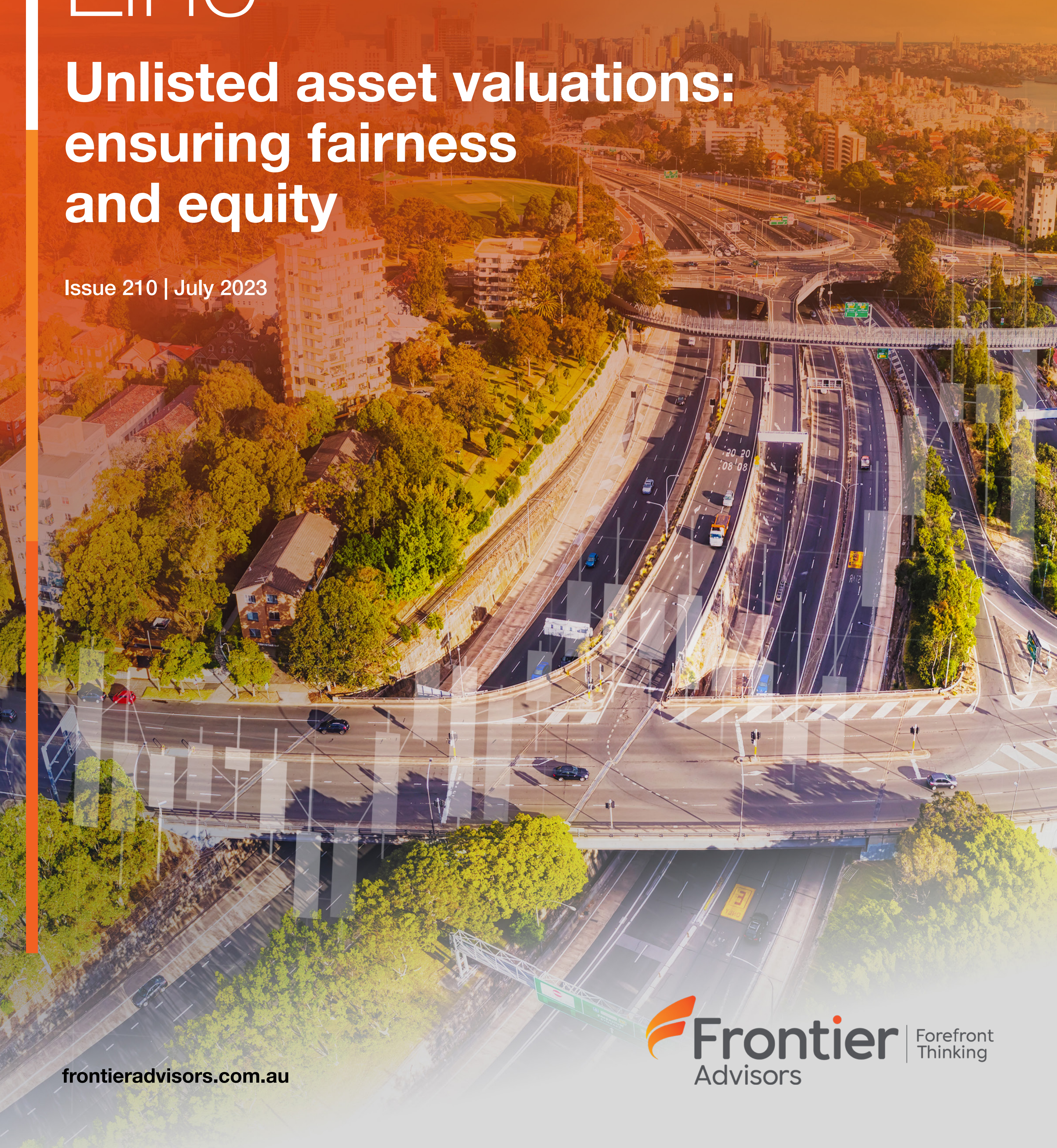
The Frontier Line

Unlisted asset valuations: ensuring fairness and equity

Issue 210 | July 2023



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About us

Frontier Advisors has been at the forefront of institutional investment advice in Australia for over 25 years and provides advice on over $600 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Our purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

Paul Newfield

Director of Sector Research

Paul Newfield is Frontier Advisors' Director of Sector Research, having joined the firm in July 2019. Paul has a primary focus on driving innovation and client alignment in our research program and works closely with our Global Investment Research Alliance (GIRA) partners. Paul joined Frontier from Willis Towers Watson where he held the role of Senior Consultant for over eight years and was involved in a number of governance and strategy areas, including liability driven clients and retirement incomes.

Prior to that, Paul spent 12 years at Mercer where he held a variety of senior roles in both Australia and New Zealand, including leading Mercer's retirement business in New Zealand and was Board Chair of their trustee company. Paul is a Fellow of the Institute of Actuaries and holds a CIMA certification as well as a Bachelor of Economic Science.

Brett Lazarides

Principal Consultant and Head of Investment Governance

Brett Lazarides joined Frontier in 2021 as a Principal Consultant and Head of Investment Governance. Brett has extensive governance and investment experience gained over several decades within some of Australia's largest financial institutions.

Brett is an experienced company director, having provided governance services across a broad spectrum of financial services and infrastructure industries, plus customised investment, financing and transactional services to superannuation funds and other institutional investors seeking access to unlisted infrastructure and other private markets.

Brett holds a Bachelor of Arts (Accounting) from University of Canberra, is a Chartered Accountant, holds a Diploma of Applied Finance and Investment from Finsia, a Diploma of Superannuation, Superannuation Law and Governance from AIST, is a Fellow of Australian Institute of Company Directors and completed the Non-Executive Director Program with the Institute for Sustainability Leadership, University of Cambridge.

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Introduction

Australian asset owners lead the world when it comes to investing in unlisted assets, particularly in infrastructure and property. It has helped Australia's $3.4 trillion superannuation sector deliver strong returns over decades.

But it also creates challenges.

Valuing unlisted assets such as property, infrastructure, private equity and private or corporate debt, is inherently more involved and uncertain than listed market valuations (as these are known in real time, if not necessarily a more accurate match to fundamental asset value). Performing unlisted valuations in a robust manner is crucial to ensure fairness and member equity.

Unlisted assets have become a growing focus for both asset owners and regulators as changing market conditions have amplified risk.

While the way asset owners (and fund managers) have valued unlisted assets is fundamentally sound, there is always room for improvement. Investors find themselves at a crucial juncture, where they are, and will continue to be, subject to increasing scrutiny (from regulators, media and members) and should, as fiduciaries, continue to embrace strong governance frameworks, which will lead to more accurate valuations.

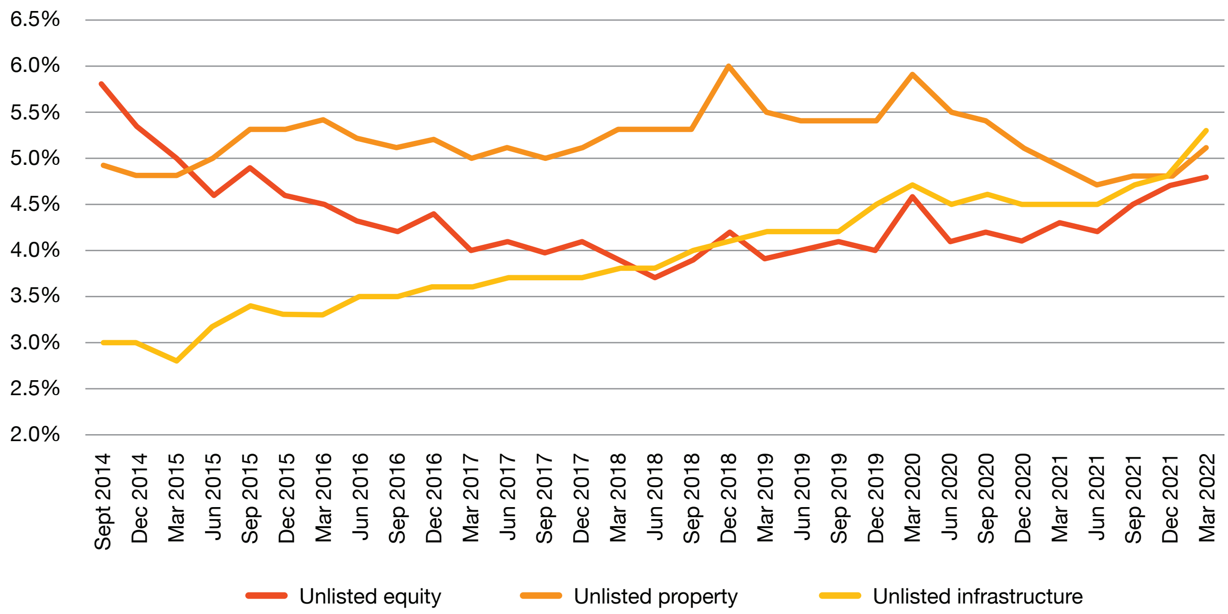
For the first time in decades, asset owners are facing the unprecedented intersection of several factors including significantly higher interest rates and bond yields (which drag down unlisted asset valuations) in a higher inflationary world with heightened macro-economic uncertainty. Many office properties have not recovered to pre-COVID occupancy levels, raising concerns around current valuation levels, particularly as Australian fund managers have been slower to reduce valuations compared to offshore managers.

While there may be good reasons behind those decisions, it requires asset owners to have a strong governance framework in place to evaluate them.

Why valuations are in the spotlight

Awareness about the importance of valuations has been rising as investments in unlisted property, infrastructure and private equity have grown in recent years.

Chart 1: Superannuation fund allocations to private markets over time



Source: APRA.

The decision to invest more in unlisted assets has, overall, paid off for members by delivering higher risk-adjusted returns over many years and through different market cycles. However, valuing unlisted assets is not as simple as listed market assets, which are continuously priced through real-world trades overseen by third-party exchanges. Unlisted asset valuations are less transparent and conducted less frequently (often quarterly or even annually).

The challenge of accurately valuing these assets has been further exacerbated by the wide range of unlisted investment structures available, which include various ownership and tax-effective holding structures. Large funds are increasingly forming in-house teams to bolster their unlisted allocations or taking part in consortiums to better compete for high-profile assets.

The COVID-19 pandemic in 2020 brought these unlisted valuation concerns to the fore. Lengthy lockdowns closed key infrastructure such as toll roads and airports, while office properties were emptied as people began working from home.

There was much focus on asset owners' liquidity as listed equity markets fell and funds simultaneously were required to release around $35 billion to members through the Commonwealth Government's COVID-19 early release of superannuation scheme. However, the regular contribution cashflows funds receive, combined with significant allocations to highly liquid assets (shares, cash and bonds), meant they were able to meet these redemptions.

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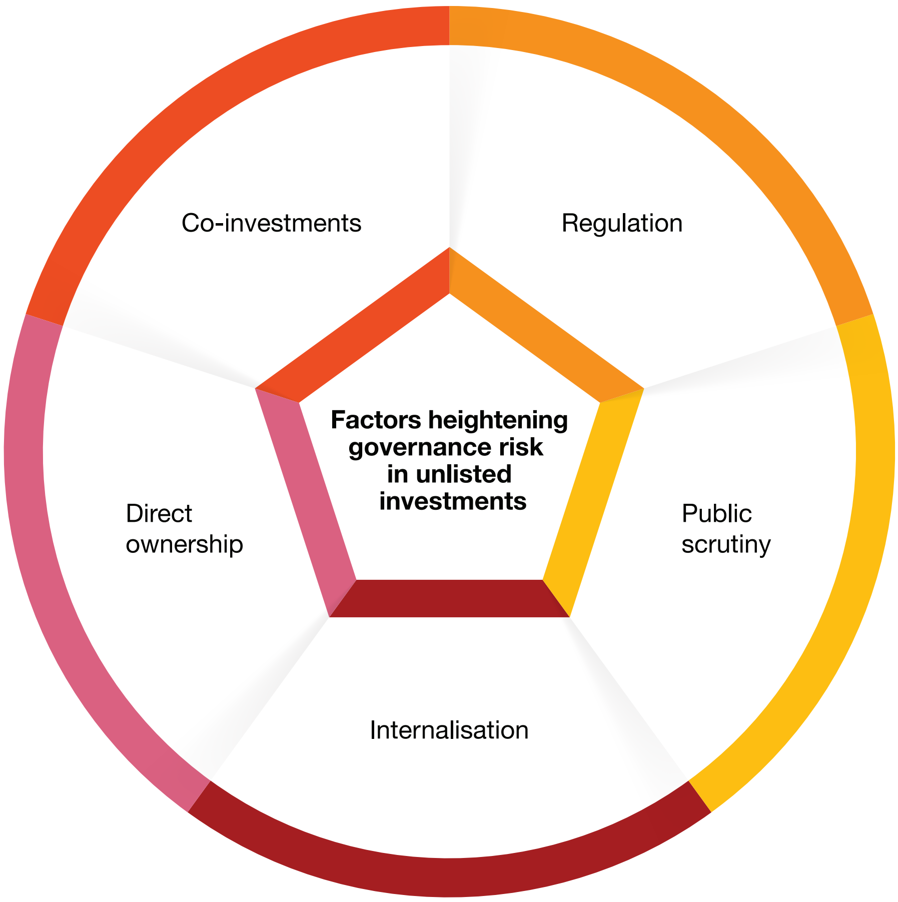
The greater concern was to ensure unlisted asset valuations remained accurate under radically different market conditions. Several funds quickly re-valued their unlisted assets out of their traditional cycle to ensure valuations remained accurate.

It sparked a rise in media attention, particularly given the divergence between similar listed and unlisted asset valuations. APRA launched an unlisted asset valuation thematic review, which found trustees were proactively revaluing unlisted assets but there were also areas that needed improvement, such as revaluation frameworks.

The focus on unlisted asset valuations was further heightened again after last year's sharp change in the macro-economic environment following a long period of historic low interest rates. Central banks have quickly hiked rates around the world in a bid to fight inflation, creating a new headwind.

All other things being equal, higher interest rates and (longer duration) bond yields will result in unlisted asset valuations falling (noting many long duration unlisted assets can be thought of as a very long-dated bond and higher interest rates and bond yields mean discounting cashflows back at higher levels resulting in capital write downs). However, the valuations of some unlisted assets, such as office property in Australia, have remained relatively resilient until very recently.

Concerns remain focused on this area given many offices remain partially empty as employees continue to work from home, while debt and construction costs have risen. Vacancy rates are also on the rise. Those concerns have been amplified by the underperformance of listed property assets up to early-2023 compared to unlisted assets, with the gap wider than may be expected based on several decades of history.



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New regulations prompt action

APRA's unlisted asset valuation thematic review, launched in October 2021, recommended trustees focus on certain governance issues. The key findings from its original analysis were that most trustees demonstrated a proactive approach to revaluing unlisted assets in response to the heightened market volatility in early-2020.

Nonetheless, it found that revaluation frameworks needed to be improved given limited board engagement and some examples of over-reliance on external parties. Those organisations with pre-established valuation committees typically had more robust valuation frameworks.

The review ultimately led to the first overhaul of SPS 530 (Investment Governance in Superannuation) in a decade, which now places the governance of valuations into a legally-binding prudential standard.

SPS 530 requires an RSE licensee to have an adequate valuation governance framework, which outlines the structures, processes, procedures and controls necessary to identify and manage valuation risk.

The valuation governance framework must include a board-approved valuation policy which, at a minimum, outlines:

- Roles and responsibilities for the oversight and management of valuation processes and procedures, including of the board, relevant board committees and senior management (valuation authorities).
- Key metrics and information that must be reported to the valuation authorities and the frequency of that reporting.
- Valuation methodology employed for each asset class (and sub-asset class and instrument/holding vehicle type where relevant), including the sources of valuation inputs.
- Circumstances where independent external valuations must be obtained.
- The frequency of valuation of investments having regard to the prevailing market, economic environment, member equity considerations and matters concerning the ongoing appropriateness of the asset valuation.
- Circumstances where interim valuations are needed to ensure the approach taken is consistent and transparent.
- The manner in which there is a clear escalation process to assess concerns about a particular valuation.

The new SPS 530 standard took effect on January 1, 2023, while an update to the associated APRA Prudential Practice Guide SPG 530 (Investment Governance) has just this month (July 2023) been issued as final by APRA after a four-month consultation period that concluded in March 2023.

Some funds are well advanced in these areas while others are strengthening their practices.

In January 2023, APRA Deputy Chair Margaret Cole said APRA expects all trustees to have undertaken self-assessments and develop plans to remediate any deficiencies identified[1].

> "The reviews focused on strategic planning and member outcomes, fund expenditure and unlisted asset valuation practices. Many of you will have already experienced APRA's ongoing focus on these areas last year. We called for additional information from a number of you in relation to your valuation practices of certain unlisted assets."
>
> – Margaret Cole

[1] APRA Deputy Chair Margaret Cole - Speech to the Conexus Financial Superannuation Chair Forum | APRA. (2023, July 20). Retrieved from https://www.apra.gov.au/news-and-publications/apra-deputy-chair-margaret-cole%C2%A0-speech-to-conexus-financial-superannuation

Why valuations are important

Getting valuations correct is a fundamental responsibility for trustees to ensure member equity, particularly in Australia where defined contributions dominate the retirement system.

Maintaining accurate unlisted asset valuations is essential for:

- **Investor protection** - Fair value provides investors with a reliable benchmark of the investment's worth.
- **Transparency** - Fair value allows investors to understand the true value of their holdings and make informed decisions regarding their investment strategies.
- **Equitable treatment** - Fair value ensures all investors are treated fairly and have equal access to the unit trust's assets, regardless of the timing of their investments.

The repercussions of inaccurate valuations have wide-ranging impacts across the entire retirement landscape:

- **Investors** - Incorrect unit prices can misinform investors and lead to poor investment decisions. They may suffer financial losses or miss out on potential gains due to inaccurate valuations.
- **Trustees** - Trustees are entrusted with the responsibility of safeguarding investors' interests. Not maintaining accurate unit prices can damage a fund's reputation and expose them to regulatory repercussions.
- **Market integrity** - Inaccurate valuations can undermine the overall integrity and stability of the market, as investors rely on accurate pricing for fair and efficient trading.

The potential impact of inaccurate valuations on members is a particularly important issue. Members have not only choice of fund, but investment choice, allowing them to quickly move or switch investments. When members move their money on a frequent basis, there is a potential timing mismatch given unlisted assets are valued quarterly, semi-annually, or annually. An inaccurate or 'stale' valuation embedded in an investment option's unit price can impact equity between members. While this timing mismatch is less of an issue in normal market conditions, it can be impactful during periods of significant change.

Different asset classes: unlisted property under pressure?

There are a wide range of sub-sectors within the unlisted asset class. While rising interest rates and inflation tend to drag down all valuations, each sub-sector responds in its own way depending on its characteristics.

For example, unlisted infrastructure valuations have largely remained resilient despite significant increases in risk-free rates across OECD countries in 2022. However, there are also sound reasons that may be driving what superficially appear to be such counter-intuitive valuation decisions.

Fund managers have had greater look-through and certainty in their unlisted infrastructure companies' business plans and revenue growth coming out of COVID-19. Assets such as airports, seaports and toll roads are often quasi-monopolies with ongoing strong demand. Revenue is often protected through inflation-linkages, or through government contracts on a fixed or availability basis rather than usage basis. As an example – people have been travelling more (making up for lost time from COVID) and some infrastructure assets are contracted on an availability basis as opposed to a usage basis. So even though discount rates are rising, assets with higher volumes or locked in revenue are less sensitive to rising rates (particularly if they have lower financial leverage and hence rising costs).

Meanwhile, gearing generally remains at conservative levels while many assets are supported by significant levels of long-term fixed financing, reducing the need to raise debt in a higher interest rate environment.

Nonetheless, valuation pressure is still building and valuers may have to continue adjusting their long-term risk free rate assumptions in this environment.

Unlisted property valuations are under greater pressure due to different factors, such as the entrenched work from home trend, which has lowered occupancy levels. There has been some speculation that unlisted property valuations could still fall by 15-20%[2].

While infrastructure assets tend to be valued on a cashflow basis, property tends to be valued on a transaction basis, and prospective sellers have not been keen to sell amid difficult market conditions.

Not all building sales among this smaller number of transactions will be used as comparable transactions.

Even if a building has been sold at a discount to its previous valuation, there may be other mitigating factors that have stopped it being used to lower the value of yet-to-be sold properties. For example, the property may have been built more recently, produce lower carbon emissions, be in a better location, or have higher quality of tenants.

Trustees must ultimately decide whether these are valid reasons to uphold the valuation or an example of a behavioural bias at play.

[2] Parker, D. (2023). Help for property investors: expert guide how to crack the stand-off in commercial real estate valuations. Australian Financial Review. Retrieved from https://www.afr.com/property/commercial/how-to-crack-the-stand-off-in-commercial-property-valuations-20230411-p5czhs

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Property valuations: a different experience overseas

Australian fund managers have been slower to raise unlisted property discount rates (and reduce unlisted valuations) compared to offshore managers. Meanwhile, valuers in the US, UK and Europe have been lowering unlisted property fund valuations since the second half of the 2022 calendar year.

There are some explanations for this difference.

The Australian market is dominated by a handful of property managers, where capital can be locked up for several years before redemption. The offshore market is overseen by a much larger universe of managers where investors can typically withdraw their capital each quarter.

This is one reason why offshore valuations have typically been conducted each quarter while Australian managers have relied on annual independent valuations, although many funds have appropriately moved to more frequent valuations while macro uncertainty persists.

Australian property funds tend to have lower leverage than overseas funds, which may also explain their slower re-valuation speed (as higher interest costs are not as much of an issue), and the Australian economy has been stronger than many other developed markets.

However, Australian funds and valuers also tend to rely more heavily on transactional data, which is problematic when there are few properties being sold during tough economic conditions or property sales are withdrawn because of unrealistic gaps between book values and offers.

There is a growing consensus that Australian property valuations are likely to fall in the next 12-18 months across several sub sectors, as cap and discount rates are adjusted.

How valuation processes can improve

The valuation processes trustees have employed to value unlisted assets has been generally sound and effective. However, there is also room to improve given the many different facets needed to produce robust valuations, particularly in a rising rate environment.

Both the SIS Act and Prudential Standard SPS 530 require trustees to "develop, maintain and implement an effective valuation governance framework".

But within this framework, there is no one-size-fits all solution. Each asset owner has their own unique challenges.

For example, a number of fund managers are currently increasing the frequency of their unlisted asset valuations to quarterly, however, this has to be balanced against the significant costs a full valuation incurs, which is ultimately borne by investors (members). Unlisted assets are long-term investments – there can be longer periods where valuations do not radically change.

Different unlisted assets also require their own unique valuation processes and challenges. A large private equity portfolio managed by an external fund manager may be harder to value than a small number of directly held infrastructure assets.

These types of issues are best worked through via an effective valuation governance framework, which trustees must carefully structure and regularly review. This ensures the framework is fit for purpose in a constantly changing regulatory and market environment. Trustees must be mindful that processes that have worked well in the past may not always work well under new market conditions.

Valuations should not be made by using a dominant single lens – such as comparable market transactions – but considered through multiple filters.

This is one of the issues currently facing the unlisted property sector. The Australian Property Institute released new guidance in 2021 addressing this exact issue ("Considerations when forming an opinion of value when there is a shortage of market transactions"), pointing to other information sources including pre-event transaction data, market intelligence, unsettled market transactions, observations from previous crisis events and the current share market, as well as market research from reputable sources.

Valuation factors such as these should be addressed in a systematic way outlined in the valuation governance framework rather than using an ad-hoc approach. This type of approach will lead to more accurate and nuanced valuations that differentiate between unlisted assets as well as their various sub-sectors.

Trustees should consider the following general rules to ensure fair value determination when valuing unlisted assets:

a. Independence. Engage independent and qualified professionals to conduct regular valuations of the unlisted assets held by the unit trust. These valuations should be based on reliable methodologies and industry best practices and should also source reference data from a variety of different sources.

b. Regular reviews. Periodically review and update the valuation of unlisted assets to reflect changes in market conditions, economic factors, and any material events that may impact their fair value.

c. Challenge. Have a process to effectively challenge valuations.

d. Oversight. Have valuation oversight by areas which are independent of the investment decisions.

e. Documentation and disclosure. Maintain comprehensive records of the valuation process, assumptions, and methodologies used. Disclose relevant information to investors, ensuring transparency and accountability.

f. Compliance. Adhere to regulatory requirements and industry guidelines concerning valuation practices, disclosure, and reporting.

g. Monitoring. Consider the assessment of, and monitoring of, external fund managers and their valuation processes. Also consider what questions to ask and when to challenge valuation outcomes.

By adhering to these principles and executing proper due diligence, trustees can enhance the accuracy and fairness of unit pricing where part of the strategic allocation involves unlisted assets, ultimately safeguarding the interests of all members.

The final word

Unlisted assets form a significant component of many asset owners' portfolios. They align well with the long-term nature of retirement investing and exhibit attractive risk-return characteristics. But valuing their worth, particularly during periods of economic or market stress, is challenging.

The heightened focus on unlisted asset valuations in recent years has been valid while recognising the system used to date has been far from broken. The necessary industry changes underway represent an evolution rather than a revolution.

Valuation governance frameworks are the key to ensuring valuations are as accurate as possible. They require careful design and structuring to ensure best practice governance such as appropriate levels of independence and oversight, including around monitoring, review, and any out-of-cycle adjustments.

An independent review of structures and systems can provide assurance to both the board and management that their valuation framework is operating effectively, meeting all regulatory obligations and represents robust, if not leading industry practice.

This can ensure trustees are meeting their fiduciary responsibility to ensure members are treated fairly and equitably across all member options, both listed and unlisted.

Want to learn more?

Frontier Advisors' Investment Governance Team offers a range of services to assist RSE licensees address the regulatory risk in this area. Please reach out to our team if you would like more information.

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