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IPEV Guidelines December 2022

A summary of the key changes

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Headlines

On 14 December 2022, the IPEV Board published revised International Private Equity and Venture Capital Valuation Guidelines (“IPEV Guidelines” or “Valuation Guidelines” or “Guidelines”), which will replace the 2018 Valuation Guidelines. The revised Guidelines are effective for periods beginning from 1 January 2023, with early adoption encouraged.

The revised Valuation Guidelines build on industry best-practice and incorporate learnings from the events and trends that had a significant impact on investment valuations across the public and private markets over the past years. The revised Guidelines also reflects consultation from industry practitioners and specialists to ensure the revisions were practical.

Whilst the revised Guidelines introduce no fundamental changes to the 2018 Valuation Guidelines, it features further guidance and clarifications on key topics, including the special interim guidance issued by the Board in March 2020 and 2022, aimed at improving valuation processes and reducing the expectation gap between the investment managers and investors.

What has changed?

The full publication of the revised Guidelines can be found HERE, which shows all the changes from the 2018 Valuation Guidelines. We have outlined some of the key changes within the Guidelines which may impact private equity valuers. This is not intended to be an exhaustive list, but highlights the areas that might require valuers to assess their processes to ensure they are in line with leading practices.

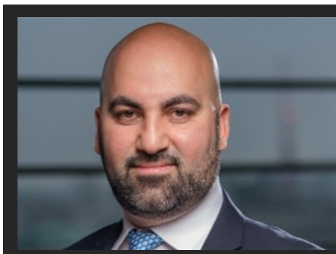
Dislocation of markets

A key theme underpinning the changes introduced to the Guidelines is the consideration of the impact of dislocation of markets for public and private assets.

As public and private markets adjust to higher inflation, rising interest rates and ongoing economic and geopolitical uncertainty, the updated Guidelines reiterate a number of key considerations arising in the event of distressed or dislocated markets with additional guidance included in *Section II 5.3 Distressed or Dislocated Markets* and *5.4 Distressed Transactions*.

The revised Guidelines provide a distinct definition of distressed or dislocated markets (shown to the right) and clarify that distressed markets will not necessarily lead to distressed transactions. The premise of fair value remains the same, that being the amount that would be received in an orderly transaction, regardless of whether the current state of the market is deemed distressed or dislocated. Transactions of comparable companies or instruments arising on distressed markets may be representative of fair value provided these are comparable.

Further, the IPEV Board emphasises that events and trends causing market distress or dislocation can have a profound impact on the performance of an investee company, its operating sectors more broadly, as well as on investors’ attitude towards risk and return for the company and its sector, all of which should be taken into consideration when assessing future valuations. For example, section 3.5 highlights the need to make an assessment of the comparability of market based transactions where those transactions occurred before a market dislocation, even if that transaction may have been recent. The analogy that can be drawn is that using a pre-Covid comparable transaction may require further assessment as to whether it is a valid indicator of fair value at the measurement date post-Covid.



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Distressed Market

Geopolitical, macroeconomic, or other significant global or local events which give rise to deemed excess volatility or limited transactions. Fair value is determined in the market which exists at the measurement date whether or not the market is deemed distressed or dislocated.

A forced liquidation or distress sale (i.e., a forced transaction) is not an Orderly Transaction and is not determinative of Fair Value. An entity applies judgement in determining whether a particular transaction is distressed or forced.

Additional guidance introduced in section 5.3 asks the users to assess Known and knowable information (discussed below), to determine whether the valuation techniques used in the past remains appropriate under the new circumstances, and to ensure that changes in performance, risk and uncertainty are properly reflected in the valuation inputs.

A series of other changes and clarifications have been introduced into the guidelines and explanatory notes in section I and additional guidance in section II alerting users on the need to consider the impact of a potential market dislocation in deriving inputs and assumptions used in assessing fair value.

The Guidelines specifically call out quoted investments and note that even in times of market volatility, the market value of a traded asset at the valuation date remains price multiplied by the quantity of shares held (without adjustment), regardless of the market state. This is in line with accounting standards which are clear that fair value for an actively traded security remains to be Price x Quantity without adjusting for market volatility. This includes situations when market volatility has occurred after the valuation date, although post balance sheet date event disclosures may well be useful for investors or a requirement of the accounting standards in such circumstances.

Known and knowable information

The IPEV Board continue to emphasise the importance of exercising prudent judgment and running a comprehensive due diligence process and consideration as well as corroboration of all reasonably known facts related to inputs and assumptions at the measurement date from the market participant's perspective. The revised Guidelines introduce additional notes explaining what known and knowable information consists of and provide guidance to valuers as to how to consider transactions after the reporting date within Guidelines in section *2.5 Exercising Prudent Judgement*.

> Known or Knowable information pertains to facts, conditions, or observable information which exists as of the measurement date and is available to the valuer or would reasonably be available to the valuer through routine inquiry or due diligence.

Environmental, Social & Governance ("ESG") Considerations

As ESG becomes a key source of risk and opportunity driving business and M&A strategy, the revised Guidelines emphasise the importance of considering the impact that quantitative and qualitative (as well as observable) ESG factors might have on fair value through the additional guidance introduced in *section II 5.17 Environmental, Social and Governance factors*.

The Guidelines suggest that these factors should be incorporated into an investee company's projected cashflows, as this encompasses all known and knowable information which would impact how a market participant would view an investment and what they would pay for that investment. The Guidelines stop well short of giving detailed guidance on estimating the impact of ESG factors on asset valuations, but they do provide helpful consideration points on factors to consider when valuing assets. Rather the guidelines ask valuers to assess the reasonably known and knowable factors which are measurable that would impact a market participant's view on an investment and notes that these should be taken into consideration.

> Key ESG considerations which are known or knowable should be incorporated into a company's cashflows.

Emphasis on good governance

The revised Guidelines highlighted the expectations of good governance within a strong control valuation framework for private capital investments within Appendix 2, *Valuation Standards*.

As these factors are listed in the appendix, the Guidelines do not mandate such an approach (as this has been left for other bodies such as the International Valuation Standards Council Principles of valuation governance), their inclusion has demonstrated the need for good governance when arriving at fair value. These considerations include but are not limited to the following:

- Documentation of the Valuer's rationale for all significant judgments.
- Appropriate processes to challenge the key assumptions, methodology, inputs, and the reasonableness of significant judgements used to determine fair value by individuals that have sufficient level of seniority and expertise.
- Appropriate levels of independence within the valuation approval process, either from outside the deal team (to avoid conflicts of interest) or from outside the firm through either independent non-executives or third-party valuation specialists.
- Maintenance of a robust and detailed documented valuation policy and process ensuring a consistent approach to determining fair value and the objectivity and independence of the team engaged in assessing, reviewing, and approving valuations.

> Investors in Private Capital expect valuers to apply sound valuation governance with a strong control framework.

Changes pursuant to ASC Topic 820 amendment

In June 2022, the Financial Accounting Standards Board (FASB) in the United States issued an amendment to *ASC topic 820 fair value measurement* introducing clarification on the fair value assessment of equity securities with a contractual restriction. This change will reduce diversity in practice and increase comparability and alignment with the International Financial Reporting Standards (IFRS). The amendment clarifies that a contractual sale restriction is a characteristic of the reporting entity holding the equity security rather than a characteristic of the asset and, therefore, shall not be considered in measuring the fair value of an equity security.

The revised Guidelines introduce expanded guidance within *Appendix 2 – Additional Information* and changes within Section I 3.6 (ii) and 3.6 (iii) to describe the prohibition of blockage discounts applied on all contractual restrictions, including restrictions arising from an underwriter's lock up period which have been previously subject to diverse interpretation and measurement approach.

> A contractual sale restriction is a characteristic of the reporting entity holding the equity security rather than a characteristic of the asset and, therefore, shall not be considered in measuring the fair value of an equity security.

Other important amendments

The revised guidelines introduced additional considerations for valuation techniques used to value early-stage companies within section I *3.10 Calibrating to the Price of a Recent Investment* and section II 5.12.

The IPEV board continues to emphasise that the price of recent investments may not be representative of fair value as the performance of the company and the market conditions evolve or change significantly, as the case might be in the event of market distress or dislocation.

Section 3.10 provided additional considerations when assessing the price of a recent investment ("PORI"). The previous iteration of the IPEV Guidelines in 2018 removed PORI as a standalone valuation technique, whereas in the latest Guidelines, there is further clarification that care needs to be taken when determining the price of a recent investment without considering the comparability of the transaction to the investment held. For example, there may be different rights and preferences among share classes which should be taken into consideration when determining the comparability of a price indicated by a recent transaction.

Further, the revised Guidelines expand to bring the practices widely adopted in analysing complex capital structures, various rights and privileges of different share classes, and the likelihood of these being executed as the chances of successful IPO or M&A exits change over time.

There is also more specific guidance when valuing debt instruments, especially where there has been significant market dislocation or distress. The Guidelines specifically mention that par value of debt may not be representative of fair value in times of distress and factors such as increasing interest rates may impact the fair value of such debt instruments.

The Guidelines reinforce the considerations around indicative offers, to confirm that an indicative offer is rarely sufficient in and of itself in being representative of fair value. Rather the valuer should use this as a data point and adjust for uncertainties in execution of the deal in arriving at fair value.

A detailed list of changes is introduced in Appendix 3 – Changes in the 2022 Version of the Guidelines. The 2022 edition of the International Private Equity and Venture Capital Valuation Guidelines is available from IPEV's official website:
https://www.privateequityvaluation.com