European Alternative Investments Valuation Conference

On May 11, 2010 industry thought leaders gathered for the second annual Duff & Phelps European Alternative Investments Valuation conference held at the Mandarin Oriental in London to discuss the issues impacting the alternative investment industry.

Conference presenters and panellists included:

Anthony Cecil
IPEV Board Member, Partner, KPMG

Chris Davison
Director of Communication, Permira Advisers

Sarah Fromson
Head of Investment Risk & Performance, Wellcome Trust

William Gilmore
Investment Director - Private Equity, Scottish Widows Investment Partnership

Alexandra Hess
Partner, Investor Relations, Cinven

Stephen Kempen
Director of Funds Administration, Apax Partners

David Larsen
IPEV Board Member, Managing Director, Duff & Phelps

Peter McKellar
Chief Investment Officer, Standard Life Capital Partners

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Managing Director, Duff & Phelps

William Wright
Publisher, Private Equity News

THERE IS NO DOUBT THAT THE FALLOUT FROM THE FINANCIAL CRISIS AND THE PUSH FOR INTERNATIONAL ACCOUNTING CONVERGENCE WILL INCREASE REGULATION IN THE ALTERNATIVE INVESTMENT INDUSTRY. THE QUESTION IS, HOW MUCH MORE REGULATION?

The impending regulatory changes

There is no doubt that the fallout from the financial crisis and the push for international accounting convergence will increase regulation in the alternative investment industry. The question is, how much more regulation? Some regulatory changes on the horizon include:

- Convergence: It is expected that before the end of the year there will be a converged Fair Value accounting standard so that the disclosures and measurement of Fair Value will be the same under IFRS and US GAAP.
- IFRS: The IASB is looking to create "investment company" accounting that would allow IFRS to become relevant for the alternative asset space.
- Financial Instruments: The FASB/IASB financial instruments project could have far reaching impacts for investors, managers, and investee companies.

There are more than 10 contemplated new accounting standards that will be released by FASB and the IASB for comment over the next 6 to 9 months. While all of the proposed changes may not directly impact private equity investors and managers, they will impact underlying portfolio companies. FASB and the IASB have recently indicated that finalisation of many of these convergence projects may be delayed until the end of 2011.

Why does Fair Value matter?

Private equity is a long term asset class where returns matter most, so why is there such focus on measuring Fair Value? Fair Value, while arguably imperfect, provides the best measurement framework because:

- Fair Value is the best basis to make "apples to apples" asset allocation decisions.
- Fair Value allows interim investment (manager selection) decisions on a comparable basis.
- Fair Value is often necessary as a basis to make incentive compensation decisions at the investor level.
- Fair Value provides a comparable basis for monitoring interim performance in the context of exercising the investor's fiduciary duty.
- Most investors are required by relevant GAAP to report their investments on a Fair Value basis. Therefore, most LP's require Fair Value.
- Investment Companies (under US GAAP; and likely under IFRS in the future) are exempt from consolidation rules because their investments are carried at Fair Value.
- Limited Partners need consistent, transparent information to exercise their fiduciary duty. Fair Value provides such information. An arbitrary reporting basis such as cost does not allow comparability.

Fair Value after the financial crisis

The recent market volatility has changed how Limited Partners look at valuation. For some it has reinforced the fact that they are long term investors focused on ultimate cash returns. For most, it has highlighted the need to ensure best practice governance, including monitoring interim investment performance. There is an increasing need for LPs to recognise the fact that they are responsible for the valuation assertions in their own financial statements.

Governance and transparency

Governance – Just a buzzword?

Governance within private equity is like a layer cake: there is governance at the LP level, the GP level and governance of the portfolio company by its management team and Board. For LPs, governance in private equity is about timely, open, honest communication, combined with an understanding that GPs and LPs are in partnership together with the shared objective of maximising returns. There is an increasing demand, driven by regulatory pressure in Europe and in the US that GPs provide information that is transparent, reliable and delivered on a timely basis. Without this, LPs cannot easily satisfy the demands of their stakeholders.

Transparency – Reliable and timely reporting

For LPs transparency is about more than just details, it is about the methodology of the valuation process. LPs require clarity on the assumptions behind valuations and those assumptions need to be consistent across reporting periods – for EBITDA, is it real EBITDA? Is it adjusted? Is it pro forma? Is it historic? Is it the last 12 months? What comparables have been used? Specific quoted companies or transaction data? Information being reported needs to be presented in a concise and understandable way to enable LPs to come to their own conclusions as to the valuation presented and underlying performance of the fund and its investments. Furthermore, GPs should communicate their proposed strategy in relation to fund investments beyond just presenting a set of bound reports and accounts.

In addition to transparency in methodologies employed, the timeliness of GPs reporting to LPs is becoming more crucial. There is no doubt that GPs are feeling the pressure from LPs. "More and quicker" often characterises the information demands from LPs. As the financial crisis unfolded, information requests from LPs increased. The majority of requests related to valuation, and debt also became subject to greater scrutiny. The challenge for GPs is to respond to the requests from LPs quickly but also with adequate detail – it can be a fine balance. Unfortunately there is rarely a 'standard' LP request so it is a challenge to automate the responses.

GP and LP responses to changing regulatory landscape

IPEV and third party valuers

The International Private Equity and Venture Capital Valuation (IPEV) Guidelines have been widely adopted in Europe. The application of the guidelines provides a consistent best practice basis for estimating Fair Value. The IPEV guidelines also demonstrate a leading self regulatory role established by the industry. With the need for LPs to validate and stand behind estimates of Fair Value, increasingly best practice is evolving to use the services of experienced independent third party valuation expert to validate Fair Value estimates. The use of a third party valuer, by the GP, and in some circumstances by LPs, while currently not mandatory, provides additional assurance and reliability in the financial reporting process. Such validation can reduce the burden for the LPs and is seen as a “value add” in fundraising. Indeed, many LPs would like their GPs that make use of third party valuers to more prominently communicate the results of such validation.

The GP back office

GPs have responded to increased accounting demands and increasing LP requests by investing in back office functions. GPs are spending significant amounts of time and money on improving systems respond to LP requests for greater transparency and more rapid reporting. Nevertheless, no matter how much investment is made in automated systems, there will always be bespoke LP requests which need to be dealt with on a case-by-case basis.

Who pays for the increased level of service from the back office? The consensus is that it should fall upon the GP to invest in delivering a more efficient level of service. However, there are some back office functions that are not specific to the fund, but specific to a particular LP, especially with the global investor base of some GPs. These costs are seen as a grey area that is open to negotiation with LPs.

Investor information demands

It is not possible to predict the information that will be required by a prospective investor based on their size, focus or geography. Some investors require a significantly greater level of detail than others. Some investors may only read the first five pages of a report, whereas others will review the details of every portfolio investment extensively. In the course of the due diligence process, some prospective investors now ask to speak with the auditors, as an additional source of information about the fund.

As LPs come under increasing pressure to determine the Fair Value of their investments, the need for transparency and timeliness in financial reporting by GPs is becoming even more important. While not a key differentiator for many investors when selecting which Managers to invest with, the ability of a GP to demonstrate its responsiveness to the needs of its investors and reduce the burden on its investors could be a final determinant in an investor’s allocation decision.

Survey of European Investors in Private Equity

Duff & Phelps partnered with Private Equity News to survey 80 of the largest European investors in private equity. The overall results show a long term commitment to the asset class, albeit with some reservations. Highlights of the survey include:

- 55% of LPs expect to increase their allocation to private equity, compared with only 10% who expect to reduce it.
- 72% of LPs intend to start or expand their co-investment programme. They want to take a more active role in their investments.
- LPs are putting pressure on GPs to change their terms: 81% expect to see a fall in management fees and nearly 30% expect a fall in performance fees. Just over half (53%) expect changes in key main clauses.
- On the issue of valuation, 71% of LPs say the majority of their LPs provide rigorous Fair Value estimates of their portfolio, and nearly 60% report that GPs have increased their rigour in this area in the past year.
- Nearly 70% support the ILPA guidelines, but there is a lack of clarity around the IPEV guidelines with nearly 60% of LPs unaware of them and not asking their GPs to apply them.

DOWNLOAD THE COMPLETE RESULTS OF THE EUROPEAN LP SURVEY HERE.

For more information about our global locations and expertise visit:

www.duffandphelps.com

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About Duff & Phelps

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