MERGERMARKET
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PRIORITIZING PORTFOLIO VALUATION

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Clarity and consistency of valuation practices in the post-global financial crisis world are becoming less an option and more a necessity as private investors continue to enter Asia-Pacific. Increasingly, alternative asset managers are under pressure from regulators and investors to enhance their governance and transparency over the valuation process.

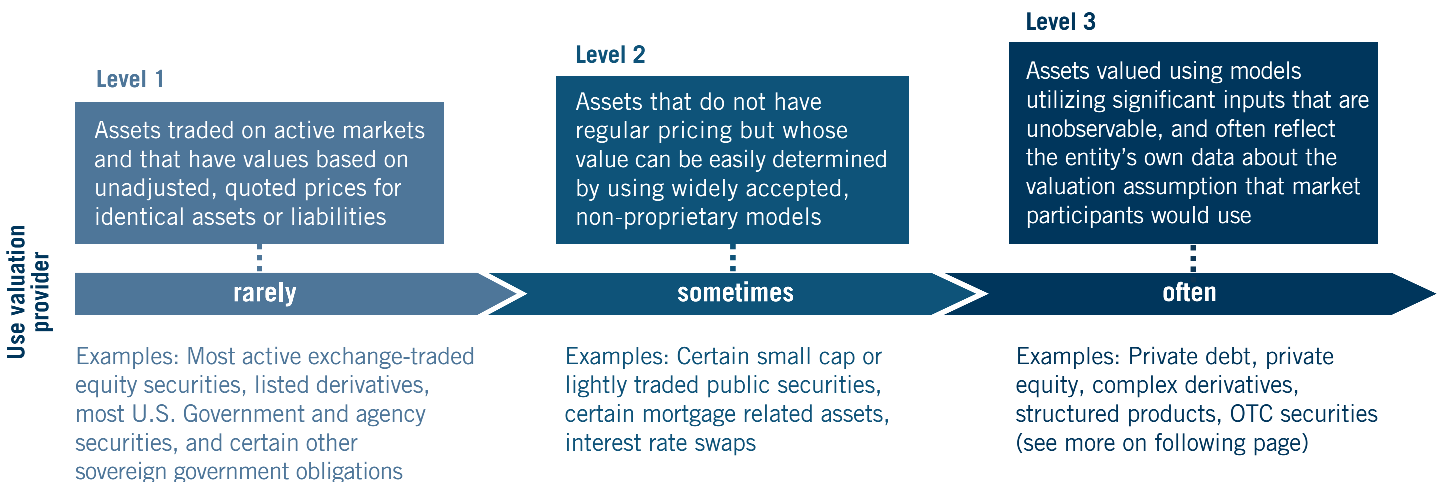
Investors, regulators and auditors demand accurate, reliable, and independent valuations of illiquid investments. This has been a major driver in the trend toward independent valuation determination and, progressively, the need for third-party valuations.

Independent valuations

Interest in hedge fund investment in Asia-Pacific has grown as fund managers and investors see profitable trading potential. However, the industry has only reached a limited share of the region's wealth, leaving room for substantial growth.

Markets across the region continue to deepen and diversify, offering hedge funds a wealth of opportunities to complete successful trades. Data shows Asia-Pacific growing in terms of hedge fund and private equity allocations as dry powder levels reach new records. Investors plan to increase investments throughout 2014. This is happening as increased competition for assets supports high valuations.

Sound valuation frameworks incorporating formal governance committees, well-documented policies and procedures, and the appropriate personnel independent of the investment decision-making process will be needed going forward. This is especially true as the United States Securities and Exchange Commission (SEC) and European regulators show growing concern about the independence of the parties evaluating valuations, while at the same time large institutional investors including pension plans, endowments, and family offices are demanding a strong valuation framework which includes conflict free, independent valuations.



Consulting third-party advisors

It is best practice to engage a third party valuation advisor if an asset management firm does not have appropriate resources and expertise to perform robust valuations that are independent of the investment decision-making process. This is also true if the fund manager cannot provide a truly conflict-free framework for the valuation. Historically, independent third-party valuations have centered around Level 3 assets, but asset managers have been increasingly using third-party valuation advisors to analyze Level 2 assets.

The timing and frequency of engaging independent valuation advisors is driven by numerous factors, including:

- Capital raisings
- Collateral valuations used for asset-based lending
- Communicating fund performance to existing investors
- Frequency of financial reporting
- Interfund transfers
- Redemptions

Assets typically valued by an independent third party

Illiquid Securities such as:

- Private equity investments
- Preferred stock
- Leveraged loans (senior secured debt, secured lien loans, subordinated loans)
- Trade claims and bankruptcy claims
- PIPEs

Corporate derivatives:

- Stock options and warrents
- Convertible bonds

Over-the-counter derivatives:

- Interest rate, credit, mortgage, commodity, currency and equity derivatives

Structured products:

- Collateralized debt obligations
- Collateralized loan obligations
- Asset-backed securities
- Residential mortgage-backed securities

However, not all independent valuation advisors are created equal. Some common pitfalls in selecting a valuation advisor include assuming that a valuation review is synonymous with a valuation opinion or selecting a service provider solely based on price.

A true valuation opinion can only result from a third-party valuation advisor performing the analysis and calculating a fair value from a perspective independent of the investment manager. The marginal cost of meeting these new regulatory and investor expectations regarding valuation pales in comparison with the potential cost of getting a valuation wrong and losing stakeholder trust.

Investors call for more transparency

While general partners (GPs) make their investment decisions substantially based on their valuations, limited partners (LPs) want transparent, reasonable, and consistent valuations on an ongoing basis to make informative asset allocation decisions. One tangible result of this quest for transparency was the 2009 (updated in 2011) publication of the Institutional Limited Partners Association's Private Equity Principles, which hold GPs to rigorous standards for alignment of interest with their LPs, governance and transparency.

LPs are looking for a robust valuation framework and qualified valuation specialists when investing in new funds. This is in line with the SEC's focus on the robustness of the valuation process, fairness of valuation, consistency in application of the process, and finally, the transparency of the process.

Scrutiny over valuation practices

For hedge funds, the industry has entered a new period in Asia-Pacific as new developments, in particular the advent of the new Securities Investment Funds Law in China, could lead to significant changes and provide a boost for these funds. In August 2013, China's securities watchdog, the China Securities Regulatory Commission (CSRC), drafted new legislation to improve regulation over the private equity industry. Previously, the CSRC operated only cautiously toward the industry, allowing fund managers to operate with considerable free rein due to an absence of more comprehensive regulation.

Sweeping changes have also occurred in the US and Europe. The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act in the US, and the 2011 Alternative Investment Fund Managers Directive (AIFMD) in Europe imposed more accountability and more stringent regulations. The AIFMD became fully effective July 22, 2014, and compliance requires either independent internal processes for valuation or appointing an external valuer. Dodd-Frank requires all but the smallest alternative asset managers to register with the SEC, while AIFMD requires asset managers with over €100 million of assets under management to register with their state regulators.

Asia-based funds with US and/or European investors therefore are potentially subject to the same regulatory scrutiny as funds based in those geographies. Throughout 2012 and into 2013 the SEC repeatedly signaled that it was also focusing on valuations, including valuations of complex and illiquid investments. On top of this, the SEC warned the industry it was focusing on the potential overvaluation of assets during the fund marketing stage. The concern was over managers exaggerating the performance or quality of these holdings by writing up the assets during a fund-raising period and then writing them down after the period closes. Since October 2012, the SEC has filed at least five cases in which it alleged false or fraudulent fund valuations.

The importance of quality valuations

Cindy Ma

Dan O'Donnell

Clear and concise valuation practices are quickly becoming the new standard in Asia. As many asset managers and general partners are finding out, a comprehensive valuation today can help avert fines from regulators and lost confidence from investors tomorrow. Houlihan Lokey Global Head of Portfolio Valuation Cindy Ma and Head of Valuations for Asia-Pacific Dan O'Donnell explain this trend and other valuation issues.

What recent events have led to the emphasis on valuation?

Before the great financial crisis the emphasis on valuation came primarily from hedge funds that had to ensure the best possible asset pricing when they had investors regularly entering and exiting their funds. Prior to the financial crisis it was typical that there were fewer rigors around valuation as the markets generally traded up or with minimal volatility. However, the financial crisis saw large price dislocations and unprecedented redemption requests. This put the spotlight on valuation and, as you can imagine, this put GPs and LPs at odds.

Since the financial crisis, valuation has become one of the most important issues for GPs at hedge funds for obvious reasons. However, in the last few years we have seen increasing pressure from LPs and regulators to enhance valuation at private equity funds. While LPs typically do not have the opportunity to redeem their committed funds, the LPs themselves want enhanced transparency into what the value of their investments are. It is no longer acceptable for endowments, institutions, and other sources of capital to commit millions of dollars and wait up to 10 years without interim results to accurately judge performance. Also, we have seen sharp growth in the secondary trades of LP positions, and, thus LPs need an accurate estimate of value in order to set price expectations in the event of a sale. As such, LPs are requesting – and increasingly requiring – GPs to put in place a robust valuation policies and procedures.

Why does this matter to GPs?

If you are raising your next fund and do not have the valuation policies and procedures, and a valuation specialist in place, it could severely impact your ability to attract LPs, particularly the large cornerstone investors. While this phenomenon has been prevalent in the US and European markets for the last few years, we are seeing Asia-based investors increasing their demands on GPs. If you are a new or growing fund that is thinking about attracting a broader base of LPs or win a mandate from the large institutional LPs based in the US or Europe, this is an issue that needs to be addressed early on.

What are the biggest challenges to the valuation process in China? In Hong Kong, and Southeast Asia?

Markets in Asia are still maturing and lack the breadth of the US or Europe. Transparency is often an issue, and business practices can also come into question. As such, the biggest challenge to performing an accurate, fair valuation on an asset in Asia-Pacific, particularly in the region's emerging markets, is gaining access to quality and reliable information from which to base valuation conclusions on. Locating this information, especially from third parties, requires a much more intense approach than in more developed markets as questionable accounting practices in countries across the region can provide an opaque picture of an asset or companies true financial condition or operational performance.

What are some of the common approaches to valuing an asset?

When valuing assets we try to use as many relevant valuation methodologies as possible so that we identify deficiencies in a particular valuation approach and then triangulate this into an answer. Practically, many types of assets can only be valued using certain specific methodologies.

Common methodologies include discounting the future cash flows of an asset to present value using risk-adjusted cost of capital and applying multiples of earnings from publicly traded companies to the comparable levels of earnings for private companies. For more complex assets, such as derivatives, convertible bonds, and structured assets, beyond Black-Scholes models we typically use lattice models or other proprietary valuation models built on complex software that can harness our accumulated market intelligence.

What kind of costs are associated with hiring a third-party advisor?

Cost can depend on a variety of factors, including what the valuation will be used for (internal planning, dissemination to LPs, transaction support, etc.) complexity of the assets, frequency of the valuation, number of positions being valued, amongst many other factors. In short, it really depends on a case by case basis. Therefore, we like to have a thoughtful scoping discussion before we discuss costs.

Houlihan Lokey is an international investment bank and a leading advisor to alternative asset managers on independent portfolio valuation and related advisory services.

Common valuation issues raised by the SEC

The recent SEC inquiry into valuation practices in the US has focused on the following issues:

- Valuations of illiquid investments were provided by consultants that were affiliated with a fund and relied on inputs obtained from the fund's portfolio managers, which resulted in valuation overstatements
- Valuations were based on old data and were not updated frequently enough to be a suitable representation of then-current market conditions
- Valuation methodologies for illiquid investments were misrepresented in the fund's marketing materials
- Fixed-income securities were appraised at face value rather than based on current, market prices available on the measurement date
- Interest paid in-kind increased the carrying value of distressed debt in circumstances where full recovery of principal and interest was unlikely

The SEC has brought actions against investment advisers for violating their own existing valuation policies and procedures in areas such as:

- Frequency of valuation meetings
- Documentation of valuation decisions
- Use of third-party specialists to provide independent valuations and/or support management's estimates
- Price override procedures
- Resolution of price challenges
- For fund-of-funds investments, valuations based on management's estimates even though the fund's policy specifically required the use of net asset value as reported by the investee entity

In light of the SEC's ongoing interest in investment advisers, funds should make compliance a priority by ensuring there is robust supervision of employees and satisfactory internal controls within the firm. Funds should also carry out periodic comprehensive reviews of its operations in order to identify gaps in compliance programs, and make changes as needed in light of new activities or products it offers.

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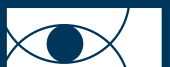
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