



## On behalf of the Public Affairs Executive (PAE) of the *EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY*

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### AIFM Directive - Independent Valuator

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The proposed requirement in the European Commission's Proposal for a Directive on Alternative Investment Fund Managers (AIFM) to appoint an independent valuator (Article 16) has no recognized benefit to protect investors in private equity<sup>1</sup> funds. Such requirements are neither appropriate nor necessary for private equity investors, nor are they required by such investors in closed-end funds for the following reasons:

- **The valuation of investments has no impact on the remuneration of managers (fees and carried interest) or on the remuneration of any other stakeholder.**

In private equity, the management fees are usually paid by reference to commitments and not by reference to the unrealised fair value of investments.

The interim valuations also have no impact on the final returns obtained by investors and fund managers. Both have to wait until the fund actually realises value (at which point the value is certain) to receive their share of the fund's return. These valuations are more of a guiding star for investors, an interim indicator of the fund's performance pending the final return at the end of the fund's life.

The only case with a potential conflict of interest would be, during the life of the fund, a subscription or redemption of fund interests on the basis of the fund valuation. With the exception of quoted investment vehicles, in which case the value is determined by market transactions, private equity funds are closed-end funds, with no possibility to open new subscription periods during the fund's life and with no possibility to redeem interests in the fund.

- The European private equity industry, through **the International Private Equity and Venture Capital Valuation Guidelines Board (IPEV Board)<sup>2</sup>**, has developed a set of **valuation guidelines** that have been **broadly adopted by investors, fund managers and auditors since 2005**. These guidelines have been endorsed by 37 different associations worldwide. The IPEV guidelines confirm fair value as the best measure of valuing private equity portfolio companies through the different phases of the market cycle. Fair value has the advantage of being a more information-rich concept than historical acquisition cost. Fair value is market-based relating to the views of all market participants while valuation based on historical acquisition cost is by nature, specific to a single entity. Fair value also requires a higher level of sophisticated application from all stakeholders, fund managers, investors and auditors. The Board's support for fair value is underpinned by the transparency it affords investors in funds, which use fair value as an indication of the interim performance of a portfolio.
- **It must be the managers' ultimate responsibility to determine the valuation of their investments.** This principle has never been called into question by any stakeholder and is provided for in all Funds' formation documents to which investors have to agree. Investors in private equity thus require that managers perform at least annual valuations and hold ultimate responsibility in determining the valuation of investments.

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<sup>1</sup> Used in a broad sense to include venture capital.

<sup>2</sup> For further information see: <http://www.privateequityvaluation.com>

The IPEV Board also confirms that it is the managers' responsibility to ensure that they thoroughly document and demonstrate to their investors (but also to auditors and regulators) the appropriateness of the process by which they consistently determine fair value, so that investors can acknowledge the accuracy of the funds' net asset value (NAV) as a basis for valuing their own investment.

It is embedded in the Fair Value concept that a significant level of informed judgment be used. The manager is indeed the best placed and the best informed party, not only regarding the current development of the portfolio company (having done a thorough due diligence before acquisition and very often sitting on the board of the company), but also regarding the value creation potential as well as the buyer market and the stock market valuation of the specific sector the company relates to.

- **The role of auditors and, as the case may be, of investors is fundamental in the valuation process.**

Funds' auditors (reputable accounting firms independent of the managers), are normally very heavily involved in the valuation process - checking that the industry valuation guidelines are applied consistently, checking the choices of multiples, the stability and visibility of earnings applied etc. It is also part of their duties to report on any changes in the valuation methodologies and to ensure that these changes, if any, are clearly explained.

It is also common practice that investors request to review, on a regular basis, the valuation methodologies used by managers.

**In conclusion, the appointment of an independent valuator would not contribute to the protection of investors in private equity funds while being a real burden for the stakeholders involved (managers and investors) in that it would be an inefficient and unnecessary new layer on top of the auditors representing significant pointless cost.**

- The decision to have an independent valuation should remain in the hands of managers and investors. Investors in private equity are sophisticated investors and the funds' formation documents are strongly negotiated between the investors and the manager at the time of their formation. Bearing in mind that the funds themselves on the one side and portfolio companies on the other side are already audited, the decision to have independent valuations should be a decision left in the hands of the investors and the manager in the framework of their usual negotiations:
  - An independent fund valuation would be a new layer, on the top of the auditors, with **extra expenses to be borne by investors** and with no added value, neither for the investors nor for the portfolio companies nor the managers. For example, a fairness opinion (without such responsibility as indicated in the AIFM Directive) costs about €100,000 per middle size company. It should be noted that due to risk diversification, some funds may have more than 20 companies in their portfolio. Based on the figure mentioned above, investors would have to bear annual costs of €2 million.
  - It is a strong indicator of the manager's quality of reporting to produce reports as soon as possible after the closing of the accounts, so that investors can include the net asset value of their investments in these funds into their own financial statements. On the top of being time consuming for the manager, the independent valuation's process **would considerably delay the release of these reports to investors.**
- There is **no systemic** risk involved in private equity valuations since transactions are not based on fair values as determined by the fund manager – any acquirer of either fund interests or portfolio companies will always come up with their own valuation process.

## Notes to the Editor

### About the PAE

The Public Affairs Executive (PAE) consists of representatives from the venture capital, mid-market and large buyout parts of the private equity industry, as well as institutional investors and representatives of national private equity associations (NVCAs). The PAE represents the views of this industry in EU-level public affairs and aims to improve the understanding of its activities and its importance for the European economy.

### About EVCA

The European Private Equity and Venture Capital Association is the voice of European private equity and venture capital, representing more than 1,300 members. In addition to promoting the industry among key stakeholders, such as institutional investors, entrepreneurs and employee representatives, EVCA develops professional standards, research reports and holds professional training and networking events.

