



Retailization of Illiquid Assets: Designing an Optimal Valuation Framework

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The explosive growth in private assets has resulted in increasing interest from retail investors who want to allocate a portion of their portfolios to illiquid assets. Interval funds may offer retail investors access to such exposure. But a key challenge is estimating the fair value of illiquid private assets on a daily, weekly, or monthly basis. Valuations of these private assets are generally based on models and unobservable inputs, given their illiquid nature. Daily valuations may be complex as they may require repeating a complex valuation process, often with limited current data about the underlying company. This is especially true when a fund is invested in a limited partnership and does not have information about the partnership's underlying holdings. The complexity is also driven by the type of investments and underlying assets, such as private credit, private equity, direct investment, co-investment, fund investment, etc.

The number and size of retail funds invested in private or illiquid assets has been growing dramatically. These funds include ERISA funds and '40 Act closed-end funds, such as interval funds, which may not trade on a secondary market but allow investors to redeem a portion of their shares at certain pre-specified dates (i.e., daily, weekly, monthly, or quarterly) at the then-current net asset value (NAV). An accurate NAV is important for both investors seeking liquidity and those remaining in the fund; however, estimating NAV is challenging as private assets typically do not have observable values.

Some examples of valuation approaches to address the need for frequent valuations include:

- 1. Adjusted Last-Reported Value Approach:** Many managers may hold values flat from the last reported value in the absence of material information about the underlying investment. The value is only revised when a subsequent value is reported or upon a measurable event, such as a distribution. The use of this approach should consider the legal and regulatory requirements for the fund and, potentially, the requirements of administrators and fund investors. Houlihan Lokey can help managers understand the feasibility of other approaches before deciding on this approach.
- 2. Fundamental Approach:** If a valuation model exists or can be built, model inputs such as spreads, rates, multiples, and collateral/financial information could be updated on a daily basis. For certain investments, such as consumer/small business loan facilities, servicing data may be available on a daily basis. But more often, financial information is not updated on a daily basis, so in such cases this approach may only reflect updating the valuation model with market data adjustments. Market adjustments are generally based on liquid public market data, so it is critical to gauge how closely to public markets such private assets would trade. Additionally, idiosyncratic information (e.g., news about a large customer contract, an uninsured loss, etc.) may need to be reflected in the valuation even if regular financial statements are not available.



In addition to the aforementioned valuation approaches, regression approaches have been used in certain situations, such as when a fund holds a limited partnership interest but does not have insight into that partnership's assets. Here, a regression model could be developed to capture multiple valuation drivers, such as market factors and the macroeconomy. The regression model could be adjusted to capture company-investment-specific information.

Another example could be valuing early-stage venture capital investments with limited data about the underlying company (capital structure, liquidation preferences, and other terms, etc.). A regression model could be built to estimate the value impact over time of changes in market factors. Lastly, regression models can be used to estimate how market inputs, such as credit spreads for private assets, generally move in relation to liquid market indices. While regression approaches may not produce reliable, fair value indications, they can be helpful when trying to consider the potential changes in value resulting from changes in broader markets, the underlying company's industry, and other factors.

The growth in retail funds in the alternative asset space presents new challenges in estimating the NAV of these funds. Managers must adapt to the changing landscape by further enhancing their current valuation processes and capabilities and embracing technology and automation, all the while ensuring compliance with regulatory standards. Houlihan Lokey works with its clients to navigate these complexities while helping maintain high standards of transparency and accuracy.

Houlihan Lokey values more than 20,000 illiquid or complex assets annually and combines this valuation expertise with its proprietary technology to provide valuations on a high-frequency basis. We understand the complexity of daily valuations and that there may not be a single approach that fits all situations. Houlihan Lokey provides daily, weekly, and monthly valuations for a broad range of asset classes, including private equity, growth equity, private credit, complex securities, asset-backed finance, CLOs, and other structured products. We also provide an educational role helping investors and fund managers understand the nuances of valuing private equity and venture capital investments within the regulatory framework for '40 Act funds. Houlihan Lokey offers a customized valuation service that meets the needs of its clients, depending on the asset class, information available to the investors, and other circumstances.

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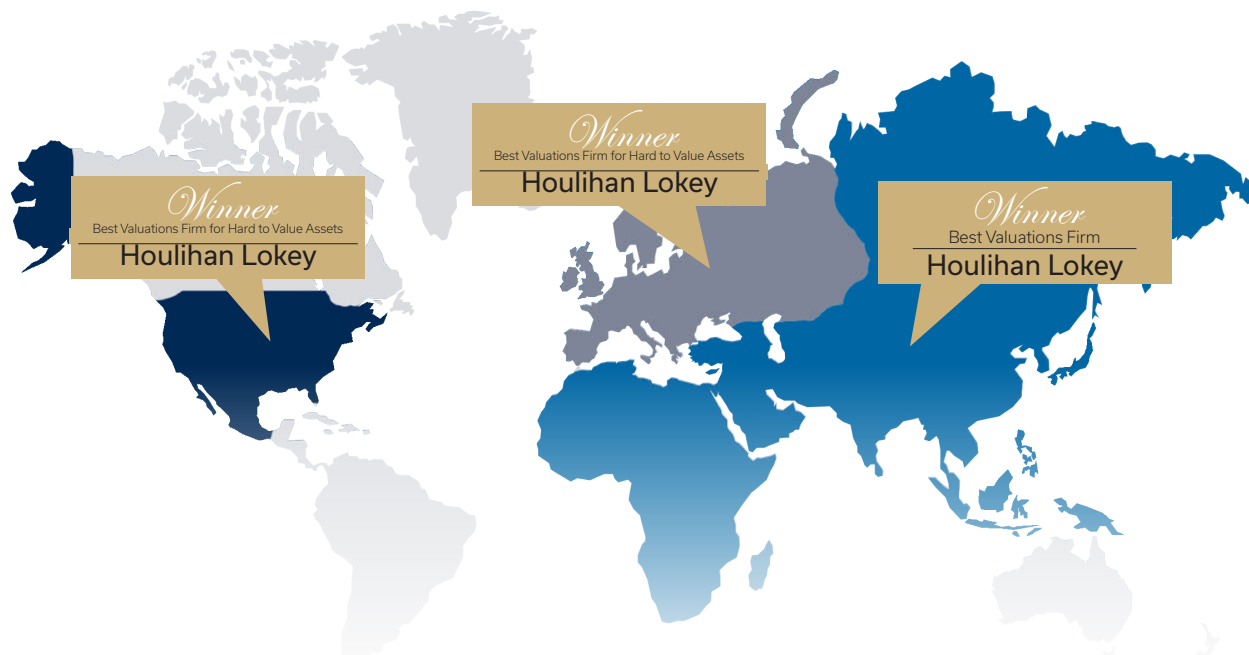
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The HFM Services Awards named Houlihan Lokey "Best Valuations Firm for Hard to Value Assets" in the U.S. in 2018–2023 and in Europe in 2020–2023, and it was named "Best Valuations Firm" in Asia in 2020–2023. Houlihan Lokey has now won these awards in all three geographic regions for four consecutive years.



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