PEI Alternative Insight

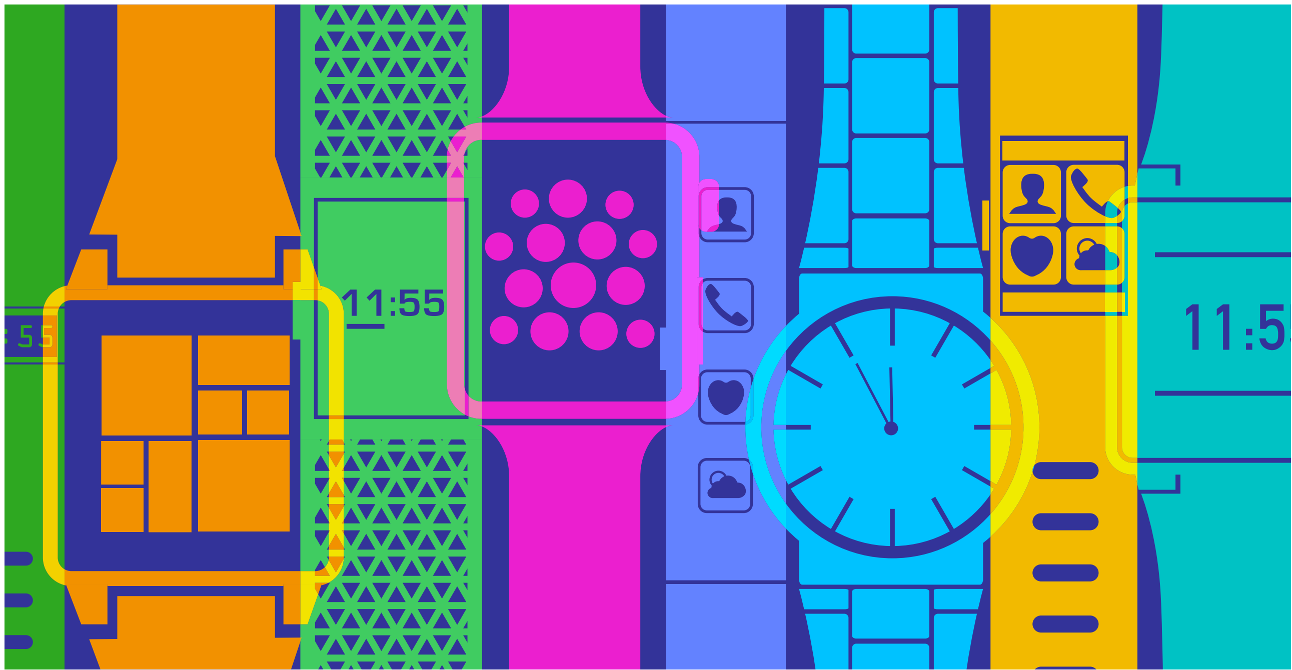
pfm
private funds management

www.privatefundsmanagement.net

FINANCE · LEGAL · COMPLIANCE · OPERATIONS · TAX

SPECIAL REPORT: VALUATIONS

THE VALUE OF YOUR TIME | MAKING YOUR MARK | OUTSOURCING VALUATION



Watch: auditors may shift the time burden on to valuations professionals

The value of your time

Valuations are coming under increasing scrutiny, with a new certification and a new benchmark. *Rob Kotecki* details what efforts alternative asset firms may have to put in

Valuation will probably never be an exact science, but the industry is striving for more rigor. Last year, three valuation professional organizations released an optional credential, Certified in Entity and Intangible Valuations. It includes a Mandatory Performance Framework, which attempts to standardize how fair value estimations are documented.

The credential grew out of regulatory concerns about valuations at publicly listed companies, but GPs will need to take a close look at how it will likely affect alternative assets firms.

The framework doesn't offer a standardized valuation methodology. Instead, it details a roadmap that reports how someone arrived at a particular valuation, which auditors are likely to adopt to save time. And as the credential and the MPF become more widely used, regulators may start expecting valuations with the CEIV stamp of approval from private funds managers, too.

3

Bodies which can grant certification

But the CEIV was born out of Securities and Exchange Commission concerns about the valuation industry, not hedge funds or buyout shops. In 2011, Paul Beswick, then chief accountant for the regulator, spoke at the American Institute of Certified Public Accountants conference, expressing concern about the valuation profession. The application of fair value and fair value-based measures included in the US GAAP was being more broadly applied, and Beswick argued the valuation industry's lack of uniform education or experience requirements might lead to analytical inconsistency or a lack of objectivity.

Beswick suggested the industry devise a single set of qualifications, standards for practice and a code of conduct. He added, "One could also contemplate whether a comprehensive inspection program and a fair disciplinary mechanism should be established to encourage proper behavior and enforce the rules of the profession in the public interest."

As a result, three valuation professional organizations, the AICPA, the American Society of Appraisers and the Royal Institution of Chartered Surveyors, devised the CEIV with the help of international valuation and audit firms. "The idea was to establish

qualifications and standards in response to the concerns expressed by the SEC prior to any regulators imposing their own on us," says Joan D'Uva of EisnerAmper.

The result was released last year and goes a long way toward addressing Beswick's concerns. "The CEIV sets a minimum of education and experience requirements for valuation professionals," says Mark Zyla of the valuation firm Acuitas. "It's a framework for consistency."

It may be too soon to tell how the industry will respond to the new process. "It's only been out since last spring, so many professionals may not have had the time to get the certification," says Travis Harms, who leads Mercer Capital's financial reporting valuation group. "In my practice, no one's explicitly inquired about the CEIV just yet."

> "[Valuations professionals] will have to indicate why they used the methodologies they did and why they didn't use other methodologies"
>
> Joan D'Uva

D'Uva: getting ahead of the regulators

Ready, set, go, once we know

Market participants suggest many valuation professionals are ready for the training and the testing but are waiting until issues surrounding the quality control process and enforcement mechanism are clarified. "The primary reason for the slow adoption is people aren't quite sure how they'll be inspected," says David Larsen of Duff & Phelps. "Nobody wants to do anything wrong, and they don't know what's wrong yet."

At the moment, the credential can be obtained from any of the three sponsoring groups, so one firm may have professionals with certification from different groups. And this raises the question of which of those three bodies will review that work, and what happens if the multiple reviews reach different conclusions?

There is also a confidentiality concern with the certification: private equity firms may not want to grant unlimited access to a monitor from the VPO who is sent to review the valuation. "One way they may resolve that is to have the monitor review the process rather than a specific valuation," says Larsen.

But the industry is more positive about the documentation standards laid out in the MPF. "The [framework] identifies how you think about the valuation work you're doing and how you document the valuation analysis and conclusions. The MPF is considered best practice and it's something that all fund managers should be implementing, and all valuation professionals should be following," advises Larsen.

The core rationale for adopting MPF-grade processes may not come down to regulators in the end, but auditors. "The guidelines already closely mirror what many audit firms outline, so it may be seen less as a radical departure, and more of a roadmap to documentations that closely mirrors the one already used by auditors," says Harms. "If I'm the fund CFO, what I really want is as little friction between the fair value process I'm overseeing internally or externally; I want to minimize the friction between that and the audit process."

"[The MPF] is going to be the de facto level of requirements for documentation that auditors will expect from either outside valuation firms or internal valuation staff," says Zyla.

Better safe than surprised

As a result, many valuation professionals serving the alternative asset industry are exploring the certification, or at very least, matching the MPF's documentation standards.

"We're incorporating the MPF into our processes and speaking with our clients and other market participants about their own internal valuation process and what needs to be tweaked so that they're compliance with this new standard," says Larsen. So how much longer of a paper trail will GPs need to produce to meet this new yardstick?

"Adherence to the MPF will involve formalizing a lot of documentation that's already being produced in an informal manner," says Harms. "The MPF requires the practitioner to document the process so that someone with reasonable knowledge could

Harms: wants to minimize friction

Aronow: forecasts can be a challenge

review the valuation materials and be able to ascertain that the conclusion is supportable," Larsen adds. That involves sharing more details about the decisions and assumptions that go into the final valuation.

"Now under the MPF, they'll have to indicate why they used the methodologies they did and why they didn't use other methodologies," says D'Uva. "There's now a more robust process to expand upon citing those reasons including ones that may seem obvious."

Don't complain, just explain

The MPF also asks people to say why certain metrics were left out of the valuation. "In the case of contrary information, that is, information that disputes the current valuation, the MPF asks that we report how such information impacts the final conclusion of value," says Larsen.

Financial forecasts may also require more documentation. "Forecasts can be a challenge to evaluate, and practically speaking it can be a challenge to gain an understanding of all the inputs used to support an acquisition price," says Michael Aronow of EisnerAmper.

"There are many factors that make a particular acquisition attractive at a transaction price, and that includes a forecast developed based on assumptions such as growth rates, market share, margins, as well as other significant assumptions that need to be properly substantiated and documented."

While the MPF doesn't advocate any particular methodology, some approaches may create more work than others, especially for a traditional private equity firm. "When an income approach is being used as valuation technique, most people do a pretty good job in identifying the discount rate and how they calibrate the inputs and such," says Larsen. "But in the case of alternative asset firms, the projections are a little less robust, or at least the documentation of projections beyond one or two years can be less robust than in the corporate environment."

> "Nobody wants to do anything wrong, and they don't know what's wrong yet"
>
> **David Larsen**

For example, if a buyout firm projects a 5 percent growth rate, they will need to explain what inputs are being used to support that and what changes will drive the performance. "In the corporate world, the projections are more rigorous, in that they know how many more widgets they'll be making, to which customers they will be sold, at which price, in which year, whereas the buyout firm may not be as detailed when it comes to projections three or four years out."

"Over time, I would expect the SEC would check that people are following the MPF and I'd expect LPs to begin asking whether their GPs are meeting that standard as well," says Larsen. "Whether they are pushing for a CEIV certification to be obtained by someone in the firm or their outside valuation provider, that remains to be seen."

Investors and regulators may not be demanding CEIV-grade valuations just yet, but auditors will be certainly want a process that makes their life easier. "I've seen it in practice now," says Aronow. "On a call recently with a large national firm and their valuation group, they only had a single question on our valuation documentation and even then, the answer was readily available in our work papers, so we were able to respond quickly."

A quick response may make auditors happy, but at the cost of valuation professionals' time. That, however, is something firms may just have to tolerate. ■

Making your mark

Valuing a portfolio company in a way that's fair, accurate and suits investors is easier than it was 10 years ago. *pfm*'s roundtable discuss the changes in the industry

by TOBY MITCHENALL and VICTORIA ROBSON

photography by LEA RUBIN

From left: Tom Angell, WithumSmith+Brown; **David Larsen,** Duff & Phelps; **Blinn Cirella,** Saw Mill Capital; **Mark McMahon**, Alvarez & Marsal; **April Evans**, Monitor Clipper Partners; **Noah Becker**, LLR Partners

Sponsored by:
Alvarez & Marsal, Duff & Phelps, WithumSmith+Brown

With one voice, our panel of portfolio company valuation experts agrees that in the decade since the global financial crisis, best practice in valuations has undergone a significant shift resulting in more consistency and transparency. "Our main concern is to be thorough and thoughtful as we value companies, and remember there is no right answer," says April Evans, chief financial officer at Boston-based mid-market firm Monitor Clipper Partners.

"The assumptions that go into an evaluation are by definition subjective. So [our goal is] being clear about what they are and consistent – period to period – and identifying the best method of valuation for each of our companies."

"The industry has come a long way," says Mark McMahon, a New York-based managing director and head of valuation services at professional services Alvarez & Marsal, "and it continues to evolve. Transparency has become institutionalized. We often forget how things were 10 years ago. I remember when fair value as we know it today was gaining traction. Conversations with the deal teams were really challenging due to this new perspective they had to consider."

"We fundamentally do a much better job of thinking about value

> "We fundamentally do a much better job of thinking about value for private investments today than we did 10 years ago"
> **David Larsen**

> "I abhor discounted cashflows. There's way too much room to play around"
> **April Evans**

for private investments today than we did 10 years ago," agrees David Larsen, managing director at valuation advisors Duff & Phelps.

Should there be an economic downturn, the industry is much better prepared than it was in 2007, Larsen says, citing a decade of experience, the existence of the new Mandatory Performance Framework and third-party validation of fair value estimates. "The infrastructure around valuation is better today," he notes.

Examination prep

A significant driver of change has been increasingly rigorous regulatory oversight, notably from the Securities and Exchange Commission.

"I've heard multiple stories of SEC examiners really digging into the valuation," says Blinn Cirella, CFO at mid-market firm Saw Mill Capital. Rather than given an opinion on the valuation itself, the regulator is more interested in whether managers have stuck to their stated guidelines and valuation policies as outlined to limited partners in the limited partnership agreement and the private placement memorandum, she says.

Managers know to be prepared for the regulator's questions. "We have a valuations notebook that's ready for the SEC when they walk in," says Cirella. "Every quarter our valuation committee sits down, we go through it and compile it. We don't even have to look and pull papers off the server. It's all there."

Valuation is a "main focus" of the regulator in any presence examination, says Tom Angell, practice leader of WithumSmith+Brown's financial

services group. "The SEC wants to see year over year consistency around valuations. They also want to see documentation surrounding the unobservable inputs. The SEC will talk to the auditors regarding their work on the valuations. They want to know what our approach was and how we got comfortable with the assumptions."

During an SEC examination, managers also need to be concerned with presentation, says McMahon, who notes that clients are often consistent in approach but "each deal team has their own view as to the most effective presentation, so you just couldn't see the methodological consistency. When we are engaged, many times the first thing we do is create a standard display template to eliminate the appearance of inconsistency."

One area that has drawn the regulator's focus is permanent impairment, says Larsen. "Often a fund agreement says the manager writes an investment down when it's permanently impaired and won't charge management fees on it, but it doesn't define permanently impaired," he notes. "The regulator will ask: Was the LP harmed because a manager didn't write an investment all the way down? It highlights [for the GP] why it's important to do a regular, quarterly valuation so you can assess where you are."

Want v need

Alongside regulators and industry bodies, investors also are paying closer attention to portfolio company valuation estimates. But dealing with different investors' demands for information and their different preferences can be challenging, the roundtable says. "I believe LPs

AROUND THE TABLE

Tom Angell is practice leader of Withum's Financial Services Group and has more than 25 years' experience providing audit, tax and consulting services to private equity funds. He advises emerging managers on all aspects of launching a private equity fund.

Noah Becker is the CFO at at technology and services-focused firm LLR, where he is responsible for financial reporting and oversight of all administrative financial matters. He has more than 20 years of experience in the corporate financial and public accounting sectors.

Blinn Cirella has been with mid-market firm Saw Mill Capital, which has focused on manufacturing, service and distribution businesses since 1998, for more than a decade. As CFO, she is responsible for managing all financial and administrative aspects of the firm.

April Evans is a partner, CFO and COO at mid-market firm Monitor Clipper Partners, where she has been since since 2005. Previously she was partner and CFO of Advanced Technology Ventures, a $1.5 billion venture capital firm and a founder of accounting firm Squillace & Evans.

David Larsen is a managing director in the San Francisco office of Duff & Phelps and part of the portfolio valuation service line. With more than 30 years of transaction, valuation and accounting experience, he specializes in fair value regulatory and financial reporting issues for alternative asset managers and investors.

Mark McMahon is the global practice leader of Alvarez & Marsal Valuation Services and leads the alternative investment services group. He specializes in the valuation of illiquid securities and provides advisory services to alternative asset managers to support of regulatory compliance, investigations and litigation.

always have and always will be more concerned with the reliability and directional accuracy of the valuations than the detailed methodology," says Noah Becker, CFO at the Philadelphia-based technology and services investor LLR Partners. "But over the years they are becoming more interested in the methodology and the underlying details and assumptions."

Cirella cites two instances where LPs questioned the firm's valuation methodology. In one case, the investor asked why the firm used the average of three valuation methods – discounted cashflow (DCF), public comparables and precedent transaction analysis – and did not pick the method that best suited the company.

"We said our approach took a lot of subjectivity out of the process. It removes the tendency to want to change methods because one works better than the other. I was surprised that the LP was advocating using the best model to get the highest valuation. We want accurate."

In another conversation, in response to the firm's preference to be conservative with its valuations, the LP replied: "Don't hold back. Value it where it should be valued," Cirella says.

Some LPs put up resistance to valuations being held at cost because their own compensation benefits from an uplift. This can be frustrating, Cirella adds. "It is a bit like the tail wagging the dog. Maybe those managers need to think about the asset class a little bit differently, rather than force us to do something that's a little unnatural and difficult to do."

"Transparency has become institutionalized"

Mark McMahon

Second guessing

The rise of the secondaries market, with investors considering liquidity before the end of a fund's life, means interim valuations do matter, says Evans. While the GP is less concerned about the purchase price when a single LP sells a stake in its fund – "I just want to know that it's all done properly and that both sides have the same information from us so that they can make their own set of decisions," says Evans – in the case of a tender offer to all LPs, the manager is typically providing a far greater amount of information, she says.

"That's a different world. The GP is part of the process. It's a lot of work. It's like selling a company. There's an extensive data room, lengthy due diligence and crafting legal documents," she says, noting that Monitor Clipper Partners has been through a tender offer process with its 2003-vintage $800 million

fund. "The way our LPA works, the first hurdle was obtaining LPs consent to even entertain the offer," she adds.

"Increasingly we're seeing in our secondaries practice a lot of different permutations and end of fund life issues," says Larsen. "In many cases secondaries are GP-led. For an LP to decide to sell its interest or continue on with the new fund, or new structure, they've got to have good information on the underlying value today of that portfolio company and then a view on where it is going in the future. Regular robust valuations provide LP's with additional information necessary when faced with secondary transaction decisions."

However, McMahon cautions against drawing conclusions on valuations from secondaries

"[Differing] valuations are not wrong because it's so subjective, but you can see human behavior issues"

Thomas Angell

Taxing reforms

The valuation industry is still getting its head around the new US tax rules

The US tax code reform bill that became effective on January 1 cuts the corporate tax rate from 35 percent to 21 percent, but for private funds valuation professionals, it has ushered in a period of uncertainty.

"For a very large portfolio company it could take a number of months to figure out what it means," says Larsen. If a manager does not close their 2017 books until April, "do I incorporate the benefits? Is that known and knowable to a market participant at that point in time? That's a very difficult judgemental question."

"And given the judgments involved, fund managers will need to have documented how they considered the impact of the new legislation at each measurement date," says Angell.

It affects net operating losses carried forward, levels of tax-efficient leverage and many other aspects of valuation, says McMahon. "All of these changes must be factored into a DCF by making relevant adjustments to projections and choosing appropriate discount rates."

Becker says he does use DCF "and part of the challenge is to assess what's been priced in the multiples during the year. You've got two effects - the moment in time event and tax law effect – so what dials are you turning? How do you manage it?"

"LPs sometimes say what they want but they don't always tell the GP what they need"

Noah Becker

transactions. "If an LP interest is sold at a discount or premium to net asset value, this does not imply that the portfolio companies were mismarked, but rather highlights the difference in required return between primary and secondaries LPs."

While managers' approaches to valuation methodology differ, Monitor Clipper Partners has chosen to apply the most appropriate valuation method to its each of its 20 portfolio companies, taking into account how that company will be valued by a buyer, says Evans. "What are they going to use – a revenue multiple, an EBITDA multiple or a DCF?" She adds: "I abhor DCFs. There's way too much room to play around."

Monitor Clipper Partners' preference is to use precedent transactions "wherever we can, as opposed to public comps, because a sale actually occurred," she says.

The panelists all agree that obtaining good data to support valuations can be a struggle. Angell notes that his firm has a database of its clients' investments and it is telling that sometimes disparities occur.

"Every so often we'll get two clients in the same investment with different valuations. [Differing] valuations are not wrong because there is some subjectivity to the assumption. Each client may approach their valuations differently but will have documentation to verify their inputs."

"Don't hold back. Value [an asset] where it should be valued"

Blinn Cirella

This makes life difficult from an audit perspective, he adds. "It's hard to see two different valuations without wondering if one is correct and the other is wrong."

Ultimately, he notes, the key is having documentation from the client that details the valuation. ■

PRIVATE DEBT INVESTOR

PEI Alternative Insight

June 20-21 | Convene Conference Center- Midtown East | New York

CFOs & COOs FORUM 2018

SPEAKERS INCLUDE:

Amy Coleman Redenbaugh
Managing Director and Chief Financial Officer
Thoma Bravo

Bryan Martoken
Managing Director/ Chief Financial Officer
Benefit Street Partners

Terrence Olson
COO & CFO
THL Credit

Vishal Sheth
Chief Financial Officer
Twin Brook Capital Partners

Lead sponsor | KIRKLAND & ELLIS

Sponsor |

Exhibitor | Cortland® Fund Administration Services

REGISTER TODAY | Up to 12 CPE credits available

https://events.privatedebtinvestor.com/cfo-and-coo-forum-2018

For sponsorship & marketing opportunities, contact **Lawrence Dvorchik**

lawrence.d@peimedia.com
+1 646 545 4429

Outsourcing valuation – why and how many?

Michael Athanason, managing director and head of alternative investment valuations, and *Federico Jost*, managing director, alternative investment valuations of BRG Corporate Finance, analyze the trends driving the rise in portfolio valuation outsourcing

As the alternative investments asset class continues to develop and mature, investment professionals are required to deliver performance that continues to appeal to their investors. Private equity and private real estate funds have delivered returns above those of their listed equivalents for many years and investors' expectations for continuing these superior returns have pushed them to increase their allocation to alternatives in their efforts to boost returns. Many market observers are concerned that the record amount of dry powder awaiting investment will drive fierce competition for deals and drive asset valuations even higher, at best reducing future returns for LPs and at worst creating asset bubbles. As the burden of regulatory complexity and the high demand of time from deal teams and CFOs creates more demand for outsourcing certain functions to generate cost efficiency, enhance independence and demonstrate transparency. Outsourcing is now a growing trend borne out of necessity and, furthermore is encouraged by investors. It is currently estimated that approximately 12 percent of GPs now fully outsource their valuations, while more than 50 percent hire third-party firms to do positive assurance.

A recent survey presented at the PEI CFOs and COOs Summit in New York showed that approximately 55 percent of CFOs want to decrease the time spent on valuations, yet understand their valuation reporting will increase over time. Also, approximately 94 percent of firms participating in the survey who outsource valuations are satisfied with the product and its quality.

Valuation outsourcing is an industry trend

Outsourcing valuations is increasing, driven by five clearly identifiable trends.

CFOs seeking operational improvements. Operational improvements often involve hiring staff to work directly in certain areas that require specialization such as valuation. This is usually treated as a manager expense. Outsourcing valuations transfers the cost out of the manager and into the fund. Additionally, smaller funds that lack operational scale and seek to demonstrate best practice should consider partnering with a valuation service provider rather than relying on deal teams that are not trained in financial reporting valuation. This does not eliminate investment professionals' critical input into the process, rather it backstops and formalizes it.

Managers require high *quality* valuations. Industry and geographic expertise is an added benefit coming from hiring a capable external provider. Leading third-party valuation firms often sit within a platform that has close ties to industry experts across multiple geographies, allowing these firms to tap into operating expertise and transaction knowledge, adding value to the assumptions going into the valuation models. Also, methodology from external providers tends to be refreshed frequently based on their broad exposure to industry, accounting, tax and deal exposure through their client base. A clear example is the impact of the tax act recently passed by the US Congress which impacts the valuation methodologies and models. There are a large number of technical adjustments being implemented now to correctly value 2017 year-end positions.

***Flexibility* is key.** Having a large number of in-house staff on board to do the

Athanason: investors' demands are pushing outsourcing

> **"Everyone agrees investment professionals should do what they do best: invest and maximize value with those investments"**

valuations has risks, primarily employee turnover. Outsourcing valuations, while maintaining internal oversight, has the benefit of institutional support every period, allowing funds to access valuations on a turnkey basis.

Investor demands. Investors are increasingly demanding valuation governance and segregation of duties when it comes to calculating the fund's net asset value. Data derived from fundraising activities in 2017 reveals that most investment consultants and placement agents agree that a well-defined set of policies and procedures and an independent valuation process are high-priority concerns for many investors.

Regulatory demands. At the January 2018 PEI CFOs & COOs Summit in New York, panelists discussed the planned increase in the number of SEC examinations and their continuing focus on valuations and expenses. SEC examiners and the Alternative Investment Fund Managers Directive specifically ask whether the manager has an independent valuation committee in place, a formal valuation policies and procedures document and the involvement of a third-party valuation provider, either preparing or reviewing (positive assurance) valuations.

The outsourcing trend has continued beyond private equity sponsors. Limited partners now routinely outsource valuations for their direct investments for many of the same reasons as general partners. Moreover, LPs are now routinely checking valuations provided by GPs in order to maintain an independent view. Many are motivated to seek third-party valuation support in order to gain geographic and industry expertise. Those that rely on quality external valuation firms can rely on a deep and stable bench, mitigate key-man risk and expect a timely delivery of results.

Jost: multiple providers is the new norm

Real estate funds and business development companies have been doing this for years, hiring multiple valuation firms based on geographic footprint, asset type and specialty. Hedge funds have moved beyond their administrators' management of positions to external specialist valuation providers for their illiquid books. Private equity is following suit – they have embraced independence as a best practice attractive to investors – rather than sticking with internal controls heavily dependent on the investment teams' inputs and giving them the ability to focus on financial reporting tasks.

One valuation provider is not enough any more

Fund governance often requires an independent valuation agent and there are various reasons why managers should not depend on only one provider and why the trend is clearly moving towards multiple providers.

Depth of perspective: As portfolios can be extensive and expertise is key, most investors with large portfolios tend to have two to three valuation firms for financial reporting valuations. Multiple providers having a diverse client base and transaction experience extends the knowledge network an investor can tap into. Service provider exposure to multiple clients, assets and jurisdictions ensures that evolving best practices are always considered.

Value and quality: Employing multiple service provider is a proven method to ensure that pricing remains competitive with market rates and service quality consistently meets expectations

Gregory Hunt, CFO at Apollo Investment Corporation with $72 billion committed to private equity, said: "A second (or third) valuation provider offers the CFO an ability to compare market pricing 'keeping providers honest and competitive' and provides assurance that the fund is paying a market rate."

Conflicts: When conflicts arise that prevent a service provider from providing a valuation, the CFO can be placed in a tough situation at crunch time – no independent marks and no time to engage a new provider. Having a diversified set of valuation specialists avoids potential disruption.

Outsourcing to multiple service providers appears to be the safest and most efficient solution to fund managers and investors. Management of these relationships must be simple and cost-efficient to be truly worth it. Service providers bring many benefits to the fund managers and investors that otherwise would have to be obtained by increasing headcount and strengthening talent retention incentives, both of these are expensive. ■

SPONSORED BY
BERKELEY RESEARCH GROUP