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Three Myths of Private Market Valuations (Second of Three Parts)

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We began our special series by dispelling the notion that privates should mimic publics. This week we tackle:

Myth 2: Private equity valuation processes lack objectivity and transparency, which inflates values compared to public counterparts.

For help we turn again to Ron Kahn, Lincoln International's head of valuations. Lincoln recently published an excellent article, "Three Myths Regarding Private Market Valuations," explaining how these valuations are determined. It also contrasts the private from BSL markets.

Ron, in our global travels over the past six months, we've encountered a certain skepticism about the relative strengths of private vs. public loan prices. Some institutional investors, even those with direct lending exposure in their portfolios, have a tough time believing the high marks aren't more fiction than fact.

"Yes, that suspicion has been endemic with private debt since its inception decades ago," Kahn said. "When you grow up in an environment where other asset classes can be measured against an index and there's a ready secondary market in which you can buy and sell loans with reasonable liquidity, it's natural to be distrustful of loans that don't trade and whose values are dependent on some manager's view of their worth.

"That's the whole thesis behind our mission to provide an independent view of loan values based on objective criteria," he continued. "Private managers have internal teams that prepare valuations based on borrower performance. But then managers also use third-party valuation firms to supplement their own estimates."

To address investors' concerns about lack of visibility to these values, what oversight can they expect with private debt investments?

Kahn replied, "The perception that non-banks lack regulatory oversight is not accurate. After the GFC and Dodd-Frank legislation, private equity and credit valuations became subject to extensive oversight. Boards of directors and audit committees, auditors, regulators, and investors all play key roles now in regularly reviewing private marks. They also help ensure best practices are followed and appropriately reflect a borrower's performance and markets.

"Finally," he concluded, "limited partners who invest in private funds are critical to valuation transparency. Their intensive due diligence is designed to align GP processes with fair value accounting standards. Analyzing valuation reports and testing assumptions of fund managers on rates, growth, and defaults has accelerated the outplacement of work to external valuation firms. All these elements have added further credibility to private equity and credit valuation processes."