Valuing illiquid and ‘hard to value’ assets

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ABSTRACT

Background: The financial crisis of 2008/2009 focused greater scrutiny on the concepts surrounding the valuation of ‘illiquid’ or ‘hard-to-value’ investment assets. The notion of ‘mark-to-market’ is often misunderstood and misreported in the press. As investors continue to allocate capital to less liquid and hard-to-value assets, it becomes increasingly important to understand what is meant by fair value.

Discussion: Fair value, the price that would be received to sell an asset in an orderly transaction between market participants, is the fundamental basis for reporting the value assets at discrete points in time. It is necessary to understand what fair value is, why it is used and how it is estimated. Generally, the value of the equity of a private company is used as the starting point for valuing individual securities. Valuing debt investments may require additional judgment. Other complexities arise when considering the interaction between debt, equity and other instruments in a capital structure. Conclusion:

Obtaining timely fair value estimates for illiquid and hard to value assets is critical for investors to exercise their fiduciary duty of monitoring and reporting investments transparently. While judgment is required to estimate fair value, best practices have been established to increase consistency in valuing illiquid assets.

Keywords: fair value, valuing illiquid assets, alternative asset valuation

‘Private’, ‘complex’, ‘Level 3’, ‘structured’, ‘frozen’, ‘toxic’ and ‘difficult’, are all words that have been used to describe ‘illiquid’ or ‘hard-to-value’ investment assets. During the economic crisis of 2008/2009 markets for certain investments dried up completely. The press vilified the concept of ‘fair value’ accounting, which they termed ‘mark-to-market’. Today, markets for most investments have returned. Investors and managers continue to allocate capital to ‘illiquid’ and ‘hard to value’ instruments, especially given the extremely low returns obtainable with theoretically less risky fixed income investments. Yet there seems to remain a nagging question as to how ‘illiquid’ investments should be valued. Valuation questions generally can be summarised as follows:

- What is ‘fair value’?
- Why use ‘fair value’?
- How is ‘fair value’ estimated?
FAIR VALUE DEFINED

For more than 70 years, ‘fair value’ has been the accounting standard required for reporting investments held by investment funds. In addition, ‘fair value’ is the standard required for valuing securities held for sale by entities such as banks, insurance companies, and other corporations. Therefore, it is surprising that one of the greatest obviations from our most recent economic crisis was depicting ‘fair value’ accounting as ‘fire sale pricing’. Ironically, fair value accounting standards prohibit the use of fire sale pricing.

Prior to 2006, accounting standards generally used the concept of ‘willing-buyer/willing-seller’ to determine fair value. The US Financial Accounting Standards Board (FASB) felt that additional guidance was needed to harmonise the definition of fair value and to expand disclosures surrounding fair value estimates. FASB did this by issuing Statement No. 157, *Fair Value Measurements* (now known as FASB ASC 820). Statement No. 157 did not change which assets or liabilities were required to be reported at fair value (other accounting standards dictate using fair value). However it did present a new definition of fair value: *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* (FASB ASC TOPIC 820 definitions; International Accounting Standards (IFRS 13) utilise the same definition). In addition, Statement No. 157 expanded disclosure requirements and introduced the concept of Levels 1, 2 and 3 (indicating the observability of inputs used to determine value). In stark contrast to some press reports, Levels 1, 2 and 3 have nothing to do with the ‘toxicity’ of an investment, but only provides the degree of observability of inputs used to determine value, as more fully discussed below.

The term ‘orderly transaction’ is included in the definition of fair value. It should be clear, that fire-sale pricing is not allowed. However, a good deal of judgment is required to estimate an orderly transaction price, especially in markets were trading has declined or ceased or for assets. Such judgments are guided by the accounting requirement to use market participant assumptions when estimating the hypothetical orderly transaction price that represents fair value. Before discussing how to estimate fair value it is worthwhile to consider why investors care about fair value in the first place.

WHY FAIR VALUE?

Accounting Standards require investment companies (hedge, venture capital, private equity, real estate, mutual funds, etc) to report investments at fair value. This is because investors who invest through investment companies, either by purchasing shares, or through limited partnership structures, manage their investments on a fair value basis. Nevertheless, based on thousands of discussions with investors and managers, it is clear that a good number of institutional investors, at times, give managers the impression that fair value reporting is not important to them with respect to less liquid investments. This impression is fed by the fact many institutional investors have a long-term investment horizon and therefore feel that volatility in reported values could be misleading. The fear of reporting volatile interim results is misguided as volatility exists, whether or not it is reported. Failing to report interim results on a fair value basis does not magically eliminate volatility; it is just hidden.

Fair value, while requiring judgment, is the best basis for reporting investment values, especially illiquid investment values because:
Institutional investors are required by accounting standards to report their investments at fair value.

Fair value information assists in making investment manager determinations.

Fair value allows asset allocation decisions to be made on a like-like basis (all asset classes are reported consistently at fair value).

Fair value allows investors to exercise their fiduciary duty to diligently monitor their investments.

Fair value provides investors with information for their own incentive compensation decisions.

Fair value satisfies third party or regulatory requirements.

Fair value reporting by investment companies eliminates the need to consolidate underlying investments. Reporting consolidated results of underlying investments would be meaningless for most investment companies.

An arbitrary reporting basis, such as cost, may be easy, but provides little decision useful information.

For actively traded securities (Level 1), determining fair value is very straightforward. Fair value is the market price multiplied by the quantity of the security held \((P \times Q; \text{price times quantity})\). For less liquid or illiquid investments, fair value because more judgmental, using various techniques. The remainder of this article focuses, at a high level, on valuing illiquid investments.

**VALUING ILLIQUID INVESTMENTS**

As noted above, actively traded securities are deemed Level 1 investments and are valued using observable inputs \((P \times Q)\). Actively traded is defined as having sufficient volume and frequency to determine a price. The determination of actively traded is a judgment call. For reasons that go beyond the scope of this article, the accounting rules prohibit adjusting the value of actively traded securities even if the size of the block held could not be sold without impacting the price in the market.

Two paragraphs from the accounting guidance help place the discussion of valuation in context. *Fair value is a market-based measurement, not an entity-specific measurement. For some assets and liabilities, observable market transactions or market information might be available. For other assets and liabilities, observable market transactions and market information might not be available. However, the objective of a fair value measurement in both cases is the same — to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions (ie an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability). (IFRS 13 paragraph 2; FASB ASC 820-10-05-1B)*

*When a price for an identical asset or liability is not observable, an entity measures fair value using another valuation technique that maximises the use of relevant observable inputs and minimises the use of unobservable inputs. Because fair value is a market-based measurement, it is measured using the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. As a result, an entity's intention to hold an asset or to settle or otherwise fulfill a liability is not relevant when measuring fair value. (IFRS 13 paragraph 3; FASB ASC 820-10-05-1C; emphasis added.)*

Investments that trade, but not actively, are generally valued using Level 2 (observable) inputs. These are often securities that are very similar to actively traded instruments, but where the actively traded instrument is used as a reference point for the value of the infrequently
traded security. Some securitized investments, such as CLOs, CDOs, CMOs etc, are valued using Level 2 inputs such as contemporaneous actionable broker quotes. Usually, broker quotes would be augmented by models, where most likely cash flows are discounted using the return assumptions that a potential buyer of the instrument would use.

Investments that do not trade, or trade very infrequently, are valued using Level 3 (unobservable) inputs. Informed judgment is necessary to value such investments. While there are many different types of investments, which may a claim on the capital structure of a company, this discussion focuses on investments in the equity of private companies and investments in private debt. Industry best practice, such as the International Private Equity and Venture Capital (IPEV) Valuation Guidelines can provide assistance with determining the techniques used to value these types of illiquid investments. A market approach (using market comparable information) and/or an income approach (discounting future cash flows using an appropriate discount rate) to valuation will be appropriate. A powerful tool used to ensure consistency in valuations is calibration of inputs and techniques with the price initially paid for the investment.

Valuing the equity of a private company

In most cases, the fair value of an investment in the equity of a private company can be determined by using a market comparable based technique such as using a multiple of a performance measure, such as EBITDA (earnings before interest, tax, depreciation, and amortisation). Comparable companies, or comparable transactions are identified. The purchase price is calibrated using the comparable companies. For example, assume a simple transaction where 100 per cent of the equity of a private company is purchased for 1,000 (assume no debt financing for simplicity’s sake). Further assume that EBITDA for the target company was 100, implying a multiple of 10. At acquisition, comparable companies are identified with an indicated EBITDA multiple of 11.1. Calibrating the inputs at acquisition means that the acquired company is effectively valued at a 10 per cent adjustment factor to the comparable companies EBITDA multiple. This information can then be used in the future to determine the fair value of the company. If the comparable companies multiple increases, to 12.2, and all other things being equal, using the same 10 per cent discount to the multiple, would indicate valuing the company using a multiple of 11 applied to the updated EBITDA (taking into account positive or negative performance). This example is by design, simplified, for example purposes. The multiple of EBITDA valuation approach would be further triangulated by using comparable market transaction information and discounted cash flows (appropriately calibrated). The 10 per cent adjustment factor would change over time as facts and circumstances dictate.

The determination of fair value becomes more complex and requires more judgment as investment structures become more complex. The rights associated with the equity investment, the percentage ownership, assumptions used by likely acquirers (market participants), are all factors that require consideration. As previously stated, the goal of estimating fair value is to determine the price that would be received for the investment, in an orderly transaction, at the date the investment is being valued. Orderly transactions are generally represented by willing buyers and willing sellers. Fire sale pricing is not fair value. However, if market conditions are distressed, as was the case in early 2009, fair value is the amount that would be
received in an orderly transaction given then current market conditions. The fact that the holder of the investment may not be interested in selling is not relevant to the determination of fair value.

Valuing debt
For situations where the investment being valued is debt, ie a loan to a private company, an income approach is generally used, augmented by market information to the extent available. Valuing using an income approach means that expected future cash flows (most likely cash flows) are discounted using a discount rate that reflects the risk, term, liquidity, and security of the instrument. As market conditions change, the value of a debt investment would be expected to change. For example, if the debt has a fixed coupon (interest payment) as risk increases or as market interest rates increase, the value of the instrument would be expected to decrease. Conversely, if market interest rates decrease the value of the investment would increase. Using such a yield analysis taking into account credit quality, market yields, and expected term, again require judgment in concluding what a market participant would pay for the debt instrument at the valuation date.

Other complexities
The description above is purposefully simplistic. In particular for Private Equity and certain Hedge Fund investments, fair value determination becomes much more complex when both debt and equity securities are being valued together; when securities are complex—including debt, equity, and option characteristics; when control/non-control becomes a consideration; etc. Some argue for example, that mathematical models, such as option pricing models, are useful in determining fair value. Yet industry guidance, such as the IPEV Valuation Guidelines use the value of a business (enterprise value) as the starting point for estimating fair value when market participants would take such an approach. Based on interactions with numerous auditors and audit firms, increasingly some auditors question this approach because, they argue that the unit of account is the minority position and since the minority shareholder cannot force a transaction to sell, that the sale of the enterprise cannot be used to estimate fair value. This is one of the reasons mathematical models have entered the valuation discussion.

The thought process whereby a minority shareholder would not be able to use the sale of the enterprise as the basis for determining fair value deviates, in most cases, from market participant perspectives where transactions normally occur with all shareholders exiting together. If investors are working in concert with other investors it is most logical and consistent with market participant perspectives to use the sale of the enterprise as the starting point for determining the value of a non-controlling interest. Most often, minority shareholders pay the same price controlling shareholders do when making the initial investment. This is because both controlling and non-controlling investors have similar investment objectives and investment horizons. So when acting in concert, non-controlling shareholders appropriately value their investments as a pro-rata share of the enterprise value.

Some believe that a non-controlling interest automatically means a discount to the control value. Yet as was just noted, the controlling shareholder normally does not pay a premium to the price paid by the other (minority) investors. That is because many private investors do not price investments in terms of premiums and discounts; they determine the price they are willing to pay, and very often the terms of the investment do not allow for dispropor-
tionate returns amongst the investors. Therefore, often when investing in the equity of private companies, the use of terms such as discounts or premiums are both confusing and misleading.

As has been noted, industry established valuation guidelines, such as IPEV, provide a framework whereby different managers will approach the valuation process using a common methodology. While the managers’ judgment will result in different, but supportable, views on valuation, using a common methodology should narrow the range of these results.

**CONCLUSION**

Obtaining timely fair value estimates for illiquid and hard to value assets is critical for investors to exercise their fiduciary duty of monitoring and reporting investments transparently. Estimating the fair value of illiquid or hard to value assets requires judgment. Fair value determinations should always be based on market participant assumptions for orderly transactions. Relevant Valuation Guidelines, such as those promulgated by IPEV, help ensure that valuation judgments take into account applicable facts and circumstances resulting in consistent, rigorous and robust, yet cost effective, estimates of fair value.

**REFERENCES**

(1) The United States INVESTMENT COMPANY ACT OF 1940 requires quarterly reporting of fair value.

(2) The IPEV Board was established in 2004 with the mission of providing high quality, uniform, globally acceptable, best practice guidance for private equity and venture capital valuation and reporting purposes. The Board’s latest Valuation Guidelines (updated December 2012) are available at www.privateequityvaluation.com.