PE HUB Wire

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Does the Stock market Really Affect Debt Valuations?

The stock market has seen incredible volatility during the last several months, and, unfortunately, the overall trend has been downward. But does a decrease in equity values affect the valuations of illiquid debt securities? The answer is yes. And why do we even care? Because many middle market lending institutions like BDCs, hedge funds, credit opportunity funds and just about any other lending institution that uses leverage, except for commercial banks, must mark- to- market, on a quarterly basis, their illiquid debt security investments. And how they mark these existing investments can impact their view towards new lending opportunities.

Valuing illiquid debt investments is still an evolving art. Values need to be determined in accordance with ASC 820, but the methodology used to calculate mark-to-market values by a particular lender and its advisor often differs among lending institutions. Regardless of the exact methodology used, however, it is imprudent to believe that the value of a portfolio company's debt instrument can be determined independently from the value of the same company's underlying equity. Because, as we've stated many times before, while leverage multiples are often cited as a method to determine a company's debt capacity, we continue to believe debt as a percent of total capitalization (based upon market value of equity, not book value) is a more relevant statistic. Lenders want to know how much cushion they have below their debt in the event liquidation becomes necessary, and debt as a percentage of total capitalization is the metric that they use to estimate this.

For example, let's consider two companies, A and B, that each has EBITDA of $20 million. Company A is in a recession-resistant industry and, therefore, has consistent, predictable earnings and an enterprise value of 8.0x EBITDA. Company B is in a highly cyclical industry with little visibility on its earnings and has an enterprise value of 5.0x EBITDA. Surely Company A should be able to borrow more debt than Company B.

Determining enterprise value is also an imperfect science but there is no question that public comparable companies play a critical role in determining value. So it is only logical to suggest that when these public comparable companies' equity values decline (and, as a result, private company equity values also decline) that lenders will decrease the amount of debt they will lend to those companies. And if the prevailing environment favors lower debt levels, then a lender's existing debt will also wind up being valued lower.

Interestingly, the minimum amount of equity as a percent of enterprise value required by lenders also fluctuates over time. In the difficult days of 2008 and 2009, lenders often required a 50% equity cushion. Post-recession, until the recent market volatility experienced over the last few weeks, lenders grew more aggressive and required only 35 – 40% minimum equity. So both the absolute value of the equity and the lenders' sentiment, expressed as the percent of equity to enterprise value, are important factors for lenders when determining debt capacity and, therefore, debt values.

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