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Fund Finance Friday

Notable in NAV: PitchBook Examines Accounting Fair Value

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Fair value accounting, commonly used to value fund assets, tends to understate the true volatility in asset values, according to a research note published by *PitchBook*. While the findings are not new, NAV lenders may find the summary to be thought-provoking given their reliance on asset values.

Fair value accounting tends to smooth asset value changes due to the infrequency of such assessments (typically quarterly) and because GPs tend to act conservatively in reflecting changes in asset values to either the upside or downside. This tendency is understandable given the absence of frequent observable transactions in any particular asset, and, from a fund perspective, it aligns with the long-term investment horizon that funds typically operate in.

NAV lenders, however, don’t exactly share the fund perspective. Loan tenors are often shorter than the remaining fund life, and the lender is concerned with being adequately secured at all times. It’s a matter of first principles: lenders don’t share in the upside in an investment and, therefore, have no interest in riding out the dips in value along the way. Instead, the NAV lender’s priority is in accurately gauging the economic value of the assets in its borrowing base throughout the loan term.

The approach to de-smoothing returns highlighted in the *PitchBook* write-up may be more relevant to an LP's conducting historical analyses than to NAV lenders, but here’s what we think lenders can take away. First, where possible, it may be helpful to supplement accounting fair value estimates with additional asset value inputs. Second, incorporating a lender appraisal challenge mechanic into the facility may be helpful to reconcile potential gaps between fair value and true economic value. Our Samantha Hutchinson examined lender revaluation negotiation points in more detail in a prior *FFF* **article**. Finally, at the portfolio level, lenders should pay attention to whether correlation and diversification assumptions rely on fair value inputs.

The *PitchBook* research note, which includes de-smoothed volatility estimates for some asset classes, is available **here** (subject to registration).