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The FCA's Private Market Valuations Review

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Background

The FCA recently published its multi-firm review of valuation processes for private market assets. The FCA's work is a comprehensive review of current practices by private equity, infrastructure and credit fund managers, with clear statements on the FCA's expectations as to good practice by firms. In its review, the FCA notes that private markets are an important means for investors to diversify their investments and seek new sources of return, and that investors need fair and appropriate valuations to understand the performance of their investments and make informed decisions, such as on asset allocation and manager selection.

The FCA referred to its work on valuations in its recent "Dear CEO Letter" on Asset Management & Alternatives – Supervisory Strategy, commenting that valuation practices are not as transparent as those for publicly traded assets.

The FCA issued its review when there is increasing interest in valuation practices in private markets globally. In September 2023, IOSCO reported on emerging risks in private finance markets, and in June 2024, the Bank of England's Financial Stability Report highlighted vulnerabilities in the private equity sector arising from opaque valuations.

Firms In Scope

The FCA states that its review included firms providing portfolio management and advisory services in the UK for private equity, venture capital, private debt and infrastructure, and is directed at asset managers, alternative investment fund managers (AIFMs), investment and portfolio managers and investment advisers. In practice, the FCA's guidance is primarily targeted at AIFMs, which are required to adopt valuation procedures for their funds. Portfolio managers and investment advisers may be

responsible for the valuations of their portfolios, depending on the mandate, and may in practice contribute to a valuation process which is the responsibility of an AIFM. In relation to portfolio managers and investment advisers, the FCA refers to its Principles, such as Principle 8, the requirement to manage conflicts of interest, as the basis for any future enforcement action.

EU AIFMs may also find the FCA's work a useful resource for best practice.

The FCA's Findings, Next Steps and Key Actions for Firms

The FCA expects firms to consider the findings from its review and identify any gaps in their approach, taking into account the firms' size and the materiality of gaps identified. As the FCA has clearly given its views on good practice, it is open to the FCA to take enforcement action against firms in the future, although that will likely only be in cases where bad practices have caused investor harm or loss.

The FCA will consider the findings of this review as it reviews assimilated law that implemented the AIFMD in the UK.

Governance Arrangements

AIFMD requires firms to have procedures for the independent valuation of the fund's assets, with any internal valuation function being independent from portfolio management, with conflicts of interest mitigated appropriately. As the FCA notes, many firms have valuation committees to oversee valuations, which may comprise investment professionals and individuals from the legal, compliance and audit functions, reflecting that many firms do not have individuals with dedicated valuation expertise. The FCA recognizes that, in some firms, the formal valuation function is more an administrative function, with investment professionals having a key role in the process, including acting as voting members of the committee.

According to the FCA, good practice is as follows:

- Arrange for an independent control function, such as compliance, to lead the valuation process, including overseeing the valuation models and preparing recommendations for the valuation committee's decisions. Ideally, the valuation committee is made up of independent individuals with sufficient valuation expertise, with those individuals able to describe the assets and valuation models in detail.

- It is better practice for investment professionals to contribute to the valuation process by giving their views, rather than acting in a decision making capacity, with the independent members being responsible for the valuation models, including any changes to inputs or assumptions. Senior investment professionals should not represent all or the majority of valuation committee voting membership. The FCA may challenge firms to explain how participation by an investment professional in the valuation function is consistent with the independence of the function.

- Maintain valuation committee minutes that explain how specific valuation decisions are made.

Conflicts of Interest

As is well-known, conflicts of interest between a firm and its investors can arise in the valuation process, such as where fees charged to investors are linked to valuations of assets, or, for closed-ended funds, where a decision to write down the value of an asset may decrease invested capital and hence reduce management fees. Open-ended funds may calculate management fees - and less commonly performance fees - on the basis of NAV. Firms are required to identify any conflicts that may arise.

The FCA identifies other conflicts that may arise in the valuations process:

- On transfers of assets to continuation funds, the FCA describes the practice of firms obtaining an independent fairness opinion for the price at which the asset is transferred, and with existing investors choosing to accept an interest in the continuation fund and incoming investors determining whether to accept the price offer for the asset.

- The use of the firm's judgement in valuing a fund's NAV for the purpose of redemptions and subscriptions for open-ended funds, and the importance of public announcements on NAV by investment trusts.

- The use of information on unrealised performance in fund-raising, which few firms in practice identify as a conflict.

- In NAV financing, the risk of inflating asset valuations to obtain a greater amount of financing or to avoid breaching a loan to value (LTV) covenant.

- The practice of firms creating a "smooth" return profile by reducing the volatility of an asset's value over time, and firms adopting valuation practices to allow for an "uplift" in value on sale of the asset.

- In some cases, linking variable pay to a change in NAV over a defined period, or offering individual profit-sharing schemes based on fees derived from valuations, or where valuations affect the perception of an individual's performance.

According to the FCA, good practice is as follows:

- When arranging the transfer of an asset to a continuation fund, the FCA does not criticize the practice described above, but does state its view that the fairness of this arrangement for incoming investors is heavily dependent on whether they have sufficient access to information to form their own view on price and valuation.

- To document the conflicts arising from the use of unrealised performance in fund-raising and clearly separate information on unrealised and realised investments in marketing materials, making clear that the unrealised performance is based on the firm's approach to valuations, and explain how unrealized values are calculated.

- To identify conflicts associated with NAV financing. In this regard, the FCA stated that most firms argue that, in practice, low LTV ratios reduce any incentive to inflate valuations, and that firms with more restrictive covenants point to the scrutiny lenders gave to valuations and other underlying portfolio metrics as a control over this conflict.

- To identify the risks of overly conservative and stable valuations, and to apply the methodology consistently over time, even when this leads to less stable valuations.

- Where conflicts arise if an investment team's pay is linked to valuations, to put in place procedures to consider the investment team's views, but formally separate that team from valuation decision-making, and, if necessary, engage a third party valuation adviser.

Policies, Procedures and Documentation

Valuation policies and models

The FCA emphasises that valuation processes rely on clear, consistent and well-documented policies, procedures and records. The FCA observes that most firms use standardised valuation templates to ensure a consistent and transparent approach, and

all valuation policies set out the roles and responsibilities of parties involved, the governance arrangements, the frequency of valuation, the methodologies and the relevant investment strategies and accounting standards.

According to the FCA, good practice in valuation policies is as follows:

- to explain the rationales for selecting methodologies and their limitations and for the required inputs and data sources;
- to describe in the policy safeguards for the independence of the valuation task, as well as the procedures for periodic review, escalation measures and the need for consistency.
- clearly to note changes in inputs, assumptions and values, and provide information on the context and performance of the assets;
- to consider using automated third-party valuation software to improve consistency and reduce the risk of human error.

Auditors

The FCA states that auditors typically review valuations for all or a sample of assets, with firms' discussions with auditors focussing on changes to key assumptions and back-testing results.

The FCA states that examples of good practice with auditors are to invite auditors to attend valuation committee meetings, addressing auditor challenges during those meetings, and to manage conflicts of interest with the auditor by rotating audit partners and firms.

Backtesting

Backtesting is comparing the realised value of an asset on exit to the last estimated valuation estimate to assess the accuracy and precision of the valuation process, and to identify any limitations of the valuation model.

The FCA states that good practice is to use the results of backtesting to inform a firm's approach to valuations, such as identifying insights about current market conditions, and potential limitations in models, assumptions and inputs.

Frequency and Ad-Hoc Valuations

The FCA reports on the most common valuation frequency of various asset types, with private equity and infrastructure generally reporting quarterly, venture capital quarterly or bi-annually and private debt reporting either quarterly or monthly. Whilst the FCA comments on the risk of less frequent valuation cycle leading to stale valuations, it appears to accept the valuation frequency that most firms have adopted.

The FCA includes some commentary on the use of ad hoc valuations, which are made outside regular intervals in the event of significant changes in market conditions or the performance of an asset. Most firms do not have a formal process for ad hoc valuations, and did not conduct such valuations on previous market events, such as the COVID-19 pandemic, waiting for changes to flow through at the next valuation cycle.

According to the FCA, good practice is to incorporate a defined process for ad hoc valuations to mitigate the risk of stale valuations, that includes the thresholds and types of events that trigger ad hoc valuations. This may include significant moves in the comparable set's average multiple, or company-specific events, and fund-level triggers, such as moves in a fund's 'unofficial' NAV tracked by the firm.

Transparency to investors

The FCA includes some survey data on how firms disclose NAV and individual asset values to investors (with most firms providing this regularly to investors, and a small number additionally providing it to the public and a small number only reporting NAV on request or to a sub-set of investors); disclose their valuation policy to investors (with different practices noted); and disclose valuation reports, models and raw data (with few firms disclosing this to investors).

As a general comment, the FCA states that firms should consider how they can improve their reporting to and engagement with investors on valuations, including providing detail on both fund-level and asset-level performance. The FCA states that good practice is to report both quantitative and qualitative information to investors on performance at the fund and individual asset level, as well as holding regular conference calls with investors. The FCA notes that some firms include a 'value bridge' in their reporting to investors to show the different components to changes in value of the NAV or assets, with illustrations of how much change was attributable to a portfolio company's underlying earnings, the valuation multiple used, cash proceeds and exchange rate changes. These examples illustrate the extent to which changes in value were driven by changes in market movements and valuation judgements compared to changes in a company's underlying financial performance.

Application of Valuation Methodologies

The FCA includes the results of its survey on valuation methodologies used by firms. For private equity, the FCA comments that most firms used the "market" approach (market transactions with comparable assets, such as multiples derived from quoted prices of public companies or prices from merger and acquisition transactions) as their primary methodology, with half of firms using the "income" approach (converting future amounts, such as cash flows or income and expenses to a single discounted amount, as a joint primary or infrequent secondary approach).

The FCA does not expect to validate firms' fair value assessments, but expects firms to apply valuation methodologies and assumptions consistently, including where they make significant adjustments. For the market approach, the FCA notes that firms were mostly consistent over time with the comparable assets used, making changes due to listings or de-listings, new market transactions, or idiosyncratic events that reduced the similarity of a comparable company or asset. For private credit, firms were mostly consistent with the comparable companies used for testing enterprise value and with the comparable debt instruments used to estimate a yield.

According to the FCA, good practice is as follows:

- to apply valuation methodologies and assumptions consistently and make valuation adjustments based solely on fair value, with valuation committees and independent functions to focus on these adjustments;
- to use industry guidelines to ensure their approach aligns with standard market practice. Firms should also consider whether to apply secondary methodologies as a sense check;
- to use another established methodology as a sense check.

Use of Third Party Valuation Advisers

The FCA states that third party valuation advisers provide additional independence and expertise. However, their value as an additional control depends on how firms engage with these providers, and firms must be mindful of potential conflicts of interest. As third party valuation advisers offer different levels of service, firms should make their investors aware of the specific nature of the service provided, including portfolio coverage and frequency, its strengths, and limitations.

According to the FCA, good practice is as follows:

- after identifying a material conflict of interest, such as in the calculation of fees, pricing of redemptions and subscriptions, or asset transfers, using a third-party valuation adviser.

- to consider the limitations of the service provided and to take steps to ensure the independence of the third party valuation adviser, and to note that the firm retains responsibility for valuation decisions.

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