AIFMD Valuation Regulations – Opportunity or Cost?

- Kevin O'Connor, Director, Markit Portfolio Valuations

The full implementation of the Alternative Investment Fund Managers Directive (AIFMD) in July 2014 is the burning platform that requires private equity funds to get their funds' assets independently valued. But meeting these requirements is only part of the picture if fund managers are to proactively work with their key investors to provide valuations that enhance transparency and better position private equity as an asset class, while alleviating investors' own reporting requirements. Will the industry be ready to take advantage of this opportunity to enable private equity to take its rightful place as part of the core portfolio holdings of all asset allocators?

After much debate and challenge we are coming to the end of the beginning of AIFMD implementation for alternative investment fund managers. The Prudential Regulation Authority (PRA) has asked UK AIFMs to submit their application for registration before April 2014 in order to meet the AIFMD July 2014 deadline.

While most of the focus at industry conferences has been on the depository regime and remuneration look-through provisions, there has been little debate on one crucial area – valuations.

AIFMD Article 19 requires that AIFMs "ensure that, for each AIF that they manage, appropriate and consistent procedures are established so that a proper and independent valuation of the assets of the AIF can be performed."

The fear is that with so much change happening in such a short time and with the focus on the cost/benefit equation, asset managers may lose sight of why they perform valuations in the first place. According to the International Private Equity and Venture Capital Valuations Board (IPEV) valuation guidelines, private equity funds need to provide sufficient, timely, comparable and transparent information, which allows investors to:

- Exercise fiduciary duty in monitoring deployed investment capital.
- Report periodic performance to the ultimate beneficiaries.
- Prepare financial statements consistent with applicable accounting standards.

In addition to AIFMD, a number of other changes affecting valuations best practice have been issued by the Securities and Exchange Commission (Form PF), the PRA (GENPRU 1.3), the Financial Accounting Standards Board (Topic 820), and industry bodies such as the Alternative Investment Management Association.

Fund managers need to be working proactively with their key investors to ensure that their reporting meets industry best practice standards. In doing so, this will help investors to meet their own reporting and regulatory requirements fully. Those private equity firms that fail to do so might find that, when it comes to the next round of capital raising, some of the larger investors may no longer be able to allocate capital to these funds.

Even if managers enhance their reporting to provide all the information needed to meet this wide range of requirements, the investor still has a problem given the lack of guidance in this area. It is likely that every manager will take a slightly different approach and make slightly different assumptions when preparing valuations. This leaves the investor with the challenge of preparing a consistent view of valuations across all their assets. Unless fund managers proactively address this issue, it is likely that more and more investors will turn to third-party valuation providers to perform this service.

The IPEV guidelines go on to say that investors may also use fair value information to:

- Make asset allocation decisions.
- Make manager selection decisions.
- Make investor-level incentive compensation decisions.

This reinforces the need for independence in the process.

The valuation of illiquid assets is a vital activity in the private equity industry. Investors rely on the estimates produced by fund managers. Not surprisingly there is a great deal of subjectivity that goes into valuing a company that is not listed or actively traded. While investors can take some steps to check key inputs and assumptions, they are heavily reliant on the subjective inputs from managers in producing these estimates. Unfortunately, managers may have conflicting interests and reasons to "manage" valuations through the investment cycle which could result in the reporting of inconsistent results.

It is easy to view all new regulation as onerous and just another cost. However, there is an opportunity for managers to use the disruption caused by AIFMD to have some meaningful conversations with their investor base about the challenges they face in their reporting framework, and work proactively to put the private equity industry at the forefront of transparency, compliance and robustness.

If we get this right, private equity should take its rightful place as part of the core portfolio holdings of all asset allocators.

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