# Portfolio Valuation

## Private Equity Marks & Trends

### Third Quarter 2015



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# Interview: A Few Thoughts on Portfolio Valuation

by Sujan Rajbhandary, CFA

Recently, we interviewed **Travis Harms**, who leads the financial reporting valuation practice at Mercer Capital. Travis commented on a few issues around portfolio valuation. The following is a lightly edited transcript.

*With respect to **portfolio valuation**, who are your clients and what services do you provide?*

In our portfolio valuation practice, clients cover the spectrum from debt-focused funds, to hedge funds, traditional private equity funds, venture funds, and sector focused credit and equity funds. Despite the diversity of strategies, what they all have in common is the need to develop reliable, defensible fair value marks for hard-to-value assets in a real time reporting cycle.

That reporting cycle varies by client – we mark some assets on a monthly basis, while we look at others annually. The frequency with which we mark assets is generally a function of the fund manager's ability to develop interim marks on their own – do they have the requisite expertise and staffing to develop and document reasonable interim marks?

Now, of course, the fund manager has the expertise to value assets. However, the fund manager's valuation objective is to determine "intrinsic" or "investment" value, which may well differ from the prevailing market consensus. That is not the objective of fair value reporting, though. Fair value is not the fund manager's price target based on his investment thesis. It is a particularly defined standard: fair value is the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. Developing and documenting the corresponding market participant inputs can be time-consuming and requires a different perspective than the fund manager is accustomed to using.

Sometimes we are developing our own independent estimates of fair value from scratch; other times we are examining the fund manager's own estimates for the purpose of providing positive assurance that the marks are reasonable. Regardless of the scope of our work, documenting, presenting, and defending our conclusions to auditors and, potentially, regulators is always part of our job.

*Recently, a* Wall Street Journal *article elaborated on some of the **difficulties that mutual funds face in valuing their investments in startups.** Based on your experience with providing periodic fair value marks for VC funds, what are some of the elements that go into valuing such investments? What are some of the pain points?*

Valuing startup investments, including "unicorns" such as those mentioned in the *Wall Street Journal* article, requires **developing a thorough understanding of the economics of the most recent funding round**, which provides a market-based "anchor" for valuation at subsequent measurement dates. What we find most effective is to build our valuation model so that it corroborates the "anchor" value as of the date of the most recent external funding round. Once our model is appropriately calibrated, we can then develop appropriate market participant model inputs for the measurement date that take into account changes in markets, company performance, and prospects for future exit with regard to timing, amount, and form.

Valuing these investments is particularly challenging given the illiquidity of the securities. When observable transactions occur only sporadically or at long intervals, it can be difficult to assess how changes in the market and company prospects will influence value. The longer the holding period – in other words, as you move from days to months to years – the greater the uncertainty regarding reasonable inputs and the wider the range of potential outcomes. Things become even more difficult when you layer in the unique features of many of these securities, such as liquidation preference, conversion, participation, and other rights and features.

*Finally, the* WSJ *article discusses the fact that there is variation, sometimes substantial, in the valuation marks provided by different investors in the same company. Is that troublesome?*

Is it troubling that different reasonably informed investment professionals come to different good faith estimates of the fair value of the securities we've been discussing? No. As we mentioned previously, illiquidity necessarily increases uncertainty. This is a phenomenon that you can observe even in securities that trade in markets – the less liquid and shallower the market, the wider the bid-ask spread will be. Even if you follow a rigorous calibration process like we outlined earlier, there is uncertainty about inputs. For example, you may know – on the basis of an observed market transaction – that a company's value was $40 at a particular date, but what you still cannot directly observe is whether that was 8 times 5 or 10 times 4. Those unobservable inputs will necessarily breed good faith differences of opinion as the $40 value becomes stale with the passage of time. That is not to say that anything goes – there is a range of reasonable conclusions. But no, different estimates of fair value for these securities are not in themselves troubling.

A different question, whether it is troubling – given this valuation uncertainty – that an open-end mutual fund owns such securities is for the regulators to decide. It may be that the fair value estimates are reasonable, and reasonably different, but those differences are simply not tolerable from a regulatory standpoint. That, however, is ultimately not a valuation question.

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# Are You GIPS-Compliant?

by Mary Grace McQuiston

The Global Investment Performance Standards (GIPS®) were adopted by the CFA Institute in 1999 and are widely accepted among the international investment management industry. GIPS are a set of ethical principles based on a standardized, industry-wide approach that apply to investment management firms and are intended to serve prospective and existing clients of investment firms. While compliance by investment firms is voluntary, many investors consider GIPS com-

## On the Call

The following is a brief compendium of quotes from 3Q15 earnings season conference calls. In general, executives are indicating that liquidity is declining, and investors remain concerned over lower-quality credits in the market.

**Josh Harris (Apollo)** – "First of all, we would never wish credit woes on anyone. But I think the market volatility in energy, which has gone on for longer than people expected, so I would say — here is what I would answer, which is the price of oil went down a lot more than the price of debt and the price — than the cost of debt and the price of equity. And so what you saw last year was almost a halving of the price of oil, but yet the equity markets and the debt markets didn't react to it and there was a lot of issuance. And that allowed many of the companies to Band-Aid their liquidity needs for some period of time."

**Kipp deVeer (Ares)** – "Capital continued to leave the leveraged finance markets as investors fear the impact of future interest rate rises and the potential for a negative credit migration. We concur with most investors that we are in the later stages of what has been an extended credit cycle. Funds flows in the leveraged loan market year to date are [decidedly] negative as almost $10 billion of capital has been redeemed from retail loan funds in the first 10 months of this year. The high yield market has been clobbered since June 30, and returns are only narrowly positive for the year. As a data point, double-B new issue high yield spreads were in the 7% range at the end of September, a level not seen since 2011. Leveraged loan issuance is also down year-over-year, with the majority of transactions being centered around M&A and new acquisitions."

**Kipp deVeer (Ares)** - "Yeah, I think we're definitely seeing spreads widening as a sort of response to the not so easily executed deals of September, October for sure [in the] outflows that I mentioned in the prepared remarks. In terms of quality, late in the cycle, it tends to be low. I mean, my own personal view, I'm sure if you looked around our investment table, people might disagree a little bit, I perceive the quality to be pretty low today."

**Michael Chae (Blackstone)** – "Market pullbacks we think and volatility are ultimately good for creating good private equity deals. It takes some time but I would say even private equity or as well in private equity, there are a number of situations where some months ago we felt like we were priced out of the situation but that now they are coming back in line as actionable opportunities."

**Bill Conway (Carlyle)** – "Last quarter we said that we were being cautious with respect to new investments for a variety of reasons: high asset prices, uncertainty over China, the significant downturn in commodity and energy prices, the strong dollar and low growth. These trends remained largely intact during the third quarter and continue to persist today. Recent market turbulence has reaffirmed our view that a cautious investment pace during the first half year was warranted. The widespread decline in assets during the third quarter revealed that today's markets are extremely sensitive to risks."

**Bill Conway (Carlyle)** – "Clearly in the loan market, you've seen some price decreases in the value of loans that have been relatively small. And we see this in the buyout business where the prices we pay, I think the markets are a little choppier, and I think spreads have widened a little bit on the credits. Not significantly yet, but it is noticeable, I would say."

**David Golub (Golub Capital)** – "I don't think that the crisis of confidence that we're seeing in our space is a result of investor disbelief in marks. I think it's principally the result of investor fatigue and lost confidence in management teams."

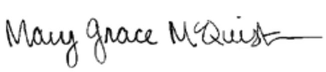
Source: All transcripts obtained from SNL.

pliance to be a requirement for doing business with an investment manager. Alternative managers have lagged behind the industry in claiming compliance with GIPS, but changes in the industry suggest GIPS compliance is becomingly increasingly important.

On the CFA Institute *Market Integrity Insights* blog, Beth Kaiser identifies two reasons GIPS compliance is becoming increasingly important, specifically for alternative investment managers. One driver is that alternative strategies are becoming increasingly mainstream and investors and consultants are engaging in more comprehensive due diligence. Compliance with GIPS can help managers to stand out amongst their peers. Furthermore, the issuance of the GIPS Guidance Statement on Alternative Investment Strategies in 2012 makes it easier for alternative investment managers to comply.

The GIPS Guidance Statement on Alternative Strategies and Structures specifically addresses compliance for hedge funds and other alternative investment strategies. GIPS standards state that portfolios must be valued in accordance with the definition of fair value and that all investments, regardless of liquidity, must have valuations that adhere to the definition of fair value. In addition, firms are to disclose if pricing has been performed internally and not by an external third party.

At the 2015 GIPS Annual Conference, it was revealed that the California Public Employees' Retirement System (CalPERS) inquires of all investment managers, including alternative investment managers, seeking to do business with them whether they are GIPS-compliant. The position of CalPERS in the industry suggests that managers will take the steps necessary to win its business and that GIPS-compliance is quickly becoming the norm for investment managers.



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**Sources**

"GIPS and Alternatives: CalPERS Takes Notice, Others Likely to Follow," *Market Integrity Insights,* CFA Institute.

*Global Investment Performance Standards Handbook, 3rd. Edition,* CFA Institute.

"Guidance Statement on Alternative Investment Strategies and Structures," *Global Investment Performance Standards,* CFA Institute.

# In the Eye of the Beholder: Increasing SEC Scrutiny of Public Company Fair Value Marks

by Samantha L. Albert

In an **article published in August 2015**, NERA Economic Consulting examined some of the effects of the SEC's increasing use of quantitative analysis to identify potential problematic valuations in public company filings. Although the SEC previously used its tools in the private fund advisor sphere, the agency is beginning to turn its gaze to publicly traded companies. Thus far, the SEC's focus has been on two main points, valuation policies that differ from actual valuation practices (including valuation methods and approaches, as well as the inputs used) and the incorporation of market conditions (or lack thereof).

The **SEC's tools have so far been successful** at flagging unusual or suspect valuations in the private equity, mutual fund, and hedge fund arena, resulting in several enforcement actions:

- **KCAP Financial, Inc.** (2013) This matter was the SEC's first enforcement action against a public company that failed to properly apply fair value principles (referred to as SFAS 157 in 2008). The **SEC settled charges** against three executives based on the alleged overstatement of the value of debt securities and CDOs. The company executives paid $125,000 in penalties.

- **GLG Partners LP** (2013) The **SEC settled charges** based on the alleged overvaluation of an emerging market coal company, which subsequently artificially increased fee revenue. GLG and its former holding company paid nearly $9 million in penalties, interest, and repayment.

- **ThinkStrategy Capital Management LLC** (2013) The **SEC settled charges** against the hedge fund's manager based on the alleged overstatement of assets, misrepresentation of the firm's history, the understatement of volatility, and the misrepresentation of credentials over a period of seven years. ThinkStrategy and the fund's manager were ordered to pay nearly $5 million in penalties and repayments.

- **Millennium Global Emerging Credit Fund** (ongoing) The **SEC charged** the Fund's portfolio manager with overstating the fund's returns and net asset value and using fictional prices for two of the fund's illiquid holdings. Although the matter is still ongoing, the portfolio manager was sentenced to four years in prison and was ordered to pay over $390 million in restitution.

In the KCAP matter, management of the company believed that the Level 2 price inputs available for the debt securities in question reflected distressed transactions and instead elected to use an "enterprise value methodology" to value the securities. By using a less visible input and implementing an atypical valuation method, KCAP opened itself to deeper scrutiny from the SEC. The agency alleged that KCAP did not adequately describe and disclose its valuation techniques, resulting in an overvaluation of the subject securities.

**As put forth in ASC 820**, there are three types of inputs in the fair value hierarchy:

- **Level 1** inputs are directly observable in an active market with unadjusted prices. In general, market transactions are typically seen as the best indication of an asset's value.
- **Level 2** inputs are based on inactive market prices for the subject asset, active market prices for similar assets, or pricing models with Level 1 inputs.
- **Level 3** inputs are unobservable (i.e., not derived from the market).

In general, valuation specialists should use directly observable inputs whenever possible. For example, if the specialist had the option of using a Level 1 or a Level 3 input, the specialist should choose to use the Level 1 input. If, for some reason, the specialist elects to not use a lower level input, the rationale for doing so and the valuation techniques used must be disclosed, lest the company incur the wrath of the SEC. Certain circumstances that would lead a valuation specialist to choose another input level are typically specific to the asset, but in all cases should reflect the assumptions of market participants for the subject asset. These factors apply regardless of whether the asset in question is a debt security or an illiquid equity holding in a portfolio company.

As the SEC ramps up its use of quantitative analytics and increasingly examines public company fair value measurements, following valuation best practices and disclosing the appropriate information will be increasingly important.

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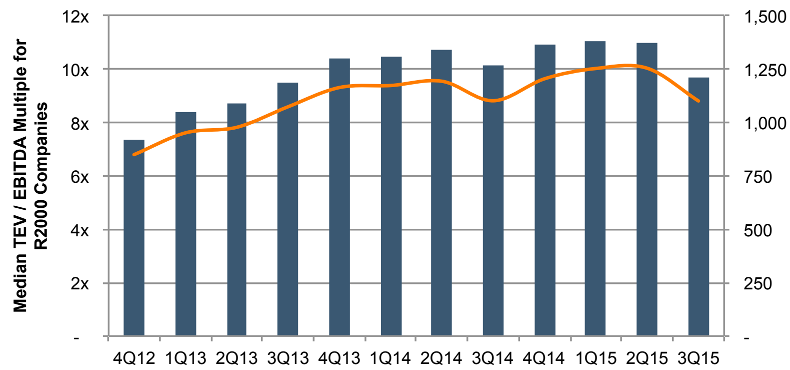
# Equity Valuation

### Russell 2000 Index Values and EBITDA Multiples

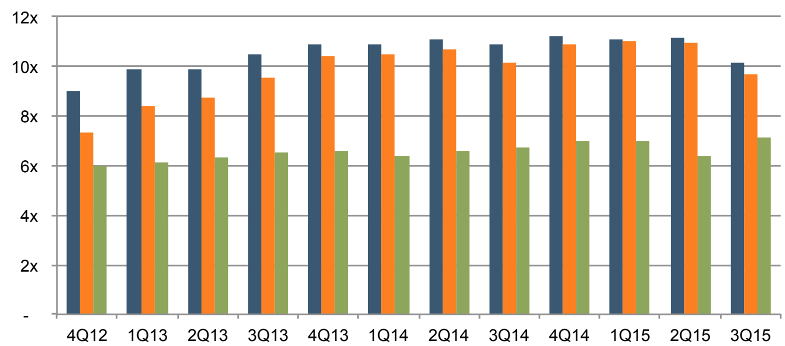
Amid volatlile markets during 3Q15, the median public small cap EBITDA multiple decreased considerably from the prior quarter-end. Favorable market returns during 2013 and 2014 were primarily attributable to multiple expansion.




*Source: Capital IQ*
*Median EBITDA Multiple (ex-financials)*

### EBITDA Multiples over Time

Over the period analyzed, the gap between multiples for small cap (Russell 2000) and large cap (S&P 500) public companies has narrowed considerably. Lower middle market M&A multiples tracked by GF Data are sensitive to available deal flow and financing conditions in addition to public market multiples.

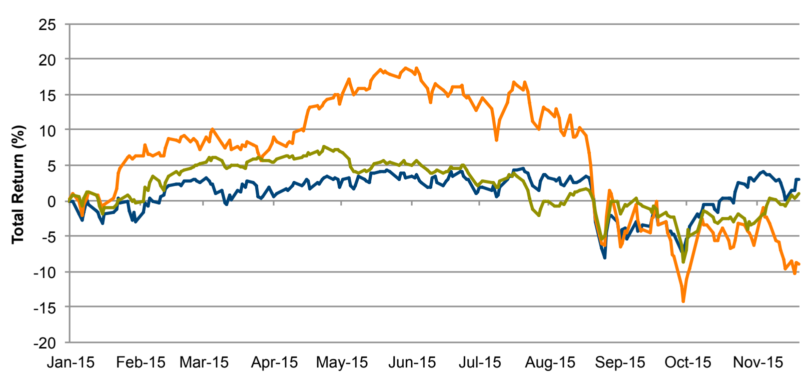



*Source: Capital IQ, GF Data*
*Excludes financials*

# Stock Performance for Publicly Traded PE Sponsors

### Total Returns (Trailing Twelve Months)

Investors remain unenthused regarding BDC shares during the year, with many share prices remaining below NAV and dividend yields approaching 10%. After a strong start to the year, the large publicly traded PE firms have given back their gains in recent months as uncertainty surrounding the timing and magnitude of interest rate increases and concerns over the growth of China's economy weigh on investors minds.

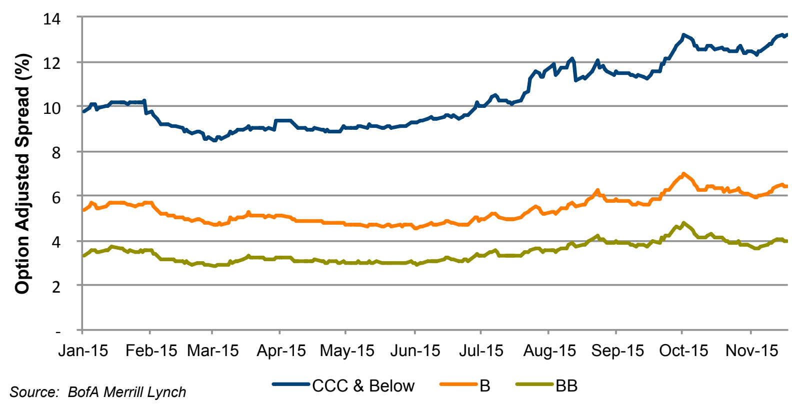



*Source: SNL Financial*

# Debt Investments

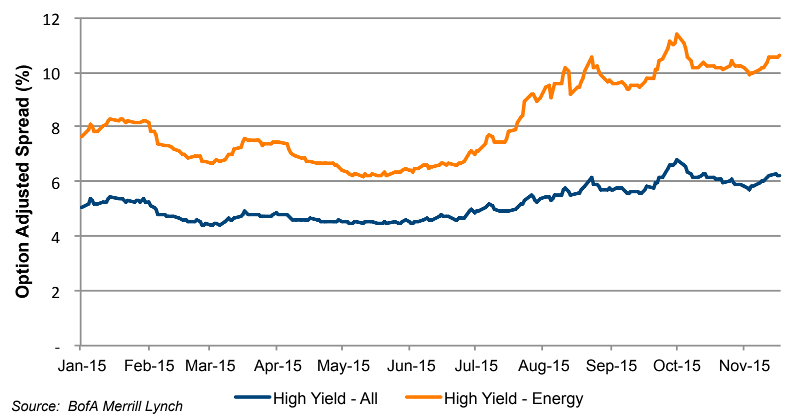
### High Yield Spreads by Credit Rating

On a year-to-date basis, credit spreads have widened, reversing the spread compression that occurred through mid-2014. Riskier credits have proven more sensitive, with yields on issues rated CCC & Below widening nearly 350 bps, compared to changes of 103 bps and 63 bps for B and BB credits, respectively.



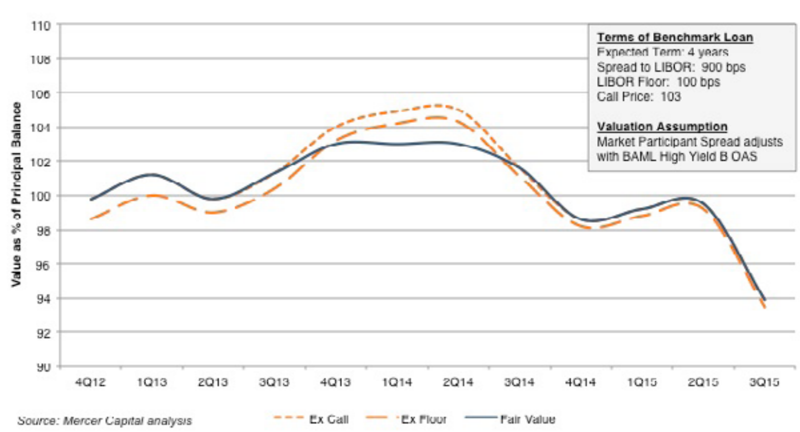

### Impact of Energy Sector on High Yield Spreads

Recent turmoil in oil markets have pushed spreads on energy credits even wider, which is contributing to the overall market trend. During 2015, high yield energy spreads have increased from 764 bps to 1,062 bps, more than double the 112 bps of widening for the overall market.




### Fair Value of Benchmark Debt Instrument

A nearly 200 basis point increase in the B0fA Merrill Lynch US High Yield B Option-Adjusted Spread during the quarter pushed the fair value of our benchmark loan from 99.5 to 93.9.



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## Business Valuation and Financial Advisory Services for Private Equity Firms and Other Financial Sponsors

Mercer Capital provides financial and advisory services to help our clients minimize risk and maximize value. For financial sponsors providing debt and equity capital to the middle market, Mercer Capital provides a comprehensive suite of financial advisory services.

- Portfolio Valuation
- Solvency Opinions
- Fairness Opinions
- Purchase Price Allocations
- Goodwill Impairment
- Equity Compensation / 409(A)
- Buy-Sell Agreement Valuations

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