Private Debt: Valuations White Paper

by the LPEA Valuations cluster

and

in collaboration with the LVPA

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About LPEA

The Luxembourg Private Equity and Venture Capital Association ("**LPEA**") aims at promoting and defending the interests of investors and professionals principally active in the field of Private Equity ("PE") and Venture Capital ("VC").

The Association is the trusted and relevant representative body of PE and VC practitioners with a presence in Luxembourg.

Created in 2010 by a leading group of PE and VC players, with more than 600 members, LPEA plays a leading role locally, actively promoting PE and VC in Luxembourg.

LPEA provides a dynamic and interactive platform, which helps investors and advisors to navigate through latest trends in the industry. International by nature, the association allows members to network, exchange experience, expand their knowledge and grow professionally attending workshops and trainings held on a regular basis.

About LVPA

The Luxembourg Valuation Professionals Association ("**LVPA**") is the leading professional body representing the valuation community in Luxembourg. Dedicated to advancing the profession, LVPA promotes the highest standards of ethics, technical excellence, and continuous education in valuation practices.

As an associate member of the International Valuation Standards Council ("IVSC"), LVPA aligns with globally recognized standards and contributes to the development of best practices in the field.

LVPA regularly hosts technical valuation sessions for its members, fostering knowledge exchange and professional development. It also offers the Chartered Valuation Professional ("CVA") certification, a mark of distinction that recognizes expertise and commitment to excellence in valuation.

About the document

The work presented herein was prepared by representatives of the Luxembourg Private Equity and Venture Capital Association (the "**LPEA**") Valuations cluster in collaboration with the Luxembourg Valuation Professionals Association (the "**LVPA**").

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Introduction

The private debt market has undergone a period of rapid expansion, driven by a combination of relatively low interest rates in public markets, investor appetite for yield, and a structural shift away from traditional bank lending. Its growth underscores the increasing importance of private debt as a core asset class, with Luxembourg continuing to serve as a leading domicile for these funds.

As the market matures, private debt funds are operating within an increasingly sophisticated accounting and valuation environment. Many are structured as Alternative Investment Funds (AIFs) under the Alternative Investment Fund Managers Directive (AIFMD), which provides a regulatory framework for valuation and accounting practices. However, AIFMD does not prescribe specific valuation methodologies. While global guidance such as the International Private Equity and Venture Capital Valuation (IPEV) Guidelines and the Association of International Certified Professional Accountants (AICPA) Valuation Guide offer frameworks for illiquid equity instruments, there is limited guidance regarding valuation of private debt. This paper aims to bridge that gap by exploring the valuation methodologies applicable to private debt, with a focus on the choice between amortized cost and fair value, key valuation considerations, and the practical implications for fund managers operating in Luxembourg.

Cost versus fair value measurement

Two primary measurement bases under the applicable accounting standards, i) Cost-based approach (amortized cost or cost less impairment) and ii) fair value measurement, are used to value private debt. The choice between them depends on the fund's investment strategy, regulatory and reporting framework, and the nature of the underlying assets.

Measurement bases	Pros	Cons
Cost based approach *(amortized cost or cost less impairment)* Amortized cost involves recognizing the asset at its initial value, adjusted for repayments, amortization of premiums or discounts, and impairment losses. Cost less impairment involves measurement at the original cost of the asset minus any impairment losses recognized to date. Cost-based approaches are particularly more suitable for instruments held to maturity with predictable cash flows and stable credit risk.	• **Stability:** Reduces earnings volatility by avoiding frequent revaluations. • **Practicality:** Cost less impairment is straightforward to apply compared to the amortized cost and fair value approaches, especially for long-term, low-risk debt. • **Alignment with business model:** Suitable for entities holding debt to maturity.	• **Limited market insight:** May not reflect changes in credit risk or market conditions. • **Reduced transparency:** Investors may not see the true economic value of assets. • **Impairment complexity:** Requires subjective judgment in estimating expected credit losses.
Fair Value measurement Fair value is defined under IFRS 13 as the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. Valuation Techniques: • Discounted Cash Flow (DCF): Projects future cash flows and discounts them using a risk-adjusted rate, which considers credit risk, liquidity, and optionality. • Market Comparables: Uses recent transactions or	• **Market relevance:** Reflects changes in creditworthiness and market sentiment. • **Transparency:** Enhances investor confidence and comparability across portfolios. • **Regulatory alignment:** Complies with best practices for private capital valuation, aligns investor expectations and	• **Volatility:** Can introduce fluctuations in reported earnings and asset values. • **Valuation challenges:** Illiquidity and lack of observable inputs require complex modeling. • **Subjectivity:** Heavy reliance on assumptions and judgment, especially in distressed markets.

observable inputs from similar instruments. • Broker Quotes: Relevant valuation benchmark which references indicative or executable prices for similar securities from market participants (may need to be used with caution in illiquid markets).	regulatory best practices. • **Investor reporting:** Fair value is often considered more appropriate for investor reporting, even if the cost approach may be used for internal accounting.	

Accounting guidance

LuxGAAP: Under Luxembourg Generally Accepted Accounting Principles (GAAP), while cost less impairment is common, entities may adopt amortized cost or fair value if it better reflects the nature of the investment and is supported by a documented accounting policy.

IFRS: Under IFRS 9, financial assets should be measured at amortized cost if they meet two criteria: i) The asset is held within a business model whose objective is to collect contractual cash flows, and ii) The contractual terms give rise to cash flows that are solely payments of principal and interest (SPPI test).

IFRS 13 provides the global financial reporting framework for fair value measurement, requiring a market-based, rather than entity-specific, perspective.

When applied to private debt, the accounting standard requires that instruments be valued at the price that would be received in an orderly transaction between market participants at the measurement date. Given the illiquid and bespoke nature of private debt, fair value may be determined using income-based approaches, most commonly discounted cash flow (DCF) model which may require relying on unobservable inputs in certain cases. This is consistent with International Valuation Standards (IVS), specifically IVS 103 Valuation Approaches and IVS 105 Valuation Models, which provide practical guidance on selecting appropriate valuation methods and handling unobservable inputs, as well as application of appropriate valuation models. Unobservable inputs fall under Level 3 of the IFRS 13 fair value hierarchy, requiring enhanced disclosure and sensitivity analysis. Importantly, IFRS 13 mandates that valuations reflect current market conditions and risks, even when no active market exists, reinforcing the need for robust, well-documented valuation methodologies in private debt portfolios.

IVS: While Market Value is one of the recognized bases of value under IVS, the definition of Fair Value as set out in IFRS 13 is acknowledged in IVS 102, paragraph A.70 ‘Other bases of value’, as an appropriate basis when valuations are prepared for financial reporting purposes.

IPEV Guidelines: The IPEV Guidelines emphasize that private capital investments, including private debt, should be reported at fair value to ensure transparency and comparability. The guidelines align with IFRS 13 and advocate for market-based and income-based valuation techniques. Importantly, IPEV clarifies that holding private debt at par, face value, or cost is not consistent with fair value unless it reflects current market conditions. This is particularly relevant in volatile or distressed markets, where IPEV provides additional guidance on assessing orderly transactions and market dislocations.

Key valuation considerations

Valuing private debt requires a nuanced understanding of both quantitative and qualitative factors. The following considerations are key in determining value of private debt (under both measurement bases), and ensuring consistency with regulatory and investor expectations:

Under the cost approach:

- **Expected Credit Losses (ECLs):** Under the amortized cost approach, estimating ECLs for debt instruments is one of the most important considerations. It involves assessing the probability of default, the exposure at default, and the loss given default over the life of the asset. Under IFRS 9, entities must adopt a forward-looking approach, incorporating both historical data and reasonable, supportable forecasts of future economic conditions. This includes evaluating credit risk at initial recognition and monitoring changes over time to determine whether a significant increase in credit risk has occurred. The ECL model requires the use of judgement and robust modeling techniques to ensure that provisions reflect the true credit risk profile of the portfolio. The concept of ECL estimation concept does not exist in Lux GAAP and, allowing funds to adopt the cost less impairment approach.

Under the fair value measurement:

- **Credit risk assessment:** Valuers of private credit usually need to rely on internal credit assessments, financial statement analysis, and qualitative judgment. For example, a loan to a family-owned logistics company with high customer concentration and thin margins may warrant a significantly higher discount rate than one to a diversified infrastructure operator with long-term contracts. Importantly, credit risk is not static. It evolves with the borrower's performance, macroeconomic conditions, and even geopolitical developments. A loan that was investment-grade at origination may become speculative-grade within months if the borrower's sector is hit by a downturn. Valuation models need to be dynamic enough to reflect these shifts.

  As such, in the absence of an observable credit rating for the borrower, synthetic credit ratings are commonly adopted by valuers. Synthetic credit ratings are model-derived estimates of a borrower's creditworthiness, designed to replicate the output of traditional agency ratings (e.g., Moody's, S&P) using quantitative methods. The estimation process typically involves regression-based models trained on large datasets of rated entities, using financial ratios and macroeconomic indicators as explanatory variables. Common inputs include leverage metrics, interest coverage, profitability, liquidity ratios, and firm size. Outputs are often mapped to agency scales (e.g., BBB, BB) using scorecard techniques. While synthetic ratings lack the qualitative overlay of traditional ratings, they offer a scalable, transparent, and data-driven approach to credit risk assessment - especially valuable in private markets where opacity is common.

In cases where synthetic credit ratings are difficult to assess, valuers assume that credit quality is stable throughout the holding period, unless there is an indication towards the contrary.

- **Market spreads assessment:** Changes in market interest rates and credit spreads are critical inputs under a fair value basis of measurement. Spread analysis involves comparing the yield on the private debt instrument to prevailing market spreads for similar credit risk profiles, maturities, and structural features. This process helps determine whether the instrument's pricing remains aligned with current market conditions or requires adjustment. Spread analysis should also consider liquidity premiums, covenant strength, and seniority, as these factors influence investor demand and pricing. Robust documentation of the sources used is essential to ensure audit defensibility.

- **Calibration**: In accordance with the IPEV Guidelines, valuation approaches should be calibrated to observable market inputs at the time of initial recognition or when a relevant market transaction occurs. Calibration ensures that valuation models are consistent with the price paid in an arm's-length transaction, assuming market participants would have priced the investment similarly. This calibration point, often reflected in the Internal Rate of Return (IRR) of the original investment, serves as a benchmark to test the reasonableness of inputs such as discount rates, risk premia, or expected performance. Calibration is not a one-time exercise and is applicable only for arm's length transactions. It should be reassessed as market conditions evolve, and new information becomes available. If the assumptions used in the original model no longer reflect the current market or the investment risk profile, the model must be updated accordingly. This is particularly important in private debt, where infrequent transactions, limited price transparency, and bespoke terms can lead to divergence between book and fair value unless properly monitored.
  In addition to calibration, backtesting should be conducted where possible to compare actual exit outcomes with prior valuations.

- **Backtesting:** Enhancing the credibility of valuation models and reinforcing governance frameworks requires identifying systematic over- or under-valuation trends. This is achieved through backtesting which despite challenges due to the illiquid and long-term nature of private debt, can deliver meaningful insights. Periodic reviews of financial performance, covenants compliance, default and recovery rates, realized exits, and restructurings help assess how well models perform over time.

- **Valuation Policy:** The valuation policy should articulate the methodologies and measurement bases applied (e.g., amortized cost, fair value), the circumstances under which each approach is used, and the governance framework for periodic reviews and approvals. It must also address how significant changes in the nature of the instrument, such as a transition from performing status to NPL are handled. Additionally, the policy should outline calibration practices, backtesting requirements, and documentation standards to ensure audit

defensibility. Incorporating triggers for reassessment (e.g., covenant breaches, credit downgrades, or macroeconomic shocks) further strengthens the robustness of the policy. Ultimately, a well-structured valuation policy not only supports regulatory compliance under IFRS, Lux GAAP, and IPEV guidelines but also enhances investor confidence by demonstrating a disciplined and principle-based approach to valuation.

- **Macroeconomic sensitivity:** No valuation exists in a vacuum, and the broader economic and sectoral context can dramatically influence the assumptions underpinning a valuation model. Valuers and fund managers need therefore to stay attuned to macroeconomic indicators such as interest rates, inflation, GDP growth, as well as sector-specific dynamics. These factors inform not only the discount rate but also the probability-weighted scenarios used in advanced valuation models.
- **Market approach:** The market approach can provide a relevant benchmark for value, especially when market conditions are stable and comparables are available. Additionally, market comparables can be used in a DCF model to estimate the discount rate by referencing yields or spreads from similar publicly traded instruments. However, in practice, applying the market approach to private debt is often challenging due to the nature of these instruments and the limited transparency of private markets. Even when market data exists, adjustments need to be made for differences in seniority, covenants, or collateral, introducing subjectivity. Additionally, it is important to consider the liquidity of instruments considered comparable (as high-risk publicly traded instruments are often thinly traded). Moreover, stale, or indicative pricing (common in private markets) may not reflect current market conditions, requiring careful judgment and robust documentation to ensure regulatory and audit defensibility.
- **Covenant structures and breach risk:** Covenants play a critical role in shaping the risk profile of a debt instrument. These serve as early warning systems for lenders. From a valuation perspective, the presence of strong covenants can enhance the recoverability of a loan and justify a lower risk profile. Conversely, covenant breaches, even if not yet realized can signal heightened risk and necessitate a valuation adjustment.
- **Embedded features and structuring complexity:** Private debt instruments often come with embedded features that add complexity to their valuation. These may include call options, step-up coupons, equity kickers, or even convertibility into equity. Each of these features introduces optionality, which needs to be modeled separately. For example, a loan with a call option allowing the borrower to prepay after year three at a modest premium requires the use of a tailored approach (a variety of approaches such as option-adjusted spread (OAS) models, binomial trees or Black-Derman-Toy Model [1]or simply some probabilistic analyses can help capture the value of that flexibility). Similarly, a

[1] The Black-Derman-Toy model is an analytical model commonly used for pricing interest-rate derivatives. The model considers a given initial zero rate term structure of interest rates and a specification of the yield volatilities of long rates to build a tree representing the evolution of the interest rates.

mezzanine loan with attached warrants gives the lender upside exposure to the borrower's equity. In such cases, the debt and equity components need to be valued separately - typically using a DCF for the debt and a Black-Scholes or Monte Carlo simulation for the warrant.

- **ESG considerations:** The growing prominence of ESG considerations in private debt markets has introduced new dynamics in valuation practices. Instruments such as Sustainability-Linked Loans (SLLs) and the rise of SFDR Article 8 and 9 debt funds illustrate how ESG performance can directly influence pricing mechanisms, notably through margin ratchets tied to sustainability targets. These features not only reflect investor demand for responsible capital allocation but also impact on the risk-return profile of debt instruments. As ESG integration becomes more mainstream, its influence on valuation—whether through enhanced creditworthiness, reputational uplift, or regulatory alignment, warrants thoughtful inclusion in any comprehensive assessment of private debt.

- **Non-performance or defaults:** Valuing non-performing loans (NPL) follows a distinct approach, as these assets no longer generate contractual cash flows and are often subject to legal recovery processes. The valuation typically shifts from a going-concern basis to recovery-based models. The cash flows are discounted using a rate that reflects both the time value of money and the elevated risk of recovery uncertainty. Key inputs include the estimated time to resolution, legal costs, collateral value (net of haircuts), and historical recovery rates. In practice, NPL valuation often relies on scenario analysis or probability-weighted outcomes, especially when outcomes are binary (e.g., full recovery vs. write-off). For NPLs, the focus shifts to lifetime expected losses, often modeled using Loss Given Default (LGD) and Probability of Default (PD) assumptions tailored to distressed scenarios.

Practical considerations

When determining the appropriate measurement basis and valuation approach for private debt, fund managers will need to consider a combination of strategic, regulatory, and operational factors. The decision is not purely technical, it reflects the fund's investment philosophy, investor expectations, and compliance obligations.

- **Investment strategy alignment:** If the fund's objective is to hold debt instruments to maturity and collect contractual cash flows, amortized cost may be appropriate provided the SPPI test under IFRS 9 is met, or equivalent principles under Luxembourg GAAP. Conversely, if the fund actively manages or trades its debt positions, or if it reports performance on a fair value basis, then fair value is more suitable.
- **Regulatory and accounting framework:** While AIFMD II does not prescribe a specific valuation method, it reinforces the need for consistent, transparent, and independently governed valuation policies. Accounting regulations allow for both the cost and fair value approaches, with fair value often preferred for investor-facing reporting.
- **Data availability and model complexity:** Amortized cost requires less frequent revaluation and is operationally simpler, but it may obscure changes in credit risk. Fair value, while more complex, offers a dynamic view of asset value (especially important in volatile or distressed markets).
- **Investor transparency and NAV sensitivity:** Fair value enhances comparability and transparency, which is often expected by institutional investors. Amortized cost may be less informative in this regard, particularly when market conditions shift.
- **Audit and governance readiness:** Fair value requires robust documentation, model governance, and sensitivity analysis - especially when using Level 3 inputs. Cost based approaches may appear simpler, but still demand rigorous impairment testing and credit risk monitoring along with significant judgement in estimating ECLs.

Conclusion

While amortized cost offers simplicity and reduced volatility, fair value measurement (particularly when guided by IPEV and IFRS 13) provides a more transparent and market-aligned view of asset value. As private debt continues to grow in scale and complexity, fund managers need to adopt valuation practices that are not only technically sound but also responsive to evolving regulatory standards and investor demands, while also considering practicalities and operational ease. A robust, well-documented, and principle-based valuation framework is essential to maintaining confidence and ensuring long-term success in this dynamic asset class.

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