Maximizing Value in Existing Funds and Creating New Funds

The Strategic Importance of Fair Value
for Alternative Investment Funds

Valuation Best Practice Beliefs for Illiquid Debt,
Equity and Derivative Securities

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Milton Friedman said: "There is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."

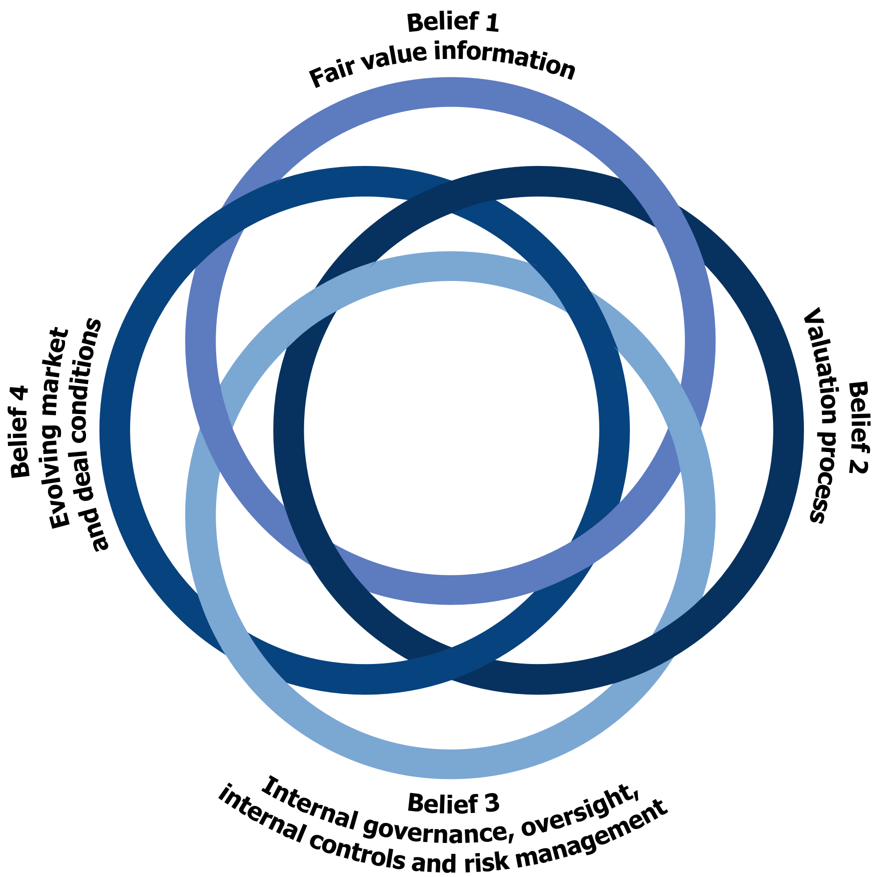
Dr. Friedman understood that in order to efficiently maximize shareholder value, creating long-term and sustainability for one's customers was paramount. In order for alternative investment funds to achieve these twin objectives, maximizing long-term profits and creating value for its customers (i.e., limited partners), fund managers must achieve positive, risk adjusted returns during the fund's life. Given the competitive nature inherent in raising, managing and investing capital, authenticating that a fund's active return strategy is superior to its peers' is frequently the difference between the launch of a future fund and failed fundraising efforts.

It is axiomatic that alternative investment fund managers are committed to valuation creation of their underlying portfolio investments. If a manger is successful in realizing returns, the general partner will indeed substantiate its thesis to new investors in launching a new fund. As a result, given the illiquid nature of alternative investments, how can an alternative investment fund manager measure their returns and ultimately demonstrate to their investors that they are creating superior value? The core of this conundrum lies in the determination of the fair value of the fund's assets.

Our view of the strategic importance of fair value measurements to a fund's general and limited partners is based on four, intertwined core beliefs:

Our Core Valuation Beliefs

Graphically, our four, intertwined valuation core beliefs can be visualized as follows:



Valuation Belief One – fair value information is important – general partners, limited partners, fund managers, regulators and other stakeholders rely on fair valuation for investment and risk management analyses and decisions.

Valuation Belief Two – the fair value process for valuing illiquid debt, equity and derivative investments is very different than valuing liquid debt, equity and derivative financial instruments.

Valuation Belief Three – as the alternative investment industry has matured, stakeholders have imposed a requirement for strong governance, oversight, internal control and risk management procedures. With this in mind, the alternative investment industry will continue to be a focus by regulators, domestically and internationally. Therefore, how alternative investment funds value their investments will remain an area of focus.

Valuation Belief Four – alternative investment fund managers have proven to be perceptive active managers. Alternative investment funds have demonstrated their capability to adapt and modify their investment decisions as markets and deal conditions evolve.

Valuation Belief One

Fair Value is the Core to Consistency, Comparability and Information

When deciding to deploy capital to a fund, investors will evaluate past returns and develop an estimate of future returns. However, if past returns cannot be substantiated, investors will not have reliable information on which to base their investment allocations as a fund's returns will just be numbers on paper and, in essence, meaningless. Therefore, understanding the risk adjusted returns on a fund's underlying holdings is critical information.

Both domestically and internationally, a financial instrument's value is measured based on an accounting construct known as *fair value*. Accounting Standards Codification Topic 820 defines fair value as: "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.[1]" Recognizing that asset classes and securities are unique, in determining the fair value of a particular unit, GAAP classifies a security based on a defined hierarchal structure (i.e. a Level 1, Level 2 or Level 3 security). A Level 1 security has a readily observable price, and therefore, a reliable fair value as it trades actively on an exchange (i.e., New York Stock Exchange, NASDAQ, Chicago Board of Options Exchange and Chicago Mercantile Exchange). From a valuation point of view, Level 2 instruments require more judgment than Level 1 instruments. Level 2 inputs are inputs other than quoted prices included within the Level 1 hierarchy but are observable for the asset or liability, either directly or indirectly. For example, an interest rate swap uses available public data, such as interest rate forecasts, to calculate its value. Therefore, while this financial instrument does not trade on an exchange, it can be valued using observable information. Another example would be valuing a bond based on quoted prices for a similar bond that traded in an active market. A Level 3 financial instrument is valued using significant unobservable assumptions and estimates. Examples of a Level 3 financial instrument include an infrequently traded bond or stock or a debt or equity investment in a privately owned company.

By definition, in estimating the fair value for a Level 3 financial instrument, the analyst must evaluate not only the performance of the underlying portfolio company but also the market in which the asset is held and its liquidity. Fair value can be analyzed with a top-down or a bottom-up approach, incorporating macroeconomic, industry and / or company specific factors.

The determination of fair value directly impacts not only the general partnership interest but also the value for the limited partnership interests. With the implementation of fair value accounting, under both GAAP and IFRS, returns are calculated in a homogeneous, consistent and comparable manner – something that is also required by the Securities and Exchange Commission (SEC) and other domestic and international regulatory organizations. As a result of these standards, investors' diligence across alternative managers becomes comparable, and limited partners can make a more informed decision regarding which alternative investment manager will retain their capital. In other words, with fair value accounting in place, limited partners will be provided a means to monitor performance and manage their own asset allocation objectives.

(1) Internationally, the definition of fair value under IFRS accounting standards (IFRS 3) is similar to US GAAP.

Valuation Belief Two

Valuation Measurements are Dependent on the Valuation Assumptions and Approaches

Defining fair value as we have above can sound simple, but the process of determining fair value and the implementation of a fair value process is complicated. As a result of the heterogeneity amongst financial instruments, there are varying degrees of complexity to consider.

Typically, the starting point is determining whether the instrument's fair value classification is defined as a Level 1, Level 2 or Level 3 instrument. Fair value measurement becomes increasingly difficult to calculate along the Level 1 to Level 3 spectrum. However, regardless of whether valuing a Level 1, Level 2 or Level 3 security, the valuation approaches to select from are the same and draw upon one or more of four business valuation approaches: market, income, asset and / or option pricing. As previously mentioned, Level 1 instruments are liquid and exchange traded. Assuming an active market, the security's fair value equals its closing price for the day multiplied by the number of shares or units owned. Conversely, a Level 3 instrument is illiquid in nature, with no active market, and less information to rely on in order to substantiate a conclusion. As a result, the Level 3 valuation requires incorporating into a financial model one or more unobservable inputs in order to determine a financial instrument's fair value.

Starting and Implementing the Fair Value Process

What steps should an alternative investment manager follow to ensure a reasonable valuation conclusion is reached on Level 3 securities? One way to think about the process for valuing an illiquid financial instrument is to reevaluate the security at each measurement date with the presumption that this financial instrument were re-underwritten.

Fair value accounting assumes a transaction between market participants occurs in an environment in which the buyer and seller have equal knowledge, are behaving in their own best interests, free of undue pressure to trade, and there is a reasonable time period for the transaction to be completed. The underwriting is a key event because it is at this point in time that a market participant considers the security's merits and risks, expectations with regards to growth, implications of control, minority and illiquidity factors, and the financial instrument's rights and preferences. But, at the end of the day, and most importantly, in most cases, the underwriting provides us with an indication of fair valuation. Thus, a fair valuation analysis should begin with the assumptions established at this point in time and evolve overtime. While at inception the financial instrument would be valued at cost, over time, the value of the security will change due to a combination of idiosyncratic factors (i.e., changes in the security's credit quality) as well as market wide changes (i.e. changes in interest rates).

Valuation Belief 1 recognizes that, over time, consistency in terms of valuing the security is an important component of the fair value process. In general terms, there are four approaches to valuation. The first, the income approach, determines the value of a financial instrument based upon the present value of its expected future cash flows. The second, the asset approach, is built around valuing the existing assets of a firm, with accounting estimates of value used as a starting point; these accounting values are then supplemented with fair value estimates for each asset and liability. The third, the market approach, estimates the value of an asset by looking at the pricing of "comparable" assets relative to a common variable such as earnings, cash flow, book value or sales. The fourth, the option pricing approach, uses option pricing models to measure the value of assets that contain option characteristics.

Generally, until there is a material event that dramatically changes the value of the security, the financial model used to value the financial instrument at inception remains in use (i.e., consistently applied) until it is liquidated or sold.

Valuation Belief Three

Industry Growth Creates Additional Scrutiny

Since 2000, private equity assets under management have grown at a nearly 14.0 percent compound annual growth rate. As a result, the alternative investment industry has had to migrate from an entrepreneurial business model to a more traditional management infrastructure. From a general partner's point of view, today, firm governance requires managing a diverse set of activities, including managing the relationships with existing investors, fundraising for new funds, operations, risk management, compliance, accounting, managing conflicts and valuation.

Valuation Scrutiny

Alternative investment fund constituencies agree that a consistent valuation process provides the necessary framework for reliably determining valuations for illiquid investments. An array of factors make the valuation of illiquid investments substantially more complicated than valuing liquid investments. Compared to the availability of information for public companies, investors have less information available when valuing Level 3 securities. Furthermore, fund governance requires compliance with a combination of legal, regulatory and contractual provisions.

Fair value information enables fund managers to exercise their responsibilities in investing and monitoring investment capital, reporting performance to stakeholders and preparing financial statements consistent with applicable accounting standards and contractual and regulatory requirements.

The valuation process entails more than just quantitative financial analysis. The valuation process also encompasses governance, segregation of responsibilities and strong internal controls and documentation. A valuation or investment committee has responsibility for ensuring all roles and responsibilities are clearly defined. The committee likely will include non-investment personnel whose compensation is not correlated to the underlying portfolio company's performance. The valuation or investment committee will establish the policies and process for regular valuations, oversee the execution of the valuations of the portfolio, engage third parties for independent valuation services and conclude on the periodic valuations. The actual execution of the valuation should also be outlined as part of the valuation process, but there are a few key points that are important:

- The valuation process needs to be balanced with flexibility to handle dynamic and complex structures but also stringent enough to allow for consistency across each valuation and over time;
- Multiple valuation approaches should be considered to capture as much information as possible in order to support a reasonable conclusion;
- All judgments and subjective assumptions should be supported with quantitative and qualitative evidence; and ultimately,
- Use common sense and consider whether a market participant would be convinced that the valuation conclusion is reasonable.
- From a valuation point of view, a fund's general partner should establish valuation policies and procedures. The policies and procedures should be approved by the fund's Board and/or Investment Committee and include:
    - Defining the fair valuation standard by which the fund will abide (e.g., ASC Topic 820);
    - Developing the valuation approaches, methodologies, models and templates to incorporate in the process;
    - Defining the valuation process, including articulating the roles and responsibilities of key personnel, ensuring the roles of the back-office professionals and investment professionals are segregated;
    - Developing a process for resolving internal valuation differences;
    - Implementing procedures and controls to eliminate or mitigate potential conflicts;
    - Identifying other contractual and regulatory factors that may influence the valuation; and
    - Identifying the parties which are empowered to sit on the fund's valuation committee and define the role of the valuation committee in the fair valuation process.

We have observed that there is no single, uniform approach to board oversight of risk management, and board practices vary and continue to evolve. Clearly, fund directors must exercise care, skill and diligence in the performance of their duties. Typically, the board of the fund, in total, or a delegated sub-set such as an Investment and Valuation Committee, will review and opine on the valuation conclusions reached during each measurement period. We believe that board level oversight of the fund's marks represents an important risk management procedure.

As the alternative investment industry continues to mature, combined with the impact of The Dodd–Frank Wall Street Reform and Consumer Protection Act, stakeholders have expanded their scrutiny of all money managers. As funds increase in size and become subject to SEC registration, they will also be subject to periodic examinations from the Office of Compliance Inspections and Examinations (OCIE). The SEC and OCIE are focused on how funds allocate and manage fees and expenses and the determination of fair value of their underlying portfolio companies. The trend of increasing scrutiny on the valuations of illiquid or hard-to-value assets does not appear to be diminishing any time soon. Furthermore, the standard is such that it is not sufficient to just write policies, but rather, an alternative investment manager must implement and adhere to its policies.

Valuation Belief Four

Ability to Create Value

Private equity funds have earned a reputation for generating risk adjusted returns above those of the public equity markets. The private equity investment thesis is to enable investors to obtain the benefits arising from diversified exposure to higher yielding and less correlated sources of investments. This premium return over public markets is required to compensate investors for the illiquidity of private equity financial instruments. Alternative investment fund managers have proven to be perceptive active managers. Fund managers have demonstrated their capability to adapt and modify their investment decisions as markets and deal conditions evolve. It is important, therefore, to understand the capital appreciation strategies of an alternative investment fund manager. Regardless of the life cycle of the investment or asset class, investment opportunities will always exist over a market and industry cycle, but each stage requires particular skills in order to maximize capital appreciation.

Fair value provides the information to general partners and limited partners on the value of their portfolio interests as of a measurement date. Rather than having to enter a sale process, the reported valuation under the definition of fair value reflects what a market participant would pay for the investment.

Successful funds create alpha for their investors. Alternative investment fund managers specializing in illiquid investments create value through active involvement via the strategies they create and implement at the investment and portfolio company level. Over the long term, value is created by fund managers implementing business and investment strategies, evaluating market conditions and modifying investment strategies as market and company conditions evolve. Monthly and quarterly valuations are the navigation tools that provide general partners the information to successfully calibrate and execute their strategy.

Conclusion

Alternative investment funds create value through a strategic and active investment style management process. Over the long term, the fund generates value by executing upon its investment thesis via its investment professionals who are responsible for managing the existing portfolio and continually identifying changes in market conditions, while pursuing growth strategies.

The importance of the regular transmission of fair value information from general partners to limited partners emanates from the need to provide transparent, independent and credible valuations to fund stakeholders. Independent valuations add to the robustness of the investment decision making process while also providing transparency to the fund's constituents.

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