



Premium / Discounts to NAV in Alternative Assets

This is a really interesting topic to me. It seems like folks are all over the place on this one. I just finished reading an article called, "Modeling Illiquidity Premiums for Alternative Investments" by Renalto Staub in the CFA Institute's June 2010 pub. Without going into details, the guy argues an incremental return for illiquidity of between 2 and 4 percent for illiquid investments with lock up periods between 5 and 7 years. His approach is a return based approach, meaning he tacks that on to the required return. Using my monkey math, which I admit could be way off, this translates to a price to NAV discounts of between 6 and 11 percent (assumptions – reference rate of 8 percent, incremental premiums of 2 and 4 percent, 5 year time horizon). This compares to market data (a press release from Cogent Partners)

Dallas – February 1, 2010 – Cogent Partners, the leading secondary sell-side advisor to institutional investors in private equity, has released the second-half 2009 update to its ongoing study of pricing levels in the secondary private equity market. The most recent analysis shows a dramatic increase in pricing for secondary assets, with an average high bid of 72.0% of net asset value (NAV) during the second half of 2009. The analysis also reveals that large secondary buyers returned to the market and were willing to bid on large portfolios late in 2009.

"As the public equity markets recovered throughout the year, secondary market pricing levels for limited partnership interests also recovered, up dramatically from the 39.6% of NAV pricing seen in the first half of 2009," said Colin McGrady, Managing Director of Cogent Partners. "Ironically, despite the rising secondary market prices, the recovery in the public markets tempered institutional investors' liquidity needs, resulting in a much lower level of overall deal flow in 2009 than originally projected by many market participants."

This would suggest realized price to NAV discounts of between 38 and 61 percent. Huge difference. In the middle are the restricted stock studies and quantitative models (QMDM, protective puts). When doing FLP or similar type valuations where high net worth individuals have large investments in alternative investments like private equity, this delta has extremely meaningful implications from a tax perspective. I like the fact that there is increasing attention being paid to this area (as evidenced by the CFA article referenced above and market entrants like Cogent Partners serving as market makers). I think that its good for us as practitioners – the market data specifically will give us solid support for larger price to NAV discounts. I can't wait for a data service that will cleanse that data and give us access to it for use in our analyses.

