FOCUS ON

WHAT DID WE LEARN?

Mark Shayne, of Empire Valuation, speaks to *HFMWeek* about the key issues being discussed by industry leaders and the challenges these bring to valuation firms

“BACKTESTING IS AN EXCELLENT WAY TO SEE WHETHER THE VALUE DRIVERS IN THE FUND’S MODELS (CASH FLOWS, EXIT MULTIPLES, DISCOUNT RATES, CAP RATES) MATCH THE ASSUMPTIONS AND VALUE DETERMINANTS OF RELEVANT MARKET PARTICIPANTS”

Mark Shayne is a managing director with Empire Valuation Consultants, LLC. He has over 25 years of valuation experience with hedge funds, alternative investments and private equity/debit fair value measurement. Shayne received a BS Degree cum Laude from Wharton and MBA with Distinction from NYU.

If you root for the NY Mets and care enough to listen to their radio broadcasts (admittedly, a small pool), the glass is half full and half empty. Half empty because the Mets have been underachievers since 2006, and even more unforgivably, generally boring; half full because Howie Rose and Josh Lewin are among the best announcers in baseball. After each game, Josh Lewin has a segment, ‘What Did We Learn?’ In the spirit of Josh’s post-mortems, let’s see what we have learned recently.

Conference agendas, media posts and client due diligence discussions often represent a barometer of the concerns that market participants face. Consistently, recent hedge fund agendas, posts and discussions have coalesced around the following issues:

- Fatca
- Management fees
- Transparency
- ODD (Operational Due Diligence)
- Valuation and compliance

For this article, we leave the Fatca and management fee discussions to others, but the other three issues are a regular concern we see and deal with. Empire has the good fortune to work with some of the top hedge funds and most astute alternative investment managers in the industry. As a result, we interact with and learn from some of the brightest people focusing on these issues.

Market participants, investors and regulatory authorities want to be sure that ‘what you see is what you get’, whether in marketing materials, compensation, trading for one’s own account, client asset protection or valuation. Investors want to know that reported asset values equate to asset fair values. Transparency, both internally and externally, is becoming more important as regulation continues to creep into more segments of the industry. Large investors are calling for transparency as a requirement for them to invest (a change for private equity funds in particular). This is critical not only for regulators and investors, but for performance assessment, benchmarking, and to ensure that asset managers are appropriately compensated based upon actual, not aspirational, returns.

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We have been the subject of ODD reviews by funds of funds interested in the performance of their investee hedge funds and other clients. We have discussed valuation philosophy, market expectations and methodologies with our clients. We have also heard from countless market participants about transparency. What role can third-party valuation firms play in providing transparency?

Generally, valuation issues surrounding level one and level two assets are straightforward. Valuation issues become more complex when dealing with level three assets, where there is no liquid market for a security and no (or an insufficient pool of) secondary market trades or broker quotes. Independent, third-party valuations or confirmations can provide the sought-after assurance and transparency to investors and regulators. This work allows investors to see, on a much more granular level, how asset values are arrived at, in some cases, or closely reviewed in others.

Illiquid securities present special challenges to the assessor of fair value. Access to information, particularly on co-investment positions, unobservable inputs, complex promote arrangements and tight financial reporting deadlines all create challenges in assessing the fair value of level three investments on a timely basis.

What practices can the valuator use to mitigate these valuation and reporting challenges? First, commit to working closely with the client fund to understand the underlying rationale for what made the investment attractive for acquisition. Read the investment memoranda, both initial documents and subsequently modified ones. Test the fund’s underlying financial investment model for the asset. Speak directly with asset managers and servicers. Compare model assumptions with market participant inputs and outputs. Track ongoing, real-time performance with prior forecasts. We also like post-transaction backtesting of model assumption inputs and concluded values or out-

puts. Backtesting is an excellent way to see whether the value drivers in the fund's models (cash flows, exit multiples, discount rates, cap rates) match the assumptions and value determinants of relevant market participants. Finally, remain acutely aware of financial filing deadlines, fund administrator reporting commitments and audit review timetables.

Compliance is at the forefront of a manager's concerns, and rightly so, especially for the valuation function. Nevertheless, one outgrowth of the implementation of the valuation process could be the evolution of the third-party valuation agent from fulfilling only a compliance/regulatory function to assisting fund management as value-added experts, whose views shed (additional) light on how markets might view hard-to-value investments. Funds are paying third-party valuation firms to confirm or value their level three investments anyway, so putting them to work in other ways makes sense.

Fund management is always looking for an incremental edge to boost performance and investor relations. Moreover, improving internal conformity in the valuation review and reporting process across funds eases return comparisons and administrative burdens. It makes sense to take advantage of the breadth of experience that the third-party valuator offers by working with multiple funds and fund manager styles, structures and asset classes, to bring potentially new best practices into one's own fund, or help expand these practices consistently across funds. ■

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