

Call to Action: Mandate Higher Price Transparency in Private Markets

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Motivation

Valuation experts and financial reporting professionals understand the pivotal role accurate and timely pricing plays in the functionality of capital markets. In public markets such as US equities, the implementation of decimalization and stringent financial reporting regulations have facilitated the availability of fair prices to the public. However, private markets like venture capital and private equity remain significantly opaque with fewer reporting requirements. Given the expanding presence of private assets, it's pertinent to evaluate whether reporting standards for these assets need enhancement to ensure investors receive fair pricing.

Investors are increasingly committing capital to private market funds and assets to gain both greater asset diversification and to identify new sources of investment returns. Managers of private assets, such as private equity or venture capital funds, typically provide asset-level valuations quarterly, with a reporting lag of 3 to 6 months. Valuation methodologies for private assets, such as discounted cash flows, heavily rely on future firm-specific fundamental assumptions like terminal growth rates of cash flows or discount rates. The absence of standardized valuation methodologies can result in considerable variations in valuations for the same private asset across different managers. Additionally, the absence of a requirement for independent valuations for private assets may create conflicts of interest, potentially leading to inflated valuations in rising markets and stale valuations in falling markets. This lack of consistency can compromise the liquidity profile for private assets, posing challenges for institutional investors when rebalancing their portfolios.

Like driving through a fog, if institutional investors and corporations do not have timely and accurate data, they are unable to anticipate and respond effectively to potential risks or market fluctuations. Institutional investors also may face audit and governance challenges when multiple venture capital firms provide different valuations for the same company for the same date. Obtaining parallel valuations from reliable, independent vendors of valuation data can act as a counterbalance and provide a sanity check.

Elevating Standards for Timeliness in Private Company Valuation

Raising standards for timely asset valuation is crucial for the overall health, efficiency, and trustworthiness of private markets. It involves a reevaluation and adjustment of policies, processes, and methodologies. In the use of diverse approaches, achieving timeliness and consistency is challenging. Transparency helps

stakeholders understand and adjust for differing methodologies, thereby creating a more level playing field for all market participants.

The private market ecosystem is comprised of many types of participants who would benefit from higher valuation standards. Start-ups often rely on valuations to assess their current market value prior to going out for a fundraise. Corporate entities require valuations of their potential acquisition targets. Credit analysts look at private equity valuations in assessing credit risk. High net worth investors look at private equity valuations when distributing assets among family members.

Limited Partner Advisory Committees (LPACs) may have a role to play in enhancing transparency. They can review and question valuation policies and procedures, which may encourage asset managers to provide detailed information on how estimates are derived and to deliver valuations more promptly. Such demonstrations of commitment to transparency not only benefit institutional investors by helping them fulfill their fiduciary duty, but also align with the responsibility of fund managers to provide investors with reliable valuations.

The landscape is evolving, especially with the SEC's private fund reform rules, adopted on August 23, 2023. Quarterly statements within 45 days, with compliance periods ranging from 12-18 months (depending on the advisor's AUM), will not only become a market practice, but also a regulatory requirement when the compliance date arrives in 2025.

While industry initiatives and enhanced disclosure requirements are underway to address this issue, achieving comprehensive transparency necessitates continued focus and commitment from all parties involved.

Actionable Facets of Price Transparency

There are at least four factors to consider when thinking about valuation and price transparency:

1. Timing
2. Data sources
3. Methodology
4. Independence of the valuation solution provider

To better understand these factors, let's revisit our weather analogy. In valuation, the timely receipt of data by respective stakeholders is crucial for strategic decision making and risk assessment. Just as a weather forecast showing the temperature from last autumn will not help you on today's winter morning commute, valuation data that is six-months stale is equally problematic. Sadly, that's what is typically provided to many investors. Clearly there is a preference for shorter reporting lags and more frequent valuations.

Temperature alone doesn't tell the whole story when it comes to the on-the-ground experience of weather. Much like considering local factors like humidity, wind, elevation, topography, and latitude when deciding how to dress for the day, sixty degrees Fahrenheit in the mountains of Denver won't necessarily be experienced in the same way as on the beaches of Miami. To produce accurate valuations, a mix of public and private data sources is required. Important context for pricing comes not only from comparing the subject company or asset with similar entities, but also from understanding broader market conditions.

Data quality can make or break a valuation. When you open the weather app on your phone, you assume the model is being fed by reliable data. It's vital to know that valuations are based upon reliable sources of data and steps have been taken to test data for accuracy.

Methodology is another consideration. Just as the variety of models your local weather forecaster uses to determine if you should pack an umbrella, there are numerous models available for calculating a private company's valuation. Much like the changing weather conditions, the valuation landscape is subject to shifts due to market trends, industry dynamics, and economic conditions. Various methodologies like discounted cash flow or precedent transaction analysis are popular for valuing private assets, each with its merits and demerits. Transparent disclosure of the chosen valuation methodology and consistency in parameter choices are essential for valuation professionals. Valuation professionals need to adapt their methodologies to ensure relevance and accuracy.

An independent valuation provider helps mitigate the risk of self-interest that is present when asset managers calculate valuations on companies held in their portfolios. By engaging an impartial valuation provider, asset managers can enhance transparency and build trust among stakeholders, fostering an environment where objective assessments prevail over potential biases, ultimately contributing to the overall integrity of the market.

Automation's Role in Fostering Transparency

Technology is driving an industry shift towards greater transparency in the private markets, given that automation has the power to enhance transparency through increased efficiency and accuracy in data collection and valuation calculations. Automated valuation calculations can be derived from using machine learning to define algorithms and rules based upon training from large data sets. This also supports accountability by enabling auditors to review and verify the inputs and methodology used in the valuation.

AI further reduces errors, enhancing process integrity. These technologies enable swift decision-making in dynamic markets by enabling large-scale, complex calculations involving numerous variables, contributing to more accurate and timely valuations.

It is important to note that automation to enable real time data is powerful in bringing transparency only if it is leveraged in conjunction with superior data sources, timely data, and rigorous methodology.

Responsibilities of LPACs in Increasing Transparency

Limited Partner Advisory Committees (LPACs) hold significant sway in shaping transparent valuation policies, ensuring the integrity and fairness of private markets. Collaborative efforts among LPACs can enhance accountability for private asset valuations.

Specifically, LPACs can contribute by:

- Evaluating and approving LP valuation policies and procedures to ensure alignment with industry standards.

- Overseeing the valuation process to ensure robustness, consistency, and transparency, while also monitoring adherence to established policies and procedures.
- Assessing fair value measurements and techniques for accuracy in representing investments.
- Actively questioning assumptions, methodologies, and inputs in the valuation process and seeking clarification on significant changes.
- Ensuring appropriate disclosures related to valuation in financial statements and investor communications and verifying compliance with accounting standards, regulatory requirements, and industry best practices.

Conclusion: Forging a More Transparent Future

Elevating performance standards for valuing private companies is critical to ensuring the overall health, efficiency, and trustworthiness of private markets. Valuation transparency transcends being just an operational detail; it is a strategic necessity that supports informed decisions and industry excellence. Leveraging technology can significantly lower the cost of implementing price transparency. It is imperative for market participants to reassess the consistency of valuation processes and methodologies, considering independent valuation data solutions. This article provides valuable insights into changes LPACs can propose to valuation firms, general partners, and regulators, aiming to ensure that prices accurately reflect true fundamental value. Let us collaboratively work towards supporting the SEC's new private fund rules and aligning with the AICPA's mission for transparency.

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