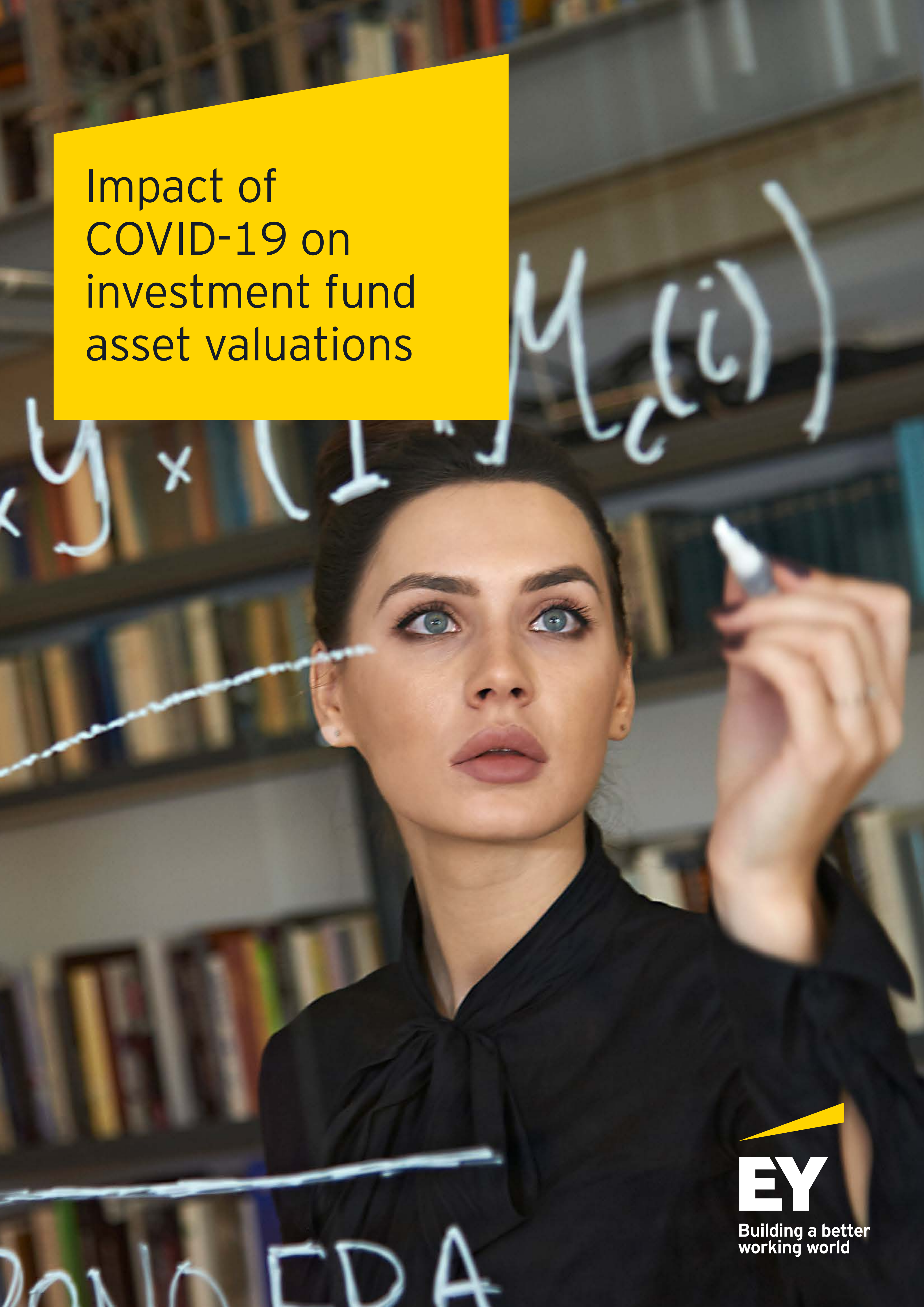
Impact of COVID-19 on investment fund asset valuations



Building a better working world

Market **impacts**

While it's clear that COVID-19 will have an economic impact on companies and their underlying investments, there is considerable uncertainty as to the extent and duration of this. Lockdowns and other significant restrictions bring a significant curtailment of normal economic activity, leading to business closures, bankruptcies and job losses, despite the growing level of government support.

Financial markets' reactions to the pandemic include plummeting and highly volatile stock markets, and increasing credit spreads.

In addition, we have seen a significant reduction in the liquidity of many asset classes, postponed M&A transactions and the temporary closure of small financial markets. This market turmoil leads to increased valuation uncertainty as well as significant pressure on fund liquidity as investors look to redeem or reallocate holdings.

As a response, asset managers have started to take significant protective measures, as illustrated by the recent decision from well-known asset managers to gate or suspend open-ended real estate investment funds to ensure equal treatment between investors.

Regulators across the globe have started asking for additional information from asset managers. Both the Irish and Luxembourg regulators have been investigating the ability of investment fund managers to meet large investor redemptions and have imposed additional reporting requirements, while the SEC has asked whether funds have experienced any delays in, or concerns with, pricing services providing daily prices.

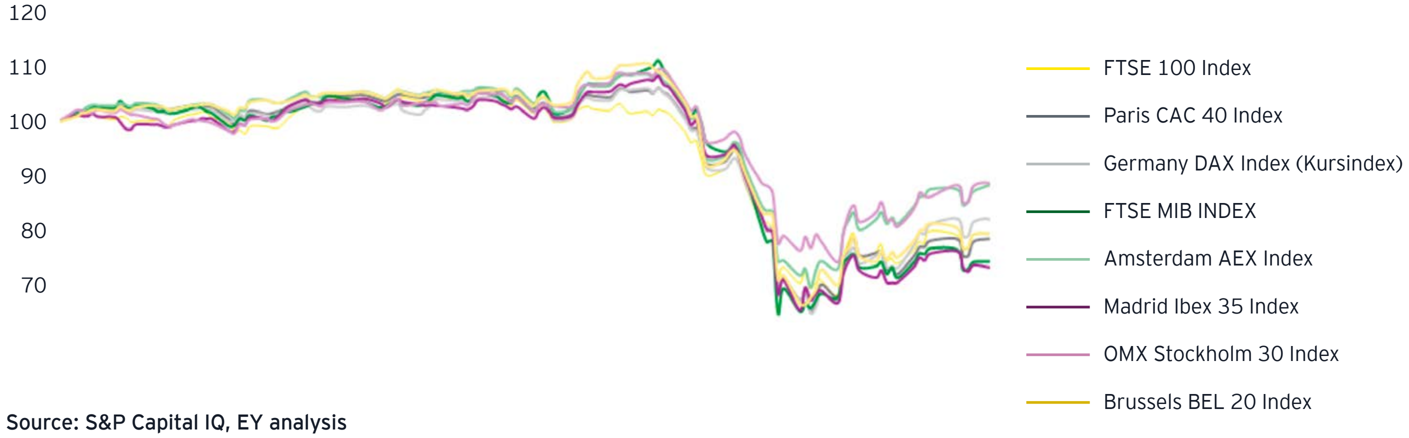
1 COVID-19 impacting investment funds' valuations

Over the last decade, the asset management industry has been forced to adapt in response to the ultra-low interest rate environment and regulatory challenges to their business models. The 2008 financial crisis highlighted that there was insufficient management of liquidity and excessive risks in the industry. Lessons learnt resulted in firms more closely monitoring their investments (including liquidity and credit issues), diversifying portfolios and increasingly focusing on their governance structure. Such measures were thought to provide increased resilience in the event of future market turmoil. Despite this, new questions have emerged as a result of the uncertainty arising from the COVID-19 pandemic.

The first priorities for asset managers have been to take care of the health of their workforce and to ensure that operations can continue while social distancing is in place.

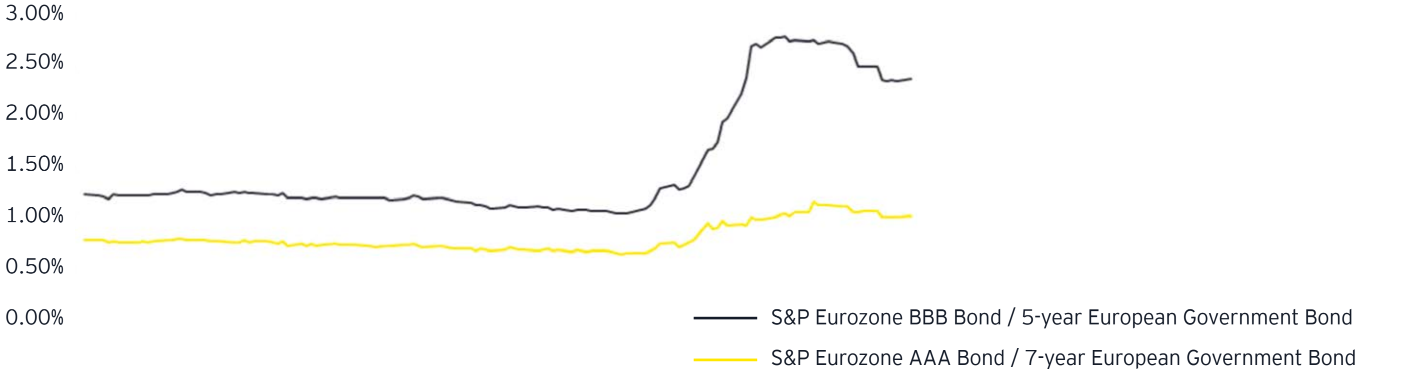
Secondary to this, but nevertheless an important topic, is assessing the impact of this pandemic on the valuations of their investment funds' portfolio assets, as well as ensuring they are sustaining sufficient liquidity to meet redemption requests. This note seeks to examine the key challenges from a valuation perspective.

Evolution of European stock market indices since 1 November 2019 as of 20 April 2020



Source: S&P Capital IQ, EY analysis

Credit Spread Evolution since 1 November 2019 as of 20 April 2020



Source: S&P Capital IQ, EY analysis

2 Dealing with valuation uncertainty

The impact of the challenging market environment differs depending on the nature of funds managed. Managers of Undertakings for Collective Investment in Transferable Securities Directive (UCITS) or other daily or regular trading funds will primarily be concerned as to the accuracy of daily Net Asset Value (NAV) for transacting purposes. Managers of alternative or closed end funds may be more concerned with valuations for financial statements or client reporting, although clearly this is also of relevance to daily trading funds.

To address such valuation uncertainty and manage risks appropriately, the asset management industry will need to address the following key considerations in relation to the investment funds under their management responsibility.

Valuation policies and guidelines

Various external sources (such as International Valuation Standards (IVS) and the International Private Equity and Venture Capital Valuation (IPEV) guidelines) provide guidance as to how to deal with volatile or illiquid markets.

It may be appropriate to reconsider the valuation approach, for example in circumstances where information from recent transactions is not reliable, other approaches may need to be considered in addition to the market approach.

Connected to this point, the European Alternative Investment Fund Managers (AIFM) Directive requires AIFMs to annually review their valuation policies and guidelines. The present situation therefore offers an opportunity to meet such a requirement.

Relevant questions include:

- Have recognized standards and guidelines been sufficiently integrated in the valuation policy?
- Are these valuation standards and guidelines proving adequate to value assets in times of financial distress or dislocated markets with no transactional activity?
- When your usual market data is no longer available or reliable, how should the value of these investments be estimated?
- Can the markets that have historically been considered 'active' still be considered as such, if transactional activity has dried up?
- Is there a need to review the determination of key valuation parameters, such as discount & premia, specific risk premia and historic calibration factors?
- Are comparable assets still being transacted at an arm's length (fair) price?
- Is sourcing data from market indices the best input for your market (fair) value estimates?

Financial models and business plans (of particular relevance to unquoted assets, private equity, real estate, infrastructure, etc.)

- Where business plans are an important input to value measurement, how should the business plan assumptions be reassessed in light of the current economic environment?
- Do the financial models for valuing your portfolio investments appropriately capture stressed liquidity scenarios, such as cash flow distress in development projects with disrupted supply chains, and re-negotiated rent agreements?
- How are your portfolio companies protecting their business and do your valuation assumptions remain reasonable?

Valuation of illiquid assets

- Illiquid assets are frequently valued based on recent comparable transactions. Since the COVID-19 outbreak, most transactional activity has been postponed and past transactions may no longer reflect current market conditions. How should value be assessed in the context of postponed transactions, a less supportive leverage environment and a lack of recent transaction valuation data? Is it reasonable to assume a return to 'normal markets' and, if so, when?

Valuation for funds of funds

- For most investments in other funds (such as private equity fund of funds), the previous quarter's NAV of those funds is frequently adopted for the fund itself. For fair value reporting as of 31 March 2020, the NAVs of these funds would be as at 31 December 2019, pre-COVID-19. How should the fund recognize the COVID-19 impact in its reporting for 31 March 2020 and adjust the reported NAVs as at 31 December 2019 appropriately?

Valuations for financial reporting

How should the impact of the COVID-19 pandemic be appropriately addressed and included in your financial statements as a post balance sheet event to keep these from being misleading?

Valuation opportunities

- Is the current environment offering an opportunity to take a critical look at some assets and take the appropriate impairment decisions?

3 Business cases

Quarterly portfolio valuations

Example issue:

The typical approach to valuing unlisted investment portfolios on a quarterly basis is to consider recent comparable transactions at each quarter, and then use the data identified to calibrate the valuation to the previous quarter and/or transaction date. However, transactional activity has been very limited since the outbreak of the COVID-19 pandemic, meaning that market data is either unavailable, unreliable or stale, and as such may not be relevant for the purposes of the quarterly valuation process. How can a portfolio valuation be performed in such a context, aligning to the applicable valuation standards and guidelines?

How EY teams can help:

- Analyzing alternative approaches to value such assets based on closely related active markets, where available that continue to provide relevant data points since the COVID-19 breakout.
- Designing a globally coherent valuation technique, in collaboration with investment managers, and calibrate this with the existing pre-COVID-19 portfolio valuations.
- Designing and implementing an updated internal valuation policy to specifically address the present situation, in respect of internationally recognized valuation standards such as IVS, AICPA and IPEV.

Fund of fund investments

Example issue:

For fund of funds, many asset managers tend to rely on the valuations included in the NAV provided by the fund they invested in. For obvious reasons, these valuations are usually not contemporary with the NAV date of the fund of funds, and frequently based on the underlying funds' past quarter NAV. We understand that for those fund of funds that are reporting as of 31 March 2020, when the impact of the pandemic struck the markets, the NAVs available to them from their fund investments are often pre-COVID-19; in particular for illiquid funds, these NAVs are typically based on 31 December 2019 (or older) valuation dates. As at those dates, and even as of the end of February 2020, the impact on the markets was less pronounced. While the impact on the listed investments can easily be verified, for unlisted investments this is less straightforward. What approach should the asset manager take when the invested fund cannot quantify such an impact?

How EY teams can help:

- For listed securities, EY professionals can provide an impact analysis based on market observations on an investment by investment basis, or of not known on a portfolio bases, based on geographic and industry indices.
- For unlisted securities, EY professionals can provide a qualitative analysis again based on geographic and industry indices with an overlay for the impact on illiquid investments versus listed securities.
- EY professionals can support updating the valuation of investments in such funds that are prepared on a pre-COVID-19 basis applying documented and market practice methodologies, and also can constructively review the valuations prepared by our audit clients.

Financial models & business plans

Business case to address:

The current social distancing requirements, including the majority of workforces working from home, combined with economic concerns are harming companies' revenues, profitability, cash flows and liquidity. Challenges are mixed by industry, with some industry segments experiencing activity slowdowns, whereas others are facing an increased demand for goods and services as a result of the pandemic.

Most organizations are faced with uncertainty in relation to their business modelling scenarios that in this environment play a key role in making decisions, provided the models are based on valid assumptions and associated risks are properly evaluated.

In order to navigate this uncertainty, decision makers need a set of forecasts, scenarios and models for operational, reporting and future investment purposes. Stakeholders may require professional assurance over these models.

How EY teams can help:

EY can provide tailored, fit-for-purpose modelling services, including:

- Building forecasts for financial planning purposes, considering business cases preparation and analysis.
- Decision support for operational improvements, restructures, reorganizations and cost and funding assessments.
- Determining change options to adjust cost structure and/or utilize different credit facilities.
- Providing deal support from a buy-side, sell-side, or financing-side perspective.
- Offering assurance over complex models that you or another party has prepared.

4 Conclusions

Regulatory attention has initially focused on fund liquidity; however, a fund manager must also consider if the valuations used on its portfolio are sufficiently robust to produce a reliable NAV.

Secondary considerations, such as the limits on untraded or illiquid assets held within portfolios need to be closely monitored. Some funds will need careful monitoring to determine whether a suspension in dealing is required in order to protect investors' interests.

Further, maintaining an appropriate control environment and valuation governance while social distancing and 'lock-down' measures are impacting many firms and employees will be challenging.

Asset managers may benefit from a degree of regulatory tolerance during the heat of a crisis but will need a sustainable approach for what may be an extended period of disruption. We would suggest that firms carefully document key decisions and judgements so that an audit trail can be produced in the event of any enquiries after the fact.

EY teams' support in addressing this valuation uncertainty

EY professionals can provide the following support, amongst other services:

- Review of your funds' valuation policies and processes in a context of financial distress and the current remote-working environment
- Assistance in disclosing the impact of COVID-19 in your financial statements
- Valuation of specific portfolio investments for financial reporting or transaction purposes
- Construction and/or independent review of financial models integrating stressed scenarios
- Assessment of business and project plan assumptions in relation to your fund investments
- Valuation opinions in the context of impairment testing

5 EY EMEIA Wealth and Asset Management

Fund Valuation contacts

Christophe Vandendorpe
Ernst & Young S.A. Wealth & Asset Management, Fund Valuations professional
t: +352 42 124 8049
e: **christophe.vandendorpe@lu.ey.com**

Michael Ferguson
EY EMEIA Wealth & Asset Management Assurance leader
t: +352 42 124 8714
e: **michael.ferguson@lu.ey.com**

Richard Gray
EY EMEIA Wealth & Asset Management Transactions leader
t: +44 20 795 12857
e: **rgray@uk.ey.com**

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