HOULIHAN CAPITAL Value. Added.

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AKRAM Assurance, Advisory & Tax

Valuing Illiquid Investments

OCTOBER 12, 2023

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Program level : Basic

No prerequisites are required

No advance preparation is required

AKRAM Assurance, Advisory & Tax | HOULIHAN CAPITAL Value. Added.

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Our Panel

Muhammad Akram

MODERATOR

Akram | Assurance, Advisory & Tax Firm

Michael Moscarelli

GUEST SPEAKER

Houlihan Capital

Steve Rosen

SPEAKER

Akram | Assurance, Advisory & Tax Firm

Hamza Shahid

SPEAKER

Akram | Assurance, Advisory & Tax Firm

Agenda

- Primary valuation approaches
- Inputs and the Fair Value Hierarchy
- Valuation considerations in the current market
- Best practices and challenges in valuation engagements

Definition of Fair Value

- **Fair Value in accordance with FASB Accounting Standards Classification Topic 820:**
  - Defined 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"
  - Fair value is an *exit price* vs. entry price
  - Fair value is a *market-based measurement* (assuming change of control), not an entity-specific measurement
  - Assumes a transaction in the principal market, or, alternatively, the *most advantageous market*
  - Fair value measurement is made up of one or more inputs based on *market participant assumptions*
  - Inputs form the basis of the fair value hierarchy
    - Level 1, Level 2, Level 3

Market to Market

- **ASC 820 requires:**

  - Positions must be marked to market (e.g., carrying values on balance sheets adjusted) using the fair value standard – Can not be held at lower of cost or impaired value
    - Hedge funds
    - Private equity funds
    - Mutual funds
  - Significant and detailed disclosures are required for securities that are classified as each of Level 1, 2, and 3 (per the fair value hierarchy)

Fund Management / Board Responsibility

- Non-delegable duty of the Fund's board
- However, the board may appoint others to assist the board in determining fair value and to perform the actual calculations
- Management / Board should:
  - Approve specific policies and procedures
  - Circumstances requiring fair value
  - Determine methodology (ies)
  - Resolve / avoid conflicts of interest
- Appoint others (IA or Valuation Committee) to implement policies and procedures
- Maintain oversight
  - Ensure all appropriate factors considered
  - Assess method for determining fair value of each security

Key Valuation Policies and Procedures (P&P) Considerations

- P&Ps should be drafted to promote fairness and consistency in the valuation process
- P&Ps should clearly indicate the methods, principles and models that be will used to value investments
  - This is especially the case for hard-to-price investments
- P&Ps are meant to be living documents. They should be reviewed at least annually and can & should be updated
- Consider forming a pricing/valuation committee to address valuation difficulties
  - This will assist in minimalizing / avoiding internal conflicts of interest
- Valuation P&Ps are likely to be the starting point for SEC examiners

Best Practices

- Adoption of written/documented valuation policies and procedures
- Improving internal systems for retaining and monitoring fund holdings data
- Establishing an internal pricing committee
- Maintaining an advisory board or committee
- Continuous investment monitoring
- Appointing an independent valuation provider

POLLING QUESTION

Which is true about Fair Value measurement?

a) Exit vs. entry

b) Market-based (control)

c) Inputs & hierarchy (Levels)

Why is Valuation So Important?

- Fair value drives net assets, can overstate performance and over-charge investors management and performance fees
- If an adviser inflates the value of the investments, then:
  - overpaid in performance fees
  - overpaid in management fees
  - investors think holdings are worth more than they are
  - new investors in a fund will overpay for their interests
  - redeeming investors in a fund will receive too much for their interests
- The opposite will occur if the adviser understates valuation

Fair Value Hierarchy

- Identifies the assumptions that a representative market participant would use to price an asset or liability, including an adjustment for risk whenever a market participant would include such an adjustment to price the asset or liability
- Establishes a fair value hierarchy that prioritizes the inputs used to measure fair value into three broad levels, considering the relative reliability of the inputs
  - **Level 1 Inputs** – quoted (unadjusted) prices in active markets for identical assets or liabilities, where the reporting entity has the ability to access these markets for a potential transaction at the measurement date
  - **Level 2 Inputs** – inputs that are observable, either directly or indirectly as of the measurement date, other than quoted prices included within Level 1
  - **Level 3 Inputs** – unobservable inputs (unobservable inputs may be used to measure fair value to the extent that observable inputs are not available)
- In practice, when valuing holdings other than publicly traded stock or debt (or other assets traded on active public markets) the valuation inputs will typically include Level 3 inputs, such as required rates of return, pricing multiples, fair yields, or management provided projections or estimates, resulting in a Level 3 conclusion of value

Fair Value Hierarchy

- **Level 1 "Mark to Market"**
  - Unadjusted quoted prices from an exchange or broker-dealer market that is deemed to be active
  - Need to have a consistent approach as to how the quoted price is used
  - Quoted prices should not be adjusted because of the size of the position relative to trading volume (i.e., blockage discount)
  - Bid (long positions) quotes are preferred, given the exit price concept
  - If any significant adjustments are made to quoted prices, these become Level 2 assets

Fair Value Hierarchy

- **Level 2 "Mark to Matrix"**
  - Observable inputs: quoted prices for similar assets in active markets
  - Broker quotes: if the trade can be executed at that price (may require more than one or two quotes)
  - Quoted prices for identical or similar assets in inactive markets (a blockage discount may be appropriate)
  - Other observable market inputs: interest rates, yield curves, volatility factors, credit risks
  - Inputs derived from or corroborated by observable market data through correlation or regression analysis
  - For Level 2 designations, any models used must be widely accepted and non-proprietary, and the data used must be observable
  - If any significant adjustments are made to Level 2 Inputs, they generally become Level 3 assets

Fair Value Hierarchy

- **Level 3 "Mark to Model"**
  - Unobservable inputs (e.g. required rates of return, pricing multiples, fair yields)
  - Models (e.g., Black-Scholes, discounted cash flow, multiple of earnings or EBITDA) utilizing significant inputs that are unobservable
  - May include publicly listed securities with very little market activity
  - Reflects the entity's own data about the valuation assumptions that market participants would use
  - Cannot ignore reasonably available information without undue cost and effort to market participants

Primary Valuation Methodologies

- **Market Approach**:
  - Comparable Company Market Multiples (e.g., EV/Revenue, Price/Book)
  - Comparable Transaction (same as above, but based on control acquisitions)
  - Previous Transaction in Subject Co.'s Stock / Last Investment Round
  - Firm Offer
- **Income Approach:**
  - Discounted Cash Flow
  - Capitalization of earnings
- **Cost Approach:**
  - Investment Cost
  - Cost to build
  - Replacement Cost

Methodology Considerations

- **Methodologies should consider a variety of factors, such as**:
  - sources of prices
  - priority of sources
  - how the sources are used
- **Methodologies should generally include, as applicable:**
  - readily available quotes (for exchange traded securities)
  - broker-dealer quotes
  - third-party pricing services
  - proprietary pricing models
  - original cost of investment, etc.

Valuation Methodologies & Examples

- **Common Equity**
  - Income Approach
  - Market Approach
  - Cost Approach
- **Preferred Equity/Convertible Preferred**
  - Current Value vs. Option Pricing Method
- **Fixed Income/Illiquid Debt/Convertible Debt**
  - Spread Based Model
  - Option Based Model (e.g., Black Scholes)
  - Recovery Value Method
- **Structured Products**
  - Collateral Input Assumptions (e.g., default rates, recovery rates
- **Other Considerations**
  - Discount for Lack of Control
  - Discount for Lack of Marketability

Valuation Firm Considerations

- Independent
- Expertise in asset class & industry
- Experience interacting with auditors, regulators, investors, administrators
- Ability to support valuation analyses and conclusions
- Team capacity to meet volume and timing needs
- Resources to access market information

POLLING QUESTION

Which valuation method do you find most reliable for determining a company's worth?

a) IMarket Approach

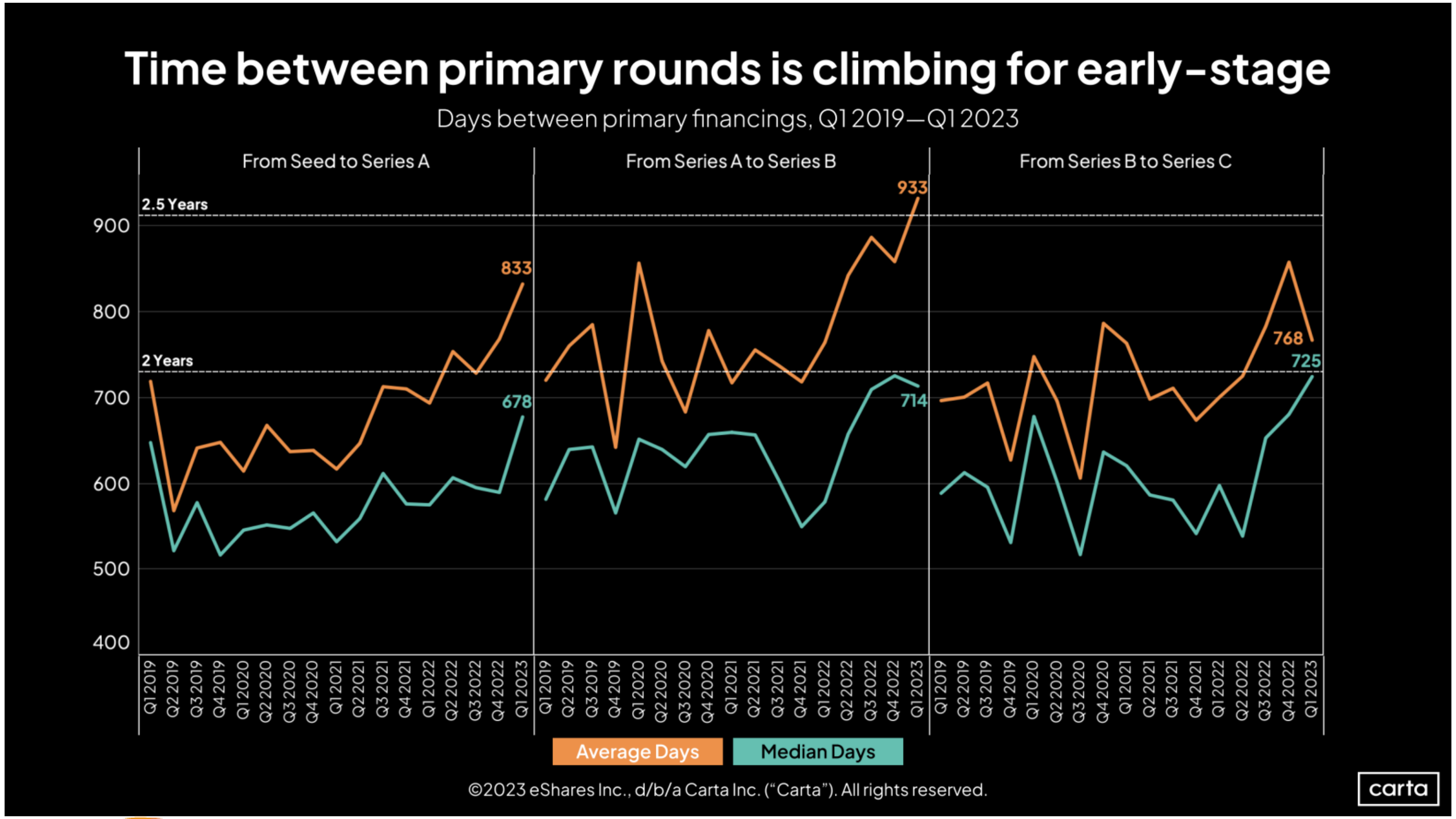
b) Income Approach

c) Cost Approach

Trends in the Valuation Environment

- Reduced funding frequency
- Changing rate environment
- Information limitations
- Increasing regulatory requirements

Trends in the Valuation Environment



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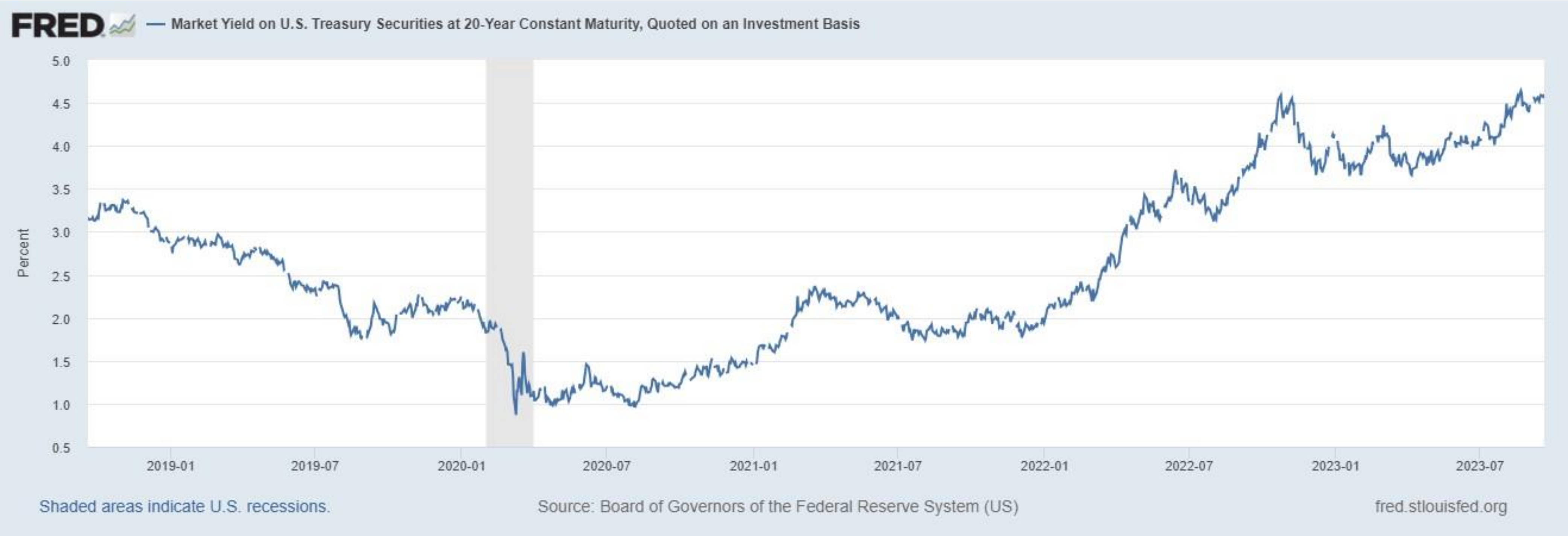

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POLLING QUESTION

Which of the following valuation environment trends do you believe has the greatest impact on financial decision-making?

a) Reduced funding frequency

b) Increasing risk-free rate

c) Information limitations

d) Growing regulatory requirements

THANKS FOR LISTENING

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