Post-Trade Valuations: Is Outsourcing Becoming the New Norm?

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In the post-Alternative Investment Fund Managers Directive (AIFMD), world deal teams remain focused on target selection, while the provision of valuations is moving to become the responsibility of finance or middle office teams. Yet the provision of independent valuations can be used as a point of differentiation to attract investors, as well as a tool to identify areas to mitigate costs.

This shift in focus has seen funds perform the valuation function in-house or outsource this to third parties, which presents an opportunity to address a range of issues:

- Increasing regulator focus on the allocation and disclosure of fund costs;
- Increasing investor demand for independent valuations;
- Increasing auditor scrutiny of Level 3 valuations;
- Increasing complexity of investor regulatory reporting.

Fund agreements need to provide clarity as to which costs will be borne by the fund and which will be a charge to the fund manager. In both cases, the requirement is to minimize costs while meeting investor and regulatory requirements.

In studies reported by Preqin, investors indicate that they are going to maintain or increase their allocation to private equity over the longer term. GPs are raising new funds at an increasing rate, and the aggregate capital raised continues at a high level.

The increased appetite from investors is exerting pressure on fund managers for independent valuations. This is often a critical component of the operational due diligence performed when an investor is considering whether to commit to a fund. In an increasingly competitive environment, being able to satisfy this requirement is a basic step fund managers should take to help them win new mandates.

If independent valuations are required in order to raise funds, then it makes sense to also use these valuations for post-trade reporting and so minimise fund costs. Regulators will require that the fund retain staff that can critique valuations provided by third parties, but outsourcing the preparation of valuations is an increasingly attractive option for many funds. This enables the fund to focus on management of its investments and the delivery of quality investor reporting, rather than staff to provide what is becoming a standardized service.

There are two other post-trade reporting costs which are often under estimated:

- Auditor scrutiny of Level 3 valuations arising from the increased focus of the Public Company Accounting Oversight Board (PCAOB) on this topic. This means that audit reviews are taking longer and that there is more discussion about the assumptions used in valuing these illiquid assets. Having an independent and comprehensive valuation report to support the valuations used in fund reporting helps minimize the time taken for the review.

- Regulators are placing additional reporting requirements on investors in Level 3 assets, for example the prudent valuation requirements contained in the EU Solvency II Directive. Although this is not a direct concern for fund managers, it can be viewed as a differentiator. If a fund can provide data which can be used by an investor to meet their reporting requirements this will aid the investor and reduce the time they need to spend collating data or, worse still, repeating work already performed by the GP.

A further consideration is the growth in codification of industry reporting best practice, such as the Institutional Limited Partner Association (ILPA) Reporting Standards. Adoption of industry best practice creates opportunities to provide a more standardized valuation service that will meet investor requirements. A more standardized service will deliver cost savings to fund managers and transparency to investors.

It could be argued that a more standardized service will mis-value investments on the assumption that valuations of illiquid debt and unlisted equity already contain assumptions which could be worse than the existing approach. On the other hand, there are cost and consistency benefits from this approach which will assist both fund managers and investors. Separating deal team pricing from post-trade valuation highlights the different drivers at work: on the one hand there is a need to obtain data which is actionable and can drive management decision making, while on the other hand, investors need to be able to make good, long-term investment decisions and report fair value to their clients.

Taken all together, the need to perform post-trade valuations away from the deal team, the requirement for comprehensive valuation reports, investor demands for reporting, and the need to adopt industry reporting standards makes use of an outsourced third-party valuation service increasingly attractive.

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