



Valuation Fund Transfers -- COVID-19 Considerations

Coming Soon: Increased Fund Restructuring in 2020

COVID-19 will significantly accelerate the restructuring of private funds through asset transfers from existing funds to related-party funds or affiliate entities. Such fund transfers have significant valuation and fairness issues that should be considered by GPs, LPs, and their advisors.

The timing of the COVID-19 crisis creates further challenges in estimating the “fair value” of investment positions. Many funds are still wrapping up year-end valuation marks for December 31, which coincided with a near peak of public equity markets, as well as strong conditions in private equity markets. What implications does this have for First Quarter 2020 (March 31) valuations, where public markets have been decimated and the duration and impact of COVID-19 is highly speculative? What are the credit and liquidity issues for GPs and LPs as a result of these changed market conditions?

LESSONS FROM 2008: Experience from the market crash of 2008 to 2010 provides lessons and insights. Fair value implies an “exit” value and is the price a seller would receive assuming normal market conditions at the date of value in an orderly transaction – not a “forced sale” or “fire sale”. Fair value requires valuation methods to be applied consistently and to be calibrated when “unobservable” inputs are used in subsequent periods that were not used previously.

Calibration ensures the valuation technique(s) reflects current market conditions and helps a fund manager determine whether an adjustment (from a prior reporting period) is necessary. The significant changes in market conditions from 4Q 2019 to 1Q 2020 will challenge fund managers and valuation committees when issuing valuation marks. Trailing 12-month EBITDA multiples may no longer be applicable and funds will struggle to obtain revised and credible financial projections from their portfolio companies. This will require use of “unobservable” inputs.

Unobservable inputs are defined by ASC 820 as inputs for which market data are not available and that are developed using the best information available about assumptions that market participants would use when pricing the asset or liability. Unobservable inputs may include inputs developed by the fund, for instance using models to extrapolate historical volatilities in the valuation of illiquid securities, as well as inputs developed by third parties, such as the value of an investment in a private operating company provided by a third-party valuation specialist. Additionally, a valuation specialist can assist in determining metrics relating to illiquid assets, such as trading volumes, market comps, multiples, discounts, and other factors having an impact on their valuation.

Fair value guidance from the 2008 financial crisis was issued to address circumstances when the volume and level of activity of an asset or liability have significantly decreased and when a transaction is deemed “not orderly”. The

guidance reinforces that fair value does not require funds to rely on quotations that reflect distressed transactions. In times when prices are not indicative of orderly market conditions, funds should utilize alternate valuation techniques to estimate fair value under current market conditions. An independent third-party valuation is highly recommended in these circumstances.

FUND RESTRUCTURINGS OR TRANSFERS: For the remainder of 2020 and beyond, fund LPs, which have suffered significant decreases in their public equities' carrying values, will likely seek liquidity from their private equity investments, particularly in funds nearing the end of their fund period. However, LPs' desire for liquidity may be in opposition to the GPs' desire to maximize value from the investment. As a result, increased fund restructurings are imminent.

When restructuring, or transferring assets between funds, valuation becomes a critical component. Not properly addressed, valuation of the underlying illiquid assets can lead to conflicts between GPs and LPs. By addressing valuation issues up front, such conflicts can be mitigated. Best practices dictate that an independent valuation be obtained when moving assets between funds. In addition, obtaining a fairness opinion provides further protection to both fund managers and investors. GPs will also find independent valuations useful in managing fund auditors who are tasked with evidencing that the fund marks are representative of fair value. GPs that aspire to get their audits completed on time follow the best practices of utilizing independent third-party valuation providers.

EXAMPLES: An Example Transaction – A Company redeemed its preferred stock plus accrued and unpaid dividends, in addition to associated warrants, held by Fund A for \$XXX. In conjunction with this Transaction, and to finance the Transaction, \$XXX of senior subordinated notes, along with detachable warrants to purchase additional equity, would be provided to the Company by Fund B, another fund managed by the same management company (“Management Company”) as Fund A. Houlihan Capital provided a fairness opinion to the Management Company and its Advisory Board that the transaction was fair, from a financial point of view, to the limited partners of Fund A.

A Second Example – Fund A, levered, held investments that significantly decreased in value during March 2020, triggering covenants that would allow its lender to force the sale of such depressed investments. However, the investment manager has the view that such investments will perform well in the long-term. The investment manager of Fund A also manages Fund B, which currently has liquidity to buy such depressed investments. A forced sale of such assets would hurt Fund A, while a planned sale from Fund A to Fund B would help both funds. In connection with the asset transfer, Houlihan Capital provided a positive assurance opinion that the methodologies used and value conclusions reached by the investment manager were reasonable.

A Third Example – Fund A is transferring assets to Fund B, both of which are managed by Investment Manager 1. Pursuant to section 206(3) of the Investment Advisors Act of 1940, Investment Manager 1 requires a representative of the Funds and limited partners thereof, to consider and approve or disapprove the cross transfer of assets, which may be consider principal transactions. Houlihan Capital has acted as such agent of the Funds and limited partners thereof, to approve or disapprove of the transfers, providing an independent review in connection with section 206(3) of the Act.

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At Houlihan Capital, we expect the trend of fund restructuring and fund transfers will continue for the next several years. Further, these restructuring transactions have been receiving increased scrutiny from the Securities and Exchange Commission (SEC). The SEC has been very open about closely monitoring the creative solutions that funds implement to ensure they don't violate federal securities laws and to safeguard that fund managers use full disclosure and alert investors of any conflicts of interest throughout the process.

Houlihan Capital has extensive experience in providing independent valuation and transaction opinions (fairness and solvency) for fund managers involving complex securities and capital structures. We are SOC-compliant, demonstrating our commitment to the highest quality industry standards.

If Houlihan Capital can be of help in your restructuring, please contact:

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