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SPOTLIGHT ON **COVID-19**

HOULIHAN LOKEY

Valuation Alert: **Key Valuation Issues in Distressed Credit**

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Coronavirus-triggered economic downturn could lead to many performing loans to become distressed, especially for highly-leveraged companies. The extent of the downturn remains unclear given uncertainties of the trajectory of the pandemic and the unprecedented volatility in the financial markets. As such, the valuation of distressed credits requires approaches and considerations different from those used for performing loans.

The valuation of a performing debt instrument is typically fairly straightforward. It is normally based on the income approach, also referred to as a discounted cash flow analysis. This involves projecting the future cash flows and discounting them at an appropriate risk-adjusted discount rate. However, when a debt security becomes distressed, a traditional yield analysis may not be appropriate. In this alert, we discuss some distressed debt valuation considerations in the context of valuations for financial reporting purposes.

When Is Debt Considered Stressed?

Distress for a debt security may take many forms, but at its most basic level, financial distress occurs when the contractual cash flows are not expected to be received by the lender. Financial distress may be caused by a variety of factors. One factor could be an industry-specific decline, for example the negative economic impact of a sharp decline in oil prices on oil exploration companies. Another factor could be a broad market decline, for example the recent decline in the global debt and equity markets driven by the fear of potential economic repercussions from the coronavirus. In addition, distress could be caused by company-specific events such as the loss of a large customer, increased competition leading to declining sales or margins, unrealized synergies following a merger, or poor operational management. Warning signs of potential financial distress include financial metrics like insufficient enterprise value coverage or asset coverage, cash flow measures such as declining interest coverage ratio, the breach (or anticipated breach) of financial covenants, or other qualitative and quantitative indicators. If such warning signs are observed and the situation continues to deteriorate, the borrower may be unable to satisfy its contractual interest and principal payments.

When a borrower becomes distressed, a debt valuation based on traditional yield analysis may not be appropriate. Simply applying a higher discount rate to reflect the distress may not reflect fair value if the debtor is not expected to fully repay contractual cash flows. Rather, the techniques used to value distressed debt often involve estimating a range of possible outcomes, understanding the extent to which the investor can influence those outcomes, and evaluating the risks and uncertainties around those outcomes. Some of the more common outcomes are a turnaround in the business, sale of the business, new capital injected into the company, amending existing credit agreements, a restructuring, or a liquidation. Ideally, a valuation analysis would consider the likelihood of the potential outcomes and incorporate them into the analysis. There must also be a thorough understanding of the rights and privileges of each security in the company's capital structure.

Distressed Debt Valuation Considerations

Considerations when valuing distressed debt include:

- What were the causes of the company's underperformance?
- Is the underperformance temporary, or is it expected to continue? What are the company's plans to address the underperformance and the costs associated with these plans?
- What are the expected future cash flows for the company and what are the risks around achieving these cash flows?
- What is the seniority of the distressed debt? Does it have any collateral or guarantees? Does the company have other securities that have a priority claim on company assets?
- Is the borrower currently in default, or expected to be in default, under any of its credit agreements? If so, what are the likely outcomes (e.g., amend and extend, acceleration, voluntary or involuntary bankruptcy)? What is the timing of the outcomes and the probability of each outcome?
- What is a realistic enterprise value for the company? How much value coverage is there for the distressed debt?
- Does the company need to raise additional capital? If so, what form will that take and how will that impact the securities in the existing capital structure?
- Is a restructuring of the company likely? If so, will it be an in-court or out-of-court financial restructuring, and what are the implications on the valuation?
- Is a liquidation of company assets likely? If so, what are the expected recovery rates for each type of asset and how would those proceeds be distributed? Is the sale or closure of a business segment more likely?
- What are the expenses that would impact expected proceeds from a capital raise, restructuring, or liquidation?
- What are the negotiating dynamics between the various classes of debt and equity holders? Will this impact the allocation of proceeds differently than a simple waterfall through the capital structure?
- Is the borrower in default, or expected to be in default, under any of their credit agreements?

The valuation of distressed company debt securities is complex and requires considerable judgment. Traditional debt valuation approaches such as yield analyses using contractual cash flows may not be appropriate. Utilizing the expertise of a valuation provider that is well versed in distressed debt valuations can help make the process more efficient and robust. However, it is critical for the valuation provider to be fully transparent about the limitations of his or her analysis and the assumptions that are made in its preparation.

Houlihan Lokey has extensive experience in valuing distressed debt securities in addition to various other financial instruments and is ready to assist you today. Please reach out to one of the team members below for more information.

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