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A Reality Check on Today's Valuation Standards

Why the right deal terms and valuation methods have become so critical for equity investors

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Alternative investors are under perpetual stress these days. With today's fast-changing market and increasing scrutiny on GPs at venture capital and private equity firms, it is extremely difficult to have consistent valuation results with clear standards. Of course, all of this is exacerbated by an inherent lack of scalability during rapid growth. Small wonder the SEC is on the case in a very big way. In a May 2014 speech called (somewhat ironically) *Spreading Sunshine in Private Equity,* Andrew Bowden, Director, Office of Compliance Inspections and Examinations of the U.S. Securities and Exchange Commission boldly stated this eye-opener at the Private Fund Compliance Forum in New York City:

> *"So…when we think about the private equity business model as a whole, without regard to any specific registrant, we see unique and inherent temptations and risks that arise from the ability to control portfolio companies, which are not generally mitigated, and may be exacerbated, by broadly worded disclosures and poor transparency...When we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we believe are violations of the law or material weaknesses in controls over 50% of the time."* [1]

50% of the time? Clearly, markets just don't have the infrastructure to handle all these evolving financial systems. As a result, there is utter chaos everywhere.

> ***"…we have identified what we believe are violations of the law or material weaknesses in controls over 50% of the time."***
> *- Andrew Bowden, SEC*

Maybe deal rights and preferences are finally starting to have their day. In the past, the very nature of alternative investment assets meant fewer regulations; this is no longer the case as government and auditor pressure has become amplified recently – and they are making their voices heard. Consider these prescient words, however, from a white paper called, *Yes, Virginia, There Is a Grinch: The AICPA Practice Aid on Alternative Investments:*

> *"And now, apparently out of the blue as far as investors are concerned, the accounting profession has fired the biggest salvo yet: if institutional investors can't satisfy their auditors on a wide variety of issues associated with alternative investments, they risk receiving a qualified opinion. And since many institutional investors have debt outstanding containing covenants that require a clean audit opinion, the accountants are wielding a very large stick indeed."* [2]

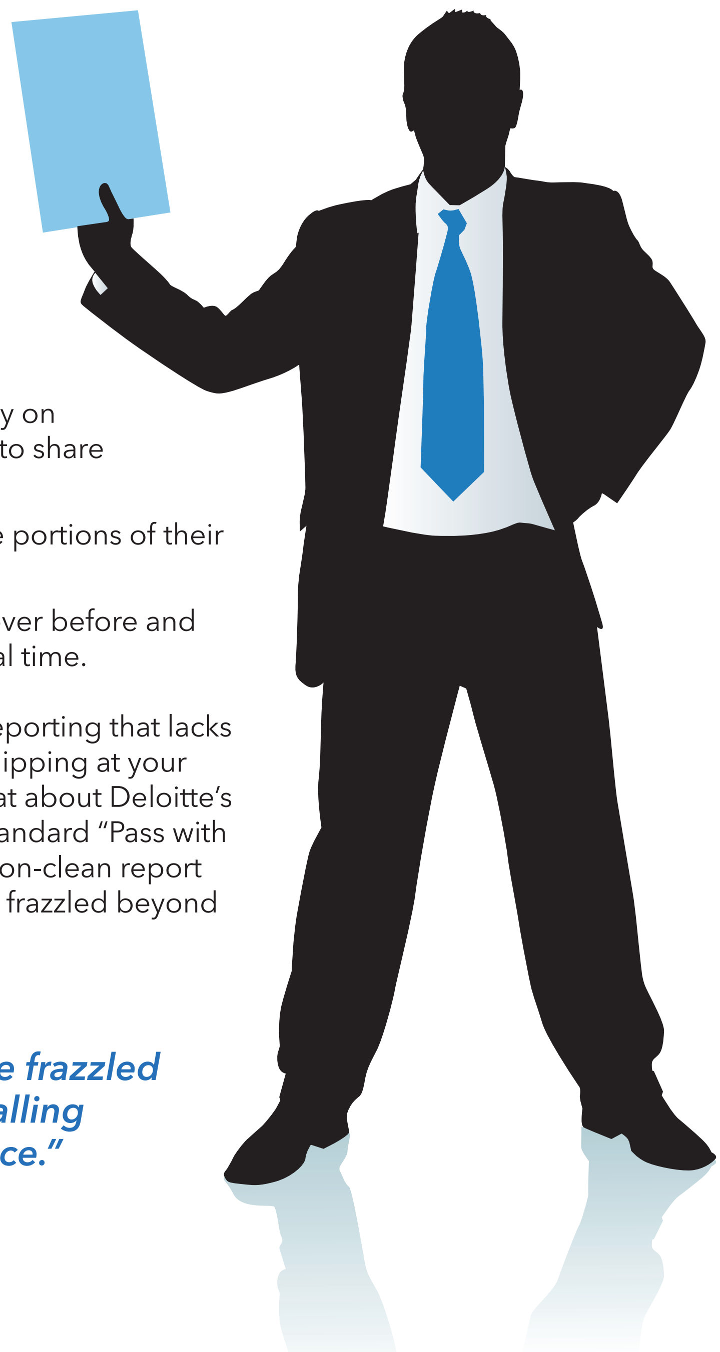
Have you thought about how deal terms are impacting, and perhaps harming, ultimate future growth from start to finish? The simple fact is that, over the past five years, the overlying theme is that when deal terms show up in securities, they have a *direct result on the value of them.* But why is this happening so often now? What has caused this to occur so frequently? "In short, deal terms matter because

[1] Private Fund Compliance Forum, Spreading Sunshine in Private Equity, May 2014.
[2] Greycourt, Yes, Virginia, There Is a Grinch: The AICPA Practice Aid on Alternative Investments, December 2006.

the market has evolved from carrying investments at cost to fair value," noted Shareholder InSite President, Brett Suchor. "Given that every security has its own unique set of preferences adding complexity to the capital structure (liquidation preference, conversion rates, vesting schedules), these must be considered in a world of fair value." [3]

"…the accountants are wielding a very large stick indeed."

Remember the S&L crisis in the 80s? How about the real estate market bubble that led to the financial meltdown to 2008? Sound like a familiar pattern? Well, it's the same story with different characters in our changing marketplace, only the characters are us:



1) GPs under scrutiny from auditors who are being cowed by the SEC, PCAOB and government regulators.
2) LPs who are mimicking GPs as they create their own direct investment funds yet continue to rely on GP reporting. It is almost impossible, however, to share valuation results without clear standards.
3) Hedge Funds, often structured as LPs, that have portions of their portfolios that look just like LPs making directs.
4) Investors who are savvy about the game like never before and want immediate information and answers in real time.

What is the ongoing result? Simply put: difficult reporting that lacks standard methodologies. With Andrew Bowden nipping at your heels. That's just if you're an investor, though. What about Deloitte's recent peer review demise after receiving a substandard "Pass with Deficiency" rating, "the first Big 4 Firm to have a non-clean report in the history of the Big 4" [4] Even the auditors are frazzled beyond belief and falling from accounting grace.

"Even the auditors are frazzled beyond belief and falling from accounting grace."

[3] Shareholder InSite, 2014.
[4] Going Concern, Deloitte Achieves Another Unflattering Milestone in Audit Quality, July 2012.

So we can just forget about scalability now? If clear standards weren't in place at the very beginning, then putting a multiplier on them can be disastrous. Remember that scalability as a term originated in technology. If your problem increases, how well does your solution work? This analogy applies especially well here since the scalability of reporting accurately in our swift financial markets is tantamount to a server that was meant to handle only 100 users that now finds itself scaling to 10,000. If you lack standards, for example, it's never the first valuation that's a problem; it's the second one that will become an issue and cause real trouble. Bowden's speech, thus, is clearly a resonant shot fired over the bow with *The Wall Street Journal* recently echoing his fiduciary crusade in a very recent article from September 14, 2014, called *SEC Finds Deficiencies at Hedge Funds: Shortcomings Include Valuation 'Flip Flopping':*

> *"Mr. Bowden, who spoke at an investment advisory conference sponsored by industry newsletter IA Watch, said regulators have discovered some funds engaging in what he called "flip-flopping," boosting valuations by changing the way they measure holdings several times a year. In some instances, the funds chose the measurement with the highest value or intentionally classified certain assets in a way that gave the fund manager more flexibility to inflate the price of the fund's holdings."* [5]

The confusing aspect of this is that the entire market is struggling but still driving tremendous growth, and that growth is superseding accurate reporting. It's just all happening too fast. Growth is outpacing clear standards, and no one seems to have the time to establish them. How does a company play catch-up, though, when defective valuation methodologies are already in place? A thousand band-aids will never fix an amputation.

"Growth is outpacing clear standards, and no one seems to have the time to establish them."

Furthermore, the life cycle of a fund's process nowadays exists in such a schizophrenic financial market that there is simply no infrastructure to withstand, or even truly understand, the chaotic systems that are evolving around it. As a result, deal terms not only matter more and more for alternative investment firms—they are in fact absolutely crucial. In other words, there is total chaos around standards and reporting. And we all know that chaos doesn't scale. Nevertheless, it's happening right now.

[5] Wall Street Journal, SEC Finds Defincies at Hedge Funds, September 2014.

Let's take a deeper look at all of the players:

1) General Partners (GPs) are right in the middle of it all; you might think of them as the eye in the surrounding hurricane, the private equity and venture funds right in the center. Everything points to them or away from them, but they have ended up being the hurricane's eye. As this market chaos spins out of control, they are amid a maelstrom of auditors and regulators while still trying to handle investor pickiness and LPs relying on them for their reporting.

2) Government Regulators, the SEC and the PCAOB are doing their best to limit fraud by pressuring best practices on auditors, who in turn are trying to standardize some kind of workflow to facilitate audits (that often fail). Even the Big 4 (Deloitte, EY, PwC and KPMG), who in essence drive accounting standards by sitting on every accounting standards board out there continue to struggle with Peer Reviews. Deficiencies in Peer Reviews reached staggering levels a couple of years ago approaching 33% with fair value standards near the top of the list.

3) Limited Partners (LPs) are like the younger cousins of GPs, but increasingly, they absolutely rely on GP reporting that is accurate and timely. For LPs there is a tremendous pressure for quality reporting of fair value. It is difficult, therefore, to share valuation results without clear standards when LPs might dilute/edit reports from GPs. We call this the "co-investor" problem. Hedge Funds can fall under LPs as well.

4) Investors know the game, but the asset class is expensive. They are almost becoming like another type of auditor. This puts more eyes on standards and methodologies. Some investors are probably more educated than the auditors these days since the investors have more capacity and focus to make sure their money is moving right.

5) Deal teams that don't have to have standards, but end up doing valuations for finance and accounting. Alternate investment firms don't have sustainable infrastructure. Hmm. So who does the valuations for financial accounting? The fact is that investment management often has no methodology.

The ultimate question here is how to scale a process that evolves without standards—a process that may be based on deal terms that work in the short-term (when a few spread sheets could do the trick), but simply can no longer sustain the same growth. It's now widely accepted that spreadsheets simply don't scale.

"Spreadsheets simply don't scale."

[6] Private Fund Compliance Forum, Spreading Sunshine in Private Equity, May 2014.

Ideally, in the process of fundraising, deal-making, investment management and the exit stage, you want the deal terms of your fund's lifecycles to evolve to include valuation reporting that is accurate. But here is the paramount question you need to ask, beyond even scalability: how, finally, do deal terms impact exits if they are unclear from the beginning? The ending of Bowden's previously mentioned speech comes across as very cautionary here, an alarming warning:

> *"OCIE's experience is that complexity and rapid growth have created governance and compliance issues that should be addressed as these firms mature and evolve…Consider it OCIE hopping down off the beach stand, wading waist-deep into the water, and offering that we see unique risks–riptides and jetties–inherent in your business model. Based on our observations of the controls and disclosures currently in place to mitigate these risks, we advise that you work to strengthen your strokes and pay greater attention and give wider berth to the potential problems that could harm your clients and your businesses, as well as the private equity industry as a whole."* [6]

Andrew Bowden isn't mincing his words. If this is not a strident wake-up call for investors, we don't know what is.

> ***"…give wider berth to the potential problems that could harm your clients and your businesses, as well as the private equity industry as a whole."***
>
> *- Andrew Bowden, SEC*

Remember Occam's Razor? The simplest solution is usually the correct one? We need to keep it simple. The deal is the beginning. The terms around that deal are the articulation of that deal. The exit is the end. From deal to exit, we have the middle. And right now something bad is happening in the middle. This is the chaos. This is the lack of scalable reporting. These are the ever-changing standards that even the regulators, the SEC, the PCAOB and the auditors cannot handle.

Perhaps it's best to start with a simple checklist regarding deal terms:

1) Know the original deal, how it was negotiated and what the key terms/conditions are.

2) Be cognizant of the investing partner's primary reason for investment.

3) Support your internal finance team on the valuation work with accurate data.

4) Always be conscious of how auditors will scrutinize the way you carry value.

5) Know the impact on liquidation payouts/valuations models.

6) Align with model-based valuation approaches under Topic 820.

7) Avoid inaccurate valuations on interim financial statements and year-end write-downs.

8) Corroborate a second approach to the original primary method of valuation.

It all begins with deal terms, but reporting remains difficult these days. How do we fix this? Or is it unfixable? If deal terms are not sacrosanct and you have a hurricane of players swirling around one another, where is the financial calm in the eye? Have you tried to amalgamate a bunch of spread sheets from different departments in a rapidly growing business? It doesn't work. It's fire-fighting. Fire-fighting, hurricanes, riptides and jetties—none of this sounds good.

No wonder alternative investors are under perpetual stress. As news of inaccurate reporting becomes more salient, maybe it's finally time for rights and preferences to really matter in the face of new auditing czars like Andrew Bowden. It's time to circle back to deal terms to avoid an economic hurricane that twists out of control right in front of our eyes.

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