Guidelines for the Valuation and Disclosure of Venture Capital Portfolios

BVCA

Representing British Venture Capital and Private Equity

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Preface

The Guidelines for the Valuation and Disclosure of Venture Capital Portfolios (Guidelines) were established by the British Venture Capital Association (BVCA), principally for venture capital fund managers to provide an industry standard for valuing unquoted investments. They were first produced in March 1991 and updated in November 1993. This edition of the Guidelines was reviewed and published in December 1997. No material changes have been made since the last edition was printed.

The BVCA represents virtually every major source of venture capital in the UK and its full members - venture capital firms - account for over 95% of annual venture capital investment in the UK. Over the last two years, the BVCA consulted its members, advisers and institutional investors and the feedback showed that the Guidelines were widely used and accepted as the industry standard and that updating was not required.

In the consultation process, the BVCA surveyed all full members' on their use and views of the Guidelines. With a 96% response rate; 85% of them said they used the Guidelines in reporting to their investors in the managers' or other reports, if not in their audited accounts; and 72% said they followed the Guidelines in their audited accounts either for all or some of their funds. Regarding interim valuations, 86% agreed that subsequent realisations proved that the Guidelines were conservative.

The BVCA is continuing to seek wider recognition of the Guidelines. Already they are increasingly used by investors in venture capital funds and other organisations. For example, insurance companies no longer have to value venture capital fund investments at zero as the BVCA obtained recognition of the Guidelines in the Guidance Notes to the 1995 Regulations of insurance companies. They are used in the BVCA's annual Performance Measurement Survey of independent venture capital funds, undertaken by a leading pension fund performance measurer The WM Company. The BVCA also requests members to acknowledge the use of these Guidelines in their audited accounts.

For further information on the BVCA, its publications and research, please contact the BVCA Secretariat.

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"The BVCA represents virtually every major source of venture capital in the UK and is dedicated to promoting the venture capital industry for the benefit of entrepreneurs, investors, venture capital practitioners and the economy as a whole."

1 Background

1.1 Reasons for valuation

Venture capital investments are valued for a variety of reasons, including business appraisal as part of investment decisions. In particular, venture capital managers need to carry out periodic valuations during the life of an investment as part of the reporting process to their investors. Those investors need such valuations in order that they can assess the value of their investment in the venture capital fund and the performance of the venture capital manager they have backed.

1.2 Purpose of guidelines

These guidelines are intended to provide a framework for BVCA members carrying out such valuations for their investors. As such they should help give those investors confidence in, or raise queries about, the underlying value of venture capital portfolios. The guidelines are not intended to provide guidance on the performance measurement or appraisal of venture capital managers. However, it is recognised that these subjects are connected and this has been taken into account in formulating the disclosure guidelines in particular.

1.3 Problems with valuation guidelines

The valuation of individual unquoted investments is a highly judgmental process, which cannot be subjected to a simple mechanistic formula. The most critical factors are that valuations must be prepared with integrity and based on a common sense approach. This should be logically cohesive and subject to a rigorous review procedure under the direction of senior management and, where applicable, non-executive directors. Valuers should have an appropriate level of experience and ability.

1.4 Disclosure of investment valuations

The portfolio valuations of venture capital investments may be either publicly available, for instance the accounts of quoted investment trusts, or subject to limited and confidential distribution to investors only, for instance limited partnerships. Full disclosure of valuations, and the reasons therefor, could be potentially damaging to investments if made publicly available, thus these disclosure guidelines make a distinction between the possible levels of disclosure based on the intended distribution of the valuations. It should be emphasised that although a level of disclosure is recommended in these guidelines, where there is a close relationship between the investor and the venture capital manager such as in a limited partnership or a captive fund, it is recognised that a significantly greater level of disclosure may be required by the particular providers of finance.

1.5 Application of guidelines

The BVCA recommends that all members comply with these guidelines when reporting to their sources of finance, and state that compliance. Any areas where members depart from these guidelines should be highlighted.

2 Valuation guidelines

2.1 Overriding principle

The fundamental principle, which should underlie all valuations of venture capital investments, is to show a fair valuation of the investment to the investor. Prudence is a central concept in valuation; however, the valuer should beware not only of unwarranted optimism in valuations, but also of excessive caution.

2.2 Early stage investments

2.2.1 All early stage investments should be valued at cost, less any provision considered necessary, until they cease to be viewed as early stage. The only exception to this principle is where a significant transaction involving an independent third party at arms-length values the investment at a materially different value. In these circumstances the guidelines set out in 2.5 should be followed.

2.2.2 A provision should be considered if the performance of the investment is significantly below the expectations on which the investment was based, leading to a diminution in value. Prima facie indicators of under-performance include the failure to meet significant milestones, to service equity or debt instruments, and breaches of covenants.

2.2.3 Provisions should be made as a percentage of cost in bands of 25% as the valuer thinks fit. The same level of provision need not be made against each of the instruments in any one investment. For example it might be considered appropriate to provide a greater percentage against the equity element than against a secured loan.

2.3 Development stage investments

2.3.1 All development stage investments should be valued according to one of the bases set out below:

- Cost (less any provision required)
- Third party valuation
- Earnings multiple
- Net assets

2.3.2 It is a matter of judgment and circumstances as to which of the above bases is the most appropriate for any investment. As a general rule, material arms-length third party valuations (other than by corporate investors) are prima facie evidence of fair valuation and should take precedence over other methods until the circumstances change (e.g. an increase/decrease in the level of profitability). Furthermore, once it has been concluded that the cost basis no longer provides reliable evidence of value, it should rarely be used again.

2.4 Development stage investments - cost basis

2.4.1 Development stage investments should generally be valued at cost for at least one year unless this basis of valuation is unsustainable.

2.4.2 A provision should be considered if the performance of the investment is significantly below the expectations on which the investment was based, leading to a diminution in value. Prima facie indicators of

under-performance include material divergence from those expectations, the failure to service equity or debt instruments, and breaches of covenants.

2.4.3 Provisions should be made on the same basis as is detailed in 2.2.3 above.

2.5 Development stage investments - third party basis

2.5.1 A change of valuation may be justified by reference to the price at which a subsequent issue of capital is made, or at which a transaction for cash in the relevant security takes place. This basis of valuation should only be used when the transaction involves a significant investment by a new investor.

2.5.2 Some investors may have strategic reasons for investing which might lead to a valuation which would be inappropriate for the venture capital investor. Therefore, particular care should be taken to consider the motives of the third party and whether this method should be used.

2.6 Development stage investments - earnings basis

2.6.1 An earnings basis is likely to be the most common basis for valuing investments above cost (or supporting their valuation at cost). It is not recommended that this basis be used until at least a year has elapsed since the investment was made. There are a number of different methods of applying this concept which can lead to significantly different results for a given investment. Therefore when using this basis the valuer should have particular regard to the overriding principle set out in paragraph 2.1 above.

2.6.2 The suggested method for this basis of valuation is to apply a discounted Price/Earnings multiple ("P/E") to the investment's earnings from which corporation tax has been deducted, normally at the full rate. It is a matter for the valuer's judgment, based on the circumstances of the individual investment, whether the earnings used should be taken before or after interest. Particular care should be taken in making this assessment where there is a high level of gearing which makes the valuation sensitive to changes in interest rates.

2.6.3 The earnings used to arrive at the valuation will normally be taken from the audited accounts most recently completed. If, however, earnings in the current period are likely to be lower than in the previous period, these earnings should be used as the basis for valuation. Equally, if the current period can be predicted with reasonable certainty to produce significantly higher earnings and these are maintainable, these may also be used as the basis for valuation, bearing in mind the requirement in paragraph 2.1 to avoid excessive caution. Having determined the appropriate earnings to be used as the basis of valuation, in those circumstances where a company's trading results have been affected by acquisitions and exceptional items, appropriate adjustments may need to be made.

2.6.4 The most suitable starting point for an appropriate P/E is that of a quoted company or companies, comparable both in business activities and where possible in magnitude of sales and profits. If such companies are not available, the specific sub-sector of the FT-SE Actuaries Share Indices may be used; however, whichever multiple is used it should be applied with considerable care as there are occasions when the holding being valued might command a lower rating than the comparable quoted company or companies.

2.6.5 The reason for discounting quoted company P/Es is, inter alia, to recognise the illiquidity and risk of unquoted investments and the approximate nature of a valuation based on earnings. The discount may be applied either to the P/E or to the value of the equity holding. Clearly, the level of discount is highly judgmental and will depend on the particular circumstances of each investment. However, the minimum discount should be 25% unless there is a strong possibility of an early realisation, in which case it might be appropriate to apply a smaller discount. Furthermore, the valuer should recognise, when selecting the appropriate level of discount, that the application of the discount to the value of the equity holding (as opposed to the P/E) will normally result in a higher valuation.

2.7 Development stage investments - net asset basis

2.7.1 It is envisaged that this basis will rarely apply to venture capital portfolios. However, some investments are more appropriately valued on this basis, for instance when there is a significant property element to the business.

2.7.2 When using this basis particular care must be taken to consider when and how each of the assets has been valued, the independence of the valuer and his/her qualifications, and whether the valuations are suitable in the current circumstances. A level of discounting will normally be appropriate to take into account the illiquidity of the investment.

2.8 Quoted investments

2.8.1 In many cases the valuer may assume that the quoted mid-market price provides a reasonable indication of fair value. If, however, the shares are subject to any particular restrictions, or the holding is significant in relation to the issued share capital of, in particular, a small quoted company, then a discount will almost certainly be appropriate.

2.8.2 The level of discount, which should be dependent on the particular circumstances of each case, will normally be in the range of 5% to 25%. When calculating the discount, the valuer should have particular regard to the overriding principle set out in paragraph 2.1 above

3 Disclosure guidelines

3.1 Overriding principle

The fundamental principle which should underlie the disclosure of the valuation of venture capital investments is to show as much detail to investors as possible without risking damage to those investments, and within the practical limitations of preparing accounts. These disclosure guidelines are supplementary to any legal and regulatory requirements to which venture capital managers may be subject.

3.2 Valuation principles and procedures

All venture capital managers preparing valuations of investments, in whatever form, should set out the valuation principles adopted. They should also state the valuation review procedures, which might include review by a valuation committee and/or non-executive directors. The valuations should also include a positive statement of compliance with these guidelines. Any areas of non-compliance should be clearly disclosed.

3.3 Portfolio valuation movement summary

3.3.1 Venture capital managers should include in the accounts of the funds they manage an analysis of the change in the aggregate valuation of the portfolio. In particular this should show the contribution to the movement from the previous valuation caused by:

- Investments
- Realisations
- Increases in value
- Decreases in value

3.3.2 Because of the wide diversity of venture capital investment vehicles, it is not possible to give general guidance on how the venture capital manager's interest (management fees, carried interest, etc) will interact with this portfolio valuation summary. Indeed disclosure of this interest is outside the scope of these guidelines.

3.4 Realisation details

Venture capital managers should disclose in the accounts of funds they manage, the aggregate realisations in the period covered by the accounts. These should be compared with original cost and the valuation at the end of the financial period immediately preceding realisation. Comparative aggregate realisation figures should be shown for the four previous periods. Reference should be made to 4.1.3 in these guidelines for the definition of a realisation.

3.5 Specific investments

3.5.1 Where the accounts of funds managed by venture capital firms are widely distributed, or a matter of public record, the details set out in paragraph 3.5.2 below should be disclosed for any investment amounting to 5% by value of the portfolio. In any event the ten largest investments measured by value should be included.

3.5.2 For those investments satisfying the criteria in paragraph 3.5.1, the details set out below should be disclosed. The latest publicly available audited accounts of the investment should be the source of the relevant information.

- Name and country of incorporation
- Business description
- Investment Information:

  - Turnover
  - Earnings before interest and tax
  - Profit before tax
  - Profit after tax
  - Extraordinary items
  - Dividends paid/declared
  - Net assets
  - Accounts date

- Proportion of share capital owned
- Cost of investment
- Date of investment
- Valuation and basis thereof
- Income received in period
- Realisation proceeds (if applicable)

Prior year comparatives should be shown.

3.5.3 Where the distribution of the venture capital firm's accounts is limited and confidential the details in paragraph 3.5.2 should be disclosed for all investments.

4 Definitions and explanatory notes

4.1 Definitions

4.1.1 Early stage investments - immature companies, including seed, start-up and other early stage investments. These are typically not earning significant maintainable profits.

4.1.2 Development stage investments - unquoted investments, including management buy-outs and buy-ins, which are not early stage investments.

4.1.3 Realisation - the sale, redemption or repayment of an investment, in whole or in part; or the receivership/liquidation of an investment where no significant return to the investor is envisaged.

4.2 Larger portfolios

It is recognized that for larger portfolios a rather more mechanistic approach may be appropriate for valuations. However, this should always be subjected to a judgmental review, with a specific review of all significant investments which fall within the criteria of 3.5.1.

4.3 Non-UK investments

When valuing an investment in a non-UK company, particular care needs to be taken. Specific areas of focus should be local valuation practice, exchange rates, tax rates and the most appropriate source of P/Es.

4.4 Loan stock and preference shares

When a venture capital manager has invested in loan stock and preference shares as part of a package, these instruments should not 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.

4.5 Ratchets and warrants or options

Valuations should be computed in accordance with the practice of quoted company investment analysts when calculating the fully diluted earnings of a quoted company. Hence any warrants or options that are exercisable at a price below the valuation price and any ratchets that will be triggered, or are likely to be triggered, because performance targets have been met, should be taken into account. Warrants or options should be valued at the excess of the value of the underlying security over the exercise price. In practice, conservative valuations may tend to lead to zero valuations of warrants or options.

4.6 Guarantees and commitments

When a venture capital manager has entered into a guarantee or similar commitment on behalf of an investee company and it is probable that this liability will crystallise, the liability should be recognised in full. To the extent that fulfillment of this commitment gives rise to an additional investment or amount due, this should be valued in accordance with these guidelines.

Appendix 1: Examples of earnings basis valuations

1. Earnings before interest and tax example

		(£m)
Earnings before interest and tax	1.00	
Less: Corporation tax at full rate	(0.33)	
Earnings after tax		**0.67**
Appropriate discounted P/E (post tax)		**10.00**
Total capitalisation	6.70	
Less: Debt	(2.00)	
Preference shares	(1.70)	
Ordinary share capitalisation		**3.00**
Valuation of venture capital holding:		
Ordinary shares (30%)	0.90	
Preference shares (100%)	1.70	
Total		**2.60**

2. Profit before tax example

		(£m)
Profit before tax	0.80	
Less: Corporation tax at full rate	(0.26)	
Earnings after tax		**0.54**
Appropriate discounted P/E (post tax)		**10.00**
Total capitalisation:	5.40	
Less: Preference shares	(1.70)	
Ordinary share capitalisation		**3.70**
Valuation of venture capital holding:		
Ordinary shares (30%)	1.11	
Preference shares (100%)	1.70	
Total		**2.81**

Appendix 2: Example disclosure of specific investment

Clarke Limited

Business description: Blender and distributer of Scotch Whiskey

Incorporated in Scotland

Investment information

	(£000s)	(£000s)
Accounts for year ended 30 June	1997	1996
Turnover	10,000	8,500
Earnings before interest	1,000	850
Profit before tax	800	600
Profit after tax	540	400
Extraordinary items	nil	nil
Dividends of preference shares	100	100
Net assets attributable to ordinary and preference shareholders	1,300	860

Other information as at 31 December 1997

	(£000s)	(£000s)
	1997	1996
Proportion of share capital owned	30%*	30%*
Cost of investment	1,800	1,800
Dates of investment	July 1995	
Valuation	2,600	1,800
Basis of valuation	Earnings - P/E 10	Cost
Gross income received during year	133	133
Realisation proceeds	Not applicable	

* NB: the ultimate proportion of equity owned will vary between 20% and 40% depending on performance

Appendix 3: Example disclosure of portfolio valuation movement summary

		Valuation
		(£m)
Opening valuation 1 January 1997		**10.0**
Investments made (at cost)		5.0
Realisations:		
Proceeds	(10.0)	
Increase/decrease over previous valuation	4.5	
		(5.5)
Unrealised investments:		
Gross increases in value	2.0	
Gross decreases in value	(1.0)	
		1.0
Closing valuation 31 December 1997		**10.5**

Appendix 4: Example disclosure of realisation details

Years ended 31 December	Realisation proceeds	Prior year valuation	Original cost
	(£m)	(£m)	(£m)
1997	5.0	4.0	2.5
1996	3.0	2.5	2.0
1995	-	0.5	1.0
1994	4.0	4.0	2.0
1993	5.0	4.0	1.0