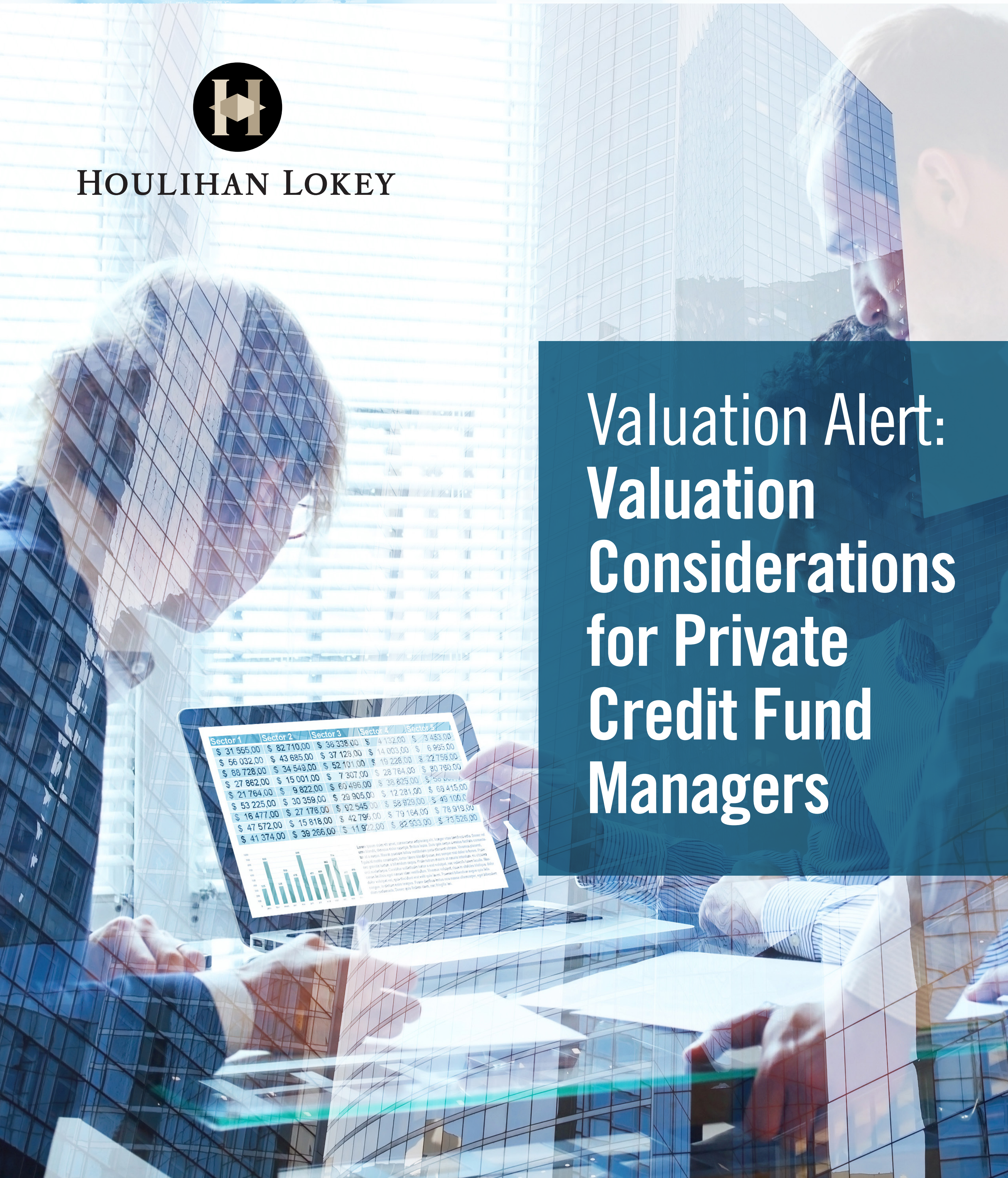
April 2, 2020

SPOTLIGHT ON **COVID-19**

HOULIHAN LOKEY



Valuation Alert: **Valuation Considerations for Private Credit Fund Managers**

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COVID-19's impact on the primary and secondary loan markets has been unprecedented. For the week ended March 27, 2020, the weighted average bid of the S&P/LSTA Leveraged Loan Index plummeted 770 bps over a two-week period to 82.37 from 90.13. According to S&P LCD, the spread between the average bid and ask LSTA Leveraged Loan Index widened to 333 bps over the same time period as the market broadly remained in price discovery mode.

In this alert—the fourth in a series of alerts—we discuss specific valuation considerations for private credit fund managers as they estimate the fair value of their investments in these turbulent times.

Principal Market

Private credit funds and associated stakeholders should frame valuation decisions and associated valuation inputs in the context of the "principal market" for the directly originated or bilateral loans under consideration. FASB Accounting Standards Codification Master Glossary defines the principal market as "[t]he market with the greatest volume and level of activity for the asset or liability." From an investment strategy perspective, private credit managers typically view their principal market for direct loans as the primary market whereby exits are usually achieved either via refinancing or sponsor- or issuer-driven trade sales. As such, fund managers should focus on analyzing current economic terms being sought in the form of LIBOR-floors, expanded interest margins, and/or deeper original issue discounts (OID) in recently closed or in-process comparable primary market transactions when trying to determine required rates of return under current market conditions. In the absence of direct originations in the primary market, fund managers may need to consider implied yields from secondary market trades when estimating the fair value of private, bilateral direct loans.

Portfolio Review and Risk Scoring

Private credit fund managers may want to risk score the underlying issuers of debt in which these managers have invested and categorize them into high, medium, and low risk buckets.

Generally, high risk buckets will include issuers in sectors clearly impacted by COVID-19 and geopolitical tensions induced demand/supply shocks as well as social distancing measures enacted by governments globally, such as travel, transportation, entertainment, leisure, and energy. Valuation methods and techniques used to estimate the fair value of the private credit instruments issued by these affected issuers may require a deeper review based on a variety of factors, such as the: (a) availability of updated financial information; (b) credit profile for the issuer prior to COVID-19 and the expected impact of COVID-19 on the issuers' businesses; (c) level of sponsor and lender support; (d) near-term liquidity needs; and (e) likelihood of an issuer experiencing technical and/or payment default under its various credit agreements. Ultimately, valuation methods for private debt may need to consider (a) an enterprise value recovery analyses through the subject instrument under current market conditions, and/or (b) the yield method, whereby contractual or expected cash flows of the subject instrument are discounted at required rates of return reflective of the heightened credit risk and higher price of risk under current market conditions.

The medium and low risk buckets will typically include issuers that are either indirectly or not materially impacted by COVID-19, geopolitical and social distancing shocks, and are performing in line or better than at underwriting (based on the latest available financial information). For these types of debt instruments, we anticipate that most private credit fund managers will continue to employ the yield method to estimate fair value, albeit with a real-time perspective on required rates of return.

Use of Observable Inputs

Fair value measurements require the use of observable inputs in the valuation process. This becomes particularly relevant for private credit fund managers that invest in larger issuers within the middle market that may have issued both quoted broadly syndicated securities and directly originated private securities within their capital structures. The yields on these traded or quoted securities can provide benchmarks, even if these issues and the supply/demand dynamics of their respective issuance markets are not identical to the issue being valued. For example, the implied yield for a directly originated subject second lien security could be benchmarked by the implied yield on a quoted or traded first lien issuance by considering the implied yield on the first lien and adjusting this observed yield for seniority and financial and business considerations associated with the subject issue. Similarly, in the current dislocated credit market environment, it may be possible to observe opportunistic trades in the secondary market whereby a private credit fund manager is able to add on to their existing position in an illiquid syndicated instrument that is typically never traded. Such trades should be evaluated to assess if they were orderly transactions and appropriate to calibrate against.

Measurement of Financial/Credit Ratios

While issuers may not have yet updated financial forecasts to incorporate the impact of COVID-19, it is critical for private credit fund managers to know if there have been any changes in a borrower's capital structure, such as recent drawdowns on revolvers and delayed draw term loans that were needed to fund operations during financial declines resulting from COVID-19. This will enable the private credit fund manager to appropriately assess the required rates of return at various attachment points across the issuer's capital structure.

The valuation of private credit instruments is even more complex today due to the uncertainty caused by COVID-19 and the associated dislocation in the private credit markets. Houlihan Lokey has assisted its clients through times of extreme volatility and exogenous events and is ready to assist you today. Please reach out to one of the team members below for more information.

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