SPECIAL REPORT

Q&A: Portfolio valuation

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Q&A

Portfolio valuation

FW moderates a discussion on portfolio valuation between Tony Loughran at Cushman & Wakefield, Dr James Dimech-DeBono at FTI Consulting, and Dr Cindy Ma at Houlihan Lokey.

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FW: Could you outline the importance of having transparent, independent and credible portfolio valuations in today's market?

Dimech-DeBono: Transparency and independence in the context of valuation should lead to credible valuations. In today's markets this remains a must as we are still recovering from the most severe financial crisis ever experienced. Needless to say, in order to generate investor confidence, the various segments within the alternatives industry and regulators alike have increased their efforts to set standards and regulations respectively. Both industry and regulators were working to increase investor confidence and protection and by doing so induce market liquidity. However, large industry players long before the financial crisis realised that providing transparent and independent valuations was an added benefit in marketing their funds to institutional investors. As a consequence, they sought third party advisers in order to provide their investors with an added level of assurance around the valuation of their portfolios. Portfolio valuation for certain level three assets remains a challenge as it becomes necessary to value such assets by marking-to-model. In such instances, financial institutions need to have robust policies and procedures to ensure that the valuations are performed in a consistent manner including the way parameters are derived. A proper governance structure should ensure that the valuations are performed by an independent function within the institution, in the case where an independent external adviser is not involved.

Ma: Since the global financial crisis, regulators have become more focused and active in the oversight of financial institutions and investment funds. In 2013, the chief of the SEC Enforcement Division's Asset Management Unit raised concerns about the lack of transparency by fund managers regarding valuations of illiquid investments. The SEC also brought charges against certain fund managers in connection with alleged valuation related matters. In addition to regulatory scrutiny, auditors often prefer independent valuation expertise for hard-to-value investments and they agree that third-party valuation providers enhance efficiency throughout the audit process. Lastly, many sophisticated limited partner investors such as pension funds and sovereign wealth funds are demanding independent valuations that are transparent and credible. We have heard that fund investors have been asking to review valuation work product in some instances, which further underscores the importance of having transparent, independent and credible valuations.

Loughran: Credible and therefore accurate valuations of commercial real estate are what are needed for a fluid and correctly functioning market. Transparency is also an important factor, so that the end-user of the valuation is aware of any relevant relationships. However, I question whether 'independence' is such a key issue. True independence can only be offered by a party that is completely removed from the market and not 'in the market' and as such, in the interests of accuracy in valuation advice, it is important that the appraiser has good first-hand knowledge of market transactions and therefore is not entirely independent but rather 'external' and unrelated to the company, acting transparently, declaring any conflicts of interest but otherwise acting with the benefit of full market knowledge.

FW: Why it is important for firms to possess a written, detailed and independent valuation when assessing the value of their portfolios? Do firms sometimes lack the necessary skills in-house to perform such valuations?

Ma: Establishing an internal valuation framework or infrastructure is a necessary first step in meeting the demand for transparent and independent portfolio valuations. Generally, best practice in establishing this infrastructure will include three critical components: written valuation policies and procedures, dedicated personnel to oversee the valuation process, and a governance committee with ultimate responsibility for determining value. The valuation infrastructure should establish a formal valuation policy framework, and define roles of the valuation committee and the board. The valuation process should also be independent from the investment process. With the valuation policy framework in place, producing an independent valuation report then becomes important as it assists in the audit process and helps to provide comfort to limited partners in certain situations. Several funds engage third party advisers because of the recognition that in-house skills may sometimes be limited especially for certain illiquid and hard-to-value securities.

Loughran: It is important for major property companies to have an external valuation of their assets so as to transmit maximum confidence in their corporate governance and general willingness to open themselves up entirely to the full audit process. Any valuation undertaken in-house will lack the insight of the external property appraiser acting with the benefit of full knowledge of current market activity and transactions, via information received through the agency teams working alongside the valuer.

Dimech-DeBono: Good documentation is necessary to ensure that the valuations are performed according to agreed upon methodologies in a consistent way from one valuation period to the next. Proper documentation should include not just the methodology for each product or asset being valued but also how the valuation parameters are derived in order to ensure consistency across asset classes – for example, interest rate curves should be consistently used across different products. The policies and procedures documents should contain details of the process the valuer should follow when, for example, information may be missing. Another aspect that such documents should cover is the governance structure within the organisation, highlighting approval processes and the committees involved, in order to ensure that the valuations are derived in an independent way. Any departure from any policy should also be documented and escalated to the right level for approval. In situations where such departures become more frequent, the policies may have to be revisited and updated. Small firms typically struggle to have a separate independent valuation function due to their size. As a result, they would typically rely on third party advisers in order to get independent valuation assurance.

FW: To what extent is demand increasing for external specialists to drive the valuation process? Can outsourced valuations adequately protect portfolio managers from accusations of overvaluation?

Dimech-DeBono: The rise in valuations by external parties has increased over the last eight years. This was mainly instigated by investor influence in the US. That trend came across the Atlantic soon afterwards, especially where funds have US-based investors. This was not the only change that we have necessarily experienced as funds have established better governance structures in order to ensure better compliance with regulation. Valuations that are performed independently, whether by an internal function or external party, should provide adequate assurance to investors. Alternatives funds that adhere to best practice have a distinct valuation back-office function, similar to the Independent Price Verification function in investment banks. The responsibility for producing valuations for monthly NAVs lies with this function that would then report to the valuations committee for final approval by the board.

Ma: It has become a best practice for fund managers to engage a third-party valuation adviser as part of their valuation processes. While not a requirement, auditors, regulators, investors and other stakeholders can gain comfort in the independence such an adviser can bring to the table. We have seen significant increases in demand for valuation services in connection with this trend. However, fund managers should remember that 'you get what you pay for'. While the gold standard is a fully independent valuation, some valuation advisers may offer a lower fee for 'assurance' opinions. These services may entail a 'light touch', and a reliance on a significant amount of information provided by portfolio managers. Fund managers should consider the scope of work proposed by third-party valuation advisers in connection with the protection they seek from misstating the values of their portfolio investments.

Loughran: Given the increased emphasis on good corporate governance, the demand for quality external valuation advice is increasing. Also, in the context of director responsibility, it is key that valuations are responsibly outsourced to well-qualified and respected external valuers, so as to provide greater assurances to shareholders of the accuracy of asset valuations. The past practice of 'test valuations' is now much less prevalent with generally greater transparency being applied in the outsourcing process. Just

to clarify, 'test valuations' were sometimes incorporated into valuer selection processes where the decision to appoint was based not just on fee level and proposed scope and quality of work but also the level of 'pre-valuation' of certain assets held by the client. Therefore, outsourcing alone does not eradicate overvaluation. It is only responsible outsourcing that achieves this.

FW: How is the increasingly robust regulatory environment impacting on portfolio valuations? Is this leading to greater transparency and consistency with valuations in order to comply?

Loughran: Regulation is not the solution, in my view. The best regulator is 'reputation'. Regulation can only audit for best practice compliance. Ultimately, it is the insurance companies, offering professional indemnity insurance cover, that are better placed to gauge the better external valuers from the poorer ones, charging lower premiums and offering better cover to the valuers with the better track record on claims. Well run property companies will always want to be seen to be appointing valuation firms with strong reputations in the market.

Dimech-DeBono: Better measures were put in place to increase both transparency and investor protection since the global financial crisis. In 2013 and 2014, the European Union introduced the European Market Infrastructure Regulation (EMIR). This regulation places additional requirements on market participants to increase transparency around their practices. Through this increase in transparency, the European Union is attempting to ultimately reduce the level of risk inherent in the derivatives market. From a valuation perspective, there are a number of requirements, such as whether fair valuation policies and procedure have been formalised, and whether an independent third party is involved in performing the valuation. Specific questions around how illiquid securities are modelled and how independently valuations are arrived at need to be addressed and disclosed. These are only a few of the aspects that need to be addressed. In Europe, the Alternative Investment Fund Managers Directive (AIFMD) makes compliance demands for alternative investment fund managers in order to give adequate protection to investors.

Ma: Funds are adapting their internal processes in response to the ever increasing scrutiny and demands of regulators. Many managers have established more formal valuation policy frameworks, which typically consist of three main elements: a written valuation policy document, an established valuation committee that oversees the process, and a board of directors that has ultimate responsibility for determining the valuation of the funds' assets. We have also seen the formal valuation policy document will typically define the roles and responsibilities of the valuation committee and the board, identify other personnel that will support the valuation process, outline the procedures and methodologies used in preparing the valuations, and mitigate conflicts of interest. Strong consideration should be given to establishing a valuation process that is independent from the investment process. When implemented, these all contribute to greater transparency and consistency in the valuation process.

FW: What technology solutions are available to assist with the reporting, monitoring and valuation process?

Dimech-DeBono: Technology is certainly playing an increasingly important role in more ways than one. If we think of the valuation process, technology is present throughout. At the onset, the information about the asset being valued is received and the necessary research is performed. This entails searching for comparable guideline companies and transactions, performing market-based research and deriving the valuation metrics. The process described so far is rather mechanical and technology-based; however, in the case of private equity, the valuer needs to apply his or her experience in order to establish how comparable the guideline companies and transaction are. This has a bearing on discounts or premia that would be subsequently applied. Although most of the calculations are performed electronically, an assessment of the reasonableness of the assumptions and finally the valuation has to be made. At the end of the process, valuation marks and the proper disclosures can also be reported electronically.

Loughran: The high quality valuation update is a detailed process that can be time consuming; nevertheless, technology has improved in terms of the amount and detail of data that can be transferred quickly between asset manager and valuer, hence within a matter of hours of commencing a new instruction it is possible to pass all data to the valuer using web-based file transfer sites. Also, the valuer has an array of tools that enhance the quality of analysis and service delivery so that the client receives a truly insightful analysis into the value of the assets or portfolio.

FW: Have you observed any significant re-evaluation of management equity for portfolio companies, given the often volatile markets seen in recent years? How much of this is being driven by regulatory scrutiny as opposed to economic imperatives?

Loughran: I am sceptical as to the influence of regulatory scrutiny. Any shift in the deployment of equity has been attributable to market forces rather than regulatory influence, in my opinion. The volatility in markets during recent years has been attributable to many factors, from currency risk in 2012 to lack of bank finance and then its re-availability more recently, resulting in major redeployment of capital and significant property company refinancings. The driver as such has been market fundamentals rather than any regulatory influence.

Dimech-DeBono: Valuation is not a science, especially when dealing with unquoted companies as an element of judgment always comes into play. With any valuation, the business plan and its achievement is always a source of uncertainty. This uncertainty emanates from management's ability to execute the plan to external market forces. Performing the necessary due diligence on the business plan is always a must. This avoids using unrealistic assumptions and unsustainable growth rates in the terminal value calculations. As such, in the recent volatile markets, particular attention was paid to issues surrounding the economics underlying the business as well as others relating to liquidity and ability to refinance. At the end of the day, having stale valuations is not ideal when managing a portfolio and one cannot base investment decisions on outdated information. These changes are necessary if we are to avoid practices that were quite prevalent in some institutions before the financial crisis.

FW: Ultimately, what trends and developments do you expect to see in the portfolio valuation space over the coming years? What do you consider to be the biggest challenges facing valuation and reporting processes?

Ma: Regulators are likely to expect managers to have formal written policies and will focus on a managers' compliance with its own internal policies. The regulatory landscape is likely to become even more complex and demanding, particularly for managers that operate in multiple jurisdictions, and investors are likely to increase their focus on transparency of information. ►►

As the secondary market for fund LP interests continues to grow, transparency of fund information along with reliable and independent valuation marks will become more important to LPs, particularly institutional LPs that periodically rebalance their investment portfolios through secondary market purchases and sales. We are also seeing more complicated capital structures again. As investors continue to hunt for yield, we are seeing funds focus on new and emerging asset classes such as maritime assets, non-performing loan pools, and long dated infrastructure assets including investments in developing markets.

Dimech-DeBono: Regulation presents an ongoing challenge for the financial industry as a whole. As a consequence of the global financial crisis, financial markets have seen a number of regulatory changes. We can expect further regulation over the next 5-10 years as the push for a global regulatory reform gains further momentum. We are at a stage where the US and the EU are leading the way on regulatory reform but regulators elsewhere are also catching up. In addition, regulatory reform is likely to follow an iterative process as lessons are learnt and further changes are implemented. This will continue to provide further tests to the industry. In light of the fact that complexity is never going away, challenges in complex asset valuation are going to remain. Technology is certainly playing an increasingly important role in more ways than one and this helps bridge some of the gaps with having more relevant data to work from and calibrate to. However, the role of the independent valuation adviser remains essential to this whole process, especially when judgement has to be taken into account and exercised.

Loughran: Valuations should be 'market led', undertaken by valuers that are external but not entirely independent from the market. A good quality asset valuation requires input from agents who are acting in the market who can comment on latest trends and comparable pricing, which is precisely the service that the client should be receiving from their adviser. Nevertheless, the involvement of agents working alongside the valuer can give rise to conflicts of interest that need to be managed, with transparency being of key importance in this context. In my opinion, regulation or, to be specific, 'over-regulation' is not the solution. In Portugal, it is now the case that valuers are personally responsible for the work they sign-off on and indeed valuation must be undertaken entirely separately from the agency function, as is the case in certain other European countries. However, this policy directly detracts from the quality of service that can be delivered as it is precisely the input of agency knowledge that enhances the quality of the valuation advice. There seems to be a level of distrust in certain countries that valuers will not act with transparency, declaring conflicts of interest. However, what is the worse evil: a valuer that acts with full market knowledge subject to the correct handling of conflicts of interest, or a valuer that is completely independent of any conflicts but lacks the market knowledge to value accurately? ■