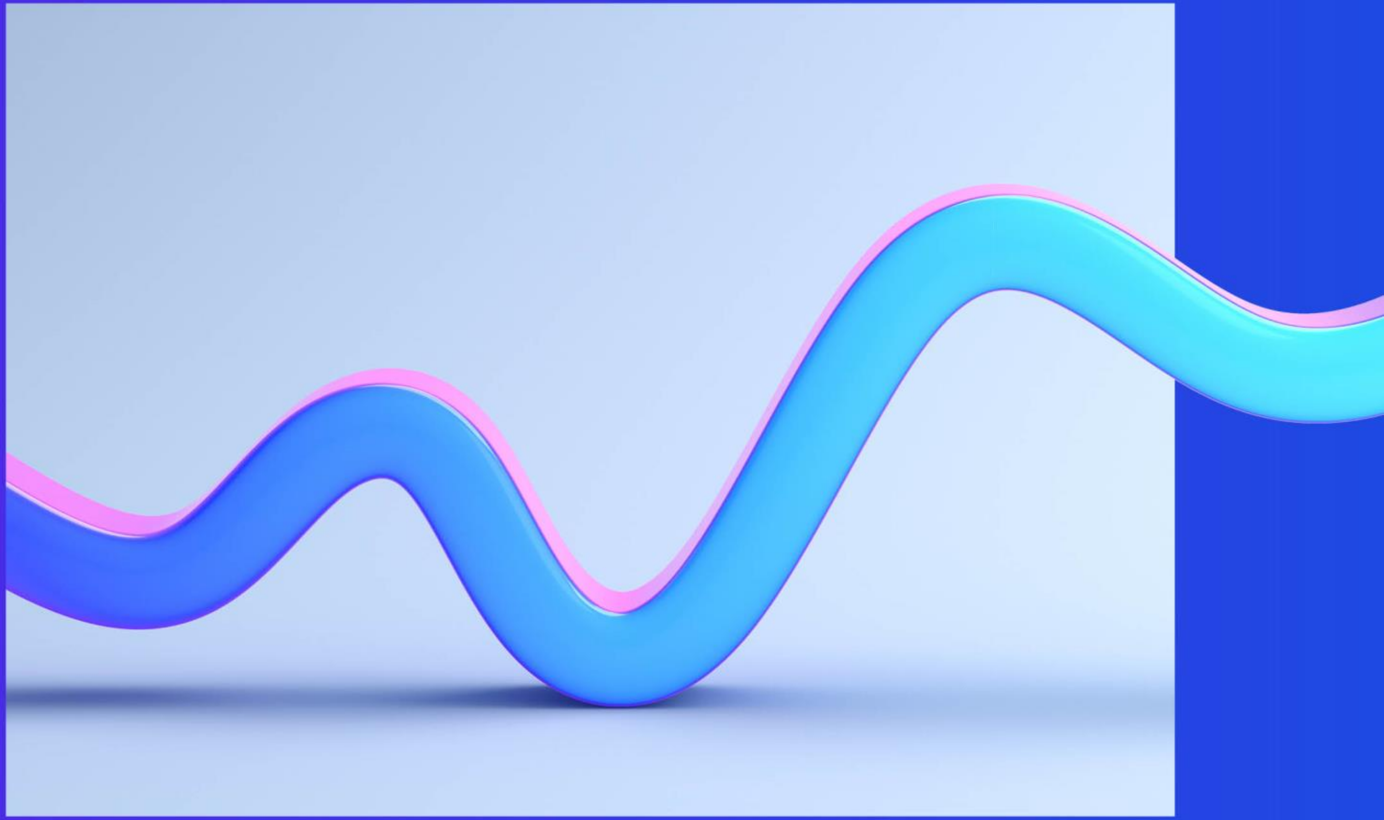
Navigating Valuations

Insights on the CBI's Dear CEO Letter and Market Update 2024



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Insights on the CBI's Dear CEO Letter

KPMG Ireland

CBI's Dear CEO Letter - Overview

On the 14th of December 2023, the Central Bank of Ireland issued a letter addressed to the chairpersons of all Irish fund management companies as a result of the European Securities and Markets Authority's (ESMA) review of Asset Valuations.

January

January 2022 Common Supervisory Action (CSA) exercise

May

ESMA) report was published on 24 May 2023

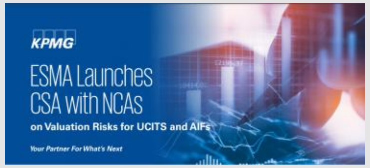
December

CBI was required to investigate. Sample of 30 entities with some follow ups.

CBI released findings on asset valuation, urging universal adoption by firms to address issues in Irish Fund Management Companies by Q2 2024

Finding 1	Finding 2	Finding 3	Finding 4
Use of group asset valuation policies and procedures	Lack of formal asset valuation error procedures	Poor quality of asset valuation policies and procedures	Limited evidence of periodic reviews

KFI Publications



EMSA launches CSA with NCAs on Valuation Risks for UCITS and AIFs

Ensuring Compliance in Asset Valuation Practices

CBI's Dear CEO Letter - Overview of Findings

1. Use of group asset valuation policies and procedures

Concerns with companies using group-wide asset valuation procedures in Ireland without adequately considering the country's distinct regulatory and operational environment.

Irish fund management firms are required to possess **asset valuation policies and procedures that are accurately detailed, thorough, and tailored** to each fund management company.

Inaccurate valuations can impact financial reporting, potentially leading to misleading financial statements.

Our Recommendation: Irish fund management firms should possess asset valuation policies and procedures that are accurately detailed, thorough, and tailored to each fund management company

CBI's Dear CEO Letter - Overview of Findings

2. Lack of formal asset valuation error procedures

The CBI have observed a concerning trend among certain firms where **standalone asset valuation error procedures are either absent or inadequately defined**.

Without clear asst valuation error procedures, **investors may face unfair treatment during pricing or NAV errors.**

The CBI notes that **several firms' error procedures inadequately outline policies and procedures** for determining or processing investor compensation.

Comprehensive, **transparent procedures mitigate valuation errors**, maintain investor trust and ensure fairness during pricing or NAV discrepancies.

Our Recommendation: All fund management companies should establish structured and detailed procedures to deal with any valuation errors or inaccurate computations of Net Asset Value (NAV). Procedures for addressing valuation errors must be reviewed at least annually and updated when necessary.

CBI's Dear CEO Letter - Overview of Findings

3. Poor quality of asset valuation policies and procedures

CBI observed some firms **lack quality asset valuation policies**.

Comprehensive policies must precisely govern asset valuation to avoid ambiguity or oversight.

Fund documentation cannot substitute independent asset valuation policies subjected to robust governance.

Firms must have detailed asset valuation policies outlining operational responsibilities.

Our Recommendation: The asset valuation process should be supported by documented policies and procedures, clearly outlining the operational tasks and responsibilities for all parties involved in the valuation process.

CBI's Dear CEO Letter - Overview of Findings

4. Limited evidence of periodic reviews

CBI found that **most firms are not regularly checking if their asset valuation policies** are still relevant and effective.

Firms that did not conduct periodic reviews lacked evidence of a clear governance process for initiating, conducting and following up on these reviews.

Without periodic reviews, firms risk using outdated or inaccurate valuation methods, **leading to potential asset valuation errors**.

Our Recommendation: Firms are advised to conduct regular reviews of their asset valuation policies and procedures, with documented evidence indicating that reviews have occurred or a transparent governance process has been followed for these assessments.

CBI's Dear CEO Letter - Overview of Findings

Observations

Liquidity Stress Testing

Supervisors assessed liquidity stress testing and scenario analysis, emphasising the importance of their integration into management frameworks for informed decision-making and risk mitigation

Independence of the Asset Valuation Function at Firms

The review found unclear asset valuation policies in some firms regarding task allocation

CBI suggests firms should segregate roles and maintain valuation function independence to mitigate conflicts of interest

Action Required

Establishing and Upholding Comprehensive Asset Valuation Policies

By the end of **Q2 2024**, Irish fund management firms must create and uphold detailed asset valuation policies, defining roles and ensuring compliance

Periodic reviews

Senior management must periodically review asset valuation policies to ensure consistent methodology application across all managed funds.

Key Takeaways

Firms should integrate results from stress testing and scenario analysis into liquidity management frameworks for informed decision-making and risk mitigation

Firms must clearly define operational tasks and responsibilities within the asset valuation function to prevent conflicts of interest

We have published a survey based on the letter issued. Please take your time to complete it if you are interested in the topic (Tap to complete survey)

Market Update

KPMG Ireland

Trade sanctions update

Frozen Russian Assets

Western countries froze roughly $300 billion in Russian foreign-currency reserves held in their central banks. Ukraine has administratively seized assets of at least two Russian banks, in addition to various other Russian State assets

Oil Price Cap

The G7 - an organisation of the world's seven largest "advanced" economies - has imposed a maximum price of $60 (£47) a barrel on Russian crude oil, to try to reduce its earnings

Restrictions on Russian Control in Crypto Services

Bans Russian nationals from owning, controlling or holding any posts on the governing bodies of the legal persons, entities or bodies providing crypto-asset wallet, account or custody services to Russian persons and residents

Economic Growth Estimates for Russia Amid Sanction Impact

It estimates that Russia's economy grew by 2.2% in 2023 and predicts growth of 1.1% in 2024. The U.S. Treasury asserts that sanctions are adversely affecting Russia, resulting in a 5% reduction in potential economic growth over the last two years

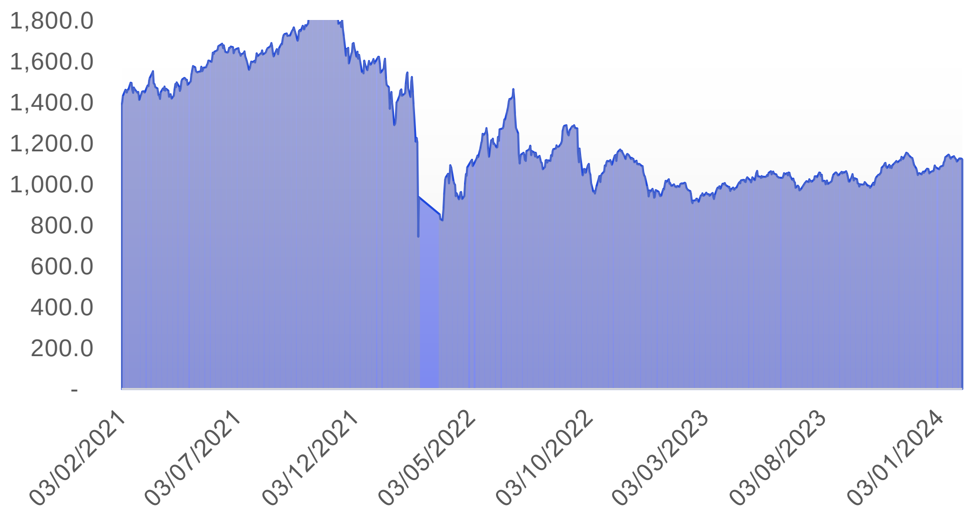
No Russia clause

A new clause which applies to EU exporters and bans the re-exportation to Russia and re-exportation for use in Russia of certain goods

Market Impacts

The RTS Index is a cap-weighted composite index calculated based on prices of the most liquid Russia stocks of the largest & dynamically developing Russia issuers presented in Moscow Exchange.

RTS Index between November 2021 and February 2024



We reviewed the change in RTS Index from November 2021 to the start of the Russia-Ukraine War, unveiling a decline of approximately ~50% during this period.

1. Sanctions from the Russia-Ukraine war restrict Western investors capacity to trade Russian stocks, causing marketability challenges.
2. The comprehensive discount, ranging between 85-99% of the USD share price as of the valuation date, is determined by assessing two key factors.
3. The **post-sanction discount**, ranging from 70-85% of the USD price of the shares, indicates the market's reaction to sanctions initiated at the onset of the Russia-Ukraine war.
4. A 15% **Discount for Lack of Marketability** constraints is applied to the shares due to sanctions limiting Western investors' trading on Russian exchanges.

Monetary policy decisions - ECB

The Governing Council decided to keep the three **key ECB interest rates unchanged** (January 2024).

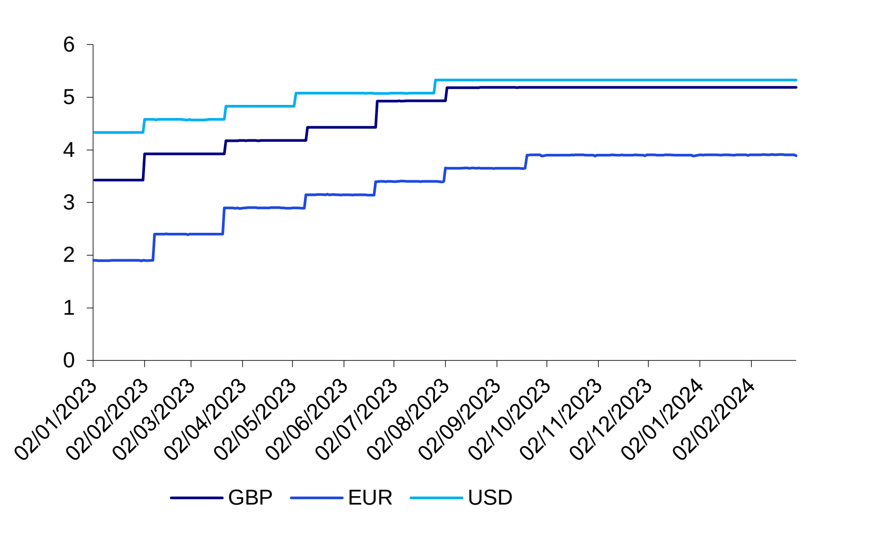
Tight financing conditions are dampening demand, and this is helping to **push down inflation.**

The diminishing effects of past interest rate hikes will gradually fade, leading to a **potential uptick in demand** for exports in the euro area.

The **risks to economic growth** remain tilted to the downside. Growth could be lower if the effects of monetary policy turn out stronger than expected.

The ECB uses **Asset Purchase Programme (APP)** to promote the transmission of monetary policy and ease financing conditions.

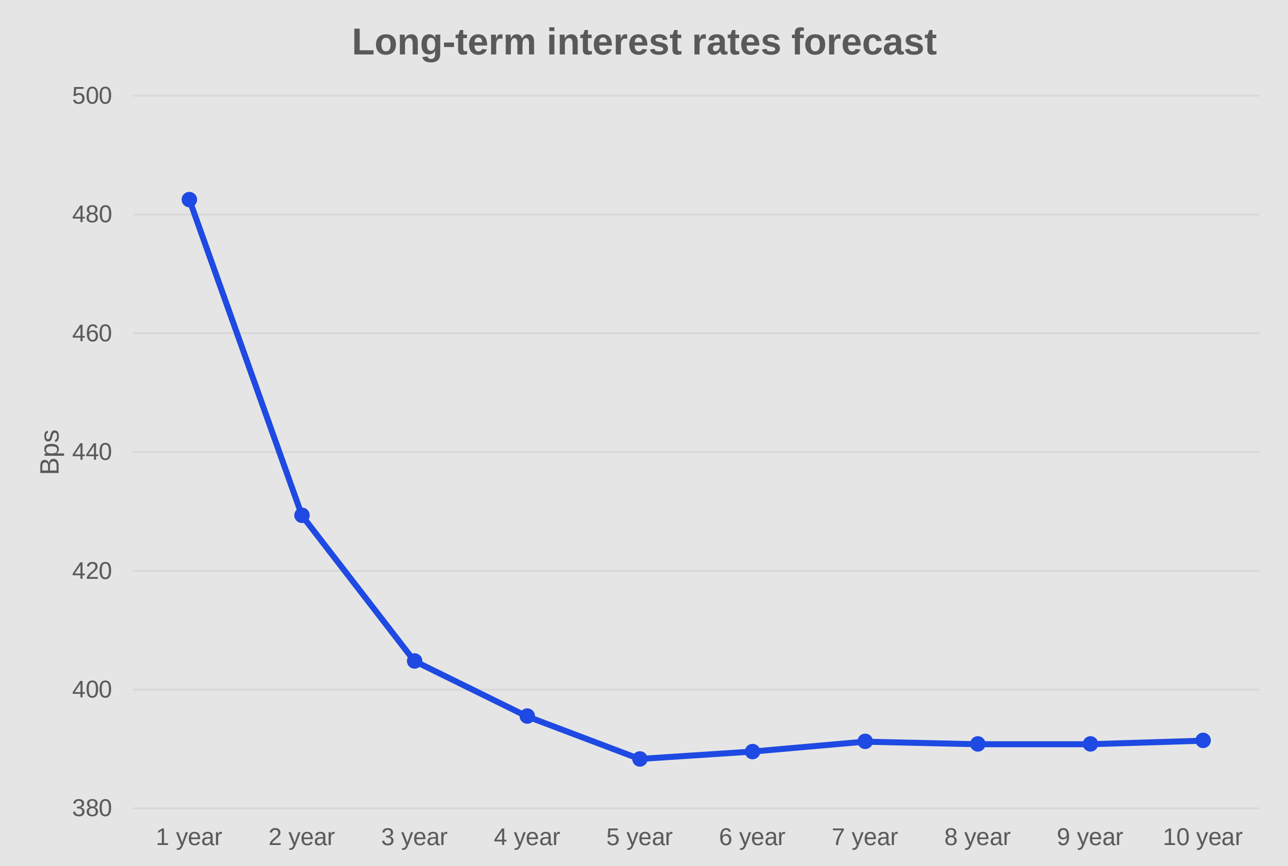
Interest Rate



Interest rate remain stable from last 6 months.

The European Central Bank maintained its interest rates at historically high levels during its March meeting, as policymakers balanced concerns over a looming recession with persistently elevated underlying inflationary pressures.

Long-term interest rates forecast



Source: US Treasury Active Curve, 29 December 2023, Bloomberg

Upon analysing the **US Treasury yield** curve as of December 29, 2023, it is evident that a **notable decline** occurred from 482.5 basis points to 388.3 basis points between the **first and fifth years.** Furthermore, a slight increase is observed from the fifth year to the tenth year, with the yield rising from 389.5 basis points to 391.4 basis points.

Emerging market economies experienced lesser fluctuations in rates.
For example, the average sensitivity of the 10-year sovereign yield of the Latin American emerging market to US interest rates has fallen by two-thirds in the current period of monetary policy tightening, when compared to the taper tantrum of 2013.

High financing costs reflect the risks associated with emerging market assets. The dollar returns on these assets have lagged compared to similar advanced economies' assets during this high-rate environment.

Over the last four years, emerging market bonds from lower-rated issuers have returned close to zero percent, while US high-yield bonds have returned 10 percent.

Volatility

1

European stock market volatility in 2023 has trended downwards, although with fluctuations throughout the year. Despite Federal Reserve officials downplaying early rate cut expectations, the S&P 500 and NASDAQ Composite climbed, showcasing the market's resilience.

2

Global markets will experience greater volatility in 2024 as the Federal Reserve cuts benchmark interest rates fewer times than many investors are pricing in.

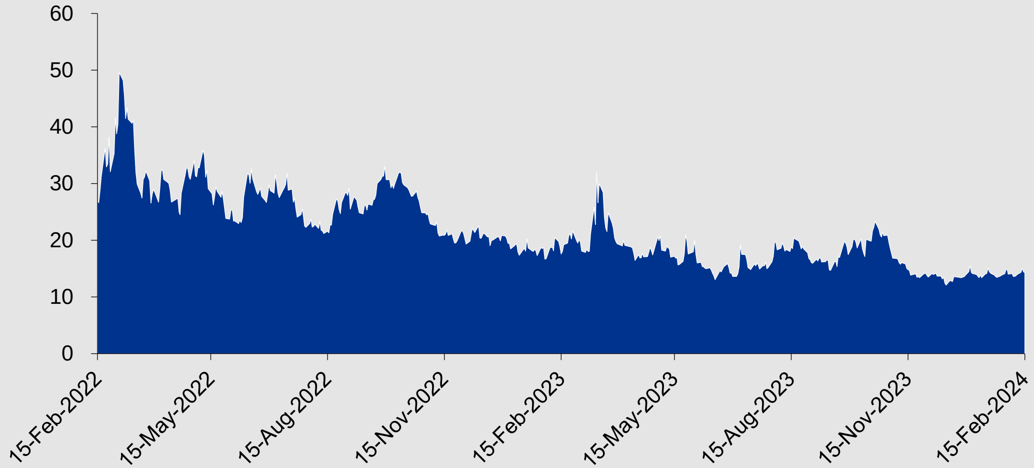
3

Geopolitical risks also remain high, with two major conflicts currently ongoing and national elections soon taking place in 40 countries, including the U.S.

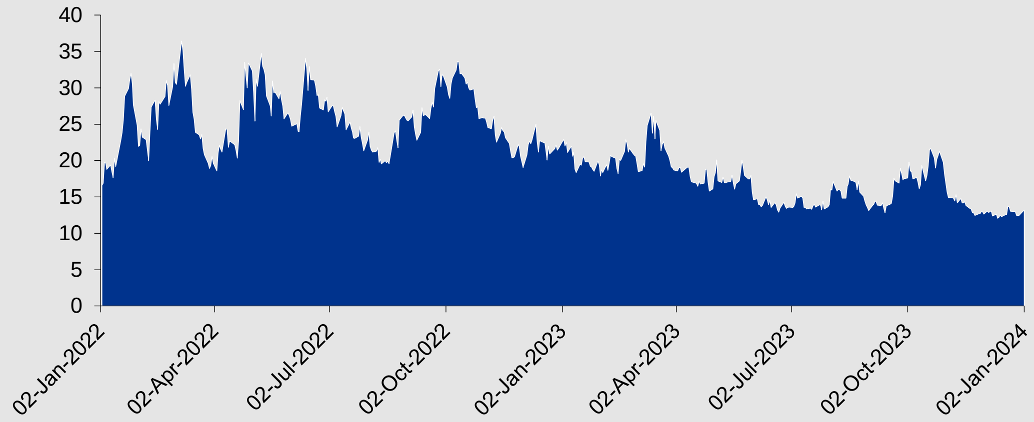
4

The US Federal Reserve has aggressively increased interest rates since March 2022. We anticipate that the **full impact of high interest rates will be felt from the second half of 2024** onwards

EURO STOXX 50 Volatility (VSTOXX) EUR Price Index

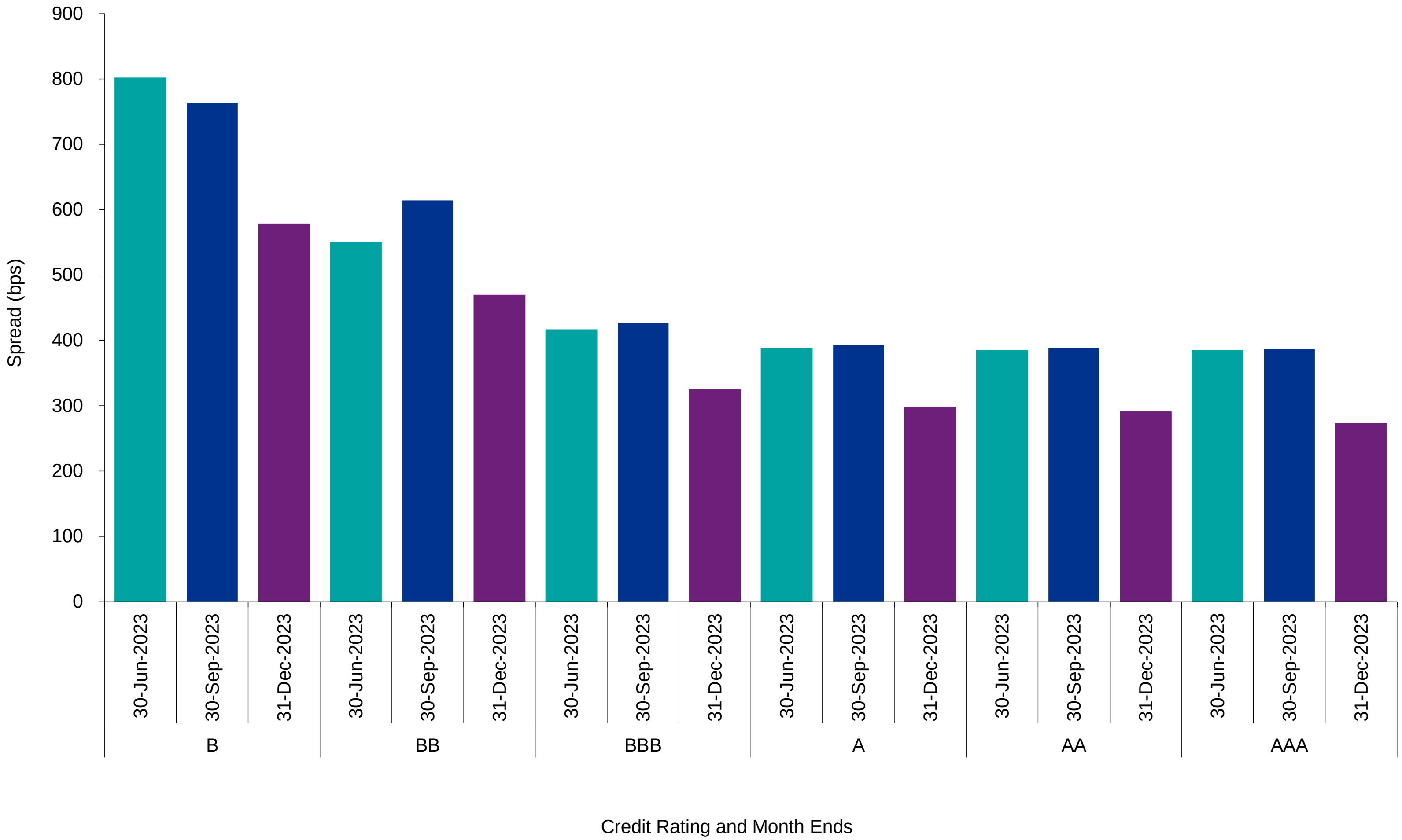


VIX Index



Credit Risk

5Y EUR CDS Generic Benchmark in Q4 2023



Risks

▶ **CDS Spread has decreased** from Q2 2023 to the last quarter.

▶ Higher interest rate burdens still lie ahead for many businesses and households despite recent market optimism and a fall in fixed-rate yields.

▶ Credit terms and conditions remain unchanged but are anticipated to become more restrictive from September to November 2023.

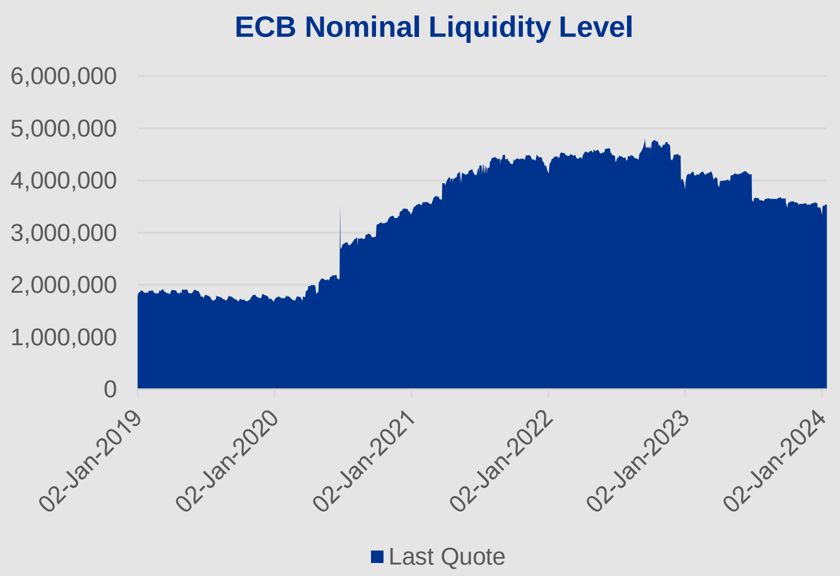
Liquidity

Global liquidity levels have stabilised at US$169.7tr, comfortably above the US$166.6tr weekly average recorded in 2023 and also above the peak US$168.7tr.

Increased volatility in bond markets which has negatively affected collateral values and hence liquidity levels.

The US Federal Reserve and the People's Bank of China have been **injecting liquidity** into money markets, the ECB and Bank of England have been tightening.

The ECB introduced a **revised framework** for liquidity lines, effective as of 16 January 2024.



Source: Refinitiv

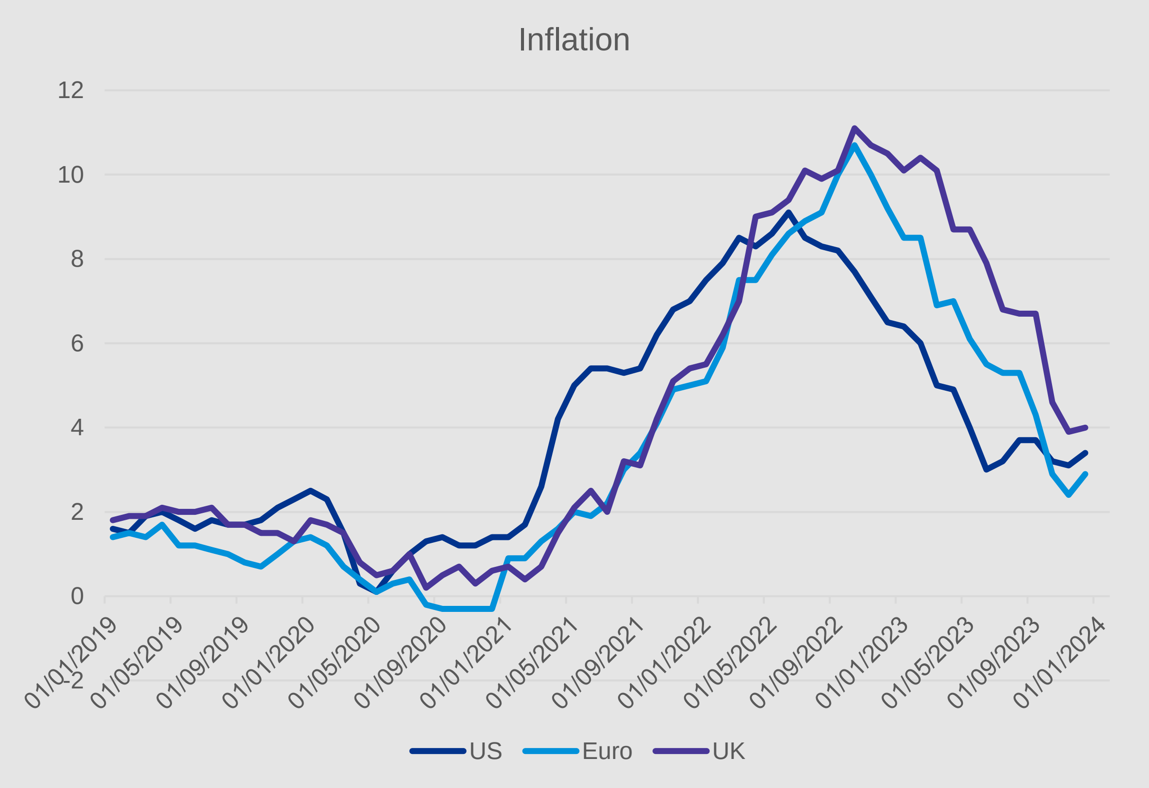
Inflation

Global inflation is projected to decrease from 8.7% in 2022 to 5.8% in 2024, driven by tighter monetary policy and lower international commodity prices.

Emerging market and developing economies are projected to have a modest decline in growth from 4.1 percent in 2022 to 4.0 percent in both 2023 and 2024.

In 2024, **softer demand, especially in the eurozone**, suggests potential easing of price pressures unless new supply shocks occur.

Lowering inflation from current levels (3.1% in the US, 2.4% in the eurozone) to target levels (2.0% in both regions) is likely to be challenging.



Source: Bloomberg

Private Equity Outlook

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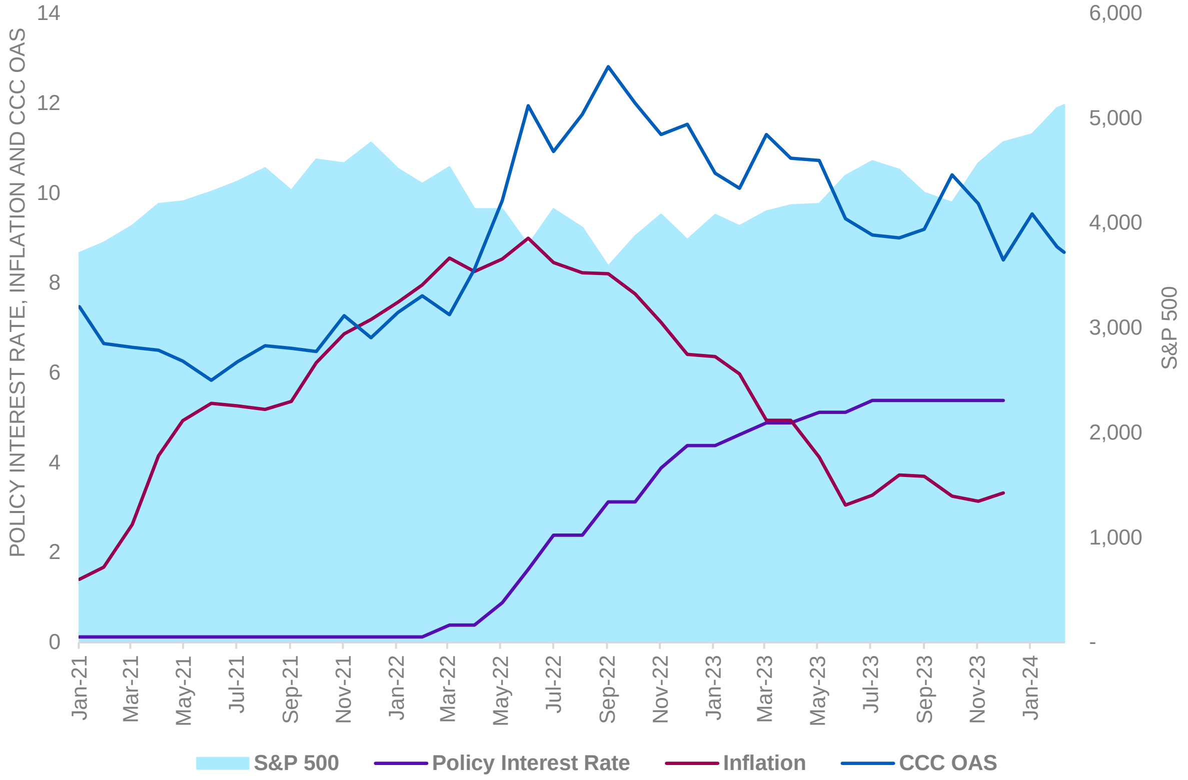
Global Market Outlook

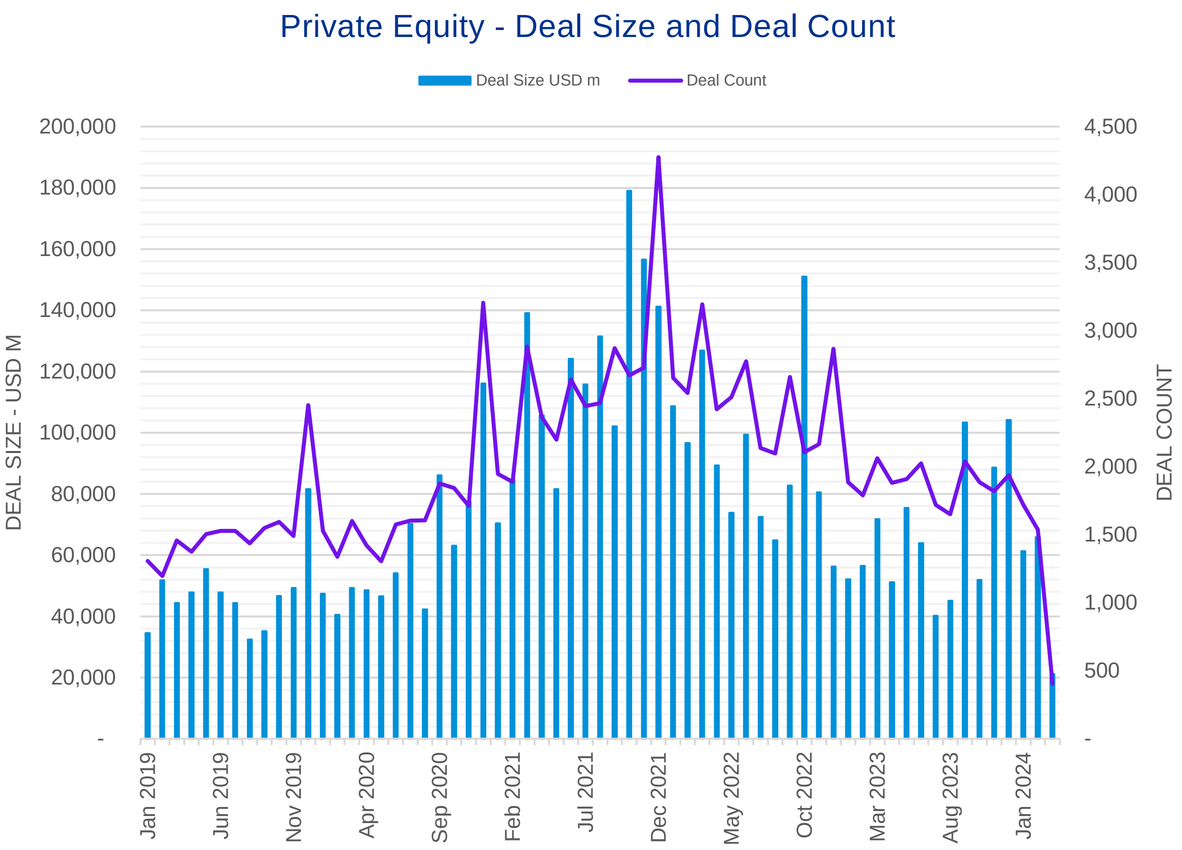
Equity and Debt markets reaction to inflation and policy rates



Source: S&P CIQ, World Economic Outlook, Reuters, IMF

- **The current data releases on different economic indicators including unemployment rates and consumer price index by US and Europe** indicate that there is a prospect of a soft landing, and the risks to global development are largely balanced.
- **Investments could gradually improve in 2024** due to the possibility of lowering interest rates and the necessity of making investments. However, expansionary monetary policy by US and ECB can't be expected anytime soon, which means multiples will continue to face pressure.
- Recent comment from US Federal reserve Chair Jerome Powell "***Not far** from confidence needed to cut rates*" caused a rally in almost all financial markets meaning that most of the expected gains could already be priced in.
- While the movement in investment grade debt securities was not as evident due to more stable cash flows and financial performance, the CCC option adjusted spread showcases the story of **high risk and start up businesses**. It is evident that market spread increased in reaction to contractionary monetary policy and perceived recession fears.
- A poll conducted by Reuters shows that **participants are expecting a rate cut in June.** Similarly, as of March 2024, CME Fed watch tool, shows a 56% probability of rate cuts in June.

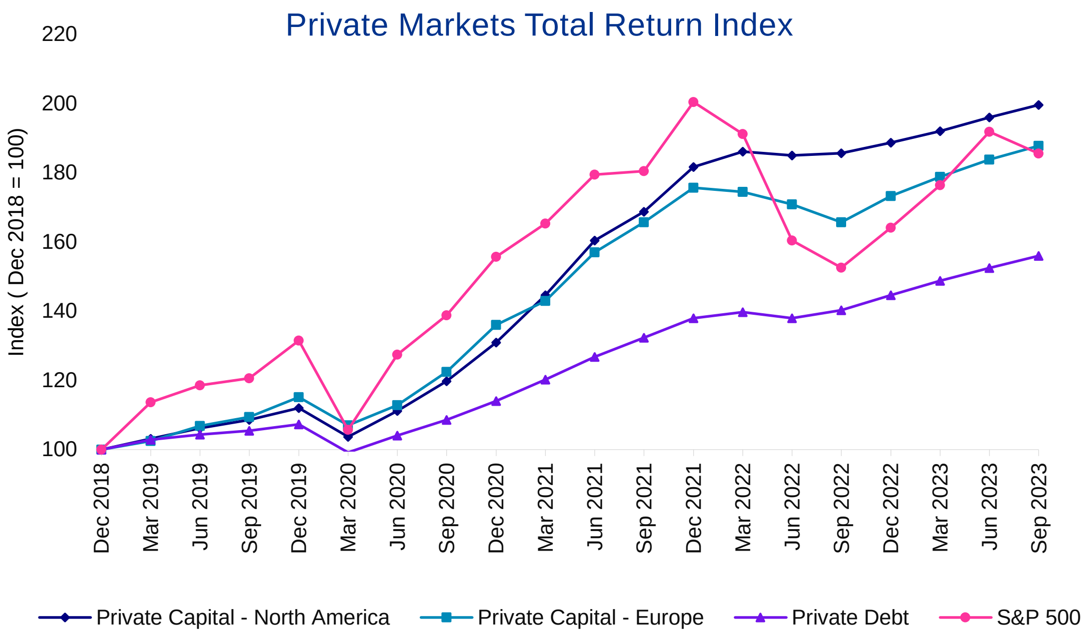
Global Private Equity Outlook



- Although liquid markets rebounded**, continuing concerns about a recession and rising interest rates hindered the growth of the private equity industry**. There was a noticeable decline in deal volume and departure activity, which made the fundraising climate quiet.
- **With expected rate normalisation in 2024,** market sentiment has moved away from the base scenario of a recession and towards peak Federal Reserve (Fed) tightening.
- **Private equity (PE) is expected to rebound** in terms of deal volume, exits, and possibly fundraising, though the latter will probably continue to be difficult.

Source: PREQIN, S&P CIQ, World Economic Outlook, Reuters, IMF

Private Equity Returns - Europe



- **Despite ongoing inflation, the invasion of Ukraine, and escalating tensions with China, the industry maintained its record-breaking surge of deal activity in 2022.**
- However, throughout the second half of the year, there was a noticeable drop in deals, exits, and fund-raising due to rising interest rates, which most likely indicated a shift in the cycle.
- Although GPs will have to come up with new strategies to generate value and manage risk in this climate, the long-term outlook for private equity is still fundamentally strong.
- In order to promote productivity and long-term value generation, the emphasis on AI will increase inside PE portfolios.
- To fulfil carbon emission targets, PE managers will also place an increasing emphasis on sustainable investing.

Source: PREQIN, S&P CIQ, World Economic Outlook, Reuters, IMF

Alternate Asset Valuations – Common Pitfalls

While valuers typically regard cash flow data as reliable/ source data that has been provided by the management, it is essential to conduct thorough assessments to ensure reliability. Valuers can enhance the evaluation process of the cash flows by performing cross-checks, such as analysing revenue forecasts of the identified comparable companies, examining industry trends, and performing assumptions testing.

Use of simplified criteria for the identification of comparable companies i.e. business description. It is one of the key components for both income and market approach-based workings. The extended criteria should include, revenue segmentation by geography/ products and its comparison to the target company. Other important factors include size, capital structure, geography, profitability, currency etc.

Use of early exit dates especially in an upward sloping yield curve environment and where the interest rates have increased from the transaction date to the valuation date. This could result in a significant difference in fair value of credit instruments as use of the early exit dates would result in a higher fair value compared to exit dates based on maturity of the investment. Exit dates should be supported by the historical deal flow or fund's valuation policy.

Alternate Asset Valuations – Common Pitfalls (Cont'd)

The practice of limiting credit instruments' fair value to 100% of par may be deemed prudent, however, it may not provide an accurate representation of the true fair value of these instruments. If market volatility causes fluctuations in the fair value of credit instruments, maintaining the par value at 100% may not reflect this accurately. In the financial statements and investor reports, this could potentially lead to investments with medium/high volatility behaving as if they have low volatility profiles.

Utilization of inaccurate methodologies in asset valuation, such as misclassifying equity instruments as credit instruments. One example is the application of a calibration approach commonly used for valuing credit instruments, to valuing intangible assets with exposure to the equity of the target company.

Utilize the recent funding round as a benchmark for determining a fair value per unit for all classes of shares, rather than calculating share prices based on liquidation preferences of each share class. This approach simplifies the allocation of equity value among each class of shares, using a back solve option pricing model.

Questions & Answers