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External mandates

Growing number of AIFMs consider external valuers

Since AIFMD came into force, institutions have interpreted the requirement for the ‘proper and independent’ valuations of an alternative investment fund’s assets in different ways. The majority carry out the valuation process internally and employ a third-party valuation agent in an advisory capacity. However, there are certain sectors of the market that may be increasingly likely to outsource valuations to an external valuer.

"The majority of our portfolio valuation work in Europe tends to be in a valuation advisory capacity," says Tomas Freyman, md at Lincoln International in London. "However, over the last six months, we've seen a significant pick-up in conversations regarding external valuer assignments.”

‘External valuer’ is a term specifically defined as part of the AIFMD (SCI passim). Freyman adds: “AIFMs based in Luxembourg or Dublin, for example, are increasingly likely to outsource the process to an external valuer."

Increased cost has been one of the fundamental outcomes of AIFMD – particularly in relation to the valuation process. The cost of outsourcing valuations to an external valuer – with all of its associated liabilities – has been deemed uneconomical for some institutions. At the same time, a fund manager wishing to carry out valuations in-house will incur cost in creating a functionally separate in-house valuations team.

“Given the emphasis on a ‘proper and independent valuation’ under AIFMD, there is a growing tendency for AIFMs to use independent valuers where possible - but this has to be balanced against cost,” says Michael McKee, partner at DLA Piper. “A manager should be comfortable that its valuations are independent. That can depend on what the role of the fund manager is, however.”

He continues: “Some managers simply manage the funds and don’t raise the funds themselves. But if a fund manager is the progenitor of the fund, it is less simple to prove that independence.”

William Normand, investment funds partner at Travers Smith, suggests that the decision as to whether to appoint an external valuer will be driven by a number of factors, not least the size of the manager. A manager with assets under €100m AUM, for example, can value internally because the full scope of AIFMD (including the valuation provisions) does not apply to it. However, the more uncertain ground is a manager that has AUM between approximately €100m and €500m.

“It’s a question of resource,” says Normand. “Does a fund manager have a valuation function that can be sufficiently separated from portfolio management in order to carry out valuations? In many cases these fund managers don’t have the capacity to separate the functions and may appoint an external valuer. Many funds that do not have a formally-appointed external valuation agent will have a review procedure done by external valuation agent for AIFMD purposes.”

AIFMs supervising funds that invest in a range of different assets are faced with the conundrum that some of the assets for which they are responsible are easily valued (Level 1), while some are not (Level 3). One European fund auditor suggests that investors will demand best-in-class and, usually, that will be independent valuers if they have a big portfolio of Level 3 assets.

“If portfolios comprise Level 1 or Level 2 assets, investors may be more comfortable with other options,” he adds.

Tom Berrigan, director at Davy, suggests that given the range of asset classes that fall into Level 3 assets, it would be unusual to find an AIFM that would have resources in-house to undertake the valuation itself - unless it limits its role to a particular asset class. “Furthermore, given the nature of debt assets in particular, an internal team for valuations would be an expensive resource for an AIFM,” he says.

For those AIFMs that choose to outsource valuations to an external valuer, there are a number of issues to consider. External valuers will have specialisms in certain asset classes, for example. Investors and auditors involved with the fund may also have a view on valuation best-practice – and even the choice of external valuer.

“Some institutional investors insist on valuations being done by an independent valuer - either by the AIFM itself or by the AIFM employing an external valuer,” says Berrigan. “We tend to consider who is best qualified as an external valuer for a particular mandate - this may be included in the fund documentation.”

Moreover, the AIFM is expected to retain personnel that are able to critique the values that are provided by the external valuer – and, if necessary, challenge those figures. This will, in many cases, fall under the remit of the risk oversight team or the investment management team.

"An AIFM shouldn't outsource valuation and forget about it," says McKee. "At one level, an AIFM should be able to consider what the correct value of the assets should be - and have a scope for a challenge mechanism."

He adds that when a fund outsources a process, the regulator expects the fund to have the capacity to manage that outsourcing. "In this context, that would be to understand the valuation process and include a challenge mechanism. My view is that an AIFM that outsources its valuation process should retain at least one person in the business who has the capacity to intelligently critique the figures they are getting back from the external valuer and ask questions about how it's being run. Given that a fund could be liable if the NAV is miscalculated, they will want to have that in place."

Article 19.8 in the AIFM Directive states that AIFMs are responsible for the proper valuation of the AIF assets and that AIFM liability towards the AIF and its investors should not be affected by the fact that the AIFM has appointed an external valuer. "In that context, an AIFM using an external valuer still retains the liability for getting the valuation right," highlights McKee.

The question of 'best practice' – and what is most practical – when it comes to AIFMD-compliant valuations remains open to debate. Indeed, some valuations consultancies have previously disclosed that they prefer to be engaged in an internal advisory role, for liability reasons (SCI passim). Other valuation firms do not offer external valuation services for certain portfolios at all, such as structured finance assets.

Concerns over valuation outsourcing costs also remain. In some situations, a compromise may be reached through the selective use of independent valuations, however.

"A fund needs to think about when it is most important to have external marks," says the auditor. "This could be once a year for reporting purposes or if a fund is going to have a big crystallisation, or even if investors are going to be moving in and out of the fund. At this point, an independent valuation for the NAV could be helpful," he says.

In the case of a portfolio of Level 3 assets, for example, the NAV is more likely to be struck quarterly, half-yearly or even yearly. "The external valuer could carry out limited reviews in certain situations," he concludes. "Funds can talk to their valuer: if nothing of significance is happening in the market in a particular month - and the valuer has signed off on their model and inputs - a limited review might be more appropriate."

Extra vigilance?

As European fund structures evolve, investors may need to pay particular attention to AIFMs and their capability from a valuation perspective. Luxembourg's latest fund structure – the RAIF – is a case in point. A RAIF is an unregulated fund structure where regulatory focus lies with the AIFM, rather than the fund itself.

“Investors in unregulated RAIFs should pay heed to who the AIFM is and their capability from a valuation perspective, as well as who the external valuer is in relation to the vehicle,” says Davy’s Berrigan. “As there is no fall-back to the regulator for RAIFs, it is particularly important that the calibre of the AIFM and the external valuer is considered by investors, as that might be the only recourse they have.”

Lincoln’s Freyman adds that it's important to note there is no recourse directly from the fund to the external valuer in this situation. "The external valuer has duty of care to the AIFM and the AIFM has a duty of care to the fund," he says.

Crestbridge last month announced the launch of the first Luxembourg RAIF platform. The platform, it says, is designed to allow swift access for non-European managers wanting to tap the European market in an AIFMD-compliant environment. Private equity, real estate and hedge funds are expected to take advantage.

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