VALUING RELATIONSHIPS – HELPING THE ASIAN PE INDUSTRY GROW

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A group of MBA students in INSEAD's recent PE elective tackled an interesting issue by surveying GPs and LPs globally. They asked: How has the recent financial crisis affected the relationship with your investors/investee funds? Have portfolio valuations been an issue?

The study is on-going, but their interim report raised some questions that are particularly relevant for the growth of Private Equity & VC in Emerging markets and worthwhile sharing.

We ask: Is it time to create a set of valuation guidelines and frameworks specifically for Asia that offer not only a benchmark for experienced GPs and LPs but also create greater transparency and clarity for new investors wishing to enter the PE & VC market?

The unprecedented turbulence in global financial markets since September 2008 and the manner in which liquidity in both credit and equity markets dried up as a result has already had far reaching implications for private equity in Asia and beyond. The key issue that faced both GPs and LPs during times of stress was the lack of transparency with regards to the valuation of their investments. Prior to this crisis, GPs have had limited and inconsistent requirements to provide information to the investors in their funds with regard to consistent valuation and updates on portfolio companies. As a consequence changes in valuations in the Private Equity industry have trailed changes in public equity markets and have also been significantly more opaque. At the risk of adding to your already thick pile of analysis on the crisis of the past year, we want to share insights from our conversations with both GPs and LPs, conducted as part of a student project on Emerging Markets Private Equity launched at INSEAD's Private Equity Initiative (PEI) earlier this year. Our study, examined the extent to which portfolio allocation and mark-to-market considerations affected the valuation of LPs' portfolios between Q4 '08 and Q3 '09 and asked whether this economic environment changed the norms and requirements of valuation and portfolio disclosure by GPs to LPs.

The study made it evident that vast disparities remain between the level of information GPs of Private Equity Funds provided to their LPs, the investors in their funds. The disparities in frequency, quality and granularity of disclosure are typically indicative of the resources available to GPs, their experience in dealing with prior economic crises and their track record, size and history. Another significant factor was the GPs' target market: Is the main focus (though not necessarily for all the funds) on mature, highly regulated and relatively low growth market such as North America and Europe or rather on Emerging Markets where regulations are weak, legal uncertainty is high and LPs are inclined to trade informational asymmetry for high rates of return. Our findings led us to categorize the GPs' responses to their relationship with LPs through this crisis in two primary categories as below:

(i) Opaque – These GPs argued that valuations provided annually are in line with industry standards (a sometimes circular argument!) and that qualitative information alone can only be provided on a quarterly basis. They typically emphasized that LPs need to be mature about the fact that PE investments are long term investments. They often provided standardized descriptions, historical comparables (of little value in this environment), a broad investment thesis and in some cases, quarterly IRRs, but not a full valuation or, critically, valuation assumptions. Typically this response is seen more in Emerging Markets as well as in GPs with, on average, a shorter track record and smaller funds under management.

(ii) Transparent – Proactive and interactive, established GPs with available resources are managing their LP relationships carefully to facilitate open dialogue and mutual trust for the long term. GPs and fund families that have a history of several top-quartile PE funds are (a) providing complete valuation data quarterly without obligation to do so (b) Increasing standards of disclosure including an explanation of their choice of multiples, broad DCF assumptions. In addition, they share insights from conversations with their portfolio companies with their LPs.

The "Transparent" category is taking an especially nuanced approach to valuation:

(i) They highlight an important point: although they may provide greater granularity of valuation data and disclosure to their LPs, the basis and rationale of the EVCA guidelines on valuation clearly states that "*Devaluations should only occur in the case of deterioration of company fundamentals and not when comparable companies are failing*".

(ii) They combine comparables-based valuation disclosure with greater DCF assumptions and make transparent the underlying assumptions they are using and the issues the portfolio company is facing. This allows them to propagate and set the tone and expectation for what they consider "reasonable" assumptions.

(iii) Other areas of pro-activity on the GP side, include voluntarily scaling back new transactions and keeping their powder dry as this both prevents LP panic/default risk and can offer even better returns once confidence returns to the market.

LPs in turn also emphasized the view that a mature approach and long term decision making is very important on both sides in managing any short-term-crisis. LPs prefer not to pressure their GPs on exiting portfolio companies as a result of short-term deteriorations in performance due to macro-economic stress as this does not necessarily reflect underlying weakness in the company *relative to the market or its industry sector*. However, it was evident that LPs are lobbying for greater disclosure, transparency and control in the underlying portfolio company's strategic evaluation.

Our interviews and conversations make it clear that in this economic environment, the approach that is most widely appreciated is an open conversation throughout the value chain of investment starting from portfolio companies to the General Partners that have controlling interests and including their respective investors. This dialogue is ideally coupled with increased disclosure, transparency and mature relationship building to establish trust and create confidence to move forward.

Currently, the primary driver for managing the GP/LP relationship seems to be the history and experience of both the LPs and GPs. More established GPs generally have more standardized practices in place with regards to valuations and have more resources to facilitate communication with their LPs.

Moreover, they have LPs that have been in the PE industry for a while and have experienced previous downturns and their implications. While the current economic cycle is considered deeper and more profound, those LPs that have experienced previous cycles are more likely to accept the GPs position that PE is a long term, illiquid asset class and hence short term events and market hysteria and contagion should not drive investment decision making for the longer term.

The challenges therefore seem to be more acute for new and first time funds with limited resources and a short track record and lack of depth in LP relationships. Such funds are more common in the emerging markets and their challenges include deciphering to what extent they should provide information to their investors (GPs want to avoid providing so much information that LPs can do their own valuation) how to deal with LPs that wish to reduce commitment, and how take into account mark-to-market considerations. Industry standards and the enforcement of best practices are in great need and may be more prevalent as a consequence of this crisis. Another challenge for funds in a growth stage is getting the required staff to process the extra work involved in increasing the transparency for their LPs. This is especially challenging given that this detracts from investment professionals' ability to focus on active portfolio management. Lastly, establishing solid relationships with LPs requires time, effort and a proven track record in order to gain the credibility and trust of LPs.

It is clear that as the GP/LP relationships evolve and mature beyond the parameters of this crisis and the short term "denominator problem", the lessons learned will drive GPs to provide more transparent and comprehensive assessments of their portfolio companies to their investors and do so on a more frequent and regular basis. This transparency will set the basis for increased trust in the GP/LP relationship and needs to be recognized through industry standardization and publication of best-practices.

In this respect our research often led us back to the EVCA's Valuation Guidelines which form a sort of unofficial industry standard for valuation disclosure in Europe. This is no doubt easier in Europe where the growth environment is less dynamic and regulations, legal systems and underlying portfolio companies exhibit a greater degree of uniformity than is seen in Asia. Nevertheless, this is an issue that some of the regional industry bodies might want to address to face future crisis situations well prepared and with a robust framework.

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