MURRAY DEVINE
VALUATION ADVISORS

Recognizing the Science Behind Fair Value

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While some in the industry may refer to valuation as an art, Murray Devine's Steve Davis notes that LPs and regulators are seeking transparency into the science that informs the process and supports consistency.

In graduate school, it was probably drilled into most M&A professionals that the best remedy for potential bias in business valuation is self awareness. If deal professionals can recognize the predispositions they may subconsciously bring into an assessment -- whether they own the assets or are negotiating to buy or sell the assets -- they can take the required steps to proactively address any partialities, whether real or perceived.

As a result, though, many private equity firms probably lean toward being more conservative in reporting fair value estimates of portfolio-company assets. This inclination, noble in its intent, may also reflect a desire to under-promise and over-deliver. That being said, given the attention both limited partners and regulators are now placing on valuations, GPs today should be far less concerned about managing expectations than instilling consistency when it comes to outlining and executing upon their stated valuation policies.

From the perspective of most LPs, precision around fair value can be critical for a number of reasons, not the least of which is that many are using this information to construct their asset-allocation models. To take a hypothetical scenario, if an institution's private equity holdings, across the board, are being valued conservatively the LP may ultimately have far more exposure to private equity than they realize or desire.

On the other end of the spectrum, though, fair-value assessments that might be considered more aggressive can lead to second-guessing. This is particularly true when the value of these illiquid investments are significantly marked down at a later point in time or when overly rich valuations coincide with fundraising or other marketing initiatives.

According to a Reuters story last year, for instance, the SEC has taken an interest in how mutual funds have been valuing their investments in privately held, VC-backed tech companies -- high fliers whose fair values often deviate substantially from one fund to the next. From the regulators' perspective, the SEC is trying to understand the extent to which these valuations may be helping fund managers beat their respective benchmarks. They are also seeking to gauge the level of risk that exists for public investors in the event that market conditions change and the assets absorb outsized markdowns.

To be sure, both limited partners and regulators do recognize the challenge of valuing illiquid assets. We work across several leading private equity and private debt firms and it's not at all uncommon for investors to provide differing mark-to-market valuations for the same private-company securities. It may be the valuation model applied (DCF vs. Relative Valuation); it may be diverging estimates about future cash flows or growth rates; or, oftentimes, differences can be related to the peer group and how comps are calculated and applied (direct comps vs. peer group average vs. adjusted averages, etc).

From the perspective of the GP, however, "correctness" around fair value should refer to how well fund managers follow their respective valuation policies. Consistency is important, and if there is any deviation from the stated policy, there should be detailed documentation around what has changed and how it has affected the methodology, including the factors that led to the decision.

Both regulators and LPs recognize the sources of variance that exist and are remiss to be too prescriptive in their expectations. That's not to say, however, they're scrutinizing the reported valuations any less rigorously. GPs – eager to comply – have increasingly sought to validate their reporting through tapping into third parties, who can not only validate fair-value estimates, but can also bring the expertise required to ensure the measures and models used are appropriate. Anecdotally, more than half of all alternative investment funds use an outsourced administrator, while nearly 60% of all private funds reported assets under management are valued using a third-party valuation firm.

These trends are due in no small part to the added operational complexity that has come with the industry's growth and maturation. In the first quarter alone, PItchbook tracked 57 new U.S. funds in the market that collectively raised $55.8 billion. But GPs also recognize that LPs are scrutinizing not only the valuations they provide but also the process that led to the fair-value estimates and how well it tracks to the firm's stated valuation policy. This is precisely where the art of valuations is replaced by the science that drives consistency and objectivity.

Steve Davis joined Murray Devine in 1999. His responsibilities include the day-to-day management of financial opinion engagements as well as the preparation of business enterprise, intangible asset, and securities valuations. Prior to Murray Devine, Steve was the Chief Financial Officer for the law firm of Hangley Aronchick Segal & Pudlin and served as an Assistant Treasurer to U.S. Congressman Robert Andrews in the 1997 New Jersey gubernatorial campaign.

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