

Private Equity Club 2008

Exploring what's on the horizon*



*connectedthinking

PRICEWATERHOUSECOOPERS 

Investments – where are we on fair value?

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Investments – where are we on fair value?

How would you rate the quality of information that the funds in which you invest provide you with, in relation to valuation techniques?

	Excellent or good	Average	Poor or very poor	Don't know	Total
Hedge Fund	14%	56%	21%	9%	100%
Private Equity	22%	59%	12%	7%	100%
Real Estate	27%	50%	14%	9%	100%

PricewaterhouseCoopers / EIU survey, January 2008

Investments – where are we on fair value?

Tuesday 8 July 2008

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Investments – where are we on fair value?

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Investments – where are we on fair value?

1 Uncertainty in the market place

- What does it mean for investors?
- What does it mean for valuers?

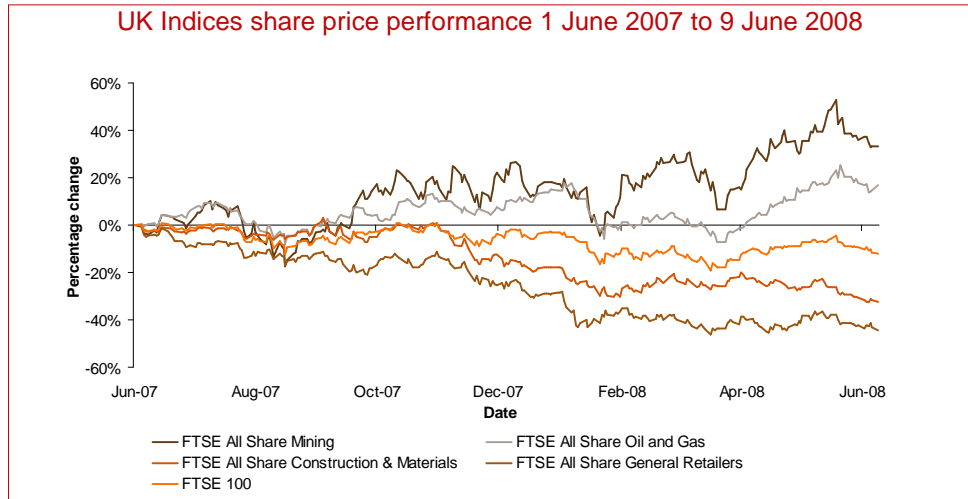
2 Spotlight on valuations

3 Conclusions

Investments – where are we on fair value?

Uncertainty in the market place – what has happened?

Equity values have tumbled while raw materials and commodity prices have soared



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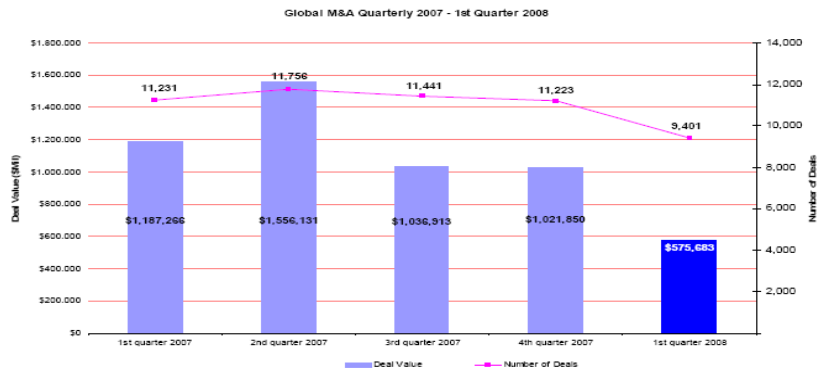
Uncertainty in the market place – what has happened?

Deals in financial markets have decreased as the impact of the credit crunch has set in

Private Equity Quarterly Update

Global M&A Quarterly Deals 2007 – 1st Quarter 2008

In first quarter 2008, deal volume decreased 14% from 11,223 to 9,401 while deal value decreased 77% from \$1,021 million to \$575.6 million.



Source: Thomson Financial

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What does it mean for investors?

- **Which sectors are being impacted?**
- **Can these companies manage the downturn?**
 - **Operational/Financial gearing**
- **Revision of expectations/business plans**
 - **What is the expected period of downturn?**
- **Communication with the market – assumes even greater importance**

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What does it mean for valuers?

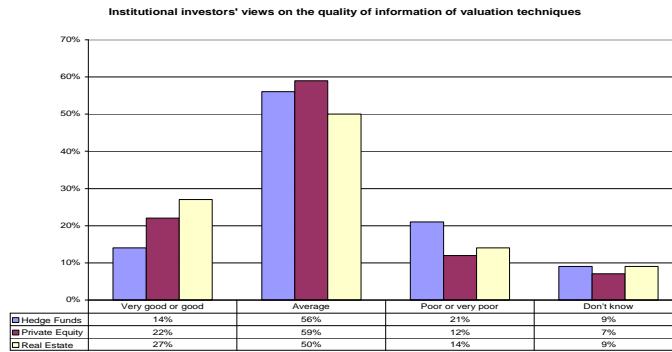
<ul style="list-style-type: none">• Illiquid markets – ability to refinance?• Higher cost of debt• Transactions for comparable assets are less frequent• Current market vs long term view	Market
<ul style="list-style-type: none">• Are cash flows being adjusted to reflect market conditions?• Impact on discount rates?	Companies

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Spotlight on valuations

PwC/Economic Intelligence Unit briefing on Alternatives **highlighted the disconnection between the perceptions of investors and providers of information.**

63% of companies considered that their valuation policies were effective at managing risk, but investors largely disagree. Only 25% of private equity investors thought that valuation policies were effective in this respect.



PwC/Economic Intelligence Unit briefing on Alternatives 'Transparency versus returns: The institutional investor view of alternative assets – March 2008' - pages 12 and 27

Spotlight on valuations

- **Performance was the overriding criteria for considering a third-party provider of alternative investments with 72% of respondents highlighting this compared to just 33% for quality of reporting.**
- **However when it comes to deselecting a provider these are considered of equal importance, 41% and 40% respectively.**
- **Investors want more robust information and will exit funds if this is not made available.**

Spotlight on valuations – key challenges

Valuation input	Impact of current market	What you will have to do
Earnings	<ul style="list-style-type: none"> • Reduction in consumer spending • Increase in costs 	<ul style="list-style-type: none"> • Use 'maintainable' earnings • Adjust business plans and forecasts
Multiples	<ul style="list-style-type: none"> • Less transaction multiples • Volatile equity markets • Distressed companies 	<ul style="list-style-type: none"> • Consider specific circumstances • Adjust for points of difference
Marketability discount	<ul style="list-style-type: none"> • Less liquidity in the market 	<ul style="list-style-type: none"> • Justify the level of discount applied
Debt	<ul style="list-style-type: none"> • Debt trading below par • Refinancing much more difficult and expensive 	<ul style="list-style-type: none"> • Debt should be robustly valued • Need to refinance may lead to impairment
Price of recent transaction	<ul style="list-style-type: none"> • Some sectors are declining quickly 	<ul style="list-style-type: none"> • 12 month rule of thumb may not be appropriate – must review each investment

Investments – where are we on fair value?

In the last 12 months, we have seen:

- The impact of liquidity on the value of financial assets;
- The credit crunch spill over from the financial markets to the consumer markets;

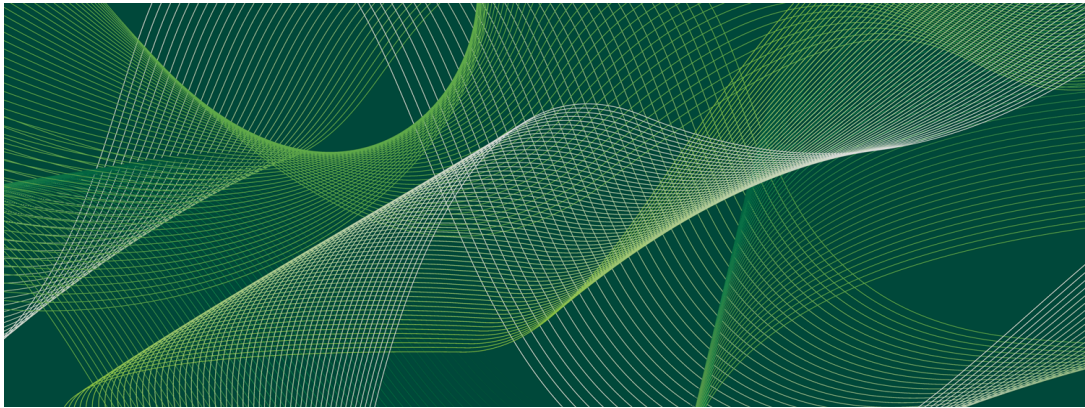
Overall uncertainty and volatility makes the world of valuations both a difficult and interesting place to be in

The scrutiny under which valuers are being placed has increased the need for consistency and robust analysis

LEHMAN BROTHERS

Private Equity
Fund of Funds, Europe
Joseph A. Malick

Fair Value: Issues and Observations of a Private Equity Fund Investor

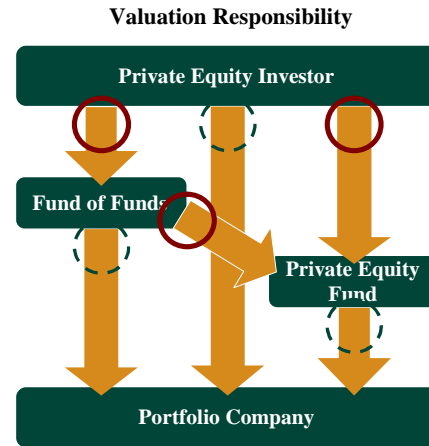


Confidential Presentation

AICPA Practice Aid Re: Auditing Valuations of Alternative Investments

The AICPA Practice Aid indirectly establishes guidance or expectations for management's procedures and controls by setting rules for auditors

- ◆ The responsibility for valuation of reported alternative assets in a portfolio cannot be outsourced.
- ◆ Investor entities (noted in green) must be able to critically evaluate an underlying investment's stated valuation.
- ◆ The new guidance forces multiple layers of monitoring and valuation responsibility within the private equity community. (*Increased layers of responsibility are illustrated in red above.*)
- ◆ The larger the portfolio of alternative assets, the greater the demand for transparency into the underlying assets, even if the valuation is not easily accessible.



Lehman Brothers Fund of Funds' Valuation of Private Equity Investments

Investments are presented in the financial statements at fair value in accordance with accounting principles generally accepted in the United States. We use the best information we have reasonably available to determine or estimate fair value

- ◆ **Publicly traded securities are valued based on quoted prices as of the last day of the reporting period, less discounts to reflect legal restrictions, if any, that affect marketability. We value securities held directly as well as known public positions held in underlying funds (on a look-through basis).**
- ◆ **The valuation of unquoted interests—both private equity funds and direct co-investments—begins with the most recent information available from the general partner of the underlying fund or the lead investor of a co-investment and is updated as follows:**
 - Updated for known transactions subsequent to the effective date of the information we have. For example, drawdowns or distributions of capital, and known realizations of portfolio companies through sale or public offering.
 - Consideration is given to other information learned from sources such as news articles and our diligence of a fund manager's process.
- ◆ **Our investment accounting system maintains the detailed information necessary to facilitate our valuation process.**
- ◆ **Our investment team includes in its initial and ongoing diligence, inquiries about valuation policy and processes at the underlying funds. Key information from ongoing monitoring is also considered in valuations.**

Current Observations and Issues

Increased volatility and transparency

- ◆ Diligence of fund valuation policies and back-office procedures is substantially more important; deficiencies are grounds for not investing in a fund
- ◆ During Q1 2008, noticeable increase in changes of marks across portfolio; hard to say if implementation of FAS 157 was the primary driver
- ◆ Expect to see an increasing frequency of inconsistent valuations of portfolio companies held by multiple private equity funds
- ◆ Transparency and detail are critical

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Investments – where are we on fair value?

Caroline Woodward

PricewaterhouseCoopers, Global Accounting Consulting Services Team

Investments – where are we on fair value?

Accounting standards and fair value

- Background to the current debate on Fair Value Measurement
- What is happening in the US with FAS 157
- What the IASB is doing
- Implications and Actions for you

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Background to the current debate

- The IASB and the FASB signed a Memorandum of Understanding in February 2006
- One of the items in the MoU is fair value measurement
- The FASB issued FAS 157 in September 2006
- The IASB issued a discussion paper on fair value measurement in November 2006

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What is happening in the US with FAS 157

- The issue of FAS 157 represents a massive change to current practice in the US
- In February 2008 the FASB deferred application of FAS 157 for one year for non-financial assets and liabilities
- The FASB formed the Valuation Resource Group in the autumn of last year
- The current view in the US is that fair value is not an attractive basis of measurement in the current economic climate!

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What the IASB is doing

- The IASB is working through the many comments received on the discussion paper
- Fair value is on the agenda at most Board meetings
- In February 2008 the IASB requested 800 parties to carry out a standard by standard review of the practical application of fair value
- Working groups have been formed to advise the Board on the level of guidance needed
- Roundtables will be held in December 2008
- ED expected next March/April
- Standard expected in June 2010

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Implications and actions for you

- The IASB supports fair value measurement
- The best way to influence the outcome is to become involved in the debate
 - Working groups
 - Roundtables
 - Exposure draft
- Consider and prepare for the changes you might need to make to current practice and disclosure

Table Discussion

- What are the current challenges you face on fair value?
- How might you respond?

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