Chapter 1

Overview of the Private Equity and Venture Capital Industry and Its Investment Strategies

Introduction

1.01 This chapter provides an overview of the private equity (PE) and venture capital (VC) industry, common strategies, structures and terms of its investment funds, and is intended to provide context for other chapters in this guide. Other investment companies, such as certain *business development companies (BDCs)*, real estate funds and hedge funds, and other noninvestment companies, such as corporate VC groups or pension funds, make investments in similar types of portfolio companies and pursue strategies consistent with those described in this chapter. When making these types of investments, these other investment companies and noninvestment companies employ similar strategies as the more typical PE and VC companies. As a result, although the legal structures of these companies may differ from *private equity fund* and *venture capital fund* structures, the background presented in this chapter may have relevance for these other companies in the subset of their portfolio that pursues similar strategies. The PE and VC business model is particularly illustrative of the motivations of investors in these types of interests and the types of strategies these investors pursue. These funds and other investment companies and other noninvestment companies (when required to report investments at *fair value*) face similar issues in valuing long-term investments in accordance with FASB *Accounting Standards Codification* (ASC) 820, *Fair Value Measurement*.

1.02 *Private equity* is a term often used to refer to illiquid *closed-end funds*, which are offered only to sophisticated investors (for example, "accredited" or "qualified" investors, which are terms defined in SEC regulations; see the "Investor Base" section in paragraphs 1.28–.38 of this chapter for further discussion). *Venture capital* generally refers to a form of PE investing focused on early-stage and start-up companies, with early investments in these companies often occurring before they have revenues. Later-stage PE investing would include pre-IPO, *growth investing* or expansion capital, *roll-up strategies*, or management buyout (MBO), management buy-in (MBI), or *leveraged buyout (LBO)* of more mature companies, and private debt. Not all investment companies that make these types of investments are closed-end funds. In an *open-end fund*, the fund generally allows limited partners (LPs) to withdraw their capital from the fund via redemptions. Typically, these redemptions are made at the fund's reported net asset value (NAV), which reflects the fair value of the fund's investments and the carrying value of other assets, less the carrying value of the fund's liabilities.

1.03 Funds are often classified based upon their typical investment strategy or sector focus. In general, the only limitation on the types of investments a PE and VC fund can make would be in the fund's organizational documents (most likely in the limited partnership agreement for the fund). As a result, a fund could have a narrow mandate (such as early-stage North American health care opportunities), or it could have a broad mandate (such as global private equity and special situations). In the former category, the fund might invest in early-stage medical devices or biotechnology companies. In the latter category, the fund might enter into a negotiated transaction to buy a 10% interest in a large, publicly traded U.S. company (a so-called *private investment in public equity (PIPE) transaction*) and, at the same time, it might invest in a technology start-up in a developing country.

1.04 For the most part, PE and VC funds invest in equity and debt instruments of portfolio companies. The fund's investment adviser or sponsor often provides board-level oversight but is unlikely to be actively engaged in day-to-day operations.

1.05 As PE and VC funds often have terms that last for 10–12 years or longer, and the development of the fund's investments may take an extended period before they can be sold or distributed, the profile of the fund and its investments may change over time. Some companies in the portfolio may have gone public or merged into other companies, and the fund may continue to hold shares of publicly traded companies for an extended period. Alternatively, what was originally acquired as a start-up company in a unique sector may, over time, become a more mature company in a crowded sector. Similarly, a fund investing in *mezzanine debt* may end up owning a significant portion of a portfolio company's equity following a debt restructuring. Therefore, from the perspective of valuation, it is important to employ valuation approaches and techniques that are appropriate and consistent with market participant assumptions for each specific investment and not presume that the type of fund or its mandate should restrict the types of valuation approaches or techniques to be used.

1.06 Regardless of strategy, the objective that PE and VC funds generally have in common is to obtain a high rate of return over what might be an extended but finite period of time. Although certain types of instruments may provide for an interest rate or a dividend rate, rarely is a fund seeking to monetize its investment solely through the receipt of periodic interest or dividends. Ultimately, the fund will typically monetize an equity investment through a *liquidity event* for the business (sale of the whole business or sale of the shares held over the period following an initial public offering *[IPO]*) and will typically monetize a debt investment either through repayment upon maturity or via acceleration upon a change of *control* for the business.

1.07 Unlike corporate conglomerates that may operate several related or unrelated businesses, PE and VC funds are unlikely to manage a portfolio company on an integrated basis with other companies in its portfolio. Although there may be some opportunities to cross-sell or collaborate within the network of the fund sponsor,[1] because each portfolio company is likely to be positioned for sale during the *investment period*, each portfolio company is generally a freestanding entity with a management team that operates independently of the fund and other portfolio companies.

1.08 Because the fair value of many PE and VC fund investments depends on level 2 or level 3 inputs, when market information is limited, valuation of investments held by these funds generally presents significantly more challenges than valuation of investments held by mutual funds, hedge funds, and other types of investment companies that invest principally in publicly traded securities. Furthermore, even though investors in PE and VC funds may ultimately

[1] Frequently, terms like *fund sponsor* are used in a nonlegal sense to be synonymous with a collection of entities that include general partner, fund manager, management company, private equity (PE) firm, venture capital (VC) firm, and their various *affiliates*.

be more focused on overall fund performance (particularly in the case of a well-diversified portfolio), each of the investments that make up the fund's NAV is required to be measured at fair value separately.[2] As a result, it is important to consider specific relevant facts and circumstances that have a bearing on each portfolio company's valuation and the value of the specific interests held by the fund.

1.09 FASB ASC 820-10-05-1B states that "the objective of a fair value measurement ... is ... to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions." Therefore, it is essential to understand the perspective of potential *market participants* (both buyers and sellers) for the portfolio company investment held by the fund to determine the fair value. However, the specific interests held by the fund and the rights associated with them are often integrally tied to the fund's strategy for the portfolio company. As such, it is helpful to gain perspective on PE and VC funds and their strategies to provide context for the valuation.

1.10 In practice, many PE and VC funds determine fair value of their *portfolio company investments* internally. Regardless of whether fair value measurements are estimated internally by fund management or with the assistance of an external third party, fund management is ultimately responsible for the fair value measurements that are used to prepare the fund's financial statements and for the underlying assumptions used in developing these fair value measurements. Practitioners are expected to understand how the valuation techniques used for measuring fair value comply with the requirements of FASB ASC 820; assess reasonableness of the inputs, assumptions, and valuations; and evaluate adequacy of the related disclosures.

1.11 The ability to assess the valuation of a fund's portfolio company investments can be enhanced by understanding the perspective of the current investor (that is, the fund) because it would allow one to (*a*) gain insight into the strategic outlook and prospects for the portfolio company; (*b*) understand the fund's internal processes and assess how it underwrote the initial investment; (*c*) leverage the fund's monitoring and technical capabilities, capital markets expertise, and track the progress from the initial underwriting; and (*d*) better understand the motivations behind development of the portfolio company's capital structure. By understanding the fund manager's strategies, outlook, and motivations, one can better assess the fund manager's perspective as well as gather data from a perspective that is independent from the portfolio company's management. Understanding the fund's perspective would also allow one to evaluate the extent to which business performance and future strategic value are dependent upon performance of current portfolio company management as well as to assess the strategic value to a potential buyer of retaining the existing management team in the context of a change in control transaction.

1.12 In addition, PE and VC funds are market participants for other investments in private company interests. As a result, when considering valuations of one PE or VC fund, it is helpful to be knowledgeable about the PE and VC industry, how it operates, and what types of strategies are typically

[2] See chapter 4, "Determining the Unit of Account and the Assumed Transaction for Measuring the Fair Value of Investments," which addresses unit of account and the methods for aggregating and grouping individual debt or equity instruments in the context of determining the fair value of the *portfolio company investments*.

employed. If, for example, a VC fund has an early-stage company in its portfolio that has had a successful product introduction but has reached the point where it needs a large amount of additional capital to build out its production, sales, and distribution functions, such portfolio company may be of interest to a growth-oriented PE fund. Understanding the perspective of a PE firm that may invest in such a portfolio company may help to value it.

1.13 The remainder of this chapter is devoted to providing a background on the PE and VC industry, its structure, strategies, and objectives. Specific attention is given to those aspects that are most relevant for valuations of portfolio company investments.

Investment Strategies and Portfolio Company Life Cycle

1.14 A helpful framework for evaluating PE and VC fund investment strategies is the stage of development of the portfolio company. Although there may be multiple dimensions to the investment strategy, stage of development is a key differentiator between the PE fund and VC fund investment strategies. VC funds generally pursue an investment strategy of investing in earlier stage enterprises. Other funds often pursue an investment strategy of investing in expansion and later-stage enterprises.

1.15 The typical stages of development for many portfolio companies are characterized in the following table.

Table 1-1[3]

Stage	***Description***
1	Portfolio company has no product or service revenue to date and limited expense history and, typically, an incomplete management team with an idea, a plan, and possibly some initial product development. Typically, *seed capital*, or first-round financing, is provided during this stage by friends and family, *angels*, or venture capital firms focusing on early-stage portfolio companies, and the interests issued to those investors are occasionally in the form of common stock but are more commonly in the form of preferred stock.
2	Portfolio company has no product or service revenue but substantive expense history because product development is under way, and business challenges are thought to be understood. Typically, a second or third round of financing occurs during this stage. Representative investors are venture capital firms, which may provide additional management or board of directors expertise. The typical interests issued to those investors are in the form of preferred stock.

[3] This table is consistent with table 2-1 in the AICPA Accounting and Valuation Guide *Valuation of Privately-Held-Company Equity Securities Issued as Compensation*, except for minor editorial differences. This table presents six stages of development. Other sources may indicate different numbers of stages.

Stage	*Description*
3	Portfolio company has made significant progress in product development; key development milestones have been met (for example, hiring of a management team); and development is near completion (for example, *alpha* and *beta testing*), but generally, there is no product revenue. Typically, later rounds of financing occur during this stage. Representative investors are venture capital firms and strategic business partners. The typical interests issued to those investors are in the form of preferred stock.
4	Portfolio company has met additional key development milestones (for example, first customer orders or first revenue shipments) and has some product or service revenue, but it is still operating at a loss. Typically, *mezzanine financing* rounds occur during this stage. Also, it is frequently in this stage that discussions would start with investment banks for an initial public offering (IPO).[1]
5	Portfolio company has product or service revenue and has recently achieved breakthrough measures of financial success, such as operating profitability or break-even or positive cash flows. A *liquidity event* of some sort, such as an IPO or a sale of the portfolio company, could occur in this stage. The form of securities issued is typically all common stock, with any outstanding preferred converting to common upon an IPO (and perhaps also upon other liquidity events).[2]
6	Portfolio company has an established financial history of profitable operations or generation of positive cash flows. Some portfolio companies may remain private for a substantial period in this stage.[3] An IPO could also occur during this stage.[4]

1 The actual stages during which liquidity events occur or discussions with investment bankers for an IPO take place depend upon several factors. Those factors include, for example, the state of the economy, investor sentiment, and the state of the IPO market.

2 See table note 1.

3 Almost all venture-capital- and private-equity-backed companies will ultimately seek liquidity through an IPO or sale of the company. Some portfolio companies (for example, family-owned or other closely held companies) may intend to remain private indefinitely. Such portfolio companies typically have simpler capital structures, and their interests may be valued using simpler methodologies. See chapter 7, "Valuation of Equity Interests in Simple Capital Structures."

4 See table note 1.

Portfolio companies in the life sciences industries (for example, biotech, medical devices, and so on) have certain differences in their stages of development, illustrated in the following table:

Table 1-2[4]

Stage	*Description*
1. Discovery	Portfolio companies that are involved in basic research. The result is a basic discovery, which may have commercial viability. An example of a basic discovery for a biotech venture would be achieving an understanding of the mechanism of action for a disease, a "druggable" target inside the body that might be able to affect that mechanism of action, and/or a class of molecules that might be able to affect that target.
2. Preclinical Development	The portfolio company starts commercialization when a compound or device is advanced to a state where it is ready to test with humans or, in the case of medical devices, with animals.
3. Clinical Testing	The portfolio company is testing the substance or device in humans. This typically happens in four clinical phases. There are significant regulatory hurdles to overcome before entering each new phase. Phase I generally tests for the safety of the drug/device by evaluating pharmacokinetic parameters and tolerance, generally in volunteers who are oftentimes already ill. Phase II tests for efficacy and side effects in a small sample population. Phase III tests for safety and efficacy in larger populations. At this point, if safety and efficacy have been shown to meet certain standards, the regulatory agencies will approve the drug or device for sale and general use. The final phase — phase IV — monitors the real-world effectiveness of a drug during an observational, non-interventional trial in a naturalistic setting.
4. Post-clinical marketing	The portfolio company's activities here will focus on marketing the drug or device to patients and clinicians.

Stages 5–6 are similar to those described in table 1-1.

The preceding tables are illustrative of stages of development. It is very common for investors to use their own tailored versions of portfolio company stages of development that are consistent with their investment philosophy.

1.16 A portfolio company may go through other stages that are not mentioned in tables 1-1 or 1-2. Some product development cycles include extensive prototyping during development and may have more than the six stages described in the tables. Moreover, not every portfolio company will necessarily go through every stage. For example, a portfolio company may develop a software product very quickly and proceed directly to production, rather than subjecting the product to extensive testing, or a portfolio company may remain private for

[4] Chapin, David, "Entering the Life Science Market – Part 1: Eight Things You Should Know," www.formalifesciencemarketing.com/white-papers/entering-life-science-market-part-1/, accessed January 28, 2019.

a substantial period in stage 6, establishing operating and financial stability. Many such portfolio companies, however, eventually undergo an IPO.

1.17 As noted previously, VC funds typically pursue a strategy of investing in earlier stage enterprises (stages 1, 2, and 3). Early-stage enterprises often invest heavily in product development with little to no offsetting revenue and, as a result, may generate significant negative cash flow (often referred to as *cash burn*). Early-stage enterprises may also be subject to a high risk of failure because the product or service is often unproven and subject to risk of successful development, regulatory approval, commercialization, and financial feasibility. A VC fund will often manage the risk of cash burn and high risk of failure by making investments in a particular portfolio company through multiple rounds of financing and investing, along with several participants.

1.18 The VC funding model rarely involves a portfolio company raising enough money in the very early stages to fund the business fully until profitability. Investing through multiple rounds allows the VC fund to manage the cash burn risk by ideally providing just enough funds to allow the portfolio company to operate through a targeted milestone or stage of development. The portfolio company will seek to invest these funds in product development, marketing or other activities, such that value will be created equal to or in excess of the investment. The VC fund will monitor the portfolio company's progress. At the time of the next financing round, the VC fund is able to reassess the portfolio company's progress, the feasibility of the business plan, and the prospects for successful exit. Based on this assessment, the VC fund can then decide whether to continue investing. Managing the cash burn is important because the VC fund will want to avoid a situation in which the portfolio company runs out of cash before achieving the targeted milestones or stage of development and next round of financing. In addition, the VC fund will have the opportunity to negotiate terms based on the perceived change in value since the last round. Often, the investors in each round will be different, and the rounds will be negotiated independently.

1.19 VC funds will normally seek to invest in portfolio companies that, if successful, have the opportunity to provide significant returns but, as mentioned previously, may also be subject to a high risk of failure. The high risk of failure can be managed through diversification which, given a particular VC fund's finite amount of investable capital, is achieved by making multiple investments in numerous portfolio companies. These investments are enabled by investing alongside other participants. Due to the possibility of significant returns if successful and the high risk of failure, VC funds may experience losses on a majority of their portfolio company investments but still provide positive overall returns as a result of extraordinary returns on a small number of investments. Although diversification is a key factor in managing risk, VC funds may focus on investing in portfolio companies in a particular industry (for example, biotech) or with another similar theme, providing the opportunity for the LPs to focus their investments and leveraging the strengths of each specific fund manager.

1.20 As a portfolio company progresses through stages 4 and 5, the focus changes from cash burn to revenue growth, and investments often occur in the form of mezzanine financing or buyouts by PE funds. Funds focusing on later-stage investments (stages 5 and 6) may consider investment strategies such as the following:

- Identifying undervalued companies or capitalizing on market dislocation (capitalizing on information advantage or asymmetry)
- Roll-up or acquisition strategies (building economies of scale, consolidating fragmented markets, vertical integration, adding complimentary products or services, and so on; PE fund will invest with the intent of making additional equity investments to fund acquisitions)
- Management improvement or cost savings (focusing on operational effectiveness, revenue growth, refocusing the company's strategy)
- Turn-arounds (acquiring underperforming businesses)
- *Corporate carve-outs* (buying businesses divested from a corporation; these funds need to be prepared to develop the infrastructure necessary for the carved-out entity to operate independently)

1.21 A common general theme in the investment strategies described in the preceding paragraph is that the fund will seek higher returns through a combination of portfolio company growth and profitability improvement. The fund will focus on investing in portfolio companies that have a path toward a successful exit. In contrast to VC funds, a PE fund investing in later-stage companies may be the sole, or at least the majority, investor in most of its portfolio company investments and may use debt to finance a significant portion of the acquisition. Funds that have a significant stake in a given portfolio company will often actively work with the portfolio company management team and co-investors to develop the strategic plan and monitor performance at any stage of the portfolio company's life cycle.

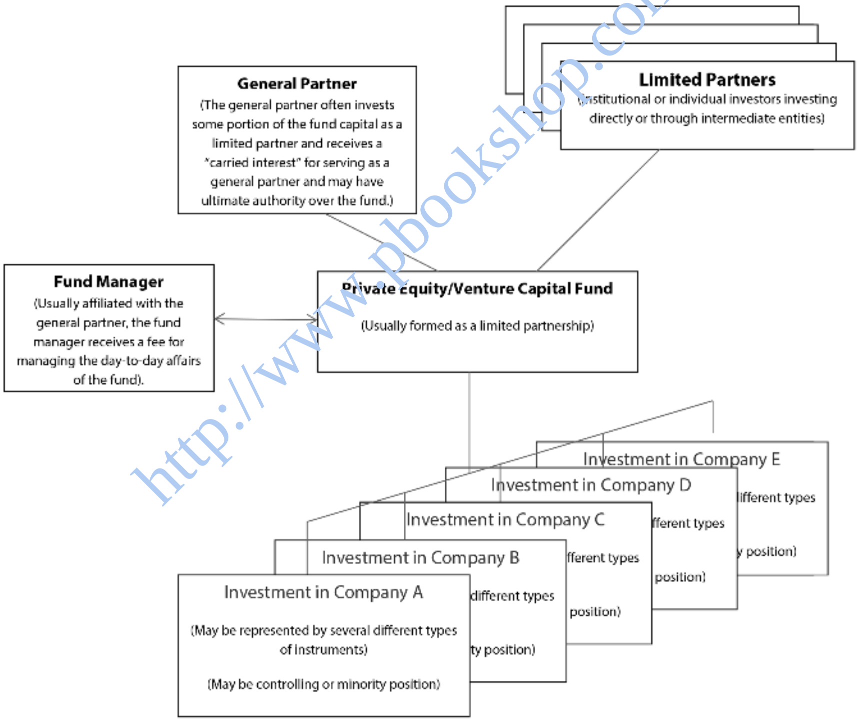
Typical Fund Structures and Role of Fund Manager

Fund Entity (Limited Partnership) — The Investment Company

1.22 A PE or VC fund is typically formed as a limited partnership (or family of limited partnerships) with the general partner (GP) (which has investment discretion over the fund assets) being an *affiliate* of the fund manager and the LPs principally including sophisticated investors who, in their capacity as LPs, take no part in the active management of the fund. LPs generally make capital commitments to fund their investment amounts over time as needed to be drawn over the fund's investment period (typically 4–6 years). The fund life is generally 10–12 years but can be extended for an additional year or more if necessary for an orderly wind-down of the fund.

1.23 The fund itself typically has no employees. The fund manager is generally charged with identifying investment opportunities, structuring and negotiating transactions, monitoring the investments, providing ongoing oversight and strategic direction to each portfolio company (which often includes serving on the portfolio company's board of directors), consulting on operational matters, making introductions across the fund manager's network, advising on capital markets and debt capital considerations, and planning and executing appropriate exit transaction strategies for the fund. The fund manager is usually responsible for performing (or managing) all administrative functions for the fund (accounting, cash management, custody, investor reporting, risk management, and so on). In some circumstances, the fund manager or an affiliate may provide additional services directly to the portfolio company. These services may be provided pursuant to a separate service arrangement for which fees are charged to the portfolio company, or the arrangement may be less formal or without compensation.

1.24 The following diagram depicts a common simplified structure for a PE or VC fund, its investors, and fund management. There may be many variations on this structure. Frequently, what is referred to commercially as a *fund* may actually be a grouping of a number of separate limited partnerships that generally invest together on a pro rata basis. Each separate limited partnership in such a structure may have been formed to address specific, relatively minor legal, regulatory, or commercial distinctions between investors or groups of investors, but they generally maintain a relatively consistent allocation of investment opportunities between the entities that collectively comprise the "fund." In addition, some larger investors negotiate with certain fund sponsors to create a managed account. A managed account allows the investor to customize fee structures and investment strategies. For practical purposes, a managed account that has a single LP investor can be viewed as a "fund."



Compensation, Fund Management Fees, and Carried Interest

1.25 The fund manager usually receives a management fee for its administrative responsibilities associated with investing and monitoring fund activities. Commonly, the fee is based upon a percentage of capital commitments or investment cost, typically measured based on the committed capital during the period that the fund is investing and based on the fund's remaining invested capital following the investment period (for example, the cost basis for the investments still outstanding). The actual percentages and basis for calculating the fee are among the terms negotiated during the process of raising the fund; these terms are set in the initial organizational documents of the fund and the fund management agreement. In situations in which the fund manager or an affiliate receives additional fee income from portfolio companies, the organizational documents often stipulate whether and to what extent a portion of the fee income is applied to reduce the management fee during the fund's life.

1.26 The GP usually receives a share of the profits (most commonly determined after expenses and, in some cases, subject to a *hurdle rate* or *preferred return*). These payments may be subject to a *waterfall*, which represents a priority of distributions between the GP and the LPs. These payments are commonly referred to as the *carried interest* in most PE and VC funds and as *performance fees* in most hedge funds.

1.27 Understanding the terms of the fund and the relative performance of the fund can be helpful in understanding the financial incentives of the fund manager and GP. The fund manager's revenues usually depend on its success in raising capital, and the fund manager will typically invite the LPs in the current fund to participate in the next fund. In many cases, LPs evaluate the fund manager based on the *internal rate of return (IRR)* of the fund manager's prior funds as well as the *multiple of invested capital (MOIC)* generated by the fund. The IRR calculation for unrealized investments would generally assume that the remaining investments were sold at fair value on the date through which the IRR is calculated. The GP's distributions usually depend directly on the performance of the fund. For funds with a hurdle rate or a preferred return, the IRR calculation against which the fund is measured usually is also used to determine whether the GP has satisfied the fund's waterfall criteria to receive carried interest distributions.

Investor Base

1.28 As discussed further in chapter 3, "Market Participant Assumptions," PE and VC funds generally target rates of return that exceed the public equity market benchmarks. Higher rates of return are required to compensate investors for the lack of liquidity and the generally greater risk profile of investments these funds make.

1.29 As a result of the illiquidity and the perceived additional risk of private equity and venture capital, there are regulatory restrictions that limit investors in private unregistered funds to sophisticated investors. Accordingly, most investors in PE and VC funds are institutional investors, such as corporate and public pension funds, insurance companies, sovereign wealth funds, development finance institutions, endowment funds, and funds of funds. Family offices and high-net-worth individuals also frequently invest in PE and VC funds.

Defined Benefit Pension Plans

1.30 Some corporate employers and numerous public entities (such as state and local governments) provide defined pension benefits to their employees. Defined benefit plans provide a guaranteed fixed payment to retirees who are vested in the plan. The amount of guaranteed benefit for each vested employee is typically determined based on the employee's highest or most recent level of compensation, age at retirement, and years of service. The employer, not the employee, makes the investment decisions and bears the investment risk. Making decisions for a large pool of employees, however, gives the employer more flexibility when deciding what types of investments to choose and how to allocate them to meet the plan's short- and long-term payment obligations. Larger defined benefit plans with significant long-term payment obligations may look to PE and possibly VC funds to be a part of a diversified portfolio, with the goal of achieving overall long-term returns sufficient to meet the plan's obligations. Because of the need to diversify and manage risk, defined pension plans typically allocate only a portion of their assets to PE and VC funds.

1.31 The largest investors in PE and VC funds are state and municipal pension plans and non-U.S. governmental pension plans that benefit public employees. In the private sector, given the continued shift away from defined benefit plans in favor of defined contribution plans, corporate pension funds are becoming a smaller portion of the investor base for PE and VC funds.

Sovereign Wealth Funds

1.32 Global sovereign wealth funds are also significant investors in PE and VC funds. These investors have capital from reserves and government surpluses that government agencies have set aside to meet future governmental obligations. Sovereign wealth fund assets and total investments in the PE and VC asset class have been increasing rapidly; therefore, these investors represent an increasing share of the capital raised by many fund managers. Many sovereign wealth funds also have dedicated teams devoted to PE and VC investment, and several have developed their programs to the point of making direct investments in PE and VC portfolio companies or have become directly competitive within the PE and VC landscape.

Development Finance Institutions

1.33 *Development finance institutions* are institutions and development banks or subsidiaries set up to provide risk capital to private sector development in developing countries. They are often majority-owned by national governments or charitable institutions and source their capital from national or international development funds or benefit from government guarantees. This improves their creditworthiness, which enables them to raise larger amounts of money on international capital markets and provide financing with more competitive terms. Development finance institutions facilitate the establishment of PE markets in the developing world.

Endowment Funds

1.34 Endowment funds established by universities or charitable entities are principally concerned with providing the institution with a source of stability and long-term financial strength to meet the institution's obligations well into the future. Given their long-term investment horizon, these investors also often find the PE industry attractive.

High-Net-Worth Individuals and Family Offices

1.35 As a result of the regulatory restrictions requiring private placements of PE and VC funds to be made only to sophisticated investors (see the "Investor Base" section of this chapter for further discussion), individuals who invest in PE and VC funds generally need to have substantial net worth and sufficient liquid net worth. These restrictions are intended to protect investors who might be unable to withstand a loss from a potentially high-risk investment or the lack of liquidity that is inherent in a PE or VC fund investment.

1.36 Even with these restrictions, however, there are large numbers of individuals and families who have substantial resources available to invest in illiquid PE and VC funds. In general, only the wealthiest individual investors are likely to invest directly in PE or VC funds, given the relatively high minimum investments levels (which can be up to $25 million for some funds). In many cases, the largest individual investors might have professionally run family offices that look after their investment portfolios and strategies.

1.37 Similar to other investors, these individuals will usually seek a balanced portfolio that comprises various asset classes, with some portion or their investments in fixed income, domestic and international equities, hedge funds, or other managed accounts, as well as in less liquid investments such as real estate, private equity, or venture capital. Some of these individuals or family offices may also be *angel investors* in early-stage companies, which provide funding to a company before it seeks VC financing. These investors may make direct investments in PE or VC funds, but they may also invest through intermediate funds known as *funds of funds*.

Funds of Funds

1.38 Funds of funds are investment companies that invest in other investment companies. A fund of funds manager raises capital from investors to invest in one or more underlying funds. These investments provide a vehicle for investors who are looking for exposure to PE and VC funds but might otherwise be unable to access some managers (who might be quite selective in who they allow to participate in their funds). In addition, investors can rely on the fund of funds manager to identify and select managers and provide diversification to their portfolio, which would not be as readily attainable from a direct investment in PE and VC funds due to the high minimum investment level. The fund of funds managers also tend to have well-established due diligence procedures and portfolio monitoring processes and handle the negotiations with the PE or VC fund manager over fund terms, rights to information and reporting, and so on. Some fund of funds managers may have related businesses that invest in PE and VC "secondary fund" interests, which are existing fund interests acquired from other LPs. Some funds of funds or other LPs may also co-invest (invest directly in an underlying portfolio company) side by side with the fund making a direct investment.

Investment Horizon and Return Considerations

Long-Term Orientation

1.39 There is some criticism of business managers, equity market analysts, and markets in general that the focus on the next quarter's earnings, sales, or volume targets is counter to the long-term interests of a portfolio company or its current or future customers. This short-term pressure can prevent managers from investing in research and development or new products or features because such investments might cause the portfolio company to fall short of its near-term financial expectations, even though they could significantly enhance the portfolio company's performance and its products in the long term.

1.40 PE and VC investing is characterized by long time horizons that allow fund managers the flexibility to work with portfolio companies to develop plans that can take several years to execute. Funds are generally structured with a duration of 10 years or longer, and LPs generally do not have the opportunity to withdraw their capital. This long-term horizon allows a fund manager to focus primarily on the magnitude and timing of the returns. Thus, when working with private companies in their portfolios, fund managers are able to look several years into the future as being a relevant investment timeframe to demonstrate meaningful value creation. In early-stage portfolio companies, this long-term focus can mean that a portfolio company that does not generate revenue for several years and does not expect to have profits for several years thereafter can still raise capital. For more mature portfolio companies, a long-term focus provides opportunities for transformation without the short-term scrutiny public markets impose on drastic changes.

1.41 The economic incentives in a PE or VC fund structure can often favor the long-term view. In a successful fund, the amount of the carried interest, or incentive fee, the GP receives can depend more on the multiple realized (MOIC) than on rate of return. This focus is also consistent with LPs looking to achieve higher levels of profits and greater multiples on invested capital from private equity or venture capital than would typically be generated in the public markets. High rates of return over short periods of time do not fully achieve the LPs' goal of growing their portfolio over long periods of time. Similarly, the typical compensation arrangements with portfolio company executives seek to align the interests of the executives with those of the shareholders. Therefore, both the fund manager and the portfolio company executives are likely to focus more on what the portfolio company will be worth at exit rather than on the impact of short-term decisions.

Risk Tolerance

1.42 Because VC and PE investments are held for relatively long periods, these portfolios can face significant uncertainties because various factors (such as markets, technologies, key personnel, and the macroeconomic environment) can change significantly before the portfolio company has an opportunity to position itself for an exit. For example, some of the most successful industry investments have been realized by taking portfolio companies public through an IPO. In times when the macroeconomic environment is strong and investors are interested in new issuances, gaining liquidity through an IPO can be quite attractive, often yielding returns far exceeding what might be available in a sale to a strategic buyer. However, if there is a market disruption, a significant regulatory change or a recession in the economy, it can take years for a favorable IPO climate to return. In fact, even in a relatively good market, some types of portfolio companies may be viewed more favorably and attract higher valuations than others, leading out-of-favor portfolio companies to delay their execution of a planned IPO or receive a lower than expected valuation. Therefore, even if a portfolio company is otherwise ready to go public, a fund manager may need to be prepared to hold an investment through an entire business cycle to achieve a successful exit. This risk is an important consideration for fund managers, especially those who invest in cyclical or more speculative businesses.

1.43 One way in which fund managers and their LPs can manage the risks associated with such long-term investments and market cyclicality is through diversification. Diversification can be achieved through, for example, investing in different industries, technologies, business models, end markets, or geographies. In addition, because many funds tend to have an investment period of up to six years, investments made early in a fund's investment period may be based upon different investment theses than those made toward the end of the fund's investment period. By staggering the fund's investments over a longer investment period, the fund reduces the "vintage" risk that might otherwise be associated with making similar investments at the same point in time. As capital market conditions and their impact on exit options tend to vary over time, the staggered maturity of the investments has the further benefit of exposing the fund to different market cycles during the fund's life.

1.44 Whatever strategies a fund manager uses to diversify and manage risks, investors in earlier stage or illiquid private companies approach each investment knowing that mistakes can be costly. Unlike investors in public markets, who may decide shortly after making the investment that their strategy is wrong or their portfolio is out of balance and can sell part or all of their investment, private company investors are locked into their investments and strategy until there is an exit opportunity. As a result, it is important for PE and VC fund managers to be disciplined in their investment processes, have a vision for how markets develop, assess the potential impact of innovation and technological advancements, and evaluate the quality and experience of the portfolio company's management team and make adjustments as needed. Fund managers may also need to be patient with portfolio companies and their management teams as they develop and adapt new processes and technologies. They may also need to be prepared for delays and setbacks when markets develop more slowly or customer or investor acceptance of a portfolio company's products or business model takes longer than envisioned.

1.45 PE and VC investment managers focus on choosing portfolio companies that they expect to be truly successful, approaching each investment with the goal of navigating the risks to achieve a high value exit. However, in practice, fund managers know that not all the investments are likely to work out as expected. Therefore, to reach an acceptable target rate of return across a portfolio of investments, a fund manager generally needs to target a rate of return for each individual investment that exceeds the expected rate of return on the portfolio as a whole. Inevitably, there will be circumstances in which one or more portfolio investments significantly underperform expectations. As a result, when making individual investment decisions as part of building a portfolio, a fund manager will generally look to higher rates of return than the target rate of return for the fund, so that the successful investments will be able to offset losses elsewhere in the portfolio. Thus, the greater the expected loss ratio of a portfolio (those investments which might be expected to return less than cost) or, in other words, the riskier a portfolio of similar investments, the more the target rate of return for each individual investment needs to exceed the expected average return for all investments.

Impact on Portfolio Company Valuations

Planning for "Exits"

1.46 Before making an investment, the fund manager develops an investment thesis, which, among other things, identifies the key aspects of the business that might lead to its success, as well as the risks that could lead to setbacks. The fund manager also assesses how to gain liquidity from the investment. In fact, the investment documentation (often in a shareholders' agreement) will frequently include terms that give the fund (or other shareholders) the right to cause a portfolio company to be sold or to "drag along" certain other shareholders into a transaction that might give a buyer control of the portfolio company. Terms might also include a right to cause the portfolio company to file for an IPO or include contingencies that are triggered if the portfolio company fails to file for an IPO during a specified timeframe.

1.47 As a PE or VC fund typically has a pre-defined life and its LPs generally expect to receive liquidity from portfolio investments during the fund's life, it is important for the fund manager to think about the potential liquidity strategies for the portfolio company once it executes its business plan. In many ways, this exercise involves assessing the potential market participants and at what point and value, various market participants would have an interest in investing in a portfolio company.[5]

1.48 In some cases, it is difficult to predict the ultimate outcome, particularly when the exit plan is far out in the future. Portfolio companies may pursue numerous alternative paths to exit, including going public, divestitures or spin offs, recapitalization, merging with other companies, or downsizing in an attempt to transform, all of which can happen within the span of one fund's ownership. However, at every stage in the process, the fund manager must continue to focus on an ultimate exit strategy, despite the potential for that strategy to change based on dynamic market conditions.

Strategic Buyers

1.49 If a portfolio company has begun generating meaningful revenue and profit growth, it may generate interest from strategic buyers because the acquisition can often improve the buyer's revenue growth rate. The buyer has the added benefit of not having had to incur the risks or the accounting losses during the development phase of target's business. Therefore, when considering possible exit options, it may be helpful for fund managers to identify strategic buyers (such as large corporations) that may potentially be interested in acquiring the portfolio company. On the other hand, large corporations can, and often do, change their strategic direction, as their circumstances and financial position change. As a result, a portfolio company with a durable business plan that can weather a business cycle and that offers multiple paths to liquidity is likely to be more attractive to a fund manager than one with a limited universe of potential buyers.

1.50 When evaluating the exit opportunities that might be available to a portfolio company, a fund manager may consider a number of factors, including the following:

- The number of larger companies for which the portfolio company's products or services would be complementary to their existing business
- The extent that the portfolio company's products or services are a "need to have" or "nice to have," either to the end user or to the potential acquirer, to round out their product portfolio
- The strategic positioning of potential buyers and their perception of need to diversify in one direction or another

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[5] See chapter 3, "Market Participant Assumptions," which discusses *market participants* and the evaluation of their perspective on valuation.

- The regulatory impediments to a strategic buyer's ability to acquire the portfolio company (for example, antitrust or anti-competition concerns)
- The strategic buyers' financial condition and their ability to finance an acquisition of the portfolio company

1.51 In some circumstances, portfolio companies can be attractive acquisition targets for financial buyers. These buyers are not looking at the portfolio company for its strategic value relative to their existing portfolio but, rather, might be looking to help the portfolio company continue to grow as an independent company or as a platform for future acquisitions. There may be situations in which, given the availability of affordable debt financing, an LBO may offer a higher price than the price the portfolio company would receive from the public markets in an IPO. A portfolio company might also prefer to remain private if it has proprietary technology or favorable economics, when disclosing these advantages through public market filings would erode value. In these kinds of situations, the potential buyers could be other PE or VC firms that specialize in later-stage investments (a so-called "sponsor-to-sponsor" transaction) or insurance companies or sovereign wealth funds (particularly, if the portfolio company offers attractive cash flow attributes).[6]

Public Equity Markets and IPO

1.52 IPOs can provide a path to liquidity for PE or VC fund investments, though they can be difficult to accomplish, even for portfolio companies that have operational success and a history of sustained performance. Typically, portfolio companies will be expected to reach a minimum scale and performance metrics to show prospective investors a path toward long-term success before public market participants will be receptive to a new issuance. Certain sectors or business models may be viewed favorably at a given time, but such sentiments can change rapidly. As a result, most fund managers pay attention to capital market activity and only prepare those portfolio companies for an IPO whose business profile has the characteristics that public market participants will find attractive.

1.53 An IPO process can involve an extended period of preparation by the portfolio company and its outside advisers.[7] As a result, significant advance planning and good insight into market expectations and the macroeconomic backdrop can be of great value in assessing a portfolio company's prospects for a successful IPO. Given the length of time it takes to complete an IPO, the risks associated with rapidly changing investor sentiment and often volatile macroeconomic conditions, it may be difficult to be certain of the timing or potential pricing of an IPO, even within a short time before the target listing date.

1.54 Although many people consider an IPO of a portfolio company as an exit, it is often more appropriate to view it as a financing event for the portfolio

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[6] These types of transactions are sometimes described as "secondary sales," meaning the proceeds from the sale would go to the existing owners, rather than adding capital to the company. The term *secondary sales* is also sometimes used to describe transfers of limited partnership interests in a *venture capital fund* or *private equity fund* as a whole, or a secondary offering in which shares of a public company are sold to public shareholders following an initial public offering *(IPO)*. Because the term *secondary* may have a number of meanings when used by VC and PE firms, it is important to understand the context in which the term is being used.

[7] For a further discussion of the IPO process, see appendix B, "Valuation Reference Guide," paragraphs B.02.01–.12, "The Initial Public Offering Process."

company, which may provide little, if any, proceeds to the PE or VC funds. Particularly for less mature portfolio companies, new investors (including public shareholders) often prefer the proceeds of an IPO to go directly to the portfolio company for use in furthering its growth plans or to pay down debt, instead of paying out existing shareholders. Typically, upon completion of the IPO, all the existing equity capital of the portfolio company is converted to a single class of common equity. Shares not sold by the fund in an IPO may be subject to a contractual lock-up with the underwriter of the offering that restricts the fund's ability to sell or distribute its shares before the expiration of a lock-up period.[8]

1.55 Following an IPO, PE and VC funds may continue to hold shares for an extended period. In some cases, the fund might look to participate in a later offering, particularly if it has *registration rights* in its original investment documents. In other cases, the fund may look to "dribble" its shares into the market through open market sales, whereas in other situations, it may prefer to make in-kind distributions to its partners to allow partners to make independent decisions regarding whether to hold or dispose of their shares.

1.56 Factors that may lead a fund to hold a significant number of a portfolio company's shares well past the expiration of the lock-up period can include the following:

- The fund manager's perception of the trading value of the portfolio company's shares relative to the expected value in the future
- The possibility of a future mergers and acquisitions (M&A) transaction involving the portfolio company
- Total size of the fund's holdings as compared to the total percentage of the portfolio company in public hands or the volume of shares that trade in a given period
- The desire to manage the public perception of the fund manager as being supportive of the portfolio company it has sponsored
- Possession by the fund manager of material nonpublic information regarding the portfolio company or other regulatory factors that may affect whether the shares are salable[9]

1.57 Even after a portfolio company is public, the fund manager may still face further challenges in managing the fund's path to ultimate liquidity well beyond the IPO date. For example, shares may be thinly traded relative to the size of the fund's holdings. In addition, most fund sponsors are protective of their reputation and desire to remain involved as active members of the board of directors well beyond the IPO date so they can help portfolio company management succeed in the transition from a private to public company.

Considerations for Early-Stage Portfolio Companies

1.58 Investors in early-stage portfolio companies face the challenge of envisioning new services, technologies, business processes and models, and deciding what they are worth before knowing whether a market will exist, the technology will work, the competitive landscape will shift, or management can

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[8] See paragraphs 13.08–.14 for a discussion of contractual restrictions on sale.

[9] A discussion of insider trading rules, SEC Rule 144, or other regulatory matters is outside the scope of this guide.

execute on a business plan sufficient to be able to capture value from the investment. Because early-stage portfolio companies often do not have revenues or profits, it may be difficult to apply the *valuation models* typically used to value more mature businesses.

1.59 Most VC or start-up opportunities exist outside the typical large corporate environment because they involve significant investment of time, effort, and financial and managerial resources; they have high degrees of risk and can take many years to provide a meaningful financial return, if at all. In addition, early-stage businesses often require employees with an entrepreneurial style that may be difficult to attract, retain, and reward within large enterprises.

1.60 For early-stage portfolio companies, which do not yet generate revenues or profits, there is often limited visibility on how the business will develop over time, and the risk of business failure is generally very high. Their business plans may go through numerous changes as the portfolio company evolves, and the market for the product or service could change dramatically over the time that it takes to get the product to market. Also, the portfolio company may get the product right but the marketing and distribution wrong, or vice versa. Alternatively, the portfolio company may misjudge the size of the market or the length of the sales cycle for a product or service so that the level of investment in a sales infrastructure significantly dilutes its profitability or growth trajectory. The pricing model or terms may not meet expectations, and margins may fall short of what is required to produce the product or service profitably. Other technologies or service delivery models may take hold before the portfolio company is able to capitalize on a perceived market need. Then again, the portfolio company may succeed in developing a product, but the new product may not be sufficiently superior to an existing product to prompt customers to change their buying patterns to adopt the portfolio company's product.

1.61 As a result, the VC funding model rarely involves a portfolio company raising enough money in the very early stages to fund the business fully until profitability. Instead, VC funding typically involves several rounds of financing, providing the portfolio company with enough money to reach another milestone and giving investors the opportunity to see how the portfolio company and the related market develop over time. This approach helps to minimize the amount of money investors stand to lose if the portfolio company does not make sufficient progress or the market develops differently from initial expectations. The ultimate decision regarding whether to invest is based on assessing the portfolio company's development prospects over a long period of time and what it may ultimately be worth. The more immediate assessment is to identify the portfolio company's future milestones and determine the probabilities of it achieving these milestones. The achievement of past milestones, probabilities of meeting future milestones, and cash needs are key factors that investors evaluate in combination with the overall outlook for the portfolio company in negotiating the pricing and aggregate level of investment for each round of financing.

1.62 Many companies that are now household names were initially start-ups funded by VC funds. However, for every early-stage company that ultimately succeeds to the level of becoming well known, there are hundreds, if not thousands, of companies that fall short of achieving such success. Not all of these lesser known, or unknown, companies fail. In many cases, they succeed, or only partially succeed, and are either acquired by another company or their technology or "know-how" is sold. Many companies succeed as independent companies and may even go public before being acquired by a larger competitor or a business looking to expand into the company's market.

1.63 From a valuation perspective, early-stage portfolio companies present a number of challenges because there may be few or no publicly traded comparable companies that can be used as benchmarks due to differences in both the expected future growth and the level of risk. To the extent that valuation metrics exist in a given sector, they may be based on revenue multiples (which may not be present in early-stage portfolio companies) or some nonfinancial criteria (for example, the number of users, which is commonly used in the internet sector). When using metrics for portfolio companies that have not yet developed a way to monetize their services, significant judgment is needed to assess how the metric (such as user traffic) will be affected when the services are monetized. For example, evaluating the nature of a service and how essential it may become to users may help predict when and how much a portfolio company can charge for its service. In addition, the extent to which the users will continue to use the service if presented with advertising or if the portfolio company were to monitor and share user information with other companies for a fee would also affect user traffic and, ultimately, the value.

1.64 As a result, even though valuation metrics may exist, they need to be assessed against the portfolio company's relative market position, its competitive landscape, and its overall chance of success. In some cases, there are observable inputs that can be used to determine the portfolio company's value. However, in many cases, traditional valuation methodologies may fall short of providing reliable indications of value, and the valuation will require significant judgment.

1.65 Although most investors in early-stage portfolio companies monitor factors that influence the probability of success and the value that may ultimately be achieved, they usually do not continually update valuation models and assumptions. As a result, various parties that are involved with determining and reviewing the fair value of an early-stage portfolio company, or the investments in that company, will need to consider numerous subjective inputs and assumptions to gain perspective about the reasonableness of any valuation. Some of the subjective factors that need to be considered when valuing an early-stage portfolio company are discussed in the subsequent sections.

The Portfolio Company's Strategy and Positioning

1.66 It is important to understand the portfolio company's strategy and positioning. An investor might start with understanding the portfolio company's mission and the details of its business plan, the metrics it will use to measure its own success, and the progress it is making toward achieving its goals. The investor may also assess the technological feasibility and the uniqueness of the portfolio company's planned solution, as well as the potential size of the market and the portfolio company's strategy to penetrate the market. Finally, the investor would consider how much money the portfolio company would need to spend to develop and commercialize the product or service. That is, how much investment will be required to develop a viable solution and then reach the market — for example, will the product ultimately be licensed or sold through independent distributors, or is the portfolio company planning to build its own sales organization? Taken together, these factors determine the potential return on the investment.

Market Opportunity

1.67 A key element of a portfolio company's strategy is identifying the market opportunity. Starting with an assessment of the current marketplace and the solutions available, a new business needs to develop a point of differentiation or core competence that can be the basis for its growth and development. When an analogous product or service is currently hard to find, businesses, VC firms, or individuals performing valuations often try to develop possible pricing models by determining how much time or money one would save by using the product or service. In the case of a biotechnology portfolio company, one could consider how many people suffer from the current disease that the proposed product intends to treat and how likely it is to improve the quality of life, their life expectancy, or both. In other words, having some way to gauge the size of the market opportunity and the potential for the portfolio company to capture some or all of that market potential is important.

Product Adoption and Customer Behavior

1.68 To understand the portfolio company's market, one needs to identify the buyer for the product and the decision makers. In consumer-oriented businesses (B2C businesses), identifying the buyer often means assessing the purchasing power of the targeted demographic and its willingness to spend on similar products or services. In business- or government-oriented businesses (B2B businesses), identifying the buyer often means assessing how the business will benefit from the product or service and what other products or services it would replace. Selling to consumers generally involves a shorter sales cycle because consumers' tastes are subject to trends and fads, whereas selling to businesses, governments, or other institutions can generally result in a longer sales cycle and slower product adoption but a greater chance of renewal or repeat business.

Competitive Landscape and Presence of a First-to-Market Advantage

1.69 For some new products and services, it can be more important to be the first to introduce the product than to have the best product. When customers associate a brand with a leading-edge product or service, the next company to the market with a similar product or service can have a hard time breaking through the market with its product. The next company to the market would generally need to demonstrate that its product or service is differentiated in some way to gain market share. Differentiation could be achieved through technological superiority, better pricing, service, reliability, and so on. When evaluating a business that is developing a new product or service, market intelligence about other products or services under development will help to assess how much of a head start the portfolio company may have, how far behind it is, or what barriers to entry might exist for competitors in introducing similar products or services.

Regulatory Approval and Other Gating Factors to Market Access

1.70 Some industries have more regulatory oversight or licensing requirements than others. For example, in financial services and medical devices sectors, the U.S. federal government has industry-specific regulatory agencies. However, businesses in other industries may also face import or export regulations or local licensing and registration requirements. In some cases, these regulations may present challenges to getting a product manufactured or service delivered. However, in other situations, regulatory complexity can be a source of competitive advantage because regulation is generally more manageable for companies that have already achieved scale while making the industry less attractive to new competitors.

Use of Subject Matter Experts and Advisers

1.71 When reviewing a business plan for a pre-revenue portfolio company, it may be difficult to evaluate the probability that the product will ultimately succeed. Using a scientific or technology expert to validate the feasibility of the proposed product's functionality or probability of success can provide investors with greater confidence in some circumstances. For example, in a biotechnology portfolio company, although a scientist will not necessarily know whether a particular compound will prove to be effective in a clinical trial at treating a particular disease, the scientist may be able to express a view on the likelihood of success based on what is known about reactions to similar compounds. This information could be helpful in forming a view of what the portfolio company might be worth in the future. Therefore, when investing in early-stage portfolio companies with a high degree of technical complexity, many investors will engage scientific or technology experts to help them evaluate these kinds of issues. Nevertheless, there will always be an element of uncertainty, and significant judgment will be required to determine the impact of the risk of failure versus potential reward from a successful launch of a product or service.

Executive Management and Their Track Records

1.72 Talented founders and entrepreneurs, particularly those with a history of successfully managing previous enterprises, can sometimes increase a business' chance of success enough to make a significant difference in the initial valuation and improve the chances of getting initial and subsequent funding. Exceptional entrepreneurs, technologists, or scientists also may attract the caliber of a management team that also warrants a high valuation. Nevertheless, previous success should not be viewed in isolation. In some cases, first-time entrepreneurs have spectacular success that is followed by a series of failures, whereas in other cases, entrepreneurs go through a series of setbacks before they succeed.

Macro Investment Environment for the Particular Early-Stage Portfolio Company

1.73 In addition to evaluating the factors described previously, investors in early-stage portfolio companies will typically also perform an overall assessment of the potential IPO or strategic exit market for that particular company. The potential exit market for early-stage portfolio companies differs by sector and strategy. For example, consider an early-stage, pre-revenue company developing a drug that may have a very large potential market. Even though the potential market is large, the high failure rate of companies developing and commercializing new drugs may have a significant negative effect on this company's value. Therefore, the IPO or strategic investors may place a judgmental cap on this company's value at a level significantly below the ultimate value that may be realized.

Regulatory Environment

1.74 As described in the "Typical Fund Structures and Role of Fund Manager" section earlier in this chapter, funds are generally established as limited partnerships through a limited partnership agreement. The limited partnership agreement defines the responsibilities of the GP, LPs, and management company, along with outlining investment strategy, fees, allocation of gains, and so on. The limited partnership agreement may also describe mechanisms for addressing potential conflicts of interest (for example, when a management company or investment professionals are responsible for investing or divesting from two or more funds). Regardless of whether GPs, management companies, and investment professionals are required to register as investment advisers, as described subsequently, they generally accept the fiduciary duty to prevent conflicts of interests, insider trading, self-dealing, and so on. Investors and LPs have become increasingly sensitive to interpretations of limited partnership agreements with respect to fees, conflicts, and appropriate governance, irrespective of whether the manager is a registered investment adviser.

U.S. Securities and Other Regulation

1.75 Historically, advisers to PE and VC funds were generally exempt from registration with the SEC because the funds typically were formed with limited numbers of investors, including only sophisticated investors. However, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), enacted in 2010, altered the requirements regarding which investment advisers are required to register with the SEC as an investment adviser under the Investment Advisers Act of 1940 (Advisers Act). Exemptions for registration under the Advisers Act are available to investment advisers that advise solely VC funds, private fund advisers with less than $150 million in assets under management, and foreign private advisers. It is common for advisers with the available exemption to choose not to register with the SEC. Even though exempt advisers are not required to register with the SEC, they are subject to informational reporting requirements, general securities laws, and fiduciary obligations to their clients that the SEC regulates.

1.76 Privately offered funds themselves are not generally registered under the Investment Company Act of 1940 (Investment Company Act) but are subject to oversight and inspection by the SEC because the fund manager is subject to inspection as a registered investment adviser. Certain investment companies that hold investments in private equity, private debt, and venture capital are registered under the Investment Company Act. Therefore, the SEC staff's views with respect to valuation have an influence on the industry.

1.77 The Dodd-Frank legislation also mandated that the PCAOB[10] expand its regulatory authority over auditors of broker-dealers. Although the PCAOB does not directly inspect the auditors of privately offered PE funds, the PCAOB does inspect the audits of public entities, including investment companies, that hold investments in private companies. Thus, the PCAOB's views with respect to the audits of valuation estimates may influence certain entities that report such investments at fair value.

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[10] The PCAOB is a nonprofit corporation established by Congress to oversee the audits of public companies to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. The PCAOB also oversees the audits of broker-dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection.

Business Development Companies and Small Business Investment Companies

Business Development Companies

1.78 A *business development company (BDC)* is a form of publicly registered company in the United States that invests in small and mid-sized businesses. This form of company was created by Congress in 1980 using amendments to the Investment Company Act. Publicly filing firms may elect regulation as BDCs if they meet certain requirements of the Investment Company Act. The election to become a BDC means the BDC must subject itself to all relevant provisions of the Investment Company Act, which, among other things, (*a*) limits how much debt a BDC may incur, (*b*) prohibits certain affiliated transactions, (*c*) requires a code of ethics and a comprehensive compliance program, and (*d*) requires regulation by the SEC. BDCs are also required to file quarterly reports, annual reports, and proxy statements with the SEC. Some BDCs are publicly traded, and others are not.

Small Business Investment Companies

1.79 In 1958, Congress created the *Small Business Investment Company (SBIC)* program to facilitate the flow of long-term capital to America's small businesses. The structure of the program is unique in that SBICs are privately owned and managed investment funds, licensed and regulated by the Small Business Administration (SBA), that use their own capital plus funds borrowed with an SBA guarantee to make equity and debt investments in qualifying small businesses.

1.80 SBICs are regulated by the SBA and, accordingly, are required to comply with Part 107 of the SBA rules and regulations. Part 107 deals with specific aspects of SBA regulation, such as the relevant audit procedures and reporting requirements of the SBA for SBICs, the system of account classification, and guidance on proper techniques and standards to be followed in valuing portfolios. SBA guidelines on valuing portfolio investments may not be fully consistent with FASB ASC 820.

1.81 The format for reporting the results of SBIC operations varies from the format used by other types of investment companies because the financial statements for SBICs are presented based on regulations promulgated by the SBA, which is a comprehensive basis of accounting other than U.S. generally accepted accounting principles (GAAP). In addition to financial statements presented on this other comprehensive basis of accounting, certain SBICs also have financial statements prepared in accordance with GAAP.