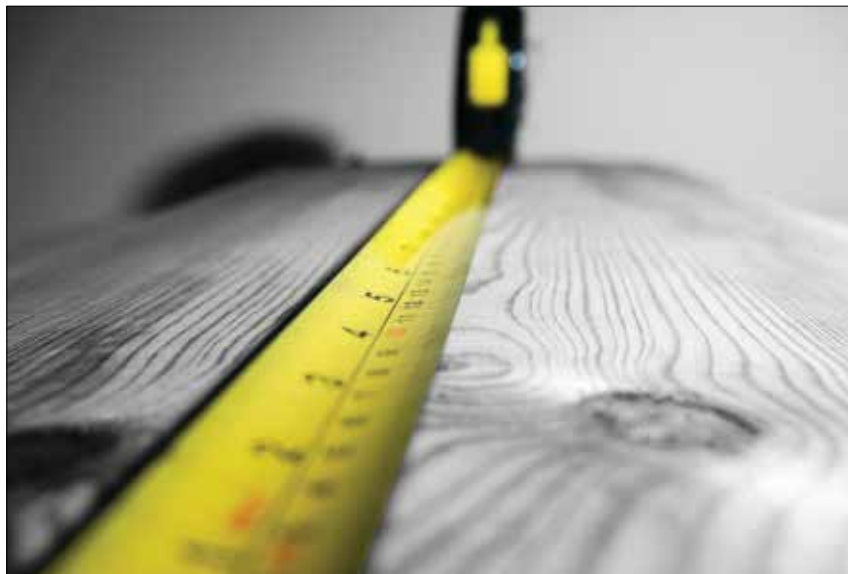


keynote interview: HOULIHAN LOKEY



Valuation best practices: continued growth

Q&A: The new normal

Pfm catches up with valuations expert **Dr. Cindy Ma** to hear about the latest valuation best practices being adopted by private fund managers and ask why audits have become so much tougher in recent memory

Valuation and transparency issues continue to be a hot topic with regulators and investors. But what's been the specific impact of this trend on GPs?

Ma: We see a number of forces impacting our clients. Even though Dodd-Frank just turned five, its impact is now being felt through SEC Enforcement Actions such as the valuation allegations against Patriarch Partners and AlphaBridge Capital as well as more recent expense allocation allegations against KKR and Fenway Partners. Then in Europe, the AIFMD has been active for slightly more than a year, and now that regulators are starting to examine and look closer at alternative investment fund managers we will understand how well the disclosure and independence requirements posed by the Directive have been implemented

by the industry.

Also, there appears to be a growing demand by institutional LP investors such as pension funds and sovereign wealth funds that alternative asset managers introduce more independence into the process of valuing their illiquid assets. From our experience and observations, this appears to be a global trend even in jurisdictions where valuation independence is not required by regulation.

Given all the new regulations, scrutiny, and transparency demands we just discussed, how are funds dealing with these developments? Are there best practices you would recommend in setting up a valuation process?

Funds are adapting their internal

processes in response to these new regulatory and investor demands, and several themes have emerged as best practices. It's probably easiest if I list a few in no particular order.

Firstly, 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 and/or the valuation committee that have ultimate responsibility for determining the valuation of the funds' assets.

Secondly, among other things, 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 interests.

Thirdly, in laying out the valuation process and procedures, strong consideration should be given to establishing a valuation process that is independent from the investment process. For larger managers with substantial and robust infrastructure, the valuation analysis may be handled internally and augmented by the third-party review. Mid- or small-sized managers may employ third-party valuation providers to perform independent valuation.

If we could pause you there... obviously no two fund managers are alike, but given what we just covered in best practices, what's the best way to get the maximum benefits from utilizing a third party valuation provider?

The valuation provider should develop a customized approach to suit the needs of the fund based upon factors such as the

type of asset classes, the number and size of investments, scale and depth of the fund's internal valuation infrastructure, and requirements from existing or prospective LP investors. Also, the fund should consider the entire spectrum of fair value analyses available including full-independent valuation and a limited scope analysis.

In a full-independent valuation, the third-party advisor typically reviews the recent historical and projected financial performance of the investment, as available, and discusses it with the portfolio manager; prepares a valuation analysis of the investment using widely recognized methodologies; and provides independent conclusions of fair value of the investment. This scope of service may be more useful for a manager that does not have the infrastructure to support an internal independent valuation function.

Alternatively, a manager that does have a robust internal independent valuation function may not need a third party to provide a full independent valuation. In this case, a limited scope analysis may be sufficient, where the third-party advisor reviews the fund manager's valuation analysis including market data relied upon, company performance data and valuation underlying the analysis, or provide other observations, and will

comment on whether or not the fair value conclusions of the manager seem reasonable, although this does not constitute an independent conclusion of fair value.

When the valuations are finally completed they are generally handed off to the auditor. How do you think their review process has changed over time? What are the most common questions your clients get now?

Many fund managers have likely noticed the increased scrutiny by auditors over the past few years. Among other things, this is driven by an increased focus on risk management, and by increased regulatory oversight of the auditor community. Auditors have to meet certain professional standards that require them to understand the assumptions utilized in the valuation. A good valuation firm will not only provide assistance to the client throughout the audit process, but will have had experience with many auditors and be able to anticipate the critical issues likely to be raised in the review. Our clients and the auditors tell us the process runs best and most smoothly when they receive a full and complete report. The report should describe the methodologies used and why. It might

also cover what is not used and why. The report should also discuss critical inputs such as multiples, discount rates, cap rates, etc. and defend each of these input assumptions. More is better!

What changes do you think are on the horizon that fund managers should be aware of?

I think we have already touched on many of these. 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. To expand a bit on this last point, as the secondary market for fund LP interests continues to grow, transparency of fund information along with reliable (and independent) valuation marks become more and more important to LPs, particularly institutional LPs that periodically rebalance their investment portfolios through secondary market purchases and sales.

Have you encountered any other interesting issues in valuation recently?

There are probably too many to address in great detail, but in summary, among other things, we are 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. Also, volatility in the commodities markets have led to a number of interesting valuation issues and considerations. ■



Based in New York, **Dr. Cindy Ma** is the global head of **Houlihan Lokey's** Portfolio Valuation & Advisory Services practice, focusing on illiquid and complex securities valuation. She has more than 20 years of extensive training, academic expertise and hands-on experience in commodities, derivatives, securities, foreign exchange, fixed incomes, structured transactions, hedging strategies and risk management issues. She has served as consulting and testifying experts for the US Securities & Exchange Commission and is a member of the Standards Board of the International Valuation Standards Council (IVSC). Dr. Ma can be reached at CMa@HL.com or +1.212.497.7970.