

A person wearing a blue jacket and a red beanie stands on the deck of a boat, looking out at the sea. The sky is cloudy and the water is dark blue. The person is barefoot and is holding onto the mast of the boat. The boat has a wooden deck and metal railings.

# How credit funds can operationally transform their valuation process



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## Accurate pricing by credit fund managers is crucial in today's economic environment. Operational improvements may be key to success.

A decade ago, as the global economy entered a recession and governments struggled to save the big banks, enforced capital requirements curtailed bank lending. In the banks' place, credit funds increasingly stepped in to fill the void.

Although interest rates have increased recently, these credit funds continue to pull in money from return deprived investors. Leading money managers, especially those that concentrate their fund raising in the private space, such as hedge funds and private equity funds, have launched new lending vehicles on a regular basis.

Despite this surge in activity, money managers continue to sit on large amounts of dry powder - a result of waiting for the right investment opportunities in an overvalued and uncertain economic environment. This has resulted in a crowded market with an excess of lenders chasing too few deals.

However, opportunities abound in relatively untapped markets such as real estate and infrastructure, and specifically in the distressed (trading between 50% and 75% of par) and deeply distressed (trading at less than 50% of par) asset categories.

For credit managers operating in these niche markets, the low liquidity levels stemming from a lack of buyers means they need to pay close attention to their valuation policies and procedures. Investors, regulators and auditors are demanding stronger levels of pricing precision than what managers have been accustomed to.

In this article, we highlight the differences between capital preservation and return maximizing strategies. We also introduce three best practices that funds should consider when addressing the demand from investors, auditors and regulators of higher levels of pricing precision.

This is the first article in a series that will further explore the operational nuances of valuation for a credit fund.



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# Finding the right strategy

In an uncertain economic environment, credit managers must be attentive to their pricing policies and procedures.





## Capital preservation strategies

Capital preservation strategies are favored by investors who aren't seeking significant capital gains but rather a reliable and steady income stream. They come in multiple asset classes:

- ▶ **Senior corporate debt** is the most common asset class – it is covered by numerous vendors and pricing issues are uncommon. The large proportion of senior debt traded by credit funds also means that back-testing analyses can efficiently validate any nuanced pricing issues that may occur.
- ▶ **Mezzanine debt** is a common capital preservation product where managers make subordinated loans to middle market borrowers who are willing to pay cash returns in excess of single digits. Equity kickers are often thrown in as an upside opportunity for capital appreciation but the primary focus for managers is generating steady income from the borrowers. Pricing is usually uncomplicated – pricing teams can evaluate changes in implied yield and compare such yield movements with those observed by comparable issuers.
- ▶ **Bank debt** is a third asset class, where loans are arranged by banks with participation from lenders such as credit funds, often with first priority in bankruptcy claims. Considering the popularity of this class, many vendors provide prices, in addition to key metrics that give further credence to the price, such as liquidity scores and depth scores.
- ▶ **Sovereign debt** from stable, developed economies remains an attractive asset class. Nations that are not going through periods of financial or political upheaval will have active, liquid pricing available from most vendors.

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## Return maximizing strategies

Return maximizing strategies are often undertaken by private equity firms that hold long-term investments and whose investors are familiar with extended lock-up periods.

Generating cash to pay for interest is challenging for issuers of distressed bonds and especially for deeply distressed issuers. Therefore, returns are typically generated through paid-in-kind interest, liquidation preferences in a restructuring scenario, and success fees for operational and financial improvements. Considering the lack of liquidity in these positions, a large number may need to be priced in-house by the valuation committee or by a third-party valuation firm.

Credit managers may also use collateralized securities to boost returns. Securitized products are generally followed by specific vendors. Key features such as prepayment rates, default rates and recovery rates may need to be broken out and independently assessed on a periodic basis to validate whether the pricing received from the vendors is correct.

# Three leading practices for pricing

By following these three practices up front, your fund gains immediate credibility from its stakeholders.



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A pricing policy determines a baseline valuation approach for investments a firm holds or intends to make. The policy should be forward thinking and offer guidelines for a variety of vehicles that are synchronized with the firm’s investment strategy.

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## 1) Establish a valuation policy and committee

Ideally, a pricing policy must be established at the beginning of the first launch of funds by a new manager.

One of the most critical pieces of a policy is for the running of missing or stale price reports on a frequent basis and the number of days in which securities on these reports are allowed to exist before they are brought up to the attention of the valuation committee.

The other ad hoc responsibility for the valuation committee is an evaluation of overrides initiated by the front office. Overrides on vendor prices routinely occur in situations where company specific circumstances unknown to vendors cause them to be inaccurate. For example, sovereign debt of a country in the middle of a financial crisis may need to be manually adjusted in the pricing system after valuation committee approval.

Other than these ad hoc responsibilities, we also recommend that the committee meets on a formal basis (at least quarterly) to discuss the overall portfolio, including sourcing of prices, complex positions that require independent assessment by a third-party valuation firm, and back-testing results with a focus on trades that breach predetermined thresholds.

Further, at least annually, a committee should assess results of vendor and broker diligence and any motions to amend the valuation policy (as applicable).

- ▶ A committee typically consists of:
- ▶ Senior accountants, e.g., the CFO and the controller
- ▶ Senior members of the pricing operations team
- ▶ Independent members of the firm's board of directors
- ▶ A rotating selection of deal team professionals who have a direct relationship with management and can maintain an unbiased approach to portfolio pricing

Decisions are normally made with a unanimous or at least an absolute majority vote. Minutes from meetings should be filed for future use by regulators or auditors, or for review by the committee at a future date.



## 2) Source prices effectively

In a low-yield, high-valuation environment, accurate pricing is crucial to investors putting their trust in credit managers.

Brokers offer arguably more accurate pricing than vendors. However, cost cutting and an improvement in pricing performance by vendors has led to a sharp increase in their use.

Numerous vendors operate in the credit space and actively seeking two to three vendor sources for each asset type is highly recommended. Periodic back-testing of vendor prices to security transactions, in addition to comparing selected vendor prices with those of independent brokers, can help to validate the accuracy of vendor feeds.

Distressed positions may only be followed by one vendor. In these situations, the fund manager should also compare prices from brokers that trade these positions to ensure accuracy.

If prices cannot be sourced from either a vendor or a broker, a firm's pricing committee may have to resort to privately valuing the security either in-house or by using a third-party specialist.

Primary vendors consistently provide the best data when comparisons are run to brokers with direct access to the market, or when their prices are back-tested periodically against transactions undertaken by the credit manager.

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### 3) Do your diligence

The initial vendor diligence process should focus on the extent of the vendor's coverage across the manager's preferred assets. It is also important to evaluate the market experience of the pricing team. Managers may want to run statistical comparisons over a select set of prices sourced by their existing vendor against those from a potential new one. It is also important to analyze the vendor's protection against data loss and cyber threats.

Ongoing broker due diligence helps evaluate if the brokers used as a price check against vendors are effective and reliable. When a single broker follows a very unique asset type, quotes must be routinely back-tested to ensure accuracy. Furthermore, site visits and in-depth vetting questionnaires may be used to provide further assurances on broker quality.

### Pricing responsibly

Credit funds have been enjoying a long period of popularity since the tail-end of the financial crises. This is especially true for private equity managers, who have branched into private credit on a wholesale basis to take advantage of debt deals that diversify their income streams and tend to be aligned with their existing equity deals.

With this resurgence comes a tremendous pricing responsibility to investors. Dedicating the right resources to this task is of utmost importance.

Valuing credit assets during a volatile economic recovery can be unnerving. A well-seasoned valuation approach, with the right amount of operational rigor, can stand strong against winds of change.

# Summary





## About the author

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With over 13 years of experience in alternative funds, Govind focuses on serving clients in private equity and private credit. He has advised companies at various stages of growth, including publicly listed firms, on internal control enhancements especially around the valuation function.

He spearheads the robotics and automation capabilities of the Los Angeles alternative fund practice by leading teams to develop efficiency plays using advanced analytics tools. An avid writer, Govind recently co-authored a whitepaper on the resurgence of interval funds.

Beginning his career with EY in Philadelphia, he relocated to Los Angeles in 2015. He earned his MBA in Finance from The Wharton School, an MS in Accounting from The University of Virginia, and a BS in Economics from Ohio Wesleyan University. Additionally, Govind is a CFA charter holder and a CPA in California and Pennsylvania.

### **How Govind is building a better working world**

Govind helps build a better working world by striving to help clients consistently outperform their prior results. He is extremely focused on helping his clients discover new ways to innovate as well as operate efficiently. As technology accelerates at hyper-speed, he seeks to never let his teams or clients fall behind.

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