VALUATION OPTIONS UNDER AIFMD

By Colin Southall, director of private equity portfolio valuations at Markit

One aim of the AIFMD is to ensure that asset valuations are performed independently of deal teams. However, hedge fund managers looking to outsource these requirements to their fund administrators may be in for a surprise. With transitional periods set to expire in most jurisdictions on 22 July and Variation of Permission forms in the UK asking for a named valuer, fund managers need to act quickly on key valuation decisions.

Hedge fund managers covered by the Directive have two options to meet asset valuation requirements: either establish an independent internal team or outsource valuations to an external valuer. Both solutions have costs and benefits.

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The options

Use of an internal valuation team carries costs for the manager, as independent staff must be hired to perform and check the valuations. For example, one of the checks specified in the Directive is to undertake a comparison with values generated by a third party. Guidance on the frequency of these checks is still needed, but even a quarterly check will have a cost for the hedge fund manager. The benefit is that the valuation process remains under the fund manager's control.

On the other hand, outsourcing to an external valuer may be a cost-effective and practical approach to meeting the AIFMD valuation requirements for small and medium-sized fund managers. The benefits are that the fund manager saves time on valuations administration and independent valuation may help attract investors when fundraising. There is clearly a cost for the service, but this may compare favourably with the cost of an internal team.

However, funds cannot assume their existing fund administrator will undertake the valuation requirements under the Directive. And in selecting an external valuer there are three areas that need to be addressed early in the selection process.

The considerations

Firstly, the Directive states that an external valuer cannot limit its liability for fund manager losses due to incorrect valuations through negligence or failure to perform. Although this risk can be mitigated through strong controls, it is a change to existing practice, and one which many service providers are understandably reluctant to accept. So the first challenge a fund manager faces is finding a provider prepared to offer this service.

Secondly, the valuation process now becomes more complex as the fund manager must contract directly with the external valuer, since the Directive does not allow this function to be sub-delegated or white labelled. This means that information flows between fund manager, fund administrator and external valuer must be actively managed in order to meet reporting deadlines.

Lastly, the fund's valuation policy must be reviewed with the external valuer, who is required to execute the agreed policy and deliver the resulting valuation directly into the NAV calculation process.

Fund managers who conclude that the cost-benefit analysis favours use of an external valuer should start the selection process immediately, given the 22 July registration deadline. ■

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