



**Reporting
and Valuation
Guidelines**

Exposure Draft

November 2002

Comments to be received by 31 January 2003

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This exposure draft is published by the BVCA for comment only. The recommendations in the draft may be modified in the light of the comments received before being issued in the form of Reporting Guidelines and Valuation Guidelines.

Comments should be submitted in writing so as to be received by **31 January 2003**.

All comments will be regarded as on the public record unless confidentiality is requested by the commentator. Comments should preferably be sent by email to: **comments@bvca.co.uk**

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Disclaimer: The BVCA has made every effort to ensure the illustrative data and examples that form part of the proposed Reporting Guidelines and proposed Valuation Guidelines are accurate but assumes no responsibility for their accuracy, nor does the BVCA assume any responsibility as regards the use that could be made of the proposed Reporting Guidelines or proposed Valuation Guidelines by any third parties.

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Foreword

This exposure draft contains proposed Reporting Guidelines, addressing the content, frequency and timing of reports to private equity investors, and Valuation Guidelines, addressing the basis and methodologies to be used for valuing private equity investments. Although the BVCA has published Valuation Guidelines since 1991, this is the first time that Guidelines will have been issued in respect of reporting requirements. The aim of both sets of Guidelines is to promote best practice and to improve consistency and comparability across the industry, thereby enabling better economic decisions by investors.

While the current set of Valuation Guidelines has undoubtedly served the industry well, a number of developments have taken place recently which together give rise to the need for an update. The industry has become substantially larger, broader and more complex over recent years; financial accounting and reporting has increasingly embraced value-based measures over cost-based measures, particularly in the context of financial instruments; the range of valuation measures and techniques has expanded in order to cope with new industry sectors and the use of more complex financial structuring; and, most importantly perhaps, is the ongoing need to be able to demonstrate to investors and potential investors in private equity the soundness of the industry's valuation practices. It is largely in response to these developments that a comprehensive review and update of the Valuation Guidelines has been undertaken.

In developing the proposed Valuation Guidelines, two of the key criteria we set ourselves were that the Guidelines should have conceptual integrity from a valuation perspective and that they should be consistent with generally accepted accounting principles. The latter criterion (mainly in the form of the current exposure draft of proposed changes to International Accounting Standard 39 Financial Instruments: Recognition and Measurement (IAS 39)) has shaped much of the content, notably the use of Fair Value as the overall basis of valuation. Possibly more controversially for the private equity industry, the IAS 39 exposure draft includes an apparent prohibition on the use of discounts to market prices in valuing quoted investments. We believe that discounting from quoted market prices should be permitted in certain circumstances and have made a submission to the International Accounting Standards Board to this effect. At this stage, the proposed Valuation Guidelines reflect our preferred position on this issue.

The project to produce this exposure draft has been underway now for almost a year, and has been conducted under the supervision of the BVCA's Investor Relations Committee. The BVCA would like to put on record its gratitude to all of those that have contributed during the process. Particularly, I would like to thank the members of the Consideration Committee which, under my chairmanship, was tasked with considering the issues in the light of comments received during the initial consultation phase, and developing and drafting proposals.

The members of the Consideration Committee are:

Humphrey Battcock	Advent International plc
Anthony Cecil	KPMG
Jennifer English	BVCA
John Mackie	BVCA
Michael Mills	3i Group plc
Richard Thompson	PricewaterhouseCoopers

In addition, the BVCA wishes to thank all of those who participated in the initial consultation phase, through submitting written comments or meeting with us to discuss the issues. The members of the Investor Relations Committee also merit thanks, both for overseeing the project and for assisting in the initial consultation process. We are also grateful to the European Private Equity and Venture Capital Association (EVCA) for allowing us to "borrow" extensively from their Guidelines in framing the proposed Reporting Guidelines; and, particularly, to Edoardo Bugnone and Didier Guennoc of EVCA for their contribution on some of the valuation issues.

The exposure draft will be "open for comment" until 31 January 2003 and I would encourage interested parties to provide us with comments and observations. The exposure draft has been endorsed by the BVCA's Council and the BVCA commends its contents.



Michael Queen
Chairman



Invitation to Comment

Comments are invited on the issues set out below as well as on any other aspect you would like to address. Comments should indicate the specific paragraph(s) or page(s) to which they relate, contain a clear rationale and, where applicable, provide suggested alternative wording or treatment.

Reporting Guidelines

1. Are there additional items of information to those specified in the proposed Guidelines that should be disclosed in reports to investors?
2. Are there any items of information specified in the Guidelines that you feel should not be required to be disclosed in reports to investors?
3. Do you agree with the proposed Internal Rate of Return disclosures advocated by the Guidelines?
4. Do you believe the Guidelines should additionally specify the format of reports to investors?

Valuation Guidelines

5. Do you agree with the use of Fair Value as the overall basis of valuation?
6. Do you agree with the use of "primary" and "secondary" categorisations for the various methodologies, with the corresponding obligation to justify the use of a secondary methodology? Are there any methodologies that you feel should be categorised differently?
7. Do you agree with the use of a Marketability Discount for unquoted investments and, more specifically, with its application at the Gross Attributable Enterprise Value level?
8. The current exposure draft of proposed changes to IAS 39 contains an apparent prohibition on the use of discounts to market prices in valuing quoted investments. Do you agree that discounting is required in certain circumstances in order to arrive at the Fair Value of a quoted investment?
9. Is the level of disclosure specified sufficient? Or excessive?

General

10. Are there any other issues you wish to raise in respect of reporting or valuation?



Reporting
Guidelines

Exposure Draft

November 2002

Preface

These Guidelines set out recommendations, intended to represent best practice, on the content, timing and frequency of reports to investors in private equity funds structured as limited partnership fixed-life funds (currently the most common fund structure within the private equity industry). It is hoped that these Guidelines will also serve as a useful reference for private equity funds structured differently. The term "private equity" is used in these Guidelines in a broad sense to include investments in early stage ventures, management buy-outs, management buy-ins and similar transactions and growth or development capital.

The Guidelines do not seek to address the accounts of private equity funds, since these will depend on the structure of the fund and will be governed by legal or regulatory provisions and by generally accepted accounting principles.

These Guidelines incorporate, with minor amendment only¹, the "Level One" provisions of the Reporting Guidelines of the European Private Equity and Venture Capital Association ("EVCA") and an excerpt, relating to the Internal Rate of Return performance measure, from the EVCA Valuation Guidelines. The BVCA would like to put on record its gratitude to EVCA for allowing this.

Neither the BVCA nor the members of any committee or working party thereof can accept any responsibility or liability whatsoever (whether in respect of negligence or otherwise) to any party as a result of anything contained in or omitted from the Guidelines nor for the consequences of reliance or otherwise on the provisions of these Guidelines.

¹ Appendix 2 contains a list of amendments made to both the EVCA Reporting Guidelines and the excerpt from the EVCA Valuation Guidelines headed Measuring Performance: The Internal Rate of Return ("IRR")



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Reporting

Introduction

The objective of these Guidelines is to set out best practice on the content, timing and frequency of reports to investors in private equity funds structured as limited partnership fixed-life funds (currently the most common fund structure in the private equity industry). It is hoped that these Guidelines will also serve as a useful reference for private equity funds structured differently.

The aim in producing these Guidelines is to promote best practice and to improve the quality and consistency of reporting to investors, thereby enabling investors to make better economic decisions.

It is recognised that some private equity firms will wish to disclose additional information to that specified below, and there is no intention that these Guidelines should restrict this.

The reporting provisions are set out below, under the headings, Timing, Fund Performance, Portfolio Reporting, Stock Distribution and Capital Account. There then follows a section addressing the Internal Rate of Return ("IRR") as a measure of performance for private equity funds and specifying some principles to be applied in its calculation. Appendix 1 contains a template illustrating how the reporting provisions might be incorporated into a report to investors.

Timing

Timing is a critical element in the reporting process.

Reporting is produced semi-annually, within 60 days (half year) and 120 days (full year). Investments should be revalued semi-annually.

Fund Performance

1. A Fund Summary that includes the following:–
 - 1.1. first closing date and vintage year (i.e. year of first cash flow) and total commitments;
 - 1.2. fund's domicile, legal form and structure, and investment focus both by stage and geography.
2. An Executive Summary that includes the following:–
 - 2.1. total commitments, total drawn and invested to date, and total distributed;
 - 2.2. current investments (significant events);
 - 2.3. new investments;
 - 2.4. realisations;



-
- 2.5. significant changes to the management company or general partner changes (especially to senior investment personnel) or the environment in which the fund operates;
 - 2.6. net IRR to investors. The mentioning of this at Executive Summary level is optional during the first 2 years of the fund; and
 - 2.7. notification of the Annual Meeting date and place.
 3. IRR, calculated on at least a monthly cash flow basis, on fund performance (net to investors), multiple of investment cost, return on Capital and Income, all on the assumption that all investments are realised on the date of the reporting.
 4. Clear statement of the overall position, by fund, including prior period comparative figures of:–
 - 4.1. total commitments;
 - 4.2. total drawn down, and when;
 - 4.3. total committed or reserved for follow-on investments;
 - 4.4. total invested, and in what;
 - 4.5. total remaining available for draw down;
 - 4.6. total distributions, to the investor, and to the manager or general partner; and
 - 4.7. total value of remaining assets.
 5. Clear statement of management fees, profit share, and carried interest paid to the manager or general partner.
 6. Clear statement of related party transactions, benefits and fees, broken down into principal categories (such as underwriting fees, directors or monitoring fees, deal fees, broken deal fees, etc). The treatment of such fees and transactions is obviously specific to each individual fund, but clarity in disclosing the treatment of such issues is key.
 7. Note of any leverage to the fund, including debt and guarantees, charges, or contingent liabilities.
 8. Value progression chart, showing the change in value of the fund over the life of the fund, broken down into investments at cost, realised gains and losses, unrealised gains and losses, and compared against total commitments. An example is included in the template (Appendix 1).
 9. IRR – in addition to the fund IRR, a gross IRR on realised and unrealised investments. Furthermore, a consistent and appropriate comparison against an industry benchmark is helpful but optional.

Portfolio Reporting

The following information should be disclosed for significant investments. A significant investment is an investment that either has a carrying amount exceeding five percent of the carrying amount of the portfolio as a whole or is one of the largest 10 investments ranked by carrying amount or is significant for some other reason.

10. General information on the portfolio company and the investment:–
 - 10.1. legal and trading names (including any changes) of portfolio company;
 - 10.2. location of head office or management;
 - 10.3. total amount invested by the fund;
 - 10.4. brief description of the business;
 - 10.5. stage of investment;
 - 10.6. statement of the fund's role in the investment (lead, co-lead etc);
 - 10.7. statement of any co-investment in transactions, in accordance with the arrangements with the fund's investors;
 - 10.8. percentage ownership and board representation (if any) by the fund; and
 - 10.9. valuation at time of investment.
11. Specific information concerning the investment:–
 - 11.1. fund's investment and divestment or distribution amounts (broken down by class, by cost, and by nature – i.e. capital or income; cash or stock/in specie distribution – and by date of investment) in the currency of the fund;
 - 11.2. other exposures, such as guarantees and loans;
 - 11.3. valuation of each investment, in accordance with BVCA Valuation Guidelines.



12. Significant events and issues:–

- 12.1. brief analysis of significant events during the reporting period and anticipated events;
- 12.2. any restrictions on the liquidity of the investment (for example, a lock-up period on listed shares);
- 12.3. disclosure of any significant extraordinary items.

Capital Account

It is strongly recommended that the funds include a capital account in their investor report. A capital account details the change in an investor's equity and capital contributions over a given period. An example of a capital account is included in the template (Appendix 1).

Measuring Performance: The Internal Rate of Return

Introduction

Returns may be measured in a number of ways. One may, for example, measure the payback period, that is to say the number of years required for the expenditure associated with a project to be recouped; or one might measure the book rate of return, this being the average annual profit made by an investment as a proportion of the original outlay. Each of these simple techniques exhibits serious deficiencies however. For example, payback does not consider the total profit which may be earned; neither method accounts for the time value of money nor for situations in which more than one investment is made.

The most common measure of performance within the private equity sector is the internal rate of return. Industry-wide private equity performance studies in the US use the IRR. Not only does this measure take the time value of money into account, as well as the ability to measure the returns on groups of investments, but it also expresses the return as a simple percentage. Thus, the BVCA has selected the IRR as being the most appropriate performance benchmark.

Private Equity/Venture Capital Managers and/or their Funders may additionally require performance to be calculated using other measures. Such arrangements between Private Equity/Venture Capital Managers and their Funders are, of course, entirely acceptable. Other benchmarks might include the following: a measure of the cumulative investment returned relative to the invested capital; the valuation of the unrealised portfolio relative to the cumulative drawn-down capital; and the payback period.

The IRR is that rate of discount which equates the present value of the cash outflows associated with an investment with the sum of the present value of the cash inflows accruing from it and the present value of the valuation of the unrealised portfolio.

Three Levels of IRR Advocated by the BVCA

Pure IRRs can only be computed when all investments have been realised and the cash has been paid back to Funders, after the deduction of carried interest, management fees and other applicable professional and ancillary charges. This is the net ('cash-on-cash') return on the wholly realised investment portfolio.

However, users of financial information regarding Private Equity/Venture Capital Companies need to be able to measure returns on a regular basis. Such interim returns are no more than indicators of the pure IRR. The more mature an investment portfolio is, though, the more confidence one may generally ascribe to these interim statistics.

Performance calculations must quantify the prowess of the Private Equity/Venture Capital Managers at two main stages: firstly, on their ability to choose suitable investment opportunities, manage them and



divest from them; and secondly, to assess their overall cost effectiveness by computing the return to Funders net of the total cost of carrying out these tasks.

The first of these stages, that is the gross return, may be usefully broken down into two levels. This enables the actual return on realised investments only to be identified separately from the gross return on all investments, which by its very nature is estimated; the latter accounts for all wholly and partially realised investments and for the subjective element of valuations on the unrealised portion of the portfolio.

The BVCA, therefore advocates that performance be measured at three levels:

1. The Gross Return on Realised Investments

This return takes account of the cash outflows (investments) and inflows (divestments, including realisation values, dividend and interest payments, repayments of the principal of loans, etc) which take place between the Fund and its realised investments.

For the purposes of this return it is recognised that there are occasional circumstances in which it would be appropriate to include the realised element of gains from a holding in a Portfolio Company where full realisation has not been effected.

In deciding which partially realised gains should be included in this category the following rules should be observed:–

- Only those realised gains should be included which represent a substantial part (>30%) of the cost of equity investment. In that case, all cash inflows relating to that equity investment are to be included in this level.
- If the investment is made at different costs per share at different dates, the allocation of gain to cost should be based on the average cost per share of the realised investment.
- Partial write-offs should not be included in this level, but will appear in the Gross Return on all Investments.
- Full disclosure should be made of those investments where partial realisations are included in this level, in particular as to the allocation of gain to cost.

2. The Gross Return on all Investments

This return takes account of all of the following:–

- The cash outflows (investments) and inflows (divestments, including realisation values, dividend and interest payments, repayments of principal of loans, etc) which take place between the Fund and:–

-
- its wholly realised investments;
 - its partially realised investments; and
 - its wholly unrealised investments.
- The valuation of the unrealised portfolio (consisting of wholly unrealised investments and the unrealised portions of partially realised investments but excluding cash and other assets held in the portfolio).

This return does not take account of carried interest or charges of any kind, such as management fees paid to the Private Equity/Venture Capital Company by the Funder, fees paid by a Portfolio Company either to the Fund or the Private Equity/Venture Capital Company, and fees paid or due to lawyers and accountants.

3. The Net Return to the Funder

This measures the return earned by the Funders in the Fund, and takes account of:–

- The cash flows which take place between the Fund and the Funders, net, by definition, of all of the following:–
 - the Private Equity/Venture Capital Company's carried interest;
 - the management fees paid to the Private Equity/Venture Capital Company by the Funders;
 - all other applicable professional and ancillary charges which are paid out by the Private Equity/Venture Capital Company in the course of investing, managing and divesting from its investment portfolio.
- The valuation of the unrealised portfolio (consisting of the unrealised portions of partially realised investments, wholly unrealised investments and also including cash and other assets), after deducting the implied carried interest.

When the portfolio is fully realised/fully distributed, the Net Return is the 'cash-on-cash' return to the Funders.

Should Private Equity/Venture Capital Managers and/or their Funders consider it desirable to do so, the performance calculated for any of the three levels given above may be broken down to demonstrate the contribution made by the individual elements of which they are made up. For example, the overall measure of the Gross Return on all Investments could be split up so as to separately show the performance of the wholly realised investments, partially realised investments, wholly unrealised investments, and the valuation of the unrealised portfolio.



The ability to break down the impact of the valuation of the unrealised portfolio on the performance may be particularly important as valuations can be no more than indicators of the pure IRR when all investments have been wholly realised.

To enable the returns calculated in accordance with the different Levels described herein by various users to be fairly compared, necessitates that the relevant parameters are always treated in an identical manner. It is for this reason that the Principles have been developed, which are set out below.

Principles

Commitments made by a Private Equity/Venture Capital Company to a Portfolio Company

The cash outflows should be taken to be the capital actually invested in a Portfolio Company at a given point in time. A Private Equity/Venture Capital Company may commit itself to making a series of investments in a Portfolio Company over an extended period of time. In such circumstances, the timing and amounts of the individual cash flows only should be taken into account.

Commitments made by a Funder to a Private Equity/Venture Capital Company

The cash outflows should be taken to be the capital actually invested in a Private Equity/Venture Capital Company by a Funder at a given point in time. A Funder may commit itself to making a series of investments (known as draw-downs) in a Fund over an extended period of time. In such circumstances, the timing and amounts of the individual cash flows only should be taken into account.

Equity Received in Lieu of Cash

Any equity received by a Private Equity/Venture Capital Company in lieu of cash in respect of services rendered to a Portfolio Company (for instance, services of directors, provision of guarantees) should be considered as investments of zero cost.

Net Return to the Funder: Carried Interest and the Unrealised Portfolio

When calculating the Net Return to the Funder, as regards the valuation of the unrealised portfolio, appropriate provision should be made for the deduction of carried interest after taking account of any hurdle rates.

Non-Domestic Currency

Where transactions take place in non-domestic currencies, two separate values of the IRR may be computed for each of the three levels which have been described – one to include the effect of exchange rate movements, the other to exclude them. Performance must be calculated with reference to the currency of denomination of the Fund. Should the Private Equity/Venture Capital Managers or Funders so desire, then performance may additionally be calculated with reference to other currencies. Should, therefore, the value of transactions need to be known in both domestic and non-domestic

currencies, the exchange rate which prevailed on the date the transaction took place should be used. Where this is not known, the conversion shall be effected using the monthly average exchange rate for the month and year in question.

Realisations

Shares in companies which are floated and distributed in specie should be considered realised upon the earliest date at which such shares may be converted into cash to the benefit of the Funder. It is implicitly recognised, therefore, that shares cannot be regarded as realised whilst any dealing restrictions are in place.

Write-offs should be accorded a nominal value of one currency unit (for example, £1) rather than zero.

As regards the calculation of the Gross Return on Realised Investments only, a written off investment should be considered as having been realised as soon as the earliest of any of the following or like events takes place: when bankruptcy proceedings are instigated against a Portfolio Company; when a Portfolio Company ceases to trade; when a Portfolio Company enters into arrangements with creditors which result in the investment being written down to zero; when insolvency proceedings are begun.

Investments which have been completely sold subject to a proportion of deferred consideration/earn out should be defined as Realised Investments and an estimate of the discounted proceeds from the deferred consideration should be included in the Realised level calculation. Appropriate disclosure should be given.

When reporting performance measurement of any of the three levels, the cost of the realised investments relative to the cost of all investments made should be given.

By agreement with the Funders, the Private Equity/Venture Capital Manager may only consider it relevant to report the Gross Return on Realised Investments after a given proportion of the investments, by amount and/or number, have been realised.

Share Exchanges

Private Equity/Venture Capital Companies sometimes exchange part or all of their stake in a Portfolio Company for shares in another company. Where such an exchange takes place, the new shareholding should be treated no differently than if it was part of the shareholding in the original Portfolio Company.

Taxation

Dividend and interest payments and capital gains received from Portfolio Companies that are paid net should be grossed up so as to be treated as pre-tax cash flows for the two measures of Gross Return, but not for the Net Return.



Timing of Cash Flows

The date attributed to each cash flow should be taken to be the first day of the month in which it occurred.

Young Investments

Care should be taken in measuring financial returns from recent investments and young funds. Nevertheless, to facilitate the computation of IRRs relating to these investments at an appropriate time in the future, the prerequisite data (cash flows and their timing), should be continuously collected.

Appendix 1 – Template

The following template is for illustrative purposes only and does not aim to represent a real fund nor are the numbers involved necessarily realistic.

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Fund Summary

First closing	30 June, 2000
Final closing	30 November, 2000
Vintage year	2000
Total commitments	£1 billion
Fund's domicile	Jersey
Legal form	Series of limited partnerships
Structure	One General Partner and fourteen Limited Partners. Management Company: "The Venture Capital Company Ltd"
Investment focus by stage	Balanced fund: <ul style="list-style-type: none">– Early stage– Development capital– Buy-out investments
Investment focus by geography	Northern Europe including the UK



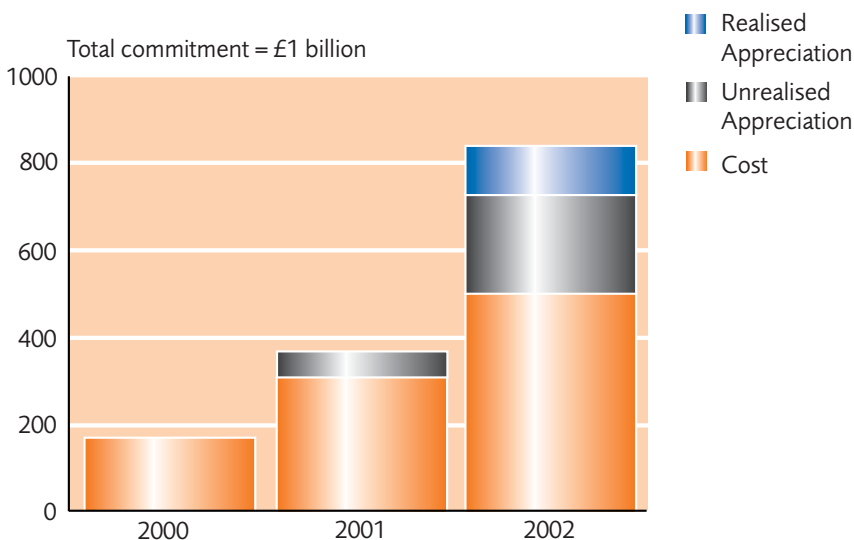
Executive Summary

Fund Update and Overview

The Alpha Fund ("the Fund") had its first closing on 30 June, 2000 and its final closing on 30 November, 2000 raising a total of £1 billion. The first draw down occurred on 30 June, 2000 thereby classifying the Fund as a vintage year 2000 fund. The Fund is a balanced fund and invests in early stage, development capital and buy-out investments. The Fund is a series of Jersey limited partnerships with a geographic investment focus predominantly in Northern Europe including the UK.

As of 31 December, 2002, the Fund had drawn down £600 million or 60% of committed capital and had committed a further £250 million or 25% for follow-on financing in those companies where the fund had invested in an early round of finance. The Fund has returned £200 million in distributions to Limited Partners (20% of committed capital or 33% of contributed capital) and has a remaining value of £800 million. The net IRR to Limited Partners through 31 December, 2002 is 45%.

Value Progression Chart



The management team has been enhanced with the addition of two associate directors: Mr. Smith has joined the UK team in London and Mr. Weiss has joined the Swiss team in Zurich. The management team now totals 38 investment professionals located in six offices. We have begun preparations for raising the Alpha Fund II and would expect to have a first closing before June 2003.

Portfolio Summary

The Fund has now invested in 20 companies for a total cost of £600 million, including 6 new investments in 2002 for a total cost of £250 million. The new investments include Company A, Company B, Company C, Company D, Company E, and Company F.

One full realisation and one partial realisation were achieved in the year. The first was Company X, which was sold to a trade buyer for total proceeds of £25 million representing a gross IRR of 41% and a 2.0 times multiple to cost. The second was the flotation of Y Company on the London Stock Exchange. The Fund sold 10% of its holding realising £25 million. The remaining shares of Y Company valued the Fund's holding at year end at £100 million yielding a gross IRR of 145% and a 6.0 times multiple to cost.

The remaining portfolio has an average holding period of less than 2 years and is therefore relatively immature. The majority of the investments are performing according to plan.

Economic and Private Equity Overview

United Kingdom

[commentary to be inserted]

Germany

[commentary to be inserted]

Switzerland

[commentary to be inserted]

Netherlands

[commentary to be inserted]

Sweden

[commentary to be inserted]

Finland

[commentary to be inserted]

We would like to thank you for your continued support of the Alpha Fund and look forward to seeing you at our Annual Meeting on 20 June, 2003.

Alpha Management Team

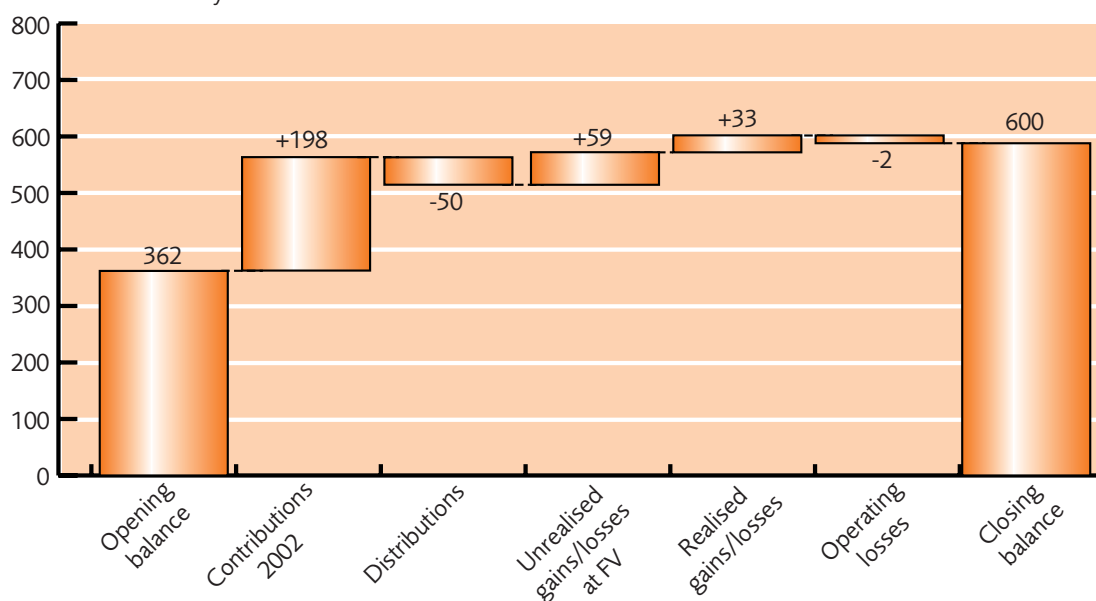


Investment Summary

	2002 £ million	2002 % Committed Capital	2001 £ million	2001 % Committed Capital
CAPITAL COMMITTED	1,000	100%	1,000	100%
Capital contributed	600	60%	402	40%
Less capital distributed	(200)	(20)%	(150)	(15)%
	400		252	
Operating loss	(5)		(3)	
Realised gains/losses	100		67	
Gain/loss on revaluation at FV	105		46	
VALUE OF FUND as of 31/12/02	600		362	
Represented by				
Value of current portfolio	595		328	
Current assets	10		65	
Current liabilities	(5)		(31)	
	600		362	
Amount reserved for follow-on	250	25%	150	15%
Available for drawdown	150	15%	448	45%
Contingent liabilities (including debt and guarantees)	50	5%	20	2%
Potential drawdowns for period	100	10%	100	0

The Alpha Fund 31 December, 2002

Investment Summary





Realisations/Portfolio Summary

REALISATIONS	Disposal Date	% Equity	Cost	Proceeds/ Valuations	Realised and Unrealised Gain/Loss	Multiple to Cost	Gross IRR	Exit Route
FOR THE PERIOD BEING MEASURED								
Total Realisations								
Company X	Jun-2002	18.00%	12.5	25	12.5	2.0	41%	Trade buyer
Partial Realisations								
Company Y	Oct-2002	7.20%	4.17	25	20.83	6.0	422%	Flotation
Subtotal Realisations			16.67	50.00	33.33	3.0	87%	
CURRENT AND PREVIOUS REALISATIONS								
Total Realisations								
Company X	Jun-2002	18.00%	12.5	25	12.5	2.0	41%	Trade buyer
Company Z	Apr-2001	13.50%	20	40	20	2.0	63%	Flotation
Company W	Jan-2001	12.00%	30	50	20	1.67	28%	Trade buyer
Partial Realisations								
Company Y	Oct-2002	7.20%	4.17	25	20.83	6.0	422%	Flotation
Company T	Oct-2001	11.00%	14	15	1.00	1.07	4%	Investor
Company U	Mar-2001	22.40%	19.33	45	25.67	2.33	34%	Flotation
Subtotal Realisations			100	200	100	2.0	39%	
CURRENT PORTFOLIO SUMMARY								
Subtotal Current Portfolio			490	595	105	1.21	14%	
Grand total realised and current portfolio			590	795	205	1.35	20%	

Cash Flow and IRR Calculations

Commitment of Investor: £ 1,000,000

DATE OF CASH FLOW	Contributions	Mgt Fee Paid	Other Expenses	Return of Capital	Income other than Capital Gains	Distribution of Capital Gains	Estimated NAV at FV	Estimated Net IRR	Total Value/ Funded
Opening balance	(402)	(22.50)	(10)	100	0	50	478.0	18.00%	0.82
Jan-02	(60)	(7.50)	(1)						
Feb-02									
Mar-02	(36)								
Apr-02									
May-02				25	5	20			
Jun-02	(33)								
Jul-02		(7.50)	(1)						
Sep-02									
Oct-02	(41)								
Nov-02									
Dec-02	(28)								
	600	(38)	(12)	125	5	70	600.0	21.00%	1.33
Relevant industry benchmark (i.e. Venture Economics)									
30%									

Note: The General Partner should provide individualised Cash Flow and IRR calculations per investor.

Current Portfolio

	Date of Initial Investment	Geography	Industry	Stage	% Equity Holding	Cost as of 31/12/02	FV as of 31/12/02	FV as of 31/12/01	FV/Cost as of 31/12/02	Gross IRR
QUOTED										
Co. Y	Sep-2001	UK	Service	Expansion	15.30%	20	85	40	4.25	196%
Co. U	Jun-2000	Holland	Retail	Expansion/Later	12.60%	22	34	27	1.55	18%
Co. W	Oct-2000	France	Automotive	Expansion	9.40%	40	58	50	1.45	18%
UNQUOTED										
Co. H	Jul-2000	UK	Retail	Expansion	9.60%	23	11	23	0.48	-26%
Co. I	Sep-2000	France	Service	Expansion	6.17%	37	40	39	1.08	3%
Co. J	Dec-2000	Sweden	Communications	Expansion	33.00%	27	44	32	1.63	26%
Co. K	Jan-2001	UK	Healthcare	Expansion	12.20%	22	11	16	0.50	-29%
Co. L	Feb-2001	Norway	Communications	Early stage	31.70%	31	31	31	1.00	0%
Co. T	Feb-2001	Germany	Communications	Early Stage	28.00%	28	40	28	1.43	21%
Co. M	May-2001	France	Industrial products	Expansion	16.10%	30	52	30	1.73	44%
Co. N	Oct-2001	France	Software	Early Stage	40.90%	12	6	12	0.50	43%
Co. A	Jan-2002	UK	Healthcare	Early Stage	37.50%	31	23	-	0.75	-26%
Co. B	Jan-2002	France	Communications	Early Stage	39.00%	29	22	-	0.75	-24%
Co. C	Mar-2002	UK	Automotive	Expansion	12.00%	36	36	-	1.00	N/A
Co. D	Jun-2002	Belgium	Service	Expansion	14.00%	33	33	-	1.00	N/A
Co. E	Oct-2002	France	Retail	Expansion	18.00%	41	41	-	1.00	N/A
Co. F	Dec-2002	Sweden	Healthcare	Early Stage	23.00%	28	28	-	1.00	N/A
TOTAL/AVERAGE						490	595	328	1.21	



Portfolio Companies

Legal and Trading Name (including any change)	Company J
Description of the Business	Develops wireless communication services
Location of Head Office or Management	Stockholm, Sweden
Development Stage	Expansion
Fund's Role in the Investment (lead, co-lead)	Co-lead
Percentage Ownership and Board Representation (if any by the fund)	33% Two Board Members – Jim Smith and David Jones
Valuation at Time of Investment	£81 million – EBITDA of 5 X
Type of Holding	Common ordinary shares
Significant events	A new generation of software is used which has significantly increased revenues

Date	Book Cost	Fair Value	Outstanding Commitments and Contingent Liabilities	Fund Hold%	Gross IRR
31/12/02	27	44	None	33%	26%

Realised	Date	Book Value	Realised Value	Type of Realisation	Liquidity Restrictions	Fund Hold%	Gross IRR
None	N/A	N/A	N/A	Income (interest/dividends) Capital (cash/stock)	N/A	N/A	N/A

Trading record – £ million	31/12/00 Actual	31/12/01 Actual	31/12/02 Actual	31/12/03 Budget/forecast
Sales	82	103	128	179
EBITDA	16	20	23	27
EBIT	8	11	11	13
Net Income	4	5	4	5

Capital Account

Consolidated LP1, LP2, LP3 and LP4		For the 12 Months Ended 31/12/02										
Investor Name*		Inception to 31/12/02	Prior Period		For the 12 Months Ended 31/12/02		31/12/02		31/12/02		31/12/02	
	% Ownership	Commitment	Cumulative Contributions	Cumulative Distributions	Capital Account at Cost	Capital Contribution	Realised Gain	Operating Expenses net of Interest Income	Cash Distributions	Capital Account at Cost	Unrealised Gains on Investments	Capital Account at Fair Value
LIMITED PARTNERS												
Investor No. 1	5.0%	50	30	10	15.80	9.90	1.67	(0)	(3)	24.75	5.25	30.00
Investor No. 2	5.0%	50	30	10	15.80	9.90	1.67	(0)	(3)	24.75	5.25	30.00
Investor No. 3	7.5%	75	45	15	23.70	14.85	2.50	(0)	(4)	37.13	7.88	45.00
Investor No. 4	10.0%	100	60	20	31.60	19.80	3.33	(0)	(5)	49.50	10.50	60.00
Investor No. 5	7.5%	75	45	15	23.70	14.85	2.50	(0)	(4)	37.13	7.88	45.00
Investor No. 6	5.0%	50	30	10	15.80	9.90	1.67	(0)	(3)	24.75	5.25	30.00
Investor No. 7	5.0%	50	30	10	15.80	9.90	1.67	(0)	(3)	24.75	5.25	30.00
Investor No. 8	7.5%	75	45	15	23.70	14.85	2.50	(0)	(4)	37.13	7.88	45.00
Investor No. 9	7.5%	75	45	15	23.70	14.85	2.50	(0)	(4)	37.13	7.88	45.00
Investor No. 10	10.0%	100	60	20	31.60	19.80	3.33	(0)	(5)	49.50	10.50	60.00
Investor No. 11	6.5%	65	39	13	20.54	12.87	2.16	(0)	(3)	32.18	6.83	39.00
Investor No. 12	7.5%	75	45	15	23.70	14.85	2.50	(0)	(4)	37.13	7.88	45.00
Investor No. 13	7.5%	75	45	15	23.70	14.85	2.50	(0)	(4)	37.13	7.88	45.00
Investor No. 14	7.5%	75	45	15	23.70	14.85	2.50	(0)	(4)	37.13	7.88	45.00
GENERAL PARTNER												
Venture Capital Co	1.0%	10	6	2	3.16	1.98	0.33	(0)	(1)	4.95	1.05	6.00
Total Partnership Investments	100%	1,000	600	200	316	198	33.3	(2)	(50)	495	105	600

*General Partners should disclose names of the investors where possible.

Fees

Year ended 31 December, 2002

	£ million
Arrangement fees	5.0
Director/monitoring fees	0.5
Broken deal fees	0.5
Broken deal costs	(2.0)
NET FEES	4.0
Credit against Mgt fee = 50%	2.0
Management fees for the period	15.0
Less 50% credit	(2.0)
Less 100% underwriting fees	(1.0)
NET MANAGEMENT FEES	12.0
Carried interest paid	–
Carried interest earned	–
Potential clawback value	–

Appendix 2 – List of Amendments to EVCA Provisions

As noted in the Preface, these Guidelines incorporate, with minor amendment only, the "Level One" provisions of the Reporting Guidelines of the European Private Equity and Venture Capital Association ("EVCA") and an excerpt, relating to the Internal Rate of Return performance measure, from the EVCA Valuation Guidelines. This Appendix lists the amendments made to the EVCA provisions.

Amendments made to "Level One" provisions of EVCA Reporting Guidelines

1. p.42 of EVCA – the section headed Annual Meeting has been deleted.
2. p.42 of EVCA – under Timing, Level One, the word "audited" has been deleted, as have the words after "revalued semi-annually".
3. p.44 of EVCA – the note between items 7 and 8 (conflicts of interest) has been deleted.
4. p.44 of EVCA – items 8 (value progression chart), 9 (IRR) and 10 (annual economic and private equity overview), which are in EVCA's Level Two provisions, have been included.
5. p.45 of EVCA – the note between items 15 and 16 (anticipated draw downs) has been deleted.
6. p.45 of EVCA – the Portfolio Reporting provisions are specified as only being required for "significant" investments.
7. p.46 of EVCA – the section on Stock Distribution has been deleted.
8. p.47 of EVCA – The words "Although not a legal requirement" and "and statutory accounts" have been excluded from the Capital Account section.
9. Template – the dates used in EVCA's Template have been updated to reflect a 31 December 2002 report; and the currency has been changed from euros to pounds sterling.
10. Template – references to "Fair Market Value" or "FMV" have been amended to "Fair Value" or "FV".
11. Template – Economic and Private Equity Review – commentary has been deleted.
12. Template – Realisations/Portfolio Summary table – the column headed "Holding Period (months)" has been deleted.
13. Template – Current Portfolio table – columns headed "Conservative Value as of 12/31/99", "Holding period (Months)" and "Currency spot rate" have been deleted.
14. Template – Portfolio Companies table – Disclosures in respect of "Other significant co-investors", "Capitalised fees", "Post investment events" and "Assessment versus Plan" have been deleted.



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15. Template – Portfolio Companies table – disclosure in respect of "Fair Value as of ..." has been deleted, as has the Valuation chart.
 16. Template – the Stock Distribution table has been deleted.

Amendments made to IRR excerpt from EVCA Valuation Guidelines

17. References to "EVCA" and "Valuation Committee" have been amended to "BVCA".
18. References to the Appendix have been deleted.
19. The Appendix has not been included.



**Valuation
Guidelines**

Exposure Draft

November 2002



Preface

These Guidelines set out recommendations, intended to represent current best practice, on the valuation of private equity and venture capital investments. The term "private equity" is used in these Guidelines in a broad sense to include investments in early stage ventures, management buyouts, management buy-ins and similar transactions and growth or development capital.

The recommendations are intended to be applicable across the whole range of investment types (venture capital, buy-outs, growth/development capital, etc) and financial instruments commonly held by private equity funds.

The recommendations themselves are set out in bold type, whereas explanations, illustrations, background material, context and supporting commentary, which are provided to assist in the interpretation of the recommendations, are set out in normal type.

The recommendations should be read in the context of the objective (set out in paragraph 1) and the definitions (set out in paragraph 6).

Where there is conflict between a recommendation contained in these Guidelines and the requirements of any applicable laws or regulations or accounting standard or generally accepted accounting principle, the latter requirements should take precedence.

Neither the BVCA nor the members of any committee or working party thereof can accept any responsibility or liability whatsoever (whether in respect of negligence or otherwise) to any party as a result of anything contained in or omitted from these Guidelines nor for the consequences of reliance or otherwise on the provisions of these Guidelines.

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Introduction

1. Private Equity Managers are generally required to carry out periodic valuations of investments as part of the reporting process to investors in the Funds they manage. The objective of these Guidelines is to set out best practice where private equity investments are reported at "value", with a view to promoting best practice and hence helping investors in Private Equity Funds make better economic decisions.
2. It is recognised that the accounts of Private Equity Funds commonly include Investments at cost or cost less provision. It is not the intention of these Guidelines to prescribe or recommend the basis on which Investments are included in the accounts of Funds.
3. These Guidelines are concerned with valuation from a conceptual standpoint and do not seek to address best practice as it relates to internal processes, controls and procedures, governance aspects, the experience and capabilities required of the Valuer or the audit or review of valuations.
4. It is important to recognise the subjective nature of private equity investment valuation. It is inherently based on forward-looking estimates and judgements about the underlying business itself, its market and the environment in which it operates, the state of the mergers and acquisitions market, stock market conditions and other factors. As such, whilst valuations do provide useful interim indications of the progress of a particular Investment or portfolio of Investments, ultimately it is not until Realisation that true performance is firmly apparent.
5. A distinction is made in these Guidelines between a basis of valuation (such as Fair Value), which defines what the carrying amount purports to represent, and a valuation methodology (such as the earnings multiple technique), which details the method or technique for deriving a valuation.

Definitions

6. **The following definitions shall apply in these Guidelines.**

Enterprise Value

The value of the financial instruments representing ownership interests in an entity plus the net financial debt of the entity.

Fair Value

The amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

The Fund (or Private Equity Fund)

Generic term used in these Guidelines to refer to any designated pool of investment capital targeted at private equity investment, including those held by corporate entities, limited partnerships and other investment vehicles.

Gross Attributable Enterprise Value

Enterprise Value attributable to the financial instruments of the Fund and other financial instruments in the entity that rank alongside or beneath the highest ranking instrument of the Fund, as calculated in accordance with paragraph 31.

Investment

All of the financial instruments in a single business or group of businesses held by the Fund.

Marketability Discount

The return market participants demand to compensate for the risk that they may not be able to sell an asset immediately.

Net Attributable Enterprise Value

Gross Attributable Enterprise Value less a Marketability Discount, as calculated in accordance with paragraph 31.

Quoted Instrument

A financial instrument for which quoted prices reflecting normal market transactions are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency.

Realisation

The sale, redemption or repayment of an Investment, in whole or in part; or the insolvency of an investee company where no significant return to the Fund is envisaged.

Unquoted Instrument

A financial instrument other than a Quoted Instrument.

Valuer

The person with direct responsibility for valuing one or more of the Investments of the Fund.



Basis of Valuation

7. **Investments should be reported at Fair Value, except in rare situations where Fair Value cannot be reliably measured. In such situations the Investment should be reported at the carrying value at the previous reporting date, unless there is evidence that the Investment has since then been impaired. In such case the carrying value should be reduced to reflect the estimated extent of impairment.**
8. Fair Value is a concept based on a hypothetical transaction – it should reflect reasonable estimates and assumptions for all significant factors that the hypothetical parties to the transaction would be expected to consider, including those which impact upon the expected cash flows from the Investment and upon the degree of risk associated with those cash flows.
9. The estimation of Fair Value does not assume either that the underlying business is saleable at the reporting date or that its current shareholders have an intention to sell their holdings in the near future. Nor is Fair Value undermined by the fact that transfers of shares in private businesses are often subject to restrictions, rights of pre-emption and other barriers – it is still possible to hypothesise what amount a willing buyer would pay to take ownership of the Investment in question.
10. Private Equity Funds often undertake an investment with a view to effecting substantial changes in the underlying business, whether it be to its strategy, operations, management, or whatever. Sometimes these situations involve rescue refinancing or a turnaround of the business in question. Whilst it might be difficult in these situations to determine Fair Value based on a hypothetical transaction involving a trade purchaser, it should in most cases be possible to conceive a hypothetical amount a Private Equity Fund would pay for the Investment in question.
11. In the vast majority of cases, the Valuer will be able to make an estimate of Fair Value by applying generally accepted methodologies in a consistent manner based on reasonable assumptions. However, in certain situations, the Valuer may conclude that Fair Value cannot be reliably measured. This would be the case if the range of reasonable Fair Value estimates were significant and the probabilities of the various estimates within the range could not be reasonably assessed. This may arise, for example, from the inability to estimate future earnings or cash flows where the underlying business has little track record and its nature of business comprises innovative discovery or development activities.

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12. In respect of Investments for which Fair Value cannot be reliably measured, the Valuer is required:–
- a. to consider whether events or changes in circumstances indicate that an impairment may have occurred. Examples of such events and changes in circumstances include the following:–
 - the performance and/or prospects of the underlying business are significantly below the expectations on which the Investment was based. Prima facie indicators of this include a failure to meet significant milestones or to service financial instruments, breaches of covenants and a deterioration in the level of budgeted/forecast performance;
 - there has been a significant adverse change either in the investee company's business or in the technological, market, economic, legal or regulatory environment in which the business operates; and
 - market conditions have deteriorated. This may be indicated by a fall in the share prices of quoted businesses operating in the same or related sectors; and
 - b. where an impairment has occurred, to reduce the carrying value of the Investment to reflect the estimated extent of impairment. Since the Fair Value of such Investments cannot be reliably measured, estimating the extent of impairment in such cases will generally be an intuitive (rather than analytical) process and may involve reference to broad indicators of value change (such as relevant stock market indices).

Valuation Methodologies

General

13. **In estimating Fair Value for an Investment, the Valuer should apply a methodology that is appropriate in light of the nature, facts and circumstances of the Investment and its materiality in the context of the total investment portfolio and should use reasonable assumptions and estimates.**
14. An appropriate methodology would incorporate available information about the business, market conditions, marketability of the Investment and all other factors that are likely materially to affect the Fair Value of the Investment.
15. In assessing whether a methodology is appropriate, the Valuer should be predisposed towards those methodologies that are generally accepted and those that draw on market-based measures



of risk and return, since both these qualities would serve to enhance the reliability of the Fair Value estimates.

16. In assessing the reasonableness of assumptions and estimates, the Valuer should note that the objective is to replicate those that the parties in the hypothetical arm's-length transaction would make.
17. **Methodologies should be applied consistently from period to period, except where a change would result in better estimates of Fair Value.**
18. **Because of the uncertainties inherent in estimating Fair Value for private equity Investments, a degree of caution should be applied in exercising judgement and making the necessary estimates. However, whilst a degree of caution is appropriate in valuing private equity investments, the Valuer should be wary of applying excessive caution.**
19. **Where the reporting currency of the Fund is different from the currency in which the Investment is denominated, translation into the reporting currency for reporting purposes should be done using the exchange rate prevailing at the reporting date.**

Unquoted Instruments

20. A number of valuation methodologies that may be considered for use in estimating the Fair Value of Unquoted Instruments are described below. These methodologies should be amended as necessary to incorporate case-specific factors affecting Fair Value. For example, if the underlying business is holding surplus cash or other assets, the value of the business should reflect that fact.
21. Because, in the private equity arena, value is generally crystallised through a sale or flotation of the entire underlying business, rather than through a transfer of individual shareholder stakes, the value of the business as a whole at the reporting date will often provide a key insight into the value of investment stakes in that business. For this reason, a number of the methodologies described below involve estimating the value of the business as a whole as an initial step.
22. It is important conceptually to distinguish the value that may be ascribed to an Investment from the value that may be ascribed to the underlying business. For example, in valuing the underlying business one may seek to estimate the amount a buyer would pay for the business at the reporting date. In valuing an investment stake in that business, one would not merely take the relevant share of the business's value, since that would fail to recognise the time, uncertainty and risk involved in actually selling the business and crystallising the investment value, and particularly the risk that value may be eroded before a sale can be achieved.

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23. There are some situations where the Fund has little ability to influence the timing of a Realisation and a Realisation is not likely in the foreseeable future, perhaps because the majority shareholders are strongly opposed to it. In these circumstances (which are expected to be rare in private equity), Fair Value will derive mainly from the expected cash flows and risk of the relevant financial instruments rather than from the value of the business as a whole. The valuation methodology used in these circumstances should therefore reflect this fact.
24. The table below identifies a number of methodologies and indicates, for each methodology, whether it should be considered a primary or a secondary methodology.

Methodology	Category
Earnings multiple	Primary
Price of recent investment	Primary
Net assets	Primary
Discounted cash flows or earnings (of underlying business)	Secondary
Discounted cash flows (from the Investment)	Secondary*
Industry valuation benchmarks	Secondary

* Primary where Realisation or flotation is imminent

Whilst a secondary methodology may be useful as a cross-check of values produced using a primary methodology, it should only be considered for use as the main basis of estimating Fair Value if all the primary valuation methodologies are inappropriate in the particular circumstances. Where a secondary methodology is so used, that fact should be disclosed together with the rationale for its use.

25. The above categorisations apply where the Investment comprises either equity or a combination of equity and other financial instruments. Where the Investment comprises principally non-equity instruments (such as debt or mezzanine debt instruments), Fair Value will derive mainly from the expected cash flows and associated risk attaching to the instruments, and methodologies such as discounted cash flow analysis are likely to be more appropriate. In the case of mezzanine debt Investments where equity warrants are included, the Valuer should value the two components (the debt and the warrants) separately.
26. Of the primary methodologies identified in the table above, the Price of Recent Investment methodology is likely to be the most appropriate for a period of one year following the date of



the investment transaction, whether the investment transaction involved the Fund or a third party. Thereafter, except for businesses whose value derives mainly from the underlying value of their assets rather than their earnings, where the Net Assets methodology is likely to be the most appropriate, the Earnings Multiple methodology will generally be the most appropriate.

27. Where Realisation of an Investment or a flotation of the underlying business is imminent and the pricing of the relevant transaction has been substantially agreed, the Discounted Cash Flows (from the Investment) methodology (or, as a surrogate, the use of a simple discount to the expected Realisation proceeds or flotation value) is likely to be the most appropriate methodology.

Earnings Multiple

28. This methodology involves the application of an earnings multiple to the earnings of the business being valued in order to derive a value for the business.
29. This methodology is likely to be appropriate for an Investment in an established business with an identifiable stream of continuing earnings that can be considered to be maintainable.
30. This methodology may be applicable to companies with negative earnings, if the losses are considered to be temporary and one can identify a level of "normalised" maintainable earnings. This may involve the use of averaging of earnings figures for a number of periods, using a forecast level of earnings or applying a "sustainable" profit margin to current or forecast revenues.
31. **In applying this methodology to derive the Fair Value of an Investment, the Valuer should:–**
- i. apply a multiple that is appropriate and reasonable (given the risk profile and earnings growth prospects of the underlying company) to the maintainable earnings of the company;
 - ii. adjust the amount derived in i above for surplus assets or excess liabilities and other relevant factors to derive an Enterprise Value for the company;
 - iii. deduct from the Enterprise Value all amounts relating to financial instruments ranking ahead of the highest ranking instrument of the Fund in a liquidation in order to derive the Gross Attributable Enterprise Value;
 - iv. apply an appropriate Marketability Discount to the Gross Attributable Enterprise Value derived in iii above in order to derive the Net Attributable Enterprise Value; and

v. **apportion the Net Attributable Enterprise Value appropriately between the relevant financial instruments.**

Guidance on the interpretation of underlined terms is given below.

"appropriate multiple"

32. A number of earnings multiples are commonly used, including price/earnings (P/E), enterprise value/earnings before interest and tax (EV/EBIT) and depreciation and amortisation (EV/EBITDA). The particular multiple used should be appropriate for the business being valued.
33. In general, because of the key role of financial structuring in private equity, multiples should be used to derive an Enterprise Value for the underlying business. Therefore, where a P/E multiple is used, it should generally be applied to a taxed EBIT figure (after deducting finance costs relating to working capital) rather than to actual after-tax profits, since the latter figure will generally have been significantly reduced by finance costs.
34. By definition, earnings multiples have as their numerator a value and as their denominator an earnings figure. The denominator can be the earnings figure for any specified period of time and multiples are often defined as "historical", "current" or "forecast" to indicate the earnings used. It is important that the multiple used correlates to the period and concept of earnings of the company being valued.

"reasonable multiple"

35. The Valuer would usually derive a multiple by reference to market-based multiples, reflected in the market valuations of quoted companies or the price at which companies have changed ownership. This market-based approach presumes that the comparator companies are correctly valued by the market. Whilst there is an argument that the market capitalisation of a quoted company reflects not the value of the company but merely the price at which "small parcels" of shares are exchanged, the presumption in these Guidelines is that the share price does correctly reflect the value of the company as a whole.
36. Where market-based multiples are used, the aim is to identify companies that are similar, in terms of risk attributes and earnings growth prospects, to the company being valued. This is more likely to be the case where the companies are similar in terms of business activities, markets served, size, geography and applicable tax rate. Where the underlying business is such that it is difficult to identify appropriate comparator companies, the Valuer may wish to obtain an independent valuation of the Investment by a suitably qualified expert.
37. In using P/E multiples, the Valuer should note that the P/E ratios of comparator companies will be affected by the level of financial gearing and applicable tax rate of those companies.



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38. In using EV/EBITDA multiples, the Valuer should note that such multiples, by definition, remove the impact on value of depreciation of fixed assets and amortisation of goodwill and other intangibles. If such multiples are used without sufficient care, the Valuer may fail to recognise that business decisions to spend heavily on fixed assets or to grow by acquisition rather than organically do have real costs associated with them which should be reflected in the value attributed to the business in question.
39. It is important that the earnings multiple of each comparator is adjusted for points of difference between the comparator and the company being valued. These points of difference should be considered and assessed by reference to the two key variables underpinning the earnings multiple – risk and earnings growth prospects. In assessing the risk profile of the company being valued, the Valuer should recognise that risk arises from a range of aspects, including the nature of the company's operations, the markets in which it operates and its competitive position in those markets, the quality of its management and employees and, importantly in the case of private equity, its capital structure and the ability of the Fund holding the Investment to effect change in the company. For example, the value of the company may be reduced if it:–
- is smaller and less diverse than the comparator(s) and, therefore, less able generally to withstand adverse economic conditions;
 - is reliant on a small number of key employees;
 - is dependent on one product or one customer;
 - has high gearing; or
 - for any other reason has poor quality earnings.
40. Recent transactions involving the sale of similar companies are sometimes used as a frame of reference in seeking to derive a reasonable multiple. It is sometimes argued, since such transactions involve the transfer of whole companies whereas quoted multiples relate to the price for "small parcels" of shares, that they provide a more relevant source of multiples. However, their appropriateness in this respect is often undermined by the following:
- the lack of forward-looking financial data and other information to allow points of difference to be identified and adjusted for;
 - the generally lower reliability and transparency of reported earnings figures of private companies; and
 - the lack of reliable pricing information for the transaction itself.

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41. It is a matter of judgement for the Valuer as to whether, in deriving a reasonable multiple, he refers to a single comparator company or a number of companies or the earnings multiple of a quoted stock market sector or sub-sector. It may be acceptable, in particular circumstances, for the Valuer to conclude that the use of quoted sector or sub-sector multiples or an average of multiples from a "basket" of comparator companies may be used without adjusting for points of difference between the comparator(s) and the company being valued.

"maintainable earnings"

42. In applying a multiple to maintainable earnings, it is important that the Valuer is satisfied that the earnings figure can be relied upon. Whilst this might tend to favour the use of audited historical figures rather than unaudited or forecast figures, it should be recognised that value is by definition a forward-looking concept, and quoted markets more often think of value in terms of "current" and "forecast" multiples, rather than "historical" ones. In addition, there is the argument that the valuation should, in a dynamic environment, reflect the most recent available information. There is therefore a trade-off between the reliability and relevance of the earnings figures available to the Valuer. On balance, whilst it remains a matter of judgement for the Valuer, he should be predisposed towards using historical (though not necessarily audited) earnings figures or, if he believes them to be reliable, forecast earnings figures for the current year.
43. Whichever period's earnings are used, the Valuer should satisfy himself that they represent a reasonable estimate of maintainable earnings, which implies the need to adjust for exceptional or extraordinary items, the impact of discontinued activities and acquisitions and forecast downturns in profits.

"appropriate Marketability Discount"

44. The notion of a Marketability Discount relates to an investment rather than to the underlying business, and paragraph 31(iv) therefore requires the discount to be considered and applied at the level at which the Fund begins to participate in the Enterprise Value of the investee company.
45. Marketability will vary from situation to situation and is a question of judgement. It should be noted that the Fair Value concept requires that the Marketability Discount is to be determined not from the perspective of the current holder of the Investment, but from the perspective of market participants.
46. Some of the factors the Valuer should consider in this respect are as follows:–
- the closer and more certain is a Realisation event for the Investment in question, the lower would be the Marketability Discount;



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- the greater the influence of the Fund over the timing of Realisation, nature of Realisation and Realisation process, the lower would be the Marketability Discount;
 - if the underlying company were not considered saleable or floatable at the reporting date, the questions arise of what has to be done to make it saleable or floatable, how difficult and risky that course of action is to implement and how long it is expected to take; and
 - the impact of stock market conditions and mergers and acquisitions activity levels on the ability to achieve a flotation or sale of the underlying business.
47. In assessing the influence of the Fund over the timing of Realisation, nature of Realisation and Realisation process, some of the factors the Valuer should consider are as follows:–
- Are there other like-minded shareholders with regard to Realisation and what is the combined degree of influence?
 - Is there an agreed exit strategy or exit plan?
 - Do legal rights exist which allow the Fund together with like-minded shareholders to require the other shareholders to agree to and enable a proposed Realisation to proceed?
 - Does the management team of the underlying business have the ability in practice to reduce the prospects of a successful Realisation? This may be the case where the team is perceived by possible buyers to be critical to the ongoing success of the business. If this is the case, what is the attitude of the management team to Realisation?
48. In determining the Marketability Discount appropriate in a particular situation, the Valuer should consider all the relevant factors. A discount rate in the range of 10% to 30% (in steps of 5%) should generally be used depending upon the particular circumstances. By way of illustration:–
- Where the Fund (together with like-minded shareholders with regard to Realisation) has legal rights and the ability in practice to initiate a Realisation process and require other shareholders to co-operate, or there is in place an agreed Realisation strategy, a discount rate of 10% may be appropriate.
 - Where the Fund (together with like-minded shareholders with regard to Realisation) does not have such a degree of influence over Realisation, possibly by virtue of holding a minority of the equity, but the other shareholders are not strongly opposed to a Realisation, a discount rate of 30% may be appropriate (NB. where a Realisation event is not foreseeable at all, perhaps because the Fund holds a minority equity stake and the majority shareholders are totally opposed to a Realisation, paragraph 23 above suggests

that methodologies which involve an assessment of the value of the business as a whole may not be appropriate).

- Where the Fund (together with like-minded shareholders with regard to Realisation) does not have the ability to require other shareholders to co-operate regarding Realisation, but there is regular discussion about Realisation prospects and timing by the board and/or shareholders, a discount rate of 20% may be appropriate.

"apportion the Net Attributable Enterprise Value appropriately"

49. The apportionment should reflect the respective amounts accruing to each financial instrument holder in the event of a sale at that level at the reporting date. Where there are ratchets or share options or other mechanisms in place which would be triggered in the event of a sale of the company at the given Enterprise Value at that date, these should be reflected in the apportionment.

Price of Recent Investment

50. Another option, which should be considered where there has been a recent investment in the company, is to base the valuation on the price of that investment. Where the Investment being valued was itself made recently, its cost will generally provide a good indication of value.
51. The validity of a valuation obtained in this way is inevitably eroded over time, since the price at which an investment was made reflects the effects of conditions that existed when the transaction took place. In a dynamic environment, changes in market conditions, the passage of time itself and other factors will act to diminish the appropriateness of this methodology as a means of estimating value at subsequent dates.
52. In addition, where the price at which a third party has invested in the company is the frame of reference for the Valuer, the motives of the third party (which may be largely strategic in nature) may serve to invalidate the methodology in the context of private equity investment valuation. Furthermore, if the absolute amount of the new investment is relatively insignificant, the price at which it was made may not be reliable as a frame of reference.
53. This methodology is likely to be appropriate for all private equity Investments, but only for a limited period after the date of the relevant transaction. Because of the frequency with which funding rounds are often undertaken in respect of businesses engaged in technological or scientific innovation and discovery, the methodology will often be appropriate for valuing Investments in such companies.
54. The length of period for which it would remain appropriate to use this methodology for a particular Investment will depend on the specific circumstances of the case, but a period of one year is often applied in practice.



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55. **In applying this methodology, the Valuer should use the cost of the Investment itself or the price at which a significant amount of new investment into the company was made by an independent third party to derive the Fair Value of the Investment, but only for a limited period following the date of the relevant transaction. During the limited period following the date of the relevant transaction, the Valuer should in any case assess whether changes or events subsequent to the relevant transaction would imply a change in the Investment's Fair Value.**
56. For example, a reduction in the Investment's Fair Value may have occurred for a number of reasons, including the following:–
- the performance and/or prospects of the underlying business are significantly below the expectations on which the Investment was based. Prima facie indicators of this include a failure to meet significant milestones or to service financial instruments, breaches of covenants and a deterioration in the level of budgeted/forecast performance;
 - there has been a significant adverse change either in the investee company's business or in the technological, market, economic, legal or regulatory environment in which the business operates; or
 - market conditions have deteriorated. This may be indicated by a fall in the share prices of quoted businesses operating in the same or related sectors.

Net Assets

57. This methodology involves deriving the value of a business by reference to the value of its net assets.
58. This methodology is likely to be appropriate for a business whose value derives mainly from the underlying value of its assets rather than its earnings, such as property holding companies and investment businesses.
59. This methodology may also be appropriate for a business that is not making an adequate return on assets and for which a greater value can be realised by liquidating the business and selling its assets. In the context of private equity, it may therefore be appropriate, in certain circumstances, for valuing Investments in loss-making companies and companies making only marginal levels of profits.
60. **In applying this methodology to estimate the Fair Value of an Investment, the Valuer should:–**

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- i. **derive an Enterprise Value for the company using appropriate measures to value its assets and liabilities (including, if appropriate, contingent assets and liabilities);**
 - ii. **deduct from the Enterprise Value all amounts relating to financial instruments ranking ahead of the highest ranking instrument of the Fund in a liquidation in order to derive the Gross Attributable Enterprise Value;**
 - iii. **apply an appropriate Marketability Discount to the Gross Attributable Enterprise Value derived in ii above in order to derive the Net Attributable Enterprise Value; and**
 - iv. **apportion the Net Attributable Enterprise Value appropriately between the relevant financial instruments.**

Guidance on the interpretation of underlined terms is given in the "Earnings multiple" section above.

Discounted Cash Flows or Earnings (of Underlying Business)

61. This methodology involves deriving the value of a business by calculating the present value of expected future cash flows (or the present value of expected future earnings, as a surrogate for expected future cash flows). The cash flows and "terminal value" are those of the underlying business, not those from the Investment itself.
62. The Discounted Cash Flows (DCF) technique is flexible in the sense that it can be applied to any stream of cash flows (or earnings). In the context of private equity valuation, this flexibility enables the methodology to be applied in situations that other methodologies may be incapable of addressing (e.g. when a business is going through a period of great change, such as a rescue refinancing or turnaround or strategic repositioning, or if it is making losses or is in its start-up phase).
63. The disadvantages of the DCF methodology centre around its requirement for detailed cash flow forecasts and the need to estimate the "terminal value" and an appropriate risk-adjusted discount rate. All of these inputs require substantial subjective judgements to be made, and the derived present value amount is often sensitive to small changes in these inputs. In assessing the appropriateness of this methodology, the Valuer should consider whether its disadvantages are such, in the particular circumstances, as to render the resulting Fair Value insufficiently reliable.
64. **In applying this methodology to estimate the Fair Value of an Investment, the Valuer should:–**



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- i. **derive the Enterprise Value of the company, using reasonable assumptions and estimations of expected future cash flows (or expected future earnings) and the terminal value, and discounting to the present by applying the appropriate risk-adjusted rate that quantifies the risk inherent in the company;**
 - ii. **deduct from the Enterprise Value all amounts relating to financial instruments ranking ahead of the highest ranking instrument of the Fund in a liquidation in order to derive the Gross Attributable Enterprise Value;**
 - iii. **apply an appropriate Marketability Discount to the Gross Attributable Enterprise Value derived in ii above in order to derive the Net Attributable Enterprise Value; and**
 - iv. **apportion the Net Attributable Enterprise Value appropriately between the relevant financial instruments.**

Guidance on the interpretation of underlined terms is given in the "Earnings multiple" section above.

Discounted Cash Flows (from the Investment)

65. This methodology applies the DCF concept and technique to the expected cash flows from the Investment itself.
66. In the context of private equity, where the period over which an Investment is held is typically relatively short, this methodology does not suffer the reduced reliability caused by the need to make cash flow forecasts over a long period of time. In addition, because private equity risk and the rates of return necessary to compensate for different risk levels are central commercial variables in the making of all private equity Investments, there exists a strong frame of reference against which to make discount rate assumptions.
67. There remains a need to estimate the "terminal value". Where the Investment comprises equity or a combination of equity and other financial instruments, the terminal value would usually be derived from the anticipated value of the underlying business at Realisation. This will usually necessitate making assumptions about future business performance and developments and stock market and other valuation ratios at the assumed Realisation date. In the case of non-equity instruments, the terminal value will usually be a pre-defined amount.
68. In circumstances where a Realisation is not foreseeable, the terminal value may be based upon assumptions of the perpetuity cash flows accruing to the holder of the Investment. These circumstances (which are expected to be rare in private equity) may arise where the Fund has

little ability to influence the timing of a Realisation and/or those shareholders that can influence the timing do not seek a Realisation.

69. This methodology, because of its flexibility, should be capable of being applied to all private equity investment situations. It is particularly suitable for valuing Investments in instruments such as debt or mezzanine debt, since the value of such instruments derives mainly from instrument-specific cash flows and risk rather than from the value of the underlying business as a whole.
70. Because of its inherent reliance on substantial subjective judgements, the Valuer should only use this methodology as a primary methodology in limited circumstances. The methodology will often be useful as a sense-check of values produced using other methodologies.
71. **In applying this methodology to estimate the Fair Value of an Investment, the Valuer should derive the present value of the Investment, using reasonable assumptions and estimations of expected future cash flows and the terminal value and date, and the appropriate risk-adjusted rate that quantifies the risk inherent to the Investment.**

Industry Valuation Benchmarks

72. A number of industries have industry-specific valuation benchmarks, such as "price per bed" (for nursing-home operators) and "price per subscriber" (for cable television companies). Other industries, including certain financial services sectors and some services sectors where long-term contracts are a key feature, use multiples of revenues as a valuation benchmark. These industry norms are often based on the assumption that investors are willing to pay for turnover or market share, and that the normal profitability of businesses in the industry does not vary much.
73. The use of such industry benchmarks is only likely to be reliable and therefore appropriate as a primary methodology in limited situations, and is more likely to be useful as a sense-check of values produced using other methodologies.

Quoted Instruments

74. Private Equity Funds may be holding Quoted Instruments for a number of reasons, including the following:–
- a business in which the Fund is invested has achieved a flotation on a stock market;
 - a business in which the Fund was invested has been acquired by a quoted company, with the consideration comprising Quoted Instruments in the acquiring company; and
 - the Fund may have acquired securities in a quoted company with a view to making a bid for it.



75. A Quoted Instrument should be valued at its market price according to the recognised conventions of the market on which it is quoted; but reduced by a Marketability Discount where:

- i. there is a risk that the holding may not be able to be sold immediately; or**
- ii. there is a formal restriction on trading in the relevant securities.**

76. For certain Quoted Instruments there is only one market price quoted, representing, for example, the value at which the most recent trade in the instrument was transacted. For other Quoted Instruments there are two market prices at any one time: the lower "bid" price quoted by a market maker, which he will pay an investor for a holding (i.e. the investor's disposal price), and the higher "offer" price, which an investor can expect to pay to acquire a holding. A third price basis for valuation purposes, as an alternative to either bid or offer, is the mid-market price (i.e. the average of the bid and offer prices). Where a bid and offer price exists, the bid price should be used, although the use of the mid-market price will not usually result in a material overstatement of value.

77. In determining the level of Marketability Discount to apply under paragraph 75 (i) above, the Valuer should generally consider the size of the holding in relation to normal trading volumes in that security. In this context, the following levels of discount should generally be used:–

Number of days trading volume	Discount %
Up to 20	0
20 to 50	10
50 to 100	20
100+	25

Occasionally, it may be inappropriate to consider marketability by reference to trading volumes. For example, where the quoted entity has a stated intention of seeking a buyer and there is a reasonable expectation of a sale of the entity in the six months following the reporting date at a price representing a bid premium, it may be appropriate in the particular circumstances for the Valuer to conclude that the positive bid premium effect offsets the negative marketability effect, such that the undiscounted market price is on balance a reasonable estimate of Fair Value.

78. In determining the level of Marketability Discount to apply under paragraph 75 (ii) above, the Valuer should consider the extent of compensation a holder would require when comparing the Investment in question with an identical but unrestricted holding. In the case of a six-month lock-

up period, a discount of 20% to the market price should generally be used at the beginning of the period, reducing to zero at the end of the period.

79. Whilst it is a matter of judgement for the Valuer, where a holding is, at the reporting date, both subject to a formal restriction on trading and also significant in relation to normal trading volumes in that security, the discount applied to the holding should be the higher of the two that would be considered appropriate in each of the circumstances in isolation.
80. As regards paragraphs 77 to 79 above, if a different level of discount is appropriate in light of the particular circumstances of an Investment, the Valuer should use that rate and should disclose the fact that he has done so together with the rationale for so doing.

Disclosure

81. **Disclosure should be made, in respect of the Fund, of the following:–**
- **the carrying amount and cost at the reporting date and the previous reporting date of the investment portfolio as a whole and of each significant class of Investment;**
 - **if the carrying amounts above include any Investments held other than at Fair Value (because Fair Value cannot be reliably measured), that fact, together with a description of the Investments, their carrying amount and an explanation of why Fair Value cannot be measured reliably;**
 - **a description of the methodologies and significant assumptions made in estimating Fair Value for each significant class of Investment (and, where non-primary methodologies have been used, the rationale for so doing);**
 - **a description of significant changes from the prior reporting date in either methodologies or significant assumptions;**
 - **the extent to which the change in the value of the portfolio since the prior reporting date or, in the case of Investments made during the current reporting period, since the date of investment is due to foreign currency translation differences;**
 - **in respect of Quoted Instruments, if Marketability Discount rates different from those specified in paragraphs 77 to 79 above have been used, that fact together with the rationale for so doing;**



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- a statement of compliance with these Guidelines, clearly highlighting any areas of non-compliance; and
 - a description of the valuation review procedures applied.
82. Insofar as it is not limited by constraints of confidentiality and commercial sensitivity, disclosure should be made, in respect of each significant Investment, of the following:–
- the carrying amount at the reporting date and the previous reporting date and the cost, each analysed by financial instrument;
 - if the carrying amount does not represent Fair Value (because Fair Value cannot be reliably measured), that fact and an explanation of why Fair Value cannot be measured reliably;
 - the proportion of the company's equity held by the Fund;
 - the date of investment by the Fund;
 - the valuation methodology used, together with significant assumptions (and, where a non-primary methodology has been used, the rationale for so doing);
 - changes from the prior reporting date in either valuation methodology or significant assumptions;
 - the extent to which the change in value of the Investment since the prior reporting date or, in the case of Investments made during the current period, since the date of investment is due to foreign currency translation differences; and
 - in respect of a Quoted Instrument, if a Marketability Discount rate different from those specified in paragraphs 77 to 79 above has been used, that fact together with the rationale for so doing.
83. A significant Investment is an Investment that either has a carrying amount exceeding five per cent of the carrying amount of the Investment portfolio as a whole or is one of the largest 10 Investments ranked by carrying amount or is significant for some other reason.
84. Illustrative excerpts from a report to investors containing the disclosure information set out above is given in Appendix 1.

Date from which Effective

85. These Guidelines should be regarded as superseding the BVCA's Guidelines for the Valuation and Disclosure of Venture Capital Portfolios with effect from 1 July 2003.

Appendix 1 – Illustrative Disclosures

This appendix contains illustrative excerpts from a report to investors containing the disclosure information set out in paragraphs 81 and 82 of the Guidelines.

Valuation Methodologies

A summary of the valuation methodologies applied by the Fund is set out below. The Fund's valuations comply with the Valuation Guidelines of the British Venture Capital Association.

Investments are stated at their estimated fair value. Where fair value cannot be estimated reliably, investments are stated at their brought forward carrying value less any estimated impairment.

Fair value is estimated using the methodologies described below.

Unquoted Investments

- a. New investments are valued at cost for a period of twelve months following the date of investment. However, if changes or events subsequent to the date of investment (for example, a significant change in the market in which the business operates) indicate that value may have increased or decreased, then value is estimated using one of the methodologies below.
- b. Investments in businesses that have raised a significant amount of external new equity finance in the twelve months before the reporting date are valued at the price at which the finance was raised. However, if changes or events subsequent to the date finance was raised (for example, a significant change in the market in which the business operates) indicate that value may have increased or decreased, then value is estimated using one of the methodologies below.
- c. Where a realisation or flotation is imminent at the reporting date and the associated pricing has been substantially agreed, the investment is valued at a discount of 10% to the estimated realisation proceeds or flotation value, as appropriate.

Where neither **a**, **b** nor **c** above apply, the following methodologies may be used to estimate fair value.

- d. Investments in property or investment businesses and businesses (other than technology businesses) which are loss-making or only marginally profitable are valued on a net assets basis, applying a marketability discount (see **g** below) to the Fund's share of net assets.
- e. Technology investments which are loss-making or only marginally profitable are valued in accordance with **a** and **b** above even beyond the initial twelve month period.
- f. Investments in businesses with a significant level of maintainable profits are valued using the earnings multiple methodology, as follows:–



- A suitable multiple is derived by reference to the multiples of comparative quoted companies or recent transactions involving the transfer of similar businesses. The multiple chosen may be the P/E (price/earnings), EV/EBIT (enterprise value/earnings before interest and tax) or EV/EBITDA (enterprise value/earnings before interest, tax, depreciation and amortisation).
 - The multiple is applied to the maintainable earnings of the investment's business. The earnings used are generally those for the most recent historical period or, where they are considered to be reliable, those forecast for the current accounting period.
 - The value derived above is adjusted to reflect factors specific to the business, such as the existence of surplus assets or liabilities.
 - The resulting enterprise value is then reduced to reflect amounts relating to financial instruments (such as bank debt) ranking ahead of the Fund's investment in the company. This adjusted enterprise value is then reduced by applying a marketability discount (see **g** below), before being apportioned amongst the various financial instruments in accordance with relevant legal provisions.
- g.** Marketability discounts of between 10% and 30% (in steps of 5%) are applied in the case of **d** and **f** above. In assessing the appropriate discount rate in a particular case, factors such as the anticipated timing of realisation, the existence of an agreed exit strategy or plan, the extent of influence over exit and the attitude and importance to the ongoing success of the business of the incumbent management team are considered.

Quoted Investments

Quoted equity investments are valued at the closing market price at the balance sheet date. Where a bid-offer spread is quoted, bid prices are used. However, where there are dealing restrictions in place over the quoted securities held, a discount of up to 20% is applied to the market price, reducing to zero at the end of the restricted period. Discounts are also applied to the market price where the holding represents more than 20 days of normal trading volume in the relevant security, at the following levels:–

Number of days trading volume	Discount %
Up to 20	0
20 to 50	10
50 to 100	20
100+	25

Portfolio Analyses

Analyses of the Fund's portfolio of investments as at 31 December 2002 and 30 June 2002 are shown below.

i. By geography (£m)

	31 Dec 2002 Valuation Cost	30 June 2002 Valuation Cost
UK		
Germany		
France		
Other		

ii. By product (£m)

	31 Dec 2002 Valuation Cost	30 June 2002 Valuation Cost
Management buy-outs		
Early stage technology investments		
Growth/development capital		

Of the aggregate carrying value of £ at 31 December, 2002, £ is not carried at fair value. This relates to investments in certain early stage technology companies where fair value could not be reliably measured because of the difficulty of estimating future cash flows and assessing the probabilities of the various outcomes for the products in development. For these investments, the carrying value at 31 December, 2002 is the carrying value at 30 June, 2002 adjusted for estimated impairments.

The growth in the value of the portfolio between 30 June and 31 December includes £ in respect of foreign currency translation differences arising on the translation of non-sterling denominated investments into sterling.

Valuation Review Procedures

The valuation of investments is carried out by the investment executive with portfolio responsibility for the investment. Valuations are subsequently reviewed by the Valuations Adviser, who has responsibility both for reviewing valuations and for summarising and reporting on valuations to the Valuations Committee. The Valuations Committee (whose members are) is convened every six months to review and approve the six-monthly valuations.



Significant Investments

The Fund's significant investments as at 31 December 2002 are as follows:

Investment	Date Invested	Cost (£m)	Equity %	Valuation (£m)	
				Dec 02	Jun 02
Company A	1998				
– equity shares		12	80	116	102
– shareholder loans		38		38	38
		50		154	140

Company A has been valued using the earnings multiple methodology. An EV/EBIT ratio of 7.2 has been applied to estimated earnings for the year to 31 December, 2002. A marketability discount of 10% has been used.

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