each private equity fund establish a Valuation Policy Committee consisting of a subset of the fund's investor representatives. The Valuation Policy Committee could be all of, or a portion of, a fund's advisory committee, if such a committee exists. (Neither these Guidelines nor GAAP require managers to obtain independent valuations).

12. The fund manager, in consultation with the Valuation Policy Committee, should establish the written valuation parameters to be consistently followed by the fund's manager using these Guidelines. **The agreed upon valuation policy and deviations from that policy should be communicated to the Valuation Policy Committee and the limited partners by the manager.** Private equity fund managers are solely responsible for establishing and documenting valuation policy, practices, procedures and methodologies as well as valuing their investments in portfolio companies The Valuation Policy Committee should not set, formulate or approve the valuations, except as required by the fund agreement. The Valuation Policy Committee should periodically discuss the level of the manager's adherence to the fund's valuation policy parameters.

II. PRIVATE COMPANY VALUATION METHODOLOGIES

General Guidelines

13. Managers are to fairly value the investments in their portfolio companies on a consistent, transparent and prudent basis. Since value is often realized through a liquidity event of the entire company, the value of the company as a whole at the reporting date will often provide the best evidence of the value of the investment in that company. As a result, **the methodologies discussed in this section involve estimating the value of the company as a whole as an initial step for valuing the company's privately issued securities. The manager will then need to determine how the total enterprise value is distributed among the various securities of the company.**

14. Managers of funds should, without undue cost and effort, contact other sophisticated investors to discuss the valuations of common investments and the factors considered in their valuations. However, managers are not required to use other investors' valuations since the estimate of fair value is the responsibility of the managers.

15. To value an investment, managers should place the most weight on valuation methodologies that are clearly objective and timely. On each valuation date managers need to take into account available information from market participants, the relevant marketplace and the global economy along with specific facts and circumstances in determining the fair value of their investments.

16. **Historically, the Private Equity Industry used cost or the value of the latest round of financing as an approximation of fair value; often without taking into account other facts and circumstances. Such an approach is incompatible with the concept of fair value described above. At each valuation date a manager must make a determination of fair value for each investment. As further outlined below, these Guidelines provide a consistent and transparent methodology for determining fair value. However, a manager may conclude, after considering the facts and circumstances as outlined below, that the best indication of fair value is provided by cost or the value of the latest round of financing.**

17. FASB Statement No. 157 allows managers to utilize three valuation techniques, either alone or in combination. These Guidelines encourage managers to use the "market approach" in most situations (see FASB Statement No. 157, paragraph 18a) utilizing Comparable Company Transactions or Performance Multiple inputs, as the primary technique to estimate the fair value of equity securities in private companies. For Private Equity, the market approach usually is the most appropriate.

18. In addition to the market approach technique discussed above, there are other valuation methodologies, some of which are discussed in paragraphs 41 and 42. These other methodologies or techniques may be appropriate in certain circumstances, and include discounting cash flows, valuing net assets, and industry-specific benchmarking (described in FASB Statement No.157 as the income and cost approaches).

19. Other valuation matters, including valuing interest bearing securities, PIK dividends, warrants, liquidation preferences, convertible securities, escrows, and other rights, privileges and preferences of preferred securities are discussed in paragraph 47.

20. Determination of valuation adjustments should typically be based upon actual positive and negative events, not upon expected accomplishments and performance.

21. Regardless of the valuation methodology used, once used, it should continue to be used until a new methodology will provide a better approximation of the investment's current fair value. It is expected that there would not be frequent changes in valuation methodology.

Cost / Latest Round of Financing

22. While entry prices and exit prices are different conceptually, for the Private Equity Industry these Guidelines presume the manager at the time of the initial investment has considered near term company performance in determining investment valuation. Therefore, cost (the transaction price) may be fair value (the exit price) upon purchase. The transaction price may not represent fair value upon purchase when:
    a) The transaction is between related parties;
    b) The transaction occurs under duress;
    c) The transaction price includes transaction costs (transaction costs are expensed under GAAP);
    d) The market in which the initial transaction takes place is different than the principal or most advantageous market in which the exit transaction would take place.

23. Managers should reconsider a company's fair value in connection with each material equity financing, regardless of the manager's participation. The value of the last round of financing is **a** factor in determining fair value, but it is not necessarily the only factor.

24. A subsequent equity financing that includes substantially the same group of investors as the prior financing is an appropriate factor to consider in valuing prior investments unless it can be demonstrated that the financing no longer represents fair value. This approach may be different from historic practice, where, typically the value of prior investments was not increased in a subsequent higher priced financing round unless a new investor 'validated' the new pricing.

25. If a private financing will be completed with a high degree of certainty in the near future, and the pricing of the transaction has been substantially agreed, to establish the value of a previous investment, a manager should consider their best estimate of the upcoming new financing if it can be objectively determined that the prospective financing is at fair value.

26. Occasionally a round of financing includes a significant investment from a strategic investor paying a premium due to benefits accruing uniquely to itself. The manager must evaluate whether such a premium is representative of what the most likely buyers of the company would also pay upon exit, and therefore, whether the price paid by the strategic investor is deemed to be the exit price (fair value) expected from market participants.

Deviations from Cost / Latest Round of Financing

27. After some period of time, cost or the latest round of financing becomes less reliable as an approximation of fair value. Therefore, the manager must assess whether fair value has changed even though there has not been a new round of financing. Examples of changes in circumstances which indicate a change in fair value may include, but are not limited to, the following:

    a) The current performance of the company is significantly above or below the expectations at the time of the original investment. Potential indicators of this situation will include evaluation of the company's success or failure in attaining certain milestones, achieving technology breakthroughs, developing proprietary technology, progressing through clinical trials or significantly exceeding or failing to meet budgets.

    b) Market, economic or company specific conditions have significantly improved or deteriorated since the time of the original investment. Potential indicators of this situation will include evaluation of broad changes in the economic climate, changes in the financing markets, changes in the legal or regulatory environment in which the company operates, changes in the company's cost structure, increased or decreased risk factors faced by the company, or significant fluctuations in share prices of quoted companies operating in the same or a related industry.

    c) Substantial decreases in the value of quoted, more senior securities of the company (e.g., public debt), defaults on any obligations of the company, a bankruptcy filing, significant ownership dilution caused by recapitalization of the company, or liquidity concerns that are expected to be more than short term in nature are circumstances which may indicate a potential impairment in value.

28. Estimating the extent of a change in fair value, if any, may not easily lend itself to an analytical process. As a result, the manager will be required to exercise prudent judgment and carefully consider the broad indicators of potential changes to fair value (such as market conditions, relevant stock market indices, and other factors as discussed above).

29. The result of such consideration will provide indications whether the carrying value of the investment should be increased or decreased to represent fair value. The longer that fair value has been estimated using cost or the price paid at the most recent round of financing, the more consideration should be given to reviewing changed circumstances and potentially determining fair value utilizing other inputs. Managers may consider historic cost or the price paid at the most recent round of financing in making their fair value determination, but should not use cost or the most recent financing price as the sole determinate of fair value.

30. These Guidelines recognize that building long-term value in a private equity backed business is not an easy task. Usually, many positive events need to happen in order for portfolio companies to succeed. However, managers often become aware that certain of their investments are likely to fail given their insight into the company. Even private companies that have significant manager involvement face a daunting task to create value for investors. Thus, it is natural that decreases in value may be more easily identified and justified than increases in value. However, both decreases and increases in investment fair value should be recognized when warranted. Because of the difficultly in building sustainable, long-term value in a private equity backed business, increases in value should only be made where the manager can support the increase using the methodologies discussed in these guidelines or using other techniques common to the marketplace, remembering that fair value is defined as the exit price on the measurement date in a hypothetical transaction. Diligence, prudence and caution should be applied when valuing private companies, and in particular when considering the valuation write-up of early-stage companies, in the absence of market-based financing events. All such changes and the factors upon which the changes are made should be reviewed with the Valuation Policy Committee. However, managers must recognize that there should be no bias toward either increasing or decreasing carrying value to record fair value.

31. When valuation adjustments are necessary, the methodology used should be based on relevant comparable data wherever possible ("relevant comparable data" as used in these Guidelines is intended to be consistent with the input hierarchy discussed in paragraphs 22-31 of FASB Statement No. 157). Recommended methodologies are discussed below.

Comparable Company Transactions

32. This methodology involves deriving the value of a company through examination of third-party investments in comparable equity securities of the company, examination of transactions in equity securities of comparable companies and direct comparisons to similar companies. These comparisons should be appropriately adjusted for any control premiums, synergistic benefits or other excess benefits or detriments that accrue to the owner when determining a proper comparable valuation.

33. These Guidelines acknowledge that until a company achieves marketplace acceptance for its product or service, it is unlikely that truly comparable companies with determinable fair values will be readily identifiable.

34. To the extent comparable transactions cannot be ascertained and fair value cannot be reasonably assessed and reliably measured using comparable transactions, the following Performance Multiple methodology should be used, if applicable.

Performance Multiple

35. The performance multiple methodology applies a relevant multiple to the performance of the company being valued in order to derive the value of the company. This approach is most applicable to companies that have achieved positive and sustainable operating performance.

36. The valuation determined using this methodology is calculated by applying the most appropriate and reasonable multiple derived from reference to market based conditions of quoted companies or recent private transactions. The multiple to be used, which may need to be adjusted for differences in terms of growth prospects and risk attributes (depending on the size of the comparison sample, among other factors), should be one of the following:

    a) Current average comparable public company multiple for similar companies in the industry;

    b) Current average multiples for recent private transactions of similar companies in the industry; and

    c) The original acquisition multiple when no other similar public or private multiples can be ascertained.

    The most appropriate and reasonable multiple as determined above will be applied to the relevant operating performance metrics of the company to estimate fair value.

37. The manager should be confident that reasonable, relevant and sustainable performance metrics are utilized, which may necessitate the adjustment for one-time and non-recurring items.

38. There may be significant changes in the financial, regulatory, economic or legal climate in which the company operates which harm or enhance the prospects of the company, but these changes may not yet have affected performance. The manager needs to consider these changes in evaluating a company's sustainable performance. Managers should share with the Valuation Policy Committee the factual data and their assumptions that support the sustainable performance used in the valuation determination.

39. The multiples used should be those that are used regularly and routinely to value companies in the industry in which the subject company is operating. If the multiples used are derived from public company comparables, a discount to a private company's equity value may be appropriate. Discounts applied to private securities may be higher than those applied to restricted public securities, which are discussed in paragraph 46. Managers should share with the Valuation Policy Committee the factual data that generates the multiples used in the valuation process.

40. To the extent fair value cannot be reasonably assessed and reliably measured using performance multiples, the following methodologies may be considered.

<u>Other Valuation Methodologies</u>

41. A few other valuation methodologies, which may be appropriate in certain circumstances, are as follows:

    a) Because of the need to use significant estimates and forward-looking information, discounted cash flow (DCF) methodologies should only be used in limited situations using a discount rate commensurate with the risks involved. These situations would involve instances where the methodologies previously discussed in these Guidelines prove incapable of addressing the specific circumstances.

    b) Net asset valuation methodologies should be used for valuing investments in businesses whose value is derived primarily from the underlying value of their tangible assets rather than their performance.

    c) Industry-specific benchmarks, which are customarily and routinely used in specific industries such as price per subscriber or other industry norms, should only be used in estimating fair value where appropriate.

42. In those circumstances where there are indications that a change in carrying value is appropriate based on paragraph 27, but the methodologies described in paragraphs 32-41 are not applicable, the manager should exercise prudent judgment in considering assumptions that marketplace participants would utilize in their estimate of fair value.

III. VALUATION OF PUBLICLY TRADED SECURITIES

Unrestricted

43. Actively traded public equity and public debt securities are required to be valued at the closing price or bid price, except as discussed below. Active markets are defined as a market in which transactions occur with sufficient frequency (daily) and sufficient volume to provide pricing information on an ongoing basis, regardless of the size of the position held.

44. Discount (blockage) factors for unrestricted securities that trade in an active market are prohibited by GAAP (FASB Statement No. 157).

Restricted

45. A discount from values of actively traded securities should be taken for holdings of securities when there is a formal **restriction** that limits sale of the securities. Examples of restrictions that may warrant a discount include rule 144 holding periods and underwriter's lock-ups. Discounts for restricted equity securities from their market price typically range from 0% to 30%. When determining a discount to actively traded restricted securities, factors that should be taken into consideration include the company's trading characteristics (the extent to which the market for the security is active), the investor's ability to sell its position when the restriction expires, and the term of the restriction. The adjustment of the discount will vary depending on the duration of the restriction. As the remaining length of the restriction decreases, the amount of the discount should also decrease. Limitations on sale based on rule 144's volume tests or based on a closed trading window for board members do not qualify as formal restrictions related to the security itself. Therefore discounts are not allowed by GAAP in these situations.

Inactive

46. A quoted price is not readily available for securities which trade in inactive markets, where transactions do not occur with sufficient frequency and volume to provide ongoing pricing data. Therefore, the last transacted price may not provide the best indication of fair value. In such situations, an adjustment to the last transacted price may be appropriate or other valuation techniques may be utilized based on all relevant factors.

IV. OTHER MATTERS

47. There are a wide variety of securities and capital structures used in the private equity industry. Such securities should be valued consistent with the Guidelines set forth above. Some examples and valuation guidance for securities and structures which have not been specifically addressed by these Guidelines include:

    a) The carrying value of private interest bearing securities should be based on the underlying company's ability to service and repay debt.

    b) PIK dividends should be accrued in accordance with the terms of the underlying security. A valuation discount may be necessary depending on the health of the company and the realizability of the underlying securities.

    c) Valuations of securities denominated in currencies other than the base currency of the fund should be adjusted for changes in the spot prices of the currency.

    d) Warrants should be carried at their fair value.

    e) The rights associated with preferred stock are generally divided into two broad categories—economic rights and control rights. Once the enterprise value of the company is determined in accordance with these Guidelines, fair value should be determined by allocating value to shares of preferred and common stock based on their relative economic and control rights

       In addition, when making their fair value determination managers should recognize that liquidation preferences are often granted to investors as an inducement to invest in a company. When a manager's past experience indicates that liquidation preferences will be renegotiated or will not be fully enforced at the time of liquidation, the manager is strongly encouraged to use the expected results in determining the valuation of a security which has a liquidation preference.

    f) Currently convertible securities should be valued at the excess of the value of the underlying security over the conversion price as if the security was converted when the conversion feature is "in the money" (appropriately discounted if restricted). If the security is not currently convertible, the use of an appropriate discount in valuing the underlying security should be considered. If the value of the underlying security is less than the conversion price, the carrying value of the convertible security should be based on the underlying company's ability to service and repay the security.

    g) If deemed *determinable beyond a reasonable doubt* (virtually certain) escrows from the sale of a portfolio company should be valued at an amount that the manager, using its best estimate, ultimately expects to receive from the buyer in light of the escrow's various conditions.

h) Because of the inefficiencies of the secondary market, purchase and sale transactions of partnership interests in and of themselves may not be appropriate in determining the value of portfolio company valuations or positions in funds.

48. FASB's Statement No. 157 *Fair Value Measurements* utilizes a hierarchy described as Level 1, 2 and 3 inputs (Statement No. 157 paragraphs 21-31). The FASB valuation hierarchy has not been restated in these Guidelines. The concepts outlined in these Guidelines are intended to be consistent with Level 1, 2 and 3 inputs as defined. The input level is a required GAAP disclosure and provides users of financial statements with additional clarity in how a manager made their determination of fair value.

V. CONCLUSION

49. As the private equity industry has matured in the United States, there is a need for greater consistency of valuation standards/methodologies by both managers of, and investors in, private equity funds. These Guidelines are designed to provide a framework for addressing the majority of the private equity industry's valuation questions on a consistent, transparent and prudent basis. It is recommended that managers and investors collaborate to share experiences and best practices across relationships. This collaboration will narrow the range of specific definitions of subjective terms and will enhance the consistent application of these Guidelines.

50. The key goals of these Guidelines are as follows:

    - Encourage managers to approach valuation from a consistent, transparent and prudent basis.

    - Focus the private equity industry on the need to determine **fair value** for each of their investments in a manner that is consistent with these Guidelines.

    - Provide greater transparency into valuation results through the use of the Valuation Policy Committee as described in the Guidelines.

51. The Guidelines are not intended to be all encompassing, nor are they intended to eliminate all subjectivity. Rather, they are to be a guide to assist managers and investors in agreeing to a valuation framework while allowing a manager to exercise its best judgment in applying the Guidelines.

52. The Private Equity Industry Guidelines Group acknowledges that the application of these guidelines may result in a departure from past valuation practices. It is recommended that managers and investors work jointly to develop a timetable to implement these guidelines. It is expected that over time the broad use of these Guidelines will become industry practice

53. These Guidelines are consistent with US Generally Accepted Accounting Principles. If managers adopt these Guidelines it is expected that their determination of fair value will be GAAP compliant. However, it is also understood that a manager may be GAAP compliant without utilizing these Guidelines.

APPENDIX I - BACKGROUND

Background on the Private Equity Industry Guidelines Group (PEIGG)

The Private Equity Industry Guidelines Group (PEIGG) was formed in February 2002, and is comprised of a volunteer group of industry-wide representatives who have come together to debate and establish a set of reporting guidelines for the industry. Its mission is to promote increased reporting consistency and transparency while at the same time improving operating efficiency in the transfer of information among market participants by establishing a set of standard Guidelines for the content, formatting and delivery of information. The Group is believed to be the first broad-based alliance, comprised of general partners, limited partners and service providers participating in both the venture and buyout segments of the private equity industry in the U.S. and overseas. The Group has created subcommittees to address key issues in private equity reporting, including valuation, underlying Portfolio Company reporting, performance reporting, and financial reporting. No member of the PEIGG or any other person involved with the preparation of these Guidelines shall have any responsibility or liability whatsoever to any person in connection with or relating to anything contained in or omitted from these Guidelines, including as a result of any person's reliance on the provisions of these Guidelines.

APPENDIX II – PEIGG MEMBERS

PEIGG BOARD

Name	Title	Affiliation
Nick Archer	Director of Fund Admin.	CVC Capital Partners Limited
Nicole Arnaboldi	Vice Chairman	Credit Suisse Alternative Investments
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Paula Chester	Director	Formerly Director of PE, NYS Common Ret. System
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Real Desrochers	Director Alternative Investments	California State Teachers' Retirement System
William B. Franklin	Managing Director	Bank of America Capital Corporation
Mario L. Giannini	Chief Executive Officer	Hamilton Lane Advisors, Inc.
Stephen Holmes*	General Partner and CFO	InterWest Partners
David L. Larsen*	Managing Director	Duff and Phelps, LLC
Lawrence S. Rusoff	Portfolio Manager	General Motors Investment Mgmt. Corp.
Jose Sinai	President	Sungard Investran
Carl Thoma	Managing Partner	Thoma Cressey Equity Partners
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***** Represents principal drafters of the Updated Guidelines.***