VALUATION SERVICES

Valuations Considerations When Loan Quotes are Widely Dispersed and There Are No Trades

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Due to the COVID-induced volatility, the number of available broker quotes has been reduced for certain credits. Credits that had two or more broker quotes may now only have a single broker quote or no quote at all. Consequently, asset managers are faced with having to revisit their valuation process. When quotes are widely dispersed and there are no trades, it is not best practice to rely on just one quote or take the average of widely dispersed quotes without further due diligence, supportable documentation and independent assessment. Valuation best practices based on the recent AICPA guide, Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies, recommends that asset managers evaluate the factors behind the quote(s) and do an independent valuation. In regards to broker quotes, valuation best practices should consider the following:

- Who is behind the quote? Is the broker a key player in that market/credit? Did the quote come from the main boss or from a junior trader on the floor? Is the quote binding or non-binding? What are the disclaimers behind the quote? Quotes that are from brokers who are known to trade in that credit will have more weight as they are more likely to execute. It also helps if the quote is directly from a key decision maker at the brokerage firm.
- What is the depth of the quote? For example, is there only one broker or are there several ones that support a tight pricing range? The more "depth" (aka broker quotes) behind a tight range, the more reliant those quotes are for fair value purposes. Remember, actual trades at or near the valuation date are always the most superior indication of fair value, as they represent an actual transaction between willing parties.

In addition to assessing the factors behind the quotes, an independent valuation should consider a number of factors including:

- **Industry/Sector Impact:** Not all industries under COVID-19 will be impacted the same. Certain industries will be more resilient as they rely less on foot traffic or shutdowns. Even as the shutdowns have eased, consumer habits have shifted. Is management and/or the sponsor well qualified and experienced with shifts in customer needs/habits? Does it have the right technologies and infrastructure in place to quickly adopt to the new normal? How savvy is the team in dealing with shifts in market demand and supply chain disruptions?

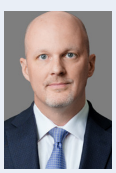
- **Liquidity and Runway:** What is the current liquidity condition and availability of other liquidity resources? Does the company have access to government loan programs? What is the relationship with the other investors? Is the senior lender willing to switch from interest payments to PIK and/or temporarily freeze amortization payments to help with liquidity needs? Is the sponsor willing to do an equity cure? Are the creditors willing to provide additional capital? Are there other assets that the company can liquidate without having a material impact on operating cash flow? At A&M we have had a number of discussions in regards to short term cash needs. Amendments and deferrals for many credits have been exhausted and it primarily comes down to the sponsor's support. How patient is the sponsor to work with turning around the business? Look back to the sponsor's track record and expertise in that market, as well as the private equity practice in respect to its fund lives, fund structure and current LP demands.
- **Leverage:** What is the current leverage and expected leverage for the next twelve months? Companies with more equity cushion and less leverage will have more bandwidth to take on more debt to provide a longer runway until the market normalizes. Is refinancing immediately needed or is the maturity a few years away? Companies that need an immediate refinancing may not get as favorable pricing since the market has shifted to be more creditor-friendly in terms of pricing and covenants. Amendments to covenants are also on the rise, which has been favorable to creditors.
- **Capital Structure:** Credits with more equity cushion and seniority will have much higher recoveries. In addition to assessing the position within the capital structure, a market participant will also measure the feasibility of capital structure in the current landscape.
- **Revenue Composition:** A market participant will gauge the most vulnerable risks by calculating the composition of top line sales such as: (i) recurring revenue vs. non-recurring; (ii) customer concentration risk; (iii) product mix (growth and margins); (iv) geographic risk; and (v) other relevant factors to the business model. Furthermore, given supply chain disruptions under a COVID-19 landscape, a market participant will also determine what revenue streams are impacted by supply chain disruptions (if any) and ascertain the magnitude and solutions available. Understanding the revenue stream enables a market participant to realize the pattern of cash inflows and provide better insight on the company's outlook.
- **Cost Structure:** How variable is the company's expense structure? The more the company can temporarily cut expenses, the better runway it has until the business can turn around. What is the current cash burn and the company's track record of reducing it? A market participant will want to understand the runway threshold given the uncertain outlook.
- **Real EBITDA vs. Adjusted EBITDA:** What is the actual EBITDA versus adjusted EBITDA? The more aggressive addbacks are for a long duration of time, the more potential there are for lower quality of earnings. A market participant will verify the company's track record in its ability to achieve revenue and cost synergy addbacks, as well its financial health prior to COVID-19. In this environment, market participants will certainly spend more time figuring out each addback line item to conclude the achievability of future EBITDA levels.
- **Capex Needs:** If the company is capex intensive, what is the current PP&E condition? If it has significant, immediate capex needs and is already highly levered, a market participant will take that into consideration and require a much higher return to compensate for that risk.

In addition to the above factors, there are valuation needs – both qualitative and quantitative – that a market participant must take into account:

- Benchmarking is a useful tool to compare the subject credit to other credits that are traded, or for companies that are public. Benchmarking can be done by comparing differences in growth, margins, terms, credit quality, and other quantitative and quantitative factors.
- Calibration as another key tool to help solidify your assumptions and documentation that are also covered in the AICPA guide. Calibration can be used for both the yield assumption and the market multiple range applied. The AICPA guide goes through a number of examples on how to use calibration for both debt and equity valuation. This tool calculates how spreads and credit fundamentals have changed since the investment was made. By bridging the fluctuations in spreads and credit fundamentals, a market participant can document these changes to better support his/her yield conclusion.

Various industries will have very diverse fundamentals and behave differently in a downturn. Credit performance tends to vary widely by (i) industry, (ii) company, (iii) position in the capital structure and (iv) over time (due to different points in the credit cycle and the economic state of the valuation date). Yields on distressed debt are widely dispersed, which makes it challenging to use market data and find comparable debt securities. Additionally, similar debt securities can have different terms, credit fundamentals and other specific nuances not relevant to the subject credit. Therefore, tools such as benchmarking and calibration are often helpful in solidifying your support and assumptions.

KEY CONTACTS



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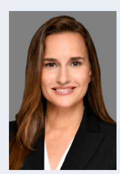

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