



## EY's Eisenberger: 'Fair-Value Pricing' Has Been Hard Amid The Virus Economy

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Chuck Jaffe, in The NAVigator podcast, interviewed Nicole Eisenberger, a partner at Ernst and Young. Read the Q & A below as Nicole explains why she says that the economic shutdown has created conditions making fair-value pricing of illiquid securities and assets difficult and



inconsistent, raising uncertainty for investors in business-development companies. Eisenberger discusses how the pricing systems work, how it impacts volatility, and what BDC investors should expect until there's a return to business as usual.

Nicole Eisenberger

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**CHUCK JAFFE:** Nicole Eisenberger, partner at Ernst and Young is here, and we're talking about fair value and what it means to business-development companies and you today on The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds and business-development companies. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry, from users and investors to fund sponsors and creators. And oh by the way, to accountants and accounting firms that work with closed-end funds and BDCs. If you're looking for excellence beyond indexing, The NAVigator's going to point you in the right

direction. My guest today is someone who works with one of those accounting firms. Her name is Nicole Eisenberger, she is a partner at Ernst and Young. If you want more information on the firm, EY.com, on Twitter @EYNews. If you want to learn more about closed-end fund investing, checking out the website of the Active Investment Company Alliance at AICAlliance.org. Nicole Eisenberger, welcome to The NAVigator.

**NICOLE EISENBERGER:** Thank you, Chuck. It's a pleasure to be here.

**CHUCK JAFFE:** We are dealing with a situation that is front and center for you and your clients. It is not necessarily something that the average public is that aware of and understands. But fair value and how things get priced on a fair-value basis is one of those things that comes up when people invest in illiquid securities. And it comes up when they have to value those securities. And when do they have to value them? Well, they have to do it pretty much every quarter. And so we've just been through a period where valuations in this viral economy, when some business are barely working and some are on life support, it all became pretty confusing. And the result has been a few rule changes, and a lot of wait and see and how do you do this, right?

**NICOLE EISENBERGER:** That's correct. I mean, you really summed it up Chuck. But I'll start with first-level setting for the audience in terms of defining fair value. I think that's a good place to start.

**CHUCK JAFFE:** That's absolutely a good place to start.

**NICOLE EISENBERGER:** Great. So the refresher for those who are familiar and for those who are less familiar, basically ASC 820 defines fair value as a the price that will be received to sell an asset or pay to transfer a liability in an orderly transaction between market participants at the measurement date. So what that basically means is that right now we're missing a lot of those components. We're not seeing a lot of those transactions. A lot of those transactions are not necessarily orderly. Who are the market participants at the 3/31 date? So a number of things that need to be considered in looking at the fair-value; a fair-value measurement is made up of one or more inputs, some observable, some not observable. And again, in this market dislocation, how will companies arrive or derive those inputs?

**CHUCK JAFFE:** And to maybe make this a little bit more accessible, think of it this way. As an individual, if you wanted to come up with fair-value and said, "Oh, I bought a valuable asset. I bought a gold ring." Well, I could say, "What's the gold price?" and we could come up with

it there. But, "Oh, does it have other things with it? What's happening with the price? What's going to happen with everything else? Ooh, the gold market's now closed." It's all that stuff that comes together. And most people would say, "Oh, I have a gold ring. It's worth what I paid for it or maybe a little bit more." And in their head, if they were calculating their net worth they would say, "Yeah, that's what the gold is worth." But we don't get to stay in our heads when we run a BDC, we've got to come with an actual market value for that thing that might be amorphous in the value, right?

**NICOLE EISENBERGER:** That's fair as well, Chuck. And especially in the past, where perhaps around the quarter end you may have had a value that was struck and transaction that occurred. We normally, or companies who normally look at that value say, "Well, that's a pretty good proxy for my value at the measurement date. It recently occurred. There hasn't been a lot of movement in the market. Perhaps the transaction price, i.e. the cost of that transaction, would be akin to what the fair value would be." Unfortunately today that's not going to be good enough. Today given the fast moving market and all the changes that are happening so rapidly, that's no longer going to be a very good proxy for fair value.

**CHUCK JAFFE:** So what we have with BDCs, is you've got business-development companies that maybe they own say, an energy company. They've got energy company assets, and the stock might be down a bunch, but the assets and some of the things that the BDC is investing in, they're not directly owning the stock. So they could be down more or less, right?

**NICOLE EISENBERGER:** That's true, and it will be specific to the asset by asset case by case, credit by credit analysis. So while you might see a particular sector or industry down by X percent, it wouldn't necessarily be appropriate to apply just that blanket percentage to the BDC's investment. They will need to look at, "Well, what do I actually own specifically? Where is it within that sector? And how has that been reflected in the fair value of my asset as opposed to this blanket percentage decrease?"

**CHUCK JAFFE:** When this translates down to an investor, does it become a case where we have to worry about whether or not we can trust the price we're seeing on a BDC? In other words, I'm looking at a BDC and it's got a market price that should be based on the net asset value of what it owns, but it's got to do a fair market value. When there's a problem with fair market value, that typically is when we see a dislocation. It's when we go, "Oh, the thing I thought was worth a hundred dollars a share yesterday is today only worth eighty dollars a

share because some underlying asset blew up." Are we in jeopardy of that kind of thing? Where you think you trust the market prices and whatever, but we could see problems? Or no, everything they're talking about right now is designed to fix that?

**NICOLE EISENBERGER:** Well, I think there's always a risk. But I think the intent is that if companies have done an appropriate job in fair valuing those underlying investments and assets, and that those are subject to some level of review by the auditors, the hope would be, and the intent is that those numbers that are being published and used in the financial statements should be accurate. Now when I say accurate, what does that mean? It means a best estimate, because nobody really has a crystal ball. Nobody really knows exactly what the fair value is, especially in this market. And so it really is going to reflect the company's best estimate for the fair value at the measurement date. And what you're going to see is, you're going to see disparaging versions of that. What I expect to see is that they'll be a number of companies that may even hold the same asset at varying prices. Where you might have seen tighter ranges, they may have been carrying it at a similar price. Now you might see very wide disparity in that range. So my expectation, because the information being used to arrive at those fair-values, the inputs being used, there's significantly less transparency in the market. And so each of those companies are going to have to take that information, digest that information, decide what is relevant for their asset, and put a number of best estimates together. The duration of this dislocation. Duration of a potential recession. Whether this industry is going to recover and when. And again, the quality of the credits of the underlying company, they probably will not have updated operating information to work with. And so each company is going to be in a difficult position to arrive at their fair value. Hence, you're going to have varying fair values. But that doesn't make them necessarily erroneous as management's best estimate.

**CHUCK JAFFE:** Yeah, it's not a case where the numbers are something that is not trustworthy. But it could be a case that we wind up seeing more volatility as more evidence comes into play, right?

**NICOLE EISENBERGER:** That's correct. And that's what's going to be very important. And I think myself, where I sit on this side of the table, it's going to be important how companies document their rationale and support those values that they arrive at. Since it's going to be that difficult, it's going to be how did you come up with that value? What information did you

use? Did you consider all information available, known and knowable? Did you consider any contrary or contradictory evidence? And in taking all that, facts known at the time, how did you assess that, come up and rationalize your value, and then document that rationalization?

**CHUCK JAFFE:** From the standpoint of somebody who invests in BDCs, is this just a case where it doesn't really effect you as long as you remain a shareholder? In other words, if you have full faith and confidence and you're going to ride it out, that's where you kind of go, "This will play out however it plays out in the end, and it will all come out in the wash." And the only people to whom it matters realistically in the interim, are those folks where you're thinking you're going to sell and you want to make sure you really understand that value is the value, and whatever the price is, as bad, or maybe as good as it appears?

**NICOLE EISENBERGER:** I think in large part that's true.

**CHUCK JAFFE:** Obviously we've got to see how the economy does, but is there a point where you could sit there and say, "Hey, when we get back to normal, fair value gets back to normal"?

**NICOLE EISENBERGER:** We would probably say fair value is exactly what it is. We're still fair valuing now in this market as in any other market. I think the difficulty is how we're coming up with those fair-value estimates, and the level of transparency and how much guesswork or estimation is involved. But at the end of the day, I think that the intent of the ASC 820 is to have fair value in any kind of market.

**CHUCK JAFFE:** Nicole, thanks so much for joining us to talk about it.

**NICOLE EISENBERGER:** My pleasure. thank you again for having me.

**CHUCK JAFFE:** The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. I am Chuck Jaffe, your host, you can learn more about my work and my show at MoneyLifeShow.com. To learn more about business-development companies and closed-end funds, go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest, Nicole Eisenberger, partner at Ernst and Young, which is online at EY.com and on Twitter @EYNews. The NAVigator podcast is available every Friday, please subscribe where you find all your favorite podcasts. We hope you'll join us again next week, and until then, please everybody, stay safe.

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