

Valuation of Private Debt Investments

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Valuation of Private Debt Investments

Executive Summary

- The European private debt market has experienced significant growth with assets under management (“AUM”) for private direct lending strategies increasing from €8B in 2012 to €120B in 2020.¹
- The increasing importance of private debt as an asset class in investors’ portfolios, coupled with the illiquidity of the underlying instruments in this market, necessitates the need for ensuring best practices and consistent standards in the valuation of such instruments.
- Incorporating fair value standards for the valuation of private debt instruments can help enhance transparency vis-à-vis investors, facilitate comparability and benchmarking of manager performance, and provide an additional representation of evolving risks associated with the underlying instruments based on credit quality of the borrower and market conditions.
- Whilst the private debt market in Europe initially lagged behind its US equivalent in terms of growth and size of the market, it has significantly increased in size in recent years. A certain convergence of best practices and standardization of valuation principles is therefore seen as a natural requirement for the asset class to become more widely accepted in portfolio investment allocation decisions.

Introduction

Over the past decade, direct lending has emerged as the dominant strategy of Europe-focused private debt. With interest rates at record lows and an influx of money supply in the economy due to the expansionary monetary and fiscal policy measures taken globally in light of the COVID-19 pandemic, asset managers are looking to private credit and direct lending for yield opportunities. Emerging from the pandemic, establishing a robust valuation framework for private debt as a growing and maturing asset class will be critical from a regulatory and investor reporting stand-point.

Developing a Framework for Private Credit Valuation

Investors in private debt funds typically require net asset value to be reported on a fair value basis consistent with IFRS 13 and US GAAP ASC Topic 820, with fair value being defined by both US and international accounting standards 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.”

Therefore, in order to decide on the appropriate approach for estimating fair value of a private debt instrument, a security coverage assessment is carried out to determine whether the debt is expected to be fully covered through a coverage assessment in the first instance.

Figure 1: Security Coverage Assessment



¹As per data from Prequin.



Assessing Debt Coverage

Such an assessment is meant to help determine the appropriate methodology to utilize for the valuation of the underlying private debt instrument. For a corporate debt exposure, the coverage analysis is based on a determination of the Enterprise Value of the borrower, which is then compared with the borrower's outstanding debt obligations via an analysis of its capital structure.

There are two approaches to assessing Enterprise Value: 1) Market Approach and 2) Income Approach.

- **Market Approach:** Obtained by selecting market observed measures of valuation metrics through comparable listed companies or precedent private transactions.
- **Income Approach:** An intrinsic approach to valuation based on the underlying cash flows of the business discounted at an appropriate discount rate.

Enterprise Valuation Methodologies

Comparable Companies: The comparable companies approach utilizes financial and market information of listed securities of companies engaged in businesses as similar as possible to those of the subject company. This method uses calculated market multiples for selected publicly listed guideline (or benchmark) companies and applies such multiples to the appropriate financial measures of the subject company to derive value indications. In this approach, one typically uses EV/EBITDA and EV/sales, which are the most common multiples. Data references should typically be aligned across comparable companies and be as current as possible to ensure that the respective market dynamics are factored in. Furthermore, comparable company selection should remain relatively stable over the life of the exposure in order for the exercise to be meaningful and ensure consistency over time, unless there are fundamental reasons for the comparable company set to evolve over time. Examples of such situations may include a newly listed comparable company being added to the set or changing product/geography mix for the subject company that necessitates a rethink of the most comparable peer set. Whilst it can be challenging to identify pure-play peers given the nature of the typical private debt borrower vs. large publicly listed companies, there is merit in making sure the comparable company set includes a range of broadly comparable peers to mitigate any potential for outliers to skew outcomes.

Precedent Transactions: This approach relies on an analysis of transactions where companies similar to the subject company have had observable corporate activity. This method calculates market multiples based on actual acquisition multiples of similar businesses and applies these to the appropriate financial metrics of the subject company to derive value indications. However, given the largely confidential nature of purchase prices being paid for assets as well as the private financials of the targets, implied EV multiples for appropriate transactions can be difficult to source.

When selecting comparable companies and precedent transactions, careful attention should be given to both operational and financial considerations for assessing comparability. Operational factors should include industry, business model, size, and geographic diversity as a minimum, but (if possible) should also factor in product diversity, competitive position and market share, nature of suppliers, customers, distribution channels, and cyclicity, amongst others. Financial factors include capital structure composition, profitability, growth prospects, liquidity, and recent or pending corporate actions. Other considerations that one must incorporate include the following:

- What are the appropriate valuation metrics (i.e. revenue, EBITDA, etc.) for the industry in which the company operates? Metrics can vary substantially by sector (e.g. financial institutions, natural resources, real estate, etc.).
- Are the selected operating metrics representative of the company's sustainable go-forward operating results?
- Is it appropriate to make any adjustments for one-time or non-recurring events?

DCF Analysis: The DCF approach provides an indication of value based on the present value of anticipated future cash flows, discounted at an appropriate present value factor reflecting the risk inherent in the investment, as well as the time value of money. The primary inputs to the weighted average cost of capital (WACC) rates are the cost of equity capital, cost of debt capital, and capital structure observed in the market. When selecting a WACC, careful consideration must be given to 1) current stage of development of the company, 2) risk profile inherent in the investment, 3) growth prospects, 4) management's ability to (and track record of) accurately projecting the company's future cash flows, and 5) nature of business model/

industry and its impact on visibility of future cash flows (e.g. a SaaS company would have high levels of visibility in contrast to a retail company).

Income Approach – Yield Analysis

When an enterprise value analysis or asset collateral analysis indicates there is sufficient coverage through the subject debt security, an income approach with a yield analysis is generally considered the most appropriate method to estimate fair value. In performing a yield analysis, the periodic cash flows that the debt instrument is expected to generate over its remaining estimated holding period are first estimated.

Projected cash flows are then converted to their present value equivalent utilizing a rate of return commensurate with the risk of achieving the cash flows, which results in an estimate of fair value of the debt instrument. The discount rate can be derived considering the rate of return implied by the original primary debt financing transaction, adjusted for changes in both market spreads and credit-specific factors.

The primary question that must be answered when analyzing changes in valuation relates to “What has changed?” Specific questions include the following: How have market spreads and yields changed? How has the company’s financial performance changed? Are there any other company- or industry-specific factors to consider?

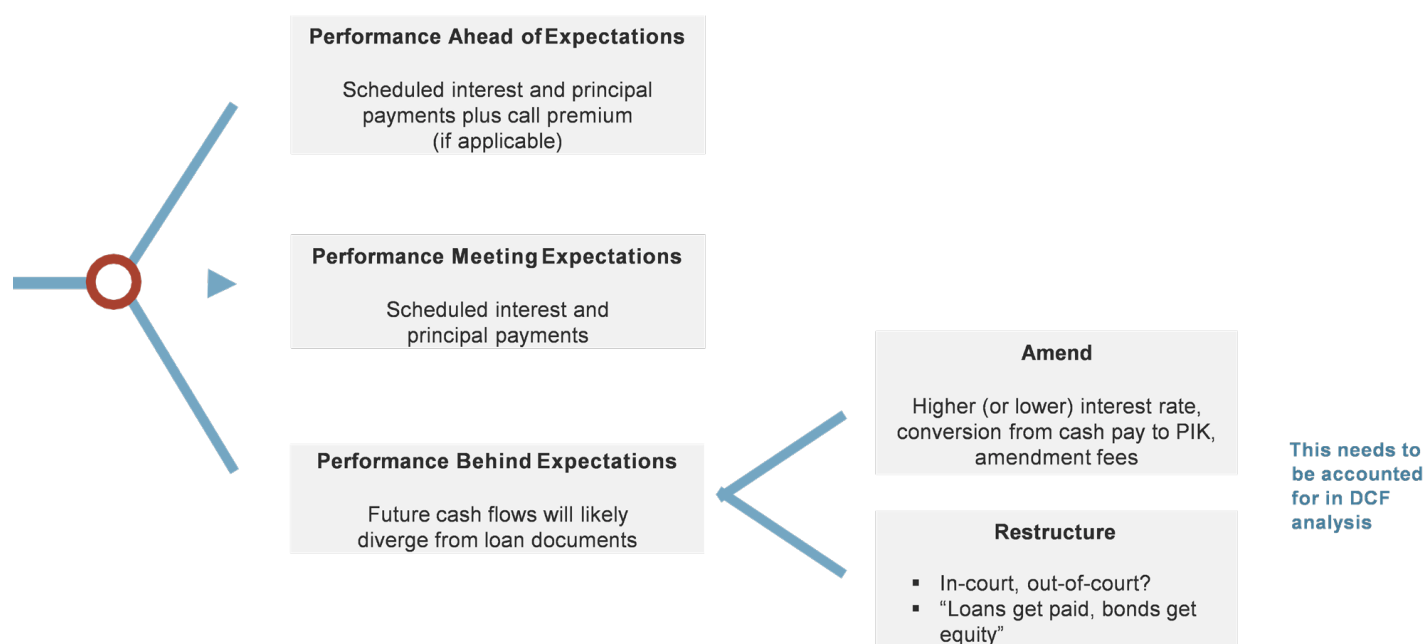
Maturity Considerations

A specific consideration that relates to the projection of cash flows for the debt valuation is the holding period applicable to the instrument (contractual maturity date vs. expected repayment date). Loans are frequently repaid or refinanced prior to maturity for a variety of reasons, including a sale of the business, refinancing to take advantage of lower interest rates, or to simply change the makeup of the financing structure, restructuring due to financial distress, etc. The timing of the cash flows is an important determinant to the value of a loan.

Since the contractual interest on a loan does not change (absent changes in margin due to ratchet mechanisms), the value of a loan adjusts to provide the investor with the required market yield. If the coupon on a loan is substantially above or below the current required yield for the loan, the impact on the value of the loan will be marginal if the loan is expected to be paid off in the near term; however, the impact could be significant if the loan is expected to be outstanding for a long period of time. If it is outstanding long enough, even a small differential between the stated coupon and the current required yield could result in a significant difference between the market value and the par value of the loan. Cash flows utilized in the valuation should typically be based on the expected term, which may not necessarily be the contractual maturity.

Figure 2: Factors Impacting Debt Valuation

Valuation Considerations	Reasons for Changes in Loan Value
Market Rates	Clear consensus in tightening/widening of spreads/yields.
Company Performance	Performance year over year. <ul style="list-style-type: none"> ▪ Performance versus budget. ▪ Performance versus expectations at origination. ▪ Leverage ratio changes since origination. ▪ Voluntary principal payments. ▪ Changes in covenant-level cushions.
Asset Coverage	Loan-to-value metrics over time.
Observed Secondary Market Trades	Non-distressed arm’s-length trade.
Other Considerations	Has been amortizing down. <ul style="list-style-type: none"> ▪ In discussions with lenders regarding refinance. ▪ In discussions regarding sale (change of control). ▪ More junior tranche is publicly traded at higher/lower yield.

Figure 3: Holding Period Assumption When Projecting Cash Flows

Net Recovery Approach

If a loan is no longer performing (i.e., in payment default) or otherwise not expected to be fully recovered under its legal terms of repayment, the net recovery approach can be used to estimate fair value. The net recovery approach is applied by performing a waterfall approach.

In the waterfall approach, the value of the subject security is determined based on the level of enterprise or collateral value coverage allocable to its tranche in the capital structure.

Liquidation Approach

When an issuer has entered bankruptcy and/or is no longer considered to be a going concern, a liquidation analysis can be utilized to estimate the value of the subject security. In this circumstance, the remaining assets are appraised at fair value and the fair value is discounted to reflect the time to liquidate, the costs of liquidation, and the uncertainty around the sale of the assets in a forced liquidation.

A liquidation approach may warrant a scenario analysis, in which potential upside and downside cases are considered.

Figure 4: Sample Waterfall

Outstanding Debt		Waterfall Approach	
		Value	Coverage (%)
First Lien	€ 80.00		
Second Lien	€ 50.00		
		Enterprise Value	€ 100.00
		Less:	
		First Lien	€ 80.00
		Second Lien	€ 50.00
			€ 130.00
		Excess/(Deficit)	(€ 30.00)
		Implied Value of Second Lien	€ 20.00



Other Specific Considerations in Private Debt Valuation

Forecast Case Selection

The selection of the appropriate financial projections is a crucial step when performing income-based valuation exercises. It is part of the valuer's role to evaluate the forecasts provided and select the most representative set of forecasts at each valuation date. Key considerations when selecting cases include the following:

- The projected cash flows should capture the amount and timing of all future cash inflows and outflows associated with the asset.
- When several sets of projections are available (e.g. base case, downside case), the selection of the appropriate set should be supported by comparisons with latest performance dynamics and discussions with forecast providers.
- If there are multiple scenarios, the projected cash flow will reflect one of the following:
 - The single most likely set of cash flows;
 - The probability-weighted expected cash flows; or
 - The scenario analysis representing a range of outcomes being the most commonly accepted approach for valuations performed in a context of high volatility and market uncertainty, as in the case of the COVID-19 market disruption.
- Discount rate adjustments to correct for stale and overstated cash flows expectations are not the best practice.
- It is part of the valuer's role to guarantee that the forecasts utilized are fully reflective of all the available information concerning the borrower and its reference market as of the valuation date.

Strength of Financial Sponsor

The strength and quality of the financial sponsor backing the issuer of the private debt facility is also an important qualitative consideration when assessing the valuation of the private debt instrument. In particular, the financial sponsor may play a key role in the preparation of robust, well-maintained financial projections and in the development of forecast cases that reflect plausible

upside and downside scenarios. In addition, the ability and willingness of a financial sponsor to support the business can be considered an important credit-enhancing feature, particularly in times of financial distress and market volatility. During the COVID-19 pandemic, borrowers that were systematically impacted by the effect of lockdowns often required shareholder liquidity injections in addition to debt covenant reliefs and other support from creditors.

Consideration of Revolving Credit Facilities (“RCFs”):

Some additional assumptions are required in order to adapt the private debt valuation income approach to the specific characteristics of an RCF. There are three main categories of approaches that can be followed in that respect:

1. Fully Drawn Approach:

- The fully drawn approach bases the valuation of the RCF facility on the assumption of such an instrument being fully drawn until its contractual maturity.
- Under this assumption, the cash flows generated by the RCF are comparable to the ones generated by other private debt instruments such as term loans.
- Although easily implementable, this approach does not allow the valuer to give an appropriate consideration to the RCF's distinguishing characteristics and expected drawdown/repayment profile.

2. Projected Drawdown:

- When detailed forecasts on the borrower's future cash flows and liquidity needs are available, the RCF valuation can rely on detailed projections of the drawn balance at each time until the instrument's maturity.
- This approach allows for a more accurate consideration of all the RCF's distinguishing characteristics and factors in the expected cash flows related to both the drawn and undrawn portion of the RCF.
- On the other hand, the implementation of such approach requires a high visibility on the borrowers' future performance and liquidity needs.

3. Average Balance Approach:

- The average balance approach assumes the RCF average drawn balance over its life based on management expectations.
- This approach considers some of the RCF's key characteristics (e.g. commitment fee) whilst ignoring some other aspects such as detailed cash sweep and drawdown expectations.
- Such an approach can be implemented in case of relatively low visibility on the borrower's future cash flows and liquidity needs.

within each valuation approach as inputs can still differ substantially but might also see a greater adaptation of practices used across the more mature North American market. Given the illiquidity of the product, we might not necessarily see a significant shift towards fair value reporting over the short term. However, managers might increasingly opt to provide valuations covering both approaches to satisfy investors' needs, which will likely also cause an uptick in the use of external valuation providers as a trend that is likely to continue further facilitating standardization.

- A supplementary comprehensive technical guide on valuation of private debt instruments has been prepared to augment the concepts introduced in this publication.

Conclusion

- This Insights publication aims to provide a primer to the methodologies and practical considerations faced by valuation practitioners when trying to assess valuation for private debt instruments.
- Traditionally, private debt fund managers in Europe have been found to be dispersed in their adoption of fair value accounting vs. impairment assessments for their credit portfolio holdings. This is also very much driven by the different investment mentalities between the US and European markets and managers typically tailoring their policies to the geo-graphic focus of their investor base or their own roots being originally state-side or European. However, given increasing scrutiny from investors, regulators and auditors, we would expect valuation practices to become more and more streamlined – that is,

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