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## In This Issue





# Common Values

***A new set of valuation guidelines for emerging markets funds takes shape, gains support***

Venture capital and private equity associations in the U.S. and Europe are keen to introduce fair value reporting as the default means of evaluating private equity portfolios globally. But for many investors in emerging markets such real time valuations may create unwarranted paper losses, if not be impossible to calculate altogether.

Just ask Scott Swensen, managing partner of Conduit Capital Partners, formerly known as Scudder Latin American Power Funds. Swensen recently followed guidelines drawn up by the European Venture Capital Association to value his group's investments, and found that there would be reason for some "monstrous" write-downs in his portfolio if he adopted the EVCA rules. But Swenson thinks such accounting would be purely fiction, given that his portfolio spins out healthy cash returns for investors and is years away from divestment.

The problem was made crystal clear when considering one small interest in Central Costanera, a power producer in Argentina, held through a holding company with a co-investor. The stake in the Argentine firm would have been halved from $3.9 million to less than $2 million under the EVCA rules. That was all the more disturbing because the holding company sold the stake for nearly $8 million at the end of March (see story, page 7, this issue), more than doubling its money in two years.

"Imposing mark-to-market or fair value calculations with no time horizon consideration and no marketability consideration would introduce great volatility into the financial statements of emerging markets investors," said Swensen. "We don't support it. Emerging markets are volatile enough." Conduit's board agreed, and rejected EVCA accounting as a result, said Swensen.

At the same time, many fund managers understand the plight of limited partners who have difficulty comparing reported returns from various funds because of a lack of common rules. And they realize that some of their peers have abused the lack of guidelines to avoid big write-downs on washed up investments over the past few years.

### Emerging Markets Guidelines in the Works

The situation has created performance reporting that seems better suited a Hall of Mirrors than a boardroom. Some funds look too fat, some too thin, and only a few appear comparable at all. With any luck, though, a clearer view may soon be available.

A group of leading development agencies and multilateral institutions is currently striving to create a set of guidelines crafted with care-

*Continued...*

| Possible Valuation Methods for Emerging Markets Investments | |
|---|---|
| Company Category | Valuation Techniques |
| I. Quoted, liquid company | 1) Mid-market price on last trading day of valuation period<br>2) For carry calculation when distributing marketable securities: Average market price 30 days before and after distribution |
| II. Unquoted or illiquid co.without 24 months of positive EBITDA or net | 1) Fair Value based on significant third party transaction within prior 12 months<br>2) Prudent Value: Cost minus material declines in value, including FX changes<br>3) Other methods, including liquidation, buy-back and revalued assets values |
| III. Unquoted or illiquid co. with 24 months of positive EBITDA or net | 1) Fair Value based on significant third party transaction within prior 12 months<br>2) Fair Value Based on a formula, such as EV/EBITDA, P/E, or DCF, minus appropriate discounts for illiquidity, minority stakes, etc.<br>3) Prudent Value, as above<br>4) Other methods, as above |
| IV. Unquoted or illiquid co. in transition; previously in Category III but now unprofitable | Same as Category II, except prudent value can be the previous carrying value minus impairment instead of original cost |

Source: International Finance Corp.

ful thought given to both emerging markets conditions and the image-enhancing inclinations of fund managers.

Led by the International Finance Corp. and the Swiss State Secretariat for Economic Affairs, the two-year old effort is now reaching its final stages, with a final version hoping to be officially ratified by the group later this year. The task force, which includes 18 other international financial institutions (IFIs), is currently awaiting an updated version of the European Venture Capital Association's valuation guidelines, which are being altered to comply with new International Accounting Standards. The intent is to ask fund managers to adopt the guidelines for existing funds on a voluntary basis, with some IFI's saying they will likely require their use in future fund agreements, once ratified.

The IFI guidelines are based upon EVCA's private equity valuation guidelines, but they quickly depart from those rules in significant ways. While embracing on its face the fair value methods touted by the EVCA and other private equity valuation guidelines, the IFI group's emerging markets valuation guidelines (EMVGs) quickly allow managers to depart from fair value for a variety of conditions prevalent at many emerging markets companies. The rules also spell out far more specifically for managers when and how assets must be written down by setting out clear time periods and tests for portfolio companies. The result is a body of standards that are at once more flexible in some ways and more restrictive in others compared with developed market guidelines.

"There was a lack of guidance out there that made sense for funds investing in emerging markets when we started this project. We hope that these guidelines will fill the gap between existing practice and the guidelines meant for mature private equity markets," said Tomoko Tatara, a senior investment officer at the IFC, and the lead IFC representative on the guidelines project.

A number of problems with EVCA's valuation guidelines were apparent from the start, she explained. For one, some general partners looked at the fair value requirements and wondered where they would find comparable valuation ratios for their investments, given the differences between smaller emerging markets, and even larger ones, like Brazil, and mature private equity markets. On the flip side, others have wanted to use cross-border comparables in order to justify higher valuations, or to resist write-downs. As a result, the IFI guidelines are very restrictive around the use of ratio based and discounted cash flow valuation analysis. "We wanted to reduce the chance for abuse of fair value methods," said Tatara.

### Dear Prudence

In addition, many GPs professed confusion over when a major impairment should be considered permanent, as called for in the EVCA guidelines, and when temporary. If one considers the economic slump and devaluation in Brazil of 2002 and 2003 as a two to three year phenomenon, then by a 7-10 year emerging markets private equity time horizon it could be viewed as a temporary condition, whereas for a shorter cycle European PE fund, such devaluation would likely be considered permanent.

Instead, in the IFI guidelines there is an emphasis on prudent or conservative valuation, which is basically cost minus significant or material declines in value. While the valuation method of choice is still fair value, the only truly reliable measure of that, under the EMVGs, is an arm's length third party investment in the company within the prior 12 months. There is also recognition that some investments should be valued by their buyback value, where such agreements exist, their liquidation value, or their revalued asset value, for investments with a significant real estate component.

The guidelines also set out different valuation preferences for different categories of companies. These include: 1) listed, highly-liquid companies; 2) unlisted or listed but illiquid firms with at least two years of profitability; 3) unlisted or illiquid firms without two years of profitability; and 4) unlisted or illiquid firms that were once profitable, but are now in a distressed or recovery state. The aim seems to be to limit more aggressive forms of valuation to companies that are highly liquid and/or profitable, and require more significant discounting and conservatism for all others than has been common among many GPs in the past.

The new guidelines won't eliminate all ambiguity, naturally, but they will help create a common set of valuation concepts and preferences, explained Tatara. "LPs and GPs will now be able to agree on the discussion points when establishing new funds. The result is we can eventually agree on what disclosures we can expect, and the methodology for calculating those disclosures," said Tatara.

It is important to note that the valuation difficulties don't exist just within a particular fund, or within a particular country or region that is in the midst of a bubble or a bust. It is truly a global issue of a lack of comparability between funds, regions and investment styles.

That became increasingly clear as the IFIs pushed forward another project on benchmarking emerging markets fund performance (For a detailed discussion of this project, see *VE-LA*'s March 29, 2004, cover article). "There's been huge pressure to move to fair value, but most managers just keep their investments at cost. The problem is not unwarranted write-ups, but with recognizing distress and appropriate write-downs," said one manager involved with the benchmarking project. Although the benchmark effort, managed by pension consultant Cambridge Associates, only uses audited financial statements, GPs currently take write downs differently, and practices vary by country and region, the manager explained. "When so few funds have reached full maturity, making sure midstream valuations are comparable is very important to making sure the performance benchmark is valid," the manager said.

**Early Warning System**

IFIs also want much more timely warning of problems with portfolio companies, or entire portfolios, than they have at times received in the past. "All of the IFIs involved have had differences of opinion with GPs over valuations and surprises due to the volatility in emerging markets investing. The hope is that these new guidelines will introduce better discipline on GPs and create better transparency of returns for emerging markets private equity as a whole," said Gene Pohren, a senior investment officer at the Overseas Private Investment Corp., and one of the OPIC representatives who has worked on the EMVGs. "We think that will be good for the market as a whole, and help attract more private sector investment to new emerging markets funds."

Many fund managers support those conclusions and the need for standards. "There's been a lot of denial by managers in the past about recognizing how things are going with their portfolios," said Varel Freeman, managing partner for Latin America at Baring Private Equity Partners. "There's concern among investors that many funds need a more disciplined process, and also a desire to see if a manager is creating or destroying value on a regular timely basis. That gives the GP and the LPs a chance to change things and affect the outcome," explained Freeman.

For his part, Freeman explains that Baring generally reports its financials to LPs using U.S. GAAP, which does not require fair value accounting, but then uses the EVCA guidelines for internal reporting and informal updates on potential values to its LPs. "We try to be as open as possible with LPs. If you have bad news, you're not going to be able to hide it forever from LPs," he said.

Swensen agrees that there is a problem that common standards may be able to eliminate, as long as they don't blindly embrace mark-to-market principles. "Managers have abused valuations and not recognized material distress in the past. That's especially true when fees are a function of market value," Swensen explained, which is the case with a minority of investor agreements, as opposed to the usual realized value. "Having one set of guidelines to use internationally, like the IFC group's potential rules, would help enhance comparability of funds." *– Ian Springsteel*