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TECHNICAL

Is fair value fair?

The issue of fair value reporting is being widely discussed this year in the context of the credit crunch, which will likely see significant value wiped off the books of corporates and financial investors alike. The debate around the definition and determination of fair value comes at a time of growing demand from stakeholders for greater transparency, and continued press attention focused on the private equity industry and valuations in general. Whether reporting fair value under IFRS or US GAAP, or determining net realisable value under UK GAAP, this is an issue that affects us all.

What's the problem?

The mid-2000s was undoubtedly a seller's market, with unprecedented competition for acquisition targets, leading to very high market prices and auction processes becoming commonplace. The result was that private equity funds, due to their relative deal professionalism compared to corporate bidders, were able to succeed with higher bids due to factoring in the price synergies and other potential upsides. These deals were also done during a period of readily available financing.

The downside of this success is that the high multiples paid, for many acquisition targets, might result in considerable write-downs when reflecting fair value in the current economic environment. This is particularly important when the medium-term cost savings and performance improvements may not yet have yielded results at the target and impacted profitability.

As the year-ends of many funds approach and stock market values near their lowest for many years, many managers are pondering how to determine the fair value of their assets. It hardly seems fair to reflect current stock market prices if you plan to hold individual investments for a few more years yet, not to mention the difficulty in finding a comparable public company. Particularly when the only interesting value is the exit price.

A sympathetic ear

Both the IASB and FASB recognise the difficulties inherent in determining fair values. Whilst they have issued some guidance on fair value accounting and reporting in illiquid or inactive markets, many are also looking to IPEV for direction.

For its part, IPEV (The International Private Equity and Venture Capital Valuation Board) has reaffirmed its support for the continued use of fair value in the valuation of private equity holdings. The Board emphasised that "fair value, when applied with informed judgement, represents the best guide to valuing portfolio companies."

The Board also announced that new guidelines are in progress and guidance to achieve full compliance with IAS 39 and FAS 157 will be issued in the second half of 2009.

Does it matter?

Some have suggested that the carrying value of assets doesn't matter, and if

investors are interested only in the exit price, why should they be so concerned about the interim values?

A recent report from PwC points out that whilst exit price is still arguably the most important figure for a private equity fund, this is not necessarily the case for investors in the fund who monitor the fund's performance and may contemplate negotiating an early exit with the GP. For them, the overall performance of the fund and its individual assets is important, as it can also determine their choice of the best home for their future investments.

Current values are therefore important. In these turbulent times, investors are likely to pay much closer attention to valuations and the underlying performance of their portfolio. Accurate valuations naturally give an indication of how investments are developing.

What to do?

The guidance expected by IPEV in 2009 is not much help to funds in their upcoming year-ends. In the meantime, there are a number of valuation methodologies available, and it will be a question of discussing these with your advisors, accountants, auditors and administrators in order to determine that most suited to your investments. A few of the options available are:

- **Earnings multiple:** There is some debate around the appropriate earnings and multiples to be applied, and whether to use transactional data or comparable public company data.

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James Watts
Head of Onshore Client Services



TECHNICAL

A Channel to success



Kerry-Anne Morley
Managing Director (Guernsey)

The Channel Islands have long been a favourite domicile for the fund industry. Although British Crown dependencies, the islands are self-governing and enjoy full judicial and fiscal independence. They share many of the attributes that make London a leading financial services centre, including a stable and transparent legal system and a predictable corporate taxation environment.

Crucially, they are conveniently located a short flight away from the major European financial centres and in the same time zone as the UK.

The small size of the Channel Islands (Jersey is the bigger of the two islands with a population of around 91,000 compared to Guernsey's 66,000) belies their role as a funds powerhouse. The Financial Services Commissions of Jersey and Guernsey placed the value of open- and closed-ended funds in late 2008 at circa £400 billion.

Whether looking at Guernsey's Qualifying Investor Funds, the Jersey Expert Fund, or closed-ended/registered funds, it is likely that the Channel Islands will have a solution to suit your needs. Augentius can support you in your move as we have significant experience servicing all fund types, specialising in private equity, property and infrastructure funds.

Staying ahead of the game

Offering broadly similar products, both islands constantly seek innovative new solutions to suit the market. Both have a history of developing more attractive forms of corporate entities, such as Incorporated Cell Companies and Protected Cell Companies, the latter of which Guernsey was at the forefront of developing in the 1990s, helping it become Europe's largest centre for captive insurance.

The legal and regulatory environment is critical to the Channel Islands' success. 2008 has seen a number of significant improvements:

Guernsey modernised and consolidated all its company legislation into The Companies (Guernsey) Law 2008. This new law brought in a number of enhancements, including allowing the passing of written resolutions by a majority of members, rather than unanimously as was previously the case. The establishment of an online company registry, in 2008, has radically reduced company formation times and associated fees. Guernsey has also recently amended its Protection of Investors law allowing administrators to perform due diligence on new promoters – a fast-track approach whereby applications through the Guernsey Financial Services Commission will be completed within 10 working days.

Recent years have seen both islands slash the approval period for establishing funds to around 72 hours. The Jersey Financial Services Commission introduced this 3-day fast-track authorisation process in January 2007 for all funds qualifying as listed funds. Guernsey followed suit for all closed-ended fund approvals in February 2007, though it has been operating the 72-hour approval process for Qualifying Investor Funds since 2005.

February 2008 saw Jersey introduce an "Unregulated Funds" regime, allowing investments funds to be established without the need for regulatory pre-approval. The two unregulated fund types are Unregulated Eligible Investor Funds (open- or closed-ended) and Unregulated Exchange Traded Funds (closed-ended and listed), adding to its current portfolio to complete a full suite of fund options. These unregulated funds, which have no investment or borrowing restrictions and no audit requirement, have given the island a further boost, with 26 such funds having been established in the first eight months since the legislation.

Whether you are seeking a fully regulated product or a lightly or unregulated structure

for professional investors, the Channel Islands will have a product to suit your needs.

Taking stock

The Channel Islands Stock Exchange (CISX), based in Guernsey but also serving Jersey, has gone from strength to strength since its establishment ten years ago. In June 2008 it had around 3,000 listed entities (90% of which were primary listings) and a market capitalisation in excess of US\$50 billion. Its success is due in part to its competitive pricing and quick turnaround times. In addition it adopts international best practice regulatory standards very similar to those applied by the UK's FSA. Augentius is a Listing Agent for the CISX.

Registration in the Channel Islands has the further advantage of easing entry to certain other European stock exchanges, including the London Stock Exchange and Euronext. A Memorandum of Understanding between the regulators in the Channel Islands and the Netherlands has facilitated the listing of Channel Islands-based companies on Euronext in Amsterdam. KKR Private Equity Investors, L.P. was the first Guernsey-based fund to list on Euronext following the conclusion of this agreement in 2006, raising more than US\$5 billion.

Furthermore, the listing of debt securities on the CISX has remained popular. Debt products constitute around half of the stock exchange's business.

Twinking the business model

The long association with the fund industry has resulted in a pool of highly skilled, specialised workforce on both Guernsey and Jersey, but the available resource is finite. Fund administrators and other service providers on the islands are, therefore, necessarily looking at ways to outsource

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TECHNICAL

GABRIEL increases reporting frequency for fund managers



Glyn Thomas, Associate Director,
Special Projects and Training

August 2008 saw the activation of GABRIEL – GAthering Better Regulatory Information EElectronically – the FSA's new electronic reporting regime.

According to the FSA, GABRIEL "is designed to make it easier for firms to submit regulatory data". Indeed, the new system should in theory make reporting a little easier, as it knows what returns individuals should submit and by what date. The electronic format also means firms will have easy access to previous submissions.

The system's launch was unfortunately marred by 'performance and technical issues' which resulted in the regulator issuing an extension to the submission deadlines. More importantly, the new system actually introduces a more onerous reporting schedule for many firms.

Applicability

GABRIEL affects all firms – including private equity and venture capital managers – which carry out regulated activities or have capital adequacy requirements determined by the FSA.

Aligning the collection of data across different firm types has meant that many firms managing collective investment schemes will have to report more regularly. The scope extends from banks and insurers down to smaller fund managers running only unregulated schemes and not handling client money. These firms may have relatively low capital adequacy requirements, but still need to report their financial data quarterly.

Same as before but a new submission method, right?

It is true that data will now be submitted exclusively online, which in theory should make the process easier. The new collection method replaces a variety of legacy systems and paper forms used by FSA regulated firms. This should make it clearer to see what

is due when (based on regulated activities), and what was submitted last time on this single platform.

The increased frequency in reporting is likely to result in added workload for many managers. Although it is noted that information such as capital adequacy levels should be monitored by the firm throughout the year in any case, the additional reporting may require more frequent control procedures and validation.

Teething troubles

Performance and technical bugs marred the launch of the system, which all but ground to a halt when dealing with the thousands of regulated firms trying to submit returns. As a result, the FSA extended the filing deadline for returns due in October and November by seven business days from the due date.

Most firms will therefore by now have submitted their returns for the quarter ended 30 September. If users found aspects of the system frustrating or encountered bugs that resulted in loss of data entered, they are certainly not alone.

Whether or not some of these features will be addressed or are here to stay will become apparent in due course. In the meantime, we suggest you protect your data and your time by noting the following common issues encountered:

- Entering zeros in any nil fields, rather than leaving blanks, may help the upload and validation checks performed by the system
- Before validation, ensure all roundings are thoroughly checked
- The forms expect text and numbers, and there is a risk of losing data on saving where "&" and other special characters are used

On top of this there has been some frustration that the system is accessible only

on Mondays to Thursdays in business hours, though these were extended temporarily for November. Do not assume the FSA will be so accommodating next quarter.

Take heed

Be aware that failure to submit your returns on time may result in an "administrative fee" of £250, which the FSA waived in light of the performance issues noted above but which are likely to be imposed in future periods.

Non-compliance may result not only in a fine, but a knock on the door by the regulator, the result of which could be enforcement action or ultimately withdrawal of permission to undertake regulated activities.

What should you do?

To make life a little easier, we recommend that you:

1. Allocate roles and permissions internally (preparation, entering, reviewing/validating, and submission)
2. Ensure your users have completed the available online training, enter data in good time, and note any "quirks" in the system for future periods and users
3. Review and submit your returns ahead of time, in case of system downtime (the FSA's or your own)

If you wish to minimise the hassle and time spent, we can help. GABRIEL allows delegation by the principal user or systems administrator (you) to third parties, enabling us to prepare and complete returns on our clients' behalf.

MORE INFO

To discuss the potential impact of the changes on your business, please contact Glyn Thomas, Associate Director, Special Projects and Training on 020 7397 5473 or at glyn@augentius.com



TECHNICAL

Augentius is named Private Equity Administrator of the Year

Augentius has been named as Private Equity Administrator of the Year by Private Equity News. Of all the awards granted throughout the year, this is the most prestigious.



"We are absolutely delighted to win this award" said David Bailey, Managing Partner. "Private Equity News is one of the most well respected publications within the industry and for Augentius to win this award is a wonderful achievement. It is a reflection of all the hard work of everyone and it was a proud moment to be able to take the trophy into the office the following morning." The award was determined by a panel of senior executives from the Private Equity industry and is a sign of just how far Augentius has come in a few short years. Augentius is now one of the largest Private Equity administrators in the world – yet it very very successfully continues to provide a high level of individual servicing to individual clients.

"We work with some of the largest groups and some of the smallest groups in the Private Equity community" said Bailey. "It is especially satisfying to help 'first time' funds get off the ground and see a GP grow into a major and well known name. We have seen it happen time after time over the last few years and we are proud of the contribution that we have made to groups who have now become 'household names' within the industry".

Augentius has become well known within the industry for helping new groups get off the ground. As the industry changes and evolves there is no doubt whatsoever that these levels of help and assistance will be actively sought out.

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- **Discounted Cash Flows (DCF):** Industry guidelines advise against using DCF, though IFRS is more supportive (perhaps in part due to IAS 39's applicability in other industries where DCF might be more appropriate).
- **Recent investment price:** Valuations may have recently taken place in the course of financing rounds, though there will remain some debate over the basis of valuation to be used.
- **Indicative offers:** Perhaps the least reliable of the valuation methods, as an indicative offer may not reflect the true value of the business. In part this is due to the bidder having incomplete information regarding the target, but may also be due to the bidder offering a high price in order to attract the funds' interest in selling – the eventual sales price, should the process get that far, may be significantly lower following negotiations and due diligence.

The key is to be consistent in your approach and to be able to convincingly explain and justify the valuation method chosen. In addition to seeking advice from your consultant and/or auditor, involve the respective investment manager in the process as he/she will likely be the closest to the asset with the best and most detailed knowledge of its underlying earnings and any comparable businesses in the market.

In conclusion

No matter which method is selected, it is imperative that treatment be consistent between assets and over different reporting periods, and that the basis and rationale for the valuation is documented and justifiable.

IPEV's 2009 guidance should be worth

the wait, and greater transparency should ultimately help the fund industry in its dealings with regulators, investors and other stakeholders. In the meantime, funds must use their judgement in determining a basis that is rational, methodical and, well... fair.

MORE INFO

To discuss the potential impact on your business, please contact James Watts, Head of Onshore Client Services on +44 (0) 20 7397 5475 or at james@augentius.com

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certain operations, with non-core activities such as back-office accounting being performed in other jurisdictions. This model has been adopted by Augentius since 2002, with others now following a similar structure.

With almost full employment in the Channel Islands there is little alternative as demand continues to grow. This is a reflection of the tremendous success of the Channel Islands – success that looks set to stay for a long time, despite competition from the Cayman Islands, Luxembourg and others. Indeed, it is difficult to argue against the sheer number and weight of the advantages of being based in the English Channel.

MORE INFO

Augentius has a long history of providing solutions. To discuss how Augentius can support you in the Channel Islands, please contact Kerry-Anne Morley, Managing Director, Augentius Fund Administration (Guernsey) Limited on 01481 734 302 or at kerry-anne@augentius.com



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