Contemplations on Fair Value – Unique Issues, Challenges, and Measurement Implications

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Defining “Fair Value”

Fair Value for Financial Reporting

- **Fair value for financial reporting (under IFRS)**

- Distinct from “fair value” in other circumstances
  - i.e. appraisal matters in various contexts (oppression/dissent) in different jurisdictions…
    …which have certain legal overlays including considerations around being equitable and the like

IFRS 13 defines fair value as:

"The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

(IFRS 13, para.9)

IFRS 13 also states:

"Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (i.e. an exit price) regardless of whether that price is directly observable or estimated using another valuation technique."

(IFRS 13, para.24)

The Fair Value Measurement Approach

- Fair value is a market-based measurement and not entity-specific
- The objective of a fair value measurement is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between **market participants** at the measurement date under **current market conditions**. A fair value measurement requires an entity to determine all the following:

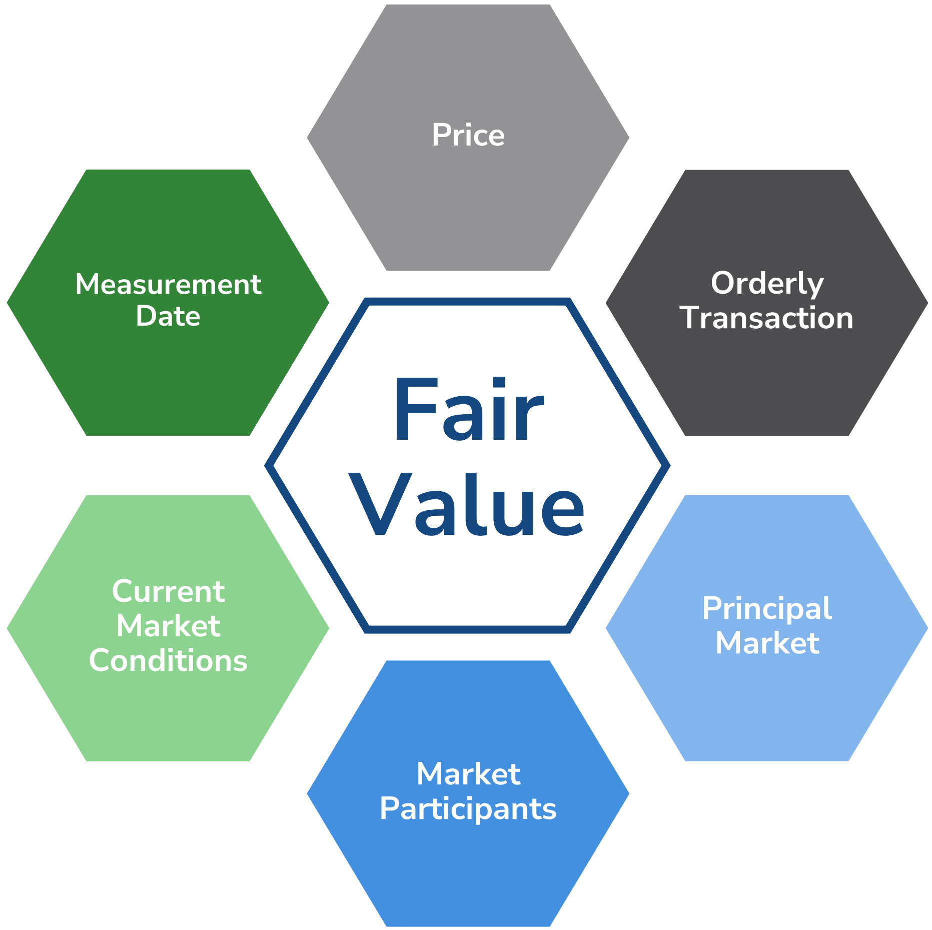
  (a) the **particular asset or liability** that is the subject of the measurement (consistently with its unit of account).

  (b) for a non-financial asset, the valuation premise that is appropriate for the measurement (consistently with its highest and best use).

  (c) the **principal (or most advantageous) market** for the asset or liability.

  (d) the valuation technique(s) **appropriate** for the measurement, considering the availability of data with which to develop inputs that represent the **assumptions that market participants would use** when pricing the asset or liability and the level of the fair value hierarchy within which the inputs are categorized.

Elements of Fair Value



The Market and Market Participants

The Market / The Transaction

Principal market

- No need to undertake an exhaustive search
- In the absence of evidence to the contrary, the principal market is **the market in which the entity would normally transact**
  - Principal market prevails, even if a price in a different market is more advantageous as at the measurement date
- In the absence of a principal market, determine the most advantageous market

Other considerations…

- Entity must have access to the principal market at the measurement date
  - But does not have to be able to sell the assets or transfer the liability as at the measurement date

Market Participants

Market Participants

- No need to identify specific market participants
- Instead, focus on the characteristics of participants having regard to:
  - The asset or liability
  - The principal or most advantageous market
  - The market participants in that market

The guidance also states:

- "*An entity shall measure the fair value of an asset or a liability **using the assumptions that market participants would use when pricing the asset or liability**, assuming that market participants act in their economic best interest.*"
- "*…an entity shall take into account the characteristics of the asset or liability if **market participants** would take those characteristics into account when pricing the asset or liability at the measurement date.*"

Market and Market Participants

Scenario

- Consider the fair value of standalone business/CGU operating in an industry that is experiencing consolidation…
  - Strategic/synergistic buyers have been active in the market (e.g. targeting "roll-ups")
- Industry multiples have recently trended upwards (but there are limited data points and sightlines re: private transactions)
- DCF falls well below the market approach (precedent transactions)

Considerations

- How are the market and the market participants defined?
- If more than one strategic (i.e. synergistic) buyer is identified, then might there be an uplift to fair value that ought to be considered?
- What are the assumptions that market participants would use when pricing the asset?
  - E.g. would those market participants consider uplift to cash flows (i.e. from synergies)… how would they view their cost of capital re: size premium and the like?
- Do some of these considerations help bridge the gap between approaches?

Important to be internally consistent; value conclusion expressed as a range

Market and Market Participants

Similar issues may arise in other circumstances. Consider the perspectives of different market participants with respect to:

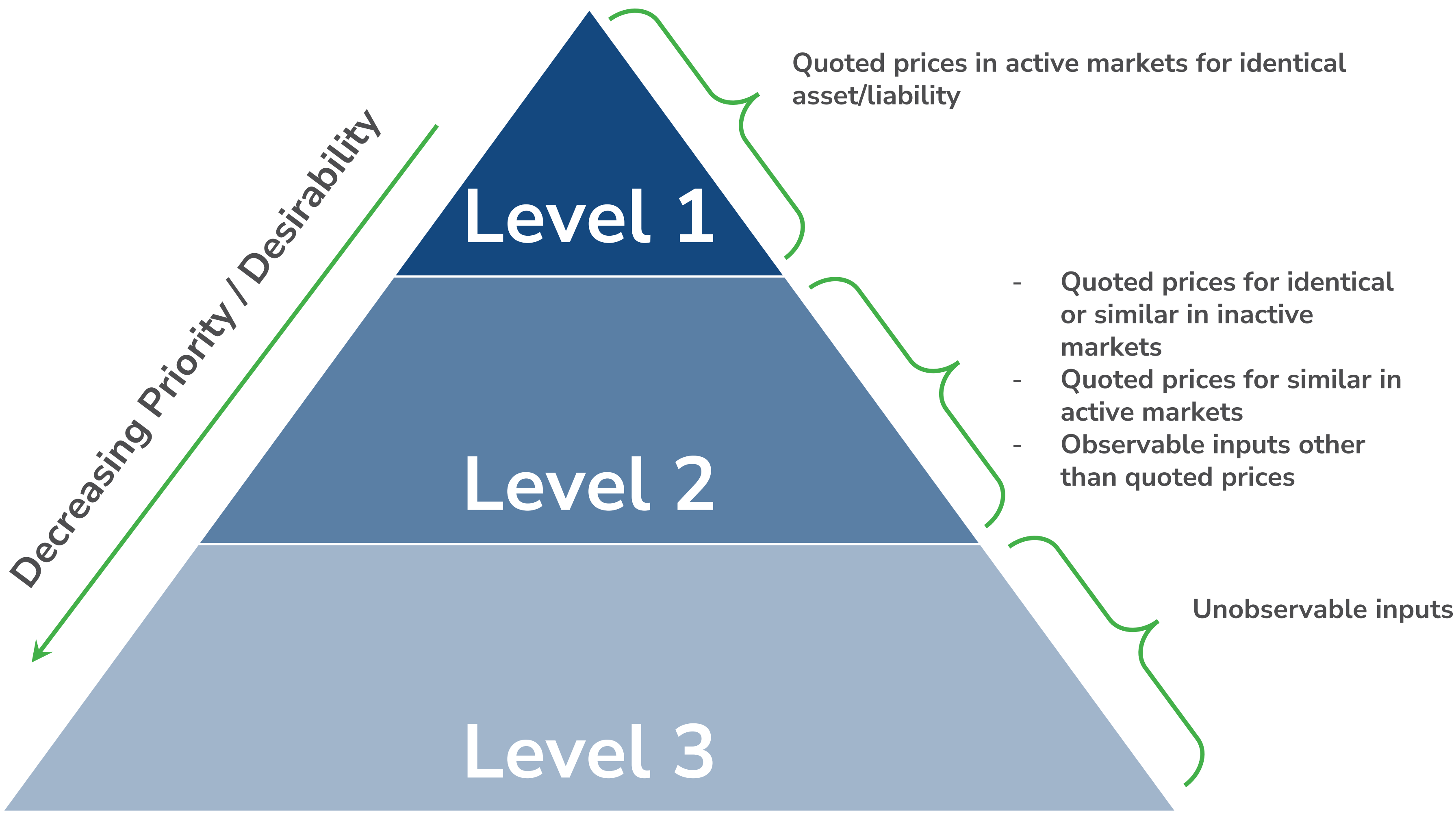
- Pricing
  - Certain cohorts of market participants may rely on different approaches / methodologies
    (i.e. using adjusted multiples and rules of thumb)
- Taxes entities
  - If the logical buyers (i.e. market participants) are more (or less) tax efficient
- Country risk premiums (and the investor perspective)

(And so on…)

Fair Value Hierarchy

Fair Value Hierarchy

Inputs To Valuation Techniques



Fair Value Hierarchy

Level 1 inputs

- **Level 1:** Quoted prices (unadjusted) in **active** markets for **identical** assets or liabilities that the entity can access at the measurement date

- Active market: "A market in which transactions for the asset or liability take place with **sufficient frequency and volume** to provide pricing information on an ongoing basis"

Fair Value Hierarchy

Level 2 inputs

- <u>**Level 2:**</u> Observable inputs other than quoted prices included with Level 1. Includes:
  - Quoted prices for identical or similar assets in inactive markets
  - Quoted prices for similar assets in active markets
  - Inputs other than quoted prices (e.g. volatilities, interest rates)

- Unlike level 1 inputs, typically requires adjustments to apply and arrive at a fair value measurement for the subject asset

Fair Value Hierarchy

Level 3 inputs

- <u>**Level 3:**</u> Unobservable inputs for the subject asset or liability.

- Unobservable inputs: “Inputs for which market data are not available and that are **<u>developed using the best information available</u>** about the assumptions that market participants would use when pricing the asset or liability”

Fair Value Hierarchy

Adjustments To Inputs

Level 1 – No Adjustment

- If a level 1 input (i.e. quote prices in an active market for an identical asset) exists, the quote price should be used without adjustment (save and except for some limited exceptions)

Permitted Adjustments

- Adjustments are permitted for example for:
  - Lack of marketability discounts (DLOMs)
  - Control premiums
  - Non-controlling/minority interest discounts

Blockage Disallowed

- Adjustments for a blockage factor (i.e. a blockage discount) is disallowed at all levels of the fair value hierarchy
  - Unit of account for financial instruments is generally the individual instrument
  - Not considered a characteristic of the instrument, rather is entity-specific

Fair Value Hierarchy

Synthesis & Key Takeaways

- It's really a hierarchy based on the nature of the INPUTS rather than the valuation approaches
  - Quoted prices preferred – may be subject to adjustment if level 2
  - (followed by) Observable inputs, i.e. inputs developed using market data (level 2)
  - (followed by) Unobservable inputs

➢ **Market is preferable (where data is available)**

- *"...the fair value measurement is categorised in its entirety in the same level of the fair value hierarchy as the lowest level input that is significant to the entire measurement."*

➢ **Quality of final output is a function of the weakest significant input**

Fair Value Hierarchy

Case Study

Background

- Buyer acquires Target from Vendor pursuant to SPA
- Purchase price is linked to the financial statements prepared in accordance with IFRS
- Dispute pertaining to the fair value of an investment in the Series B shares of Company X reported in the Target's financial statements
- Subsequently, 1.5 year later, Company X conducted a Series C financing round at 4x the Series B pricing
- V-Date is few months after the Series C financing round

- **Vendor argued** the Series C pricing is an unbiased, market observable, level 2 input that is probative of fair value
  - Buttressed by comps and other analysis

- **Buyer argued** the Series C financing round was:
  - Dominated by inside investor and hence unreliable
  - Series C round and pricing was materially dissimilar to Series B re: downside protection given Company X was burning cash and in a precarious financial position
  - Forecasts prepared by Company X mgmt. during the relevant period did not accord with a 4x increase in value (over the 1.5 years)

Fair Value Hierarchy

Case Study

Outcome

- Jointly retained expert in dispute process agreed with the Vendor
- Motivations and alleged lack of fundamental analysis of Vendor purchasing the Series B shares of Company X was seen as irrelevant
- Series C pricing, a level 2 input, was seen to be probative of the fair value of the Series B shares held
  - Series B and C considered to be similar (enough)
- No requirement to get into a detailed analysis of the Series C round and resulting pricing, given the investors were at arm's length to Company X
- DCF analyses focused on by the Buyer is subjective, a level 3 measurement outcome, and trumped by the market-observable level 2 input

➢ **Market is preferable**

Initial Recognition
(Day 1 Gains / Losses)

Fair value at initial recognition

Transaction Price or “Entry Price”

The transaction price is the price paid to acquire the asset or received to assume the liability

Fair Value or “Exit Price”

The price that would be received to sell the asset or paid to transfer the liability

In many cases the transaction price will equal fair value… but not always…

Fair value at initial recognition

The **transaction price may not equal fair value** if any of the following conditions are present:

Between Related Parties

Unless there is evidence that the transaction was based on market terms

Duress / forced sales

Sometimes obvious but there may be grey areas

Different unit of account

For the transaction price vs. that of the asset or liability being measured at fair value

Different markets

Market giving rise to the transaction price is different than the principal or most advantageous market

Polling Question #1

Challenges – Day 1 Gains / Losses

Re: Market for the transaction price being different than the principal or most advantageous market

- E.g. In instances where it is suggested that there was a limited pool of buyers (or exclusivity) giving rise to the transaction price then one needs to consider/understand:
  - The circumstances surrounding the transaction
    e.g. relative negotiating strengths of the parties
  - How would the market / market participants in the principal market differ (from that for the transaction price)?
  - What requirement / threshold must be met in order to record a Day 1 gain / loss?

Re: Different unit of account for the transaction price vs. that of the asset or liability being measured at fair value

- E.g. where a standalone business is acquired and then folded into a larger group, should synergies / elements of now being within the group be considered in striking fair value?
  - Unlike the unit of account for a financial instrument, there is a different perspective when considering the business(es)

Subsequent Events

Polling Question #2

Challenges – Subsequent Events

Principle

- Fair value ought to be struck based on what is known (or knowable) as at the measurement date

Example

- Mark for an investment in a private company is currently based on pricing from the most recent financing round 15 months prior to the measurement date
- 2 months after the measurement date, the private company announces the IPO to the market at 3x most recent financing round

Example (contd.)

- IPO occurs 3 months after the measurement date
- Preparations for IPO and related due diligence process, discussions with financial advisor/underwriter had commenced and underway prior to the measurement date (unbeknownst to the market)

➢ What does one do with such hindsight information? Ignore or consider?

Emergence of Retail-focused Private Funds

Democratization of Private Markets

Valuation Challenges – Technical Considerations

- **Direct financial impacts**
  - Gain/loss in a retail fund is not paper money
  - NAV will impact the crystallization of carry/performance fees; redemption and subscription price

- **Frequency and Timing of Valuation**
  - Quarterly vs. monthly vs. daily
  - Tight reporting timelines
  - Availability of information and timeline mismatch in information flow

- **Market Dislocation**
  - How to approach the valuation when there is a market dislocation and the information is limited
  - Different behavior in public and private markets

- **Disparity in practice and lack of consensus**

Democratization of Private Markets

Valuation Challenges – Operation Considerations

- **Valuation Policy and Process**
  - Closed-end funds valuation policy and process might not fit for retail products
  - Involvement of external valuation advisor
- **Resource and Technology Readiness**
  - Does the GP have appropriate valuation and technological resources to manage the valuation risks and deliver the reporting package in a timely fashion
- **Regulatory Scrutiny**
  - Elevated scrutiny is expected
  - Processes and guardrails
- **Feeder funds vs. Master funds**

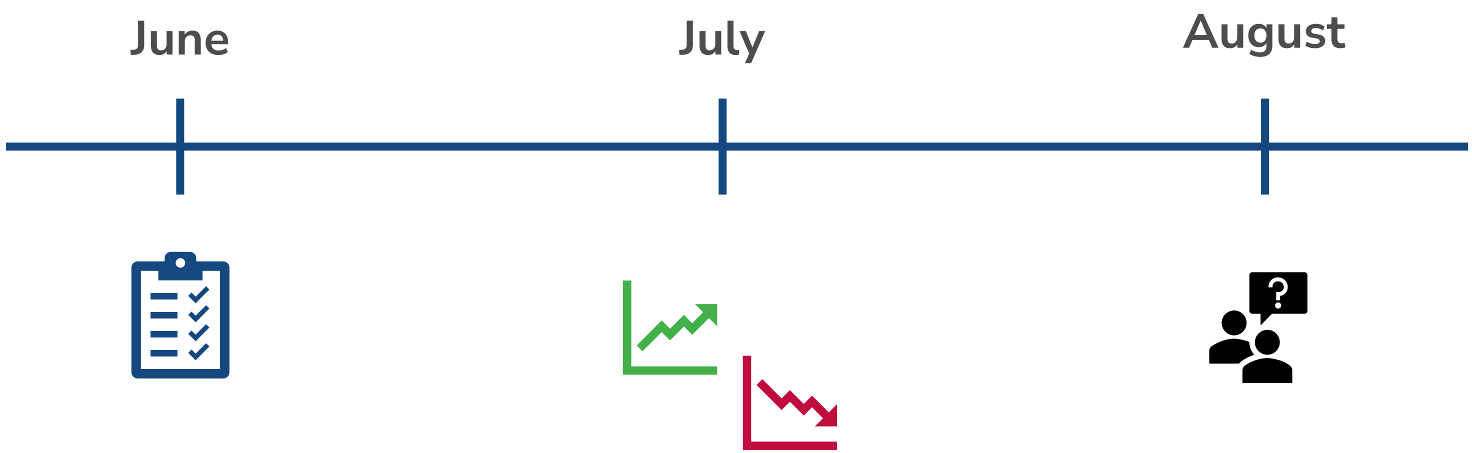
Democratization of Private Markets

Case Study

<u>Consider the following:</u>

- Assessing fair value for a fund of funds portfolio as at August 31st
- The latest capital statement from the GP sponsors was as at June 30th
- There is a significant change in market indices (S&P, Nasdaq, etc.) between June 30th and August 31st .

➢ **How would you approach the fund of funds valuation for August 31st?**



Discussion / Questions?