



Private Debt | Valuation White Paper

FEBRUARY 2022

Introduction and Purpose of this paper

When it comes to valuation of private debt assets, it is essential to keep in mind the great diversity that characterizes the asset class. Private debt first appeared in Europe as an add-on to the evolving bank-lending model. It originally concentrated on middle-market direct lending strategies, essentially comprised of senior debt instruments. The asset class then rapidly expanded across the entire spectrum of credit markets, from mezzanine to unitranche, special situations and opportunistic strategies, distressed debt, venture debt and secondaries. This also means a variety of underlying assets. Private debt instruments come in many shapes and forms, each with their own risk and return profile. Value may also be driven by special considerations, such as the addition of equity kickers, the co-existence of private and public debt securities, the quality and enforceability of the underlying collateral, and the varying degree of liquidity of the assets. Considering the diversified nature of the asset class, the premise of this paper is that there is no one-size-fits-all valuation model for private debt assets.

Furthermore, private debt funds evolve in an increasingly complex accounting and valuation framework. More private debt funds are setup as alternative investment funds under the Alternative Investment Fund Manager Directive (the "AIFMD"). It provides a general regulatory framework around accounting standards and valuation functions for all alternative investment funds. However, it does not impose any prescriptive valuation methodology. Most international guidance such as the International Private Equity and Venture Capital Valuation Guidelines (the "IPEV Guidelines") or the American Institute of CPAs Accounting and Valuation Guide for Private Equity and Venture Capital Industry (the "AICPA Guide") were primarily designed to address the valuation of unquoted and illiquid equity instruments. Private debt has long been considered as a niche market, and as such, has not been addressed in a sophisticated manner in most valuation literature.

The purpose of this paper is to raise awareness of the main difficulties faced while performing the valuation of private debt assets, especially when the instruments have no observable market prices.

Focus on valuation of debt instruments

A) What really matters

When deciding on the most appropriate method to value a debt portfolio, asset managers need to be mindful of several factors which will ultimately impose one method or the other, or even a combination of methods.

The thought process shall be initiated at time of designing the investment product, even before the legal team starts writing the incorporation documents of the vehicle. Too often the valuation method ends up being imposed a posteriori by the choice of an accounting principle or valuation guidelines with no consideration for the specificities of the debt portfolio to be valued. It is unfortunate considering the way it affects investors' reporting and may deviate from how market participants would actually value the instruments.

What matters?

Commonly what matters in the choice of a valuation approach is the investors' needs, the fund's need for liquidity and the applicable accounting framework:

- Investors' needs: when regulation allows it, investors' expectations will ultimately dictate reporting requirements.
- Fund's need for liquidity: open-ended funds must ensure a certain level of liquidities in case of redemptions. Consequently, those funds may typically invest in a more liquid portfolio with the possibility to trade on a secondary market and this portfolio should be valued accordingly. For all other funds, it is not that simple.
- Applicable accounting framework for financial reporting purposes: accounting principle provides more or less stringent requirements when it comes to valuation. In the case of IFRS, there is a common misconception that one can voluntarily opt for fair value and freely choose its valuation technique. However, under IFRS 9 not all loans should be fair valued. Indeed, if the loans' contractual cash flows consist solely of payments of principal and interest (the so-called SPPI test) and the business is held to collect contractual cash flows, amortized cost is to be used. When using amortized cost or cost less impairment, the asset manager needs to put in place a robust impairment or expected credit loss model. It is to be noted that IFRS also requires fair value disclosures when amortized cost is used in the main statements.

What are often ignored and are paramount for private debt players in the way portfolios' performance should be reported are the investment strategy of the fund and the economic purpose of the deal's terms:

- Investment strategy: is the investment vehicle committed in a buy-and-hold strategy or did it opt for a more opportunistic approach, trading assets on secondary markets? In the case of buy-and-hold strategies, risk of default of the issuer, loan servicing, timing of repayment and potential equity upsides are what really matters, much more than a hypothetical secondary market price.



- Economic purpose of deal terms: valuation theories may tend to recommend breaking down instruments in order to value them in pieces. In their vast majority, private debt players will not have any majority equity stake nor be part of shareholders' agreement which would assimilate their positions to a controlling role over the issuer. They may even have no alignment in interest with equity holders. However, the way they invest requires deal structuring and thorough reading of contractual terms and conditions. Most private debt deal will have tailored economic features. Even though from a pure legal point of view, the contracts can be split into loan agreement, put and call option agreements, warrant certificates etc...., those instruments are part of a unique deal and interact among each other according to the economic developments of the issuer (e.g., outperformance, budget not met, special circumstances...) and the specific return objectives of the investment manager (e.g., recurring cash flows, downside protection, equity upside...).

What is fair value for Private Debt?

The fair value of debt reflects the price at which the debt instrument would transact at arm's length between market participants transacting in an orderly manner at the measurement date. This value would consider the contractual terms of the debt instrument (e.g., coupon rate, contractual maturity, amortization and other pre-payment features, change of control provisions, conversion rights if any), the historical and projected financial performance of the borrower, the information that market participants would have regarding the plans of the borrower (e.g., expected time horizon), the risk of the instrument and the current market conditions.

What does it mean in practice?

Most likely market participants for this asset class would be buy-and-hold investors, and, to a minor extent, secondary buyers generally using a more opportunistic approach.

Secondary market trades are scarce for unlisted instruments, making the exercise of searching for a market price relatively vain.

When using either a mark-to-model, amortized cost or cost less impairment, it is essential to put in place a robust credit risk analysis. To do so, the fund manager needs to be able to have access to underlying financial information of portfolio companies. Due diligence process at time of acquisition and constant monitoring of the companies' KPIs are key.

B) Why inherent credit risk is key

When determining the value of private debt instruments, contractual terms and underlying asset exposure are taken into consideration. The debt instruments addressed in this paper are instruments with no market price publicly available or with observable prices which are not representative of a fair market value due to special circumstances or the lack of transactions in the market. An investor concerned by the actual cash flows to be received along the life of the debt instrument may have little interest in secondary transactions and market volatility at each valuation date, especially in a buy-and-hold strategy. For this type of



investor, an amortized cost approach would be better understood than a market yield approach.

Considering the small volumes of public comparable trades and the level of approximation it would concede, building a virtual yield curve at each valuation date would lead to a valuation outcome with a relatively low level of accuracy and disconnected from future cash flows. In the perspective of determining a market price for the debt instrument, a yield curve may still be built at the cost of a great amount of research. The level of accuracy reached by such a curve may however not weigh enough in the balance compared to the tremendous efforts it requires.

The underlying exposure (mostly business operating outlook, credit worthiness of the underlying company) is key in valuation. Therefore, a well-defined mechanism around credit risk management and restructuring plan in case of credit deterioration or default contributes to a more relevant valuation model. Credit risk framework considers the borrower's financial performance, capacity to meet interest and principal payments, valuation of the underlying collateral and its future market prospects. Covenant breaches are also a large part of the credit risk framework. In these cases, the adjustments in the valuation of the asset might be reflected through recoverable value. In addition, debt assets may be paired with equity kickers, options, warrants or rolled-up interest. A valuation model should then be more reflective of the underlying credit risk and counterparty risk.

c) Where option pricing models approach can fail

While private debt investment packages (including their equity kickers) prove their interests and attractiveness, their valuation appears to be an evolving subject. International guidelines may state that unquoted put and call options need to be valued through option pricing models and similar techniques. But, in the case of options attached to private debt, investors may be penalized by such models. Indeed, the options are singled out from the debt instruments in such a way that the economic substance of the deal as a whole is ignored, whereas the instruments are supposed to interact.

Existing option pricing models, from the simplest one to the most advanced, require key inputs. Here, valuations methods test the limits of all pricing models applied to unquoted debt ecosystem. While some determinants (strike price, expiry, dividends or risk-free rate) are well defined, some others may lead to instability, i.e.:

- How to determine a correct underlying volatility level?
- What is the correct current asset price at time of valuation?

Besides, the models have their own limits making them doubly penalizing for private debt pure players. They require large inputs and intrinsic assumptions which turn them complex to handle. In theory, option pricing models could be used to value any type of investments, including equity instruments, particularly in industries such as oil and gas, mining, life sciences and technology. However, in practice, market participants are reluctant to apply them considering the tremendous work and efforts it involves.



Alternative approaches to these models deserve to be researched and could consist in using a better quantification of the counterparty risk tied to those unquoted instruments through specifically designed default scoring models.

D) What if a loan is not performing?

With respect to loans under this category, it is important to understand the situation of the issuer: is it in default or close to default? What is the seniority of the distressed debt? Is it going through bankruptcy or has it breached covenants?

In case of insolvency or default, one needs to determine the recoverable value on the basis of the amount recoverable based on information received from the insolvency administrators such as the timing, the value and the cost to access collateral and guarantees, if any. In case of access to a collateral, the value of a collateral may be determined using the income, market or cost approach as appropriate based on the nature of the collateral. In case of access to guarantees, the terms of the guarantee agreement, the creditworthiness of the guarantor and consequent probability of recovery become essential. Careful consideration needs to also be placed to take into account applicable selling or liquidation costs.

In a going concern situation, the income approach may remain appropriate. The key difference with performing loans is to factor in the analysis of restructuring options, adjust cash flow forecasts based on updated payment schedules, and determine the probability of default and recoverability ratios. The probability of default can be estimated using historical data, credit rating methodologies, market data and other probabilistic statistical models. The recoverability ratio may be determined based on the enterprise value of the issuer applying commonly used valuation techniques.

Further, the issuer's forecast operating cash flows are also an important element in determining the recoverability of the loan cash flows. This requires a thorough analysis of the issuer's financial situation, the available cash flows, financial indicators, business plans, forecasts and circumstances to determine the most realistic future cash flows which can be recovered. The aim is to adopt a probabilistic approach, together with historical data from the loan and forecast financial information to predict how much the issuer will repay in the future.

The valuation of non-performing and distressed loans requires a high amount of judgement and technicity. Clearer guidance on the topic would help improving comparability of investors' reporting among fund managers.

Closing word

Private debt has been booming for the past decade, bringing to the market more sophisticated products and innovative investment strategies. Investors deserve to have a valuation guidance designed for this specific asset class and tailored for their reporting needs. This paper aimed at bringing light on the main challenges faced by debt managers when they report their performance. Discussions must be continued.