

Client Bulletin

Private Equity Practice



Wildman Harrold
Attorneys and Counselors

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Private Equity Industry Guidelines Group (PEIGG) Revised Valuation Guidelines

The Private Equity Industry Guidelines Group (PEIGG) recently issued a revised version of the U.S. Private Equity Valuation Guidelines, which provide guidance to private equity funds in valuation of their portfolio investments. The revised guidelines can be found on our website, and a list of frequently asked questions and answers published by PEIGG can also be found on our website.

Most private equity funds are required to deliver financial statements prepared in accordance with generally accepted accounting principles (GAAP), either by fund documents or by investors who must conduct their own financial reporting in accordance with GAAP. GAAP requires private equity funds to report portfolio investments on their financial statements at "fair value." Until recently, however, there was no authoritative guidance on how to determine the fair value of an investment.

PEIGG originally published its U.S. Private Equity Valuation Guidelines in 2003 to promote consistency in the valuation of private equity portfolio investments. The original Guidelines can be found on our website. The overall approach recommended by the Guidelines was to "estimate the exchange price at which hypothetical willing marketplace participants

would agree to transact." The Guidelines recommended that valuations be conducted or updated on a quarterly basis subject to written parameters established in consultation with a valuation committee composed of fund investors. While investments could be valued at cost for some period, the Guidelines suggested quarterly review of other factors, such as other recent transactions involving securities of a portfolio company, objective measurements of the company's performance, and the occurrence (or non-occurrence) of significant events such as technological breakthroughs or other milestones.

In September 2006, the Financial Accounting Standards Board issued Statement No. 157 (FASB 157), to clarify the meaning of "fair value" for GAAP reporting purposes. FASB 157 defines fair value as "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." This definition emphasizes projected exit value as the measure of an investment's fair value. FASB 157 also establishes three levels of factors that may be considered in determining fair value. For example, quoted prices in active trading markets are considered the most reliable indicators of value, while other objective data regarding a

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BUSINESS TRANSACTIONS:
John Eisel

EDITORS:
Alan Roth
(312) 201-2633
rotha@wildmanharrold.com

Mark Kromkowski
(312) 201-2768
kromkowski@wildmanharrold.com

Christopher Douglass
(312) 201-2370
douglass@wildmanharrold.com

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Chicago Office
225 West Wacker Drive
Suite 3000
Chicago, Illinois 60606
(312) 201-2000

www.wildmanharrold.com

company's performance are deemed less reliable. Least reliable are unobservable factors that require assumptions about how market participants would value an investment. The factors used in valuation must be disclosed, providing insight into the potential reliability of the valuation.

PEIGG's newly-revised Guidelines are intended to assist private equity funds in complying with the new standards of FASB 157. The exit value emphasis of FASB 157 is of particular interest to the private equity industry because private equity funds historically have tended to value investments at cost and make adjustments only in connection with subsequent financing rounds or achievement of milestones. The revised Guidelines stress that the initial cost of the investment and the valuation in the latest round of financing are factors that may be considered, but they lose reliability over time and must be evaluated in connection with other factors. The revised Guidelines also emphasize that fair value must be determined at each financial statement date or other reporting date and that valuation must take into account any information that is available from the market without undue effort.

For publicly-traded securities, the best indicator of fair value remains the market price of those securities. The revised Guidelines recommend valuing publicly-traded securities at the closing price or the bid price on the relevant date. That price should be discounted only where the sale of

the securities is subject to a formal restriction. Positive or negative adjustments may also be necessary where trading volume is low enough to suggest that the market does not truly reflect exit value.

For most securities of privately-held businesses, the revised Guidelines recommend a market approach to valuation. This approach optimally relies on transactions involving sales of similar securities of the same company or sales of securities of comparable companies. Where the portfolio has issued no comparable securities or where no comparable company transactions are available for comparison, the Guidelines suggest using performance multiples set on the basis of market conditions or recent private transactions. In limited circumstances, the revised Guidelines endorse other valuation methods such as discounting cash flows and valuation of net assets. These approaches may differ from past practice in the private equity industry, but PEIGG expects them to become common as funds adapt to FASB 157.

The Private Equity Practice at Wildman Harrold is dedicated to keeping our clients advised of new legislative and judicial developments as they occur. If you have any questions regarding these issues, please feel free to contact your primary attorney at Wildman Harrold or email us at privateequity@wildmanharrold.com for further information.

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