Finding Value in the Valuation

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A few *FFF* editions ago, I described how the appetite for NAV-backed facilities had increased significantly across the private markets in a post-COVID world and how the structures of these facilities were becoming more flexible as they attracted the interest of larger managers, particularly in the primary private equity space. However, whilst facility terms and structures are evolving, the fundamental concept and benchmark underlying these transactions is the “loan to value” ratio. We know that the Q1 marks have not given us any meaningful visibility on the impact of COVID on investments and portfolio companies and that the market is anticipating that visibility via the Q2 marks which managers are in the process of preparing. NAV financiers to existing portfolios are in active dialogue with managers to try to gauge the anticipated impact on borrowing bases of asset write-downs, and lenders are grappling with how to value portfolios in the absence of the Q2 marks for underwriting new financings.

Whilst valuations have been tested many times before, we have arguably never seen a crisis hit this quickly and this extensively across all markets, sectors and industries, and, as a result, lenders and advisers are looking at valuations and valuation methodologies with much more scrutiny than ever before. Helpful guidance has been issued in relation to the factors managers should and should not take into account when assessing the value of their portfolios, which make sense from an investor long-term investment outlook perspective but raises the question: Are the current methodologies and guidelines really fit for purpose in the context of a NAV-financing? In this piece, I focus on how managers are valuing their portfolios, where there may be a disconnect between the usefulness of the valuation for investors on the one hand and financiers on the other, and where additional protections are being sought by lenders in the market underwriting new NAV-financings.

Where it began

Whilst private markets participants entered 2020 anticipating and preparing for some form of short- to mid-term market correction, it’s fair to say that no one could have predicted the scale and suddenness with which the COVID crisis would hit and impact markets globally. The effect on the public markets was visible virtually immediately, with equity markets globally dropping by as much as 30%, but the time lags associated with private fund managers’ calculations and reporting of “net asset value” has meant that investors and financiers to the private markets have had to wait significantly longer to see the impact of COVID on portfolio company and investment performance. As we approach the end of Q2, we’re at a juncture whereby:

- lenders to existing portfolios are preparing to see marks released in the summer which will more meaningfully reflect the impact of COVID on investment portfolios and whether or not this will result in any LTV breaches;
- at the same time, we’re seeing a rush by managers to lock in NAV-backed facilities to provide liquidity either for supporting existing portfolio companies or for strategic acquisitions, in each case prior to the Q2 valuations being released.

Approaches and applications of valuation methodologies have advanced significantly since the GFC, but how confident should lenders be in the numbers they are presented with? Should they and can they apply further discounts to these numbers? Should they and can they require an independent valuation and, if so, how often, what should be the scope and who should pay for that valuation? Whilst these factors were considered to a degree prior to COVID in the context of NAV-backed facilities, they have become of paramount importance in a post-COVID world.

How are managers currently valuing their portfolios?

Whilst there are a number of standards and guidelines available to private markets managers to assist in ascribing value to investment portfolios, the most widely adopted standard is the International Private Equity and Venture Capital

Valuation Guidelines. In response to the challenges being faced by managers in valuing their portfolios post-COVID, on 31 March 2020 the IPEV board issued special guidance as to factors that should and should not be taken into account in determining the “Fair Value” of investments, the widely accepted benchmark for private equity valuations. The special guidance clarifies that “Fair Value” should be interpreted as the value that would be received by a manager in an orderly sale of the relevant investment using market participant assumptions as at the measurement date. The concept of “Fair Value” does not assume a fire sale of the relevant investment and should take into account both macro and micro market conditions which are known and knowable as at the relevant date. Managers should be continuing to use appropriate comparables from the public markets whilst being mindful of the differences in inputs and drivers underlying those public market valuations.

Ironically, whilst market participants anticipate that the Q2 marks are likely to show greater value declines than the Q1 valuations, managers are actually in a much better position to assess more accurately the impact of COVID on underlying businesses. We have far more knowns and knowables reaching the end of Q2 than was the case for Q1, which should make those numbers and calculations more robust. Managers have now had the opportunity to evaluate their portfolios at both a macro and micro level. They are now much better placed to understand which portfolio companies need more liquidity and, as lock-downs begin to ease, which portfolio companies can begin to recover and those which are still likely to be in some form of distress. The ranges of outcomes now is narrower for portfolio companies than was foreseen at the end of Q1. Certain industries have recovered well, and other sectors will clearly continue to struggle. We have also seen the backdrop of public markets stabilising and the impact of government stimulus. In that respect, whilst there is undoubtedly still uncertainty at both a macro and micro level and whilst we anticipate that the Q2 numbers as a whole may not look pretty, we should have more confidence that these numbers are more reflective of where businesses really are and where they are likely to go which should make assessing “net asset value” for the purpose of determining compliance with financial covenants and for underwriting new financings much easier.

But is that really the case?

There is still a great deal of subjectivity in valuing private assets. Whilst a rebounding of the public markets is a factor managers can take into account, there is very little comparable data available in the private markets themselves given acquisition and loan origination activity has all but halted, which makes direct comparables very difficult. Is the strong rebound in the public markets really justifiable and how much weight should managers be giving this to write up investments? Managers have to look at their investments on an investment-by-investment/company-by-company basis and come to a view as to the outlook for a particular business, taking all relevant factors into account and understanding that this assessment may well be different from one manager to another with similar portfolios. In addition, whilst “fair value” is the universal reporting standard in the U.S., there are more variations applicable to European funds, where different jurisdictions have different accounting provisions and reporting conventions, making a true “like for like” comparison much more difficult.

Whilst the guidance issued by IPEV certainly makes sense for investors in the private markets with mid-/long-term investment outlooks, a financier lending against a portfolio of investments is looking for the valuation to accurately reflect the value that would be obtained were the lender to foreclose on the portfolio at any given point in time during the life of the facility. This draws a fundamental distinction between the “value” of these valuations to investors and managers, versus the value to financiers. This dislocation has led many lenders looking to provide new financings against investment portfolios to seek to mitigate this risk by:

- reducing LTVs to more conservative levels than those seen pre-COVID or maintain previously seen LTV levels but with a significant upward pricing adjustment;
- conducting their own valuations of the portfolios either at the outset of the financing for the purpose of striking the initial NAV and having the ability to revalue the portfolio on an ongoing basis whether internally or via an independent valuation agent. Although the concept of re-valuing portfolios was seen in NAV trades pre-COVID, in our experience it is now rare to see a NAV financing which does not include revaluation mechanics to some degree. The points of negotiation will be:
    - What are the triggers for the revaluation? If the lender does not consistently calculate the adjusted net asset value throughout the life of the facility, is the revaluation right triggered by LTV hitting a certain threshold, the lender reasonably suspecting that the LTV threshold is or will be breached and/or a material drop in a relevant index?
    - How many times can a lender revalue a portfolio? Again, if the lender isn’t already calculating the adjusted net asset value, how many times over the life of the facility can the revaluation right be exercised and, if this is

limited, what should be the position if a third party or internal valuation by the lender consistently demonstrates that the portfolio is overvalued by the relevant manager?

- What is the scope of the revaluation? A lender will want the entirety of the valuation methodology *and* its application to be capable of being reviewed, not just the application, and by reference to all relevant data.
- Which independent valuation agents should be appointed? The approaches taken by valuation agents in their analyses can differ, which will have a material effect on the direction of the valuation.
- What happens to distributions whilst revaluations are being carried out? Clearly, from a lender perspective, it will be imperative that cash is trapped until the revaluation has been carried out, but what time periods should apply here such that the cash isn't blocked unnecessarily for a long period of time?

Clearly, the need from managers for liquidity solutions to manage their portfolios in circumstances where nether internal capital nor additional headroom within sub-lines is available represents a significant opportunity for financiers with credit appetite to underwrite investment portfolios. But the usual valuation methodology and application thereof by a manager may not be sufficient for a lender's purposes – arriving at a settled approach on the valuation overlaying the valuation carried out by the manager will be critical.