

# Why Valuations Matter (Fifth of a Series)

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*“Only those who will risk going too far can possibly find out how far one can go.” –T.S. Eliot*

So far in our special series on valuations we’ve reviewed key variables that impact equity valuations, and the strategies private equity has used to address them. We’ve also shared sponsors’ perspectives on challenges of higher purchase price multiples.

This week Lincoln International’s Larry Levine, managing director, valuations and opinions, discusses the backdrop for valuations:

“Despite market turmoil at the year’s start, and concern about weak overseas growth, Q1 GDP was up 3.2% – the strongest first-quarter in four years. Purchase price multiples, while continuing to be high, seem to be peaking or slowing. For Q4, the enterprise value over Ebitda for borrowers over 9x increased from 26% in 2013 to 48% today. Almost 25% of Ebitda can be attributed to pro forma adjustments.”

What’s the outlook for those multiples? “The technicals influencing purchase prices – fundraising for both private equity and private credit – will remain strong,” Levine said. “That suggests multiples will be sustained at this level for the foreseeable future.”

What’s your methodology on loan valuations? “It’s based on ‘fair value,’” he said. “That’s today’s price established by a willing buyer and seller. We value the debt as if it’s being underwritten as of that date, focusing on interest rate and credit risk.

“If Ebitda is off plan, all other things being equal, a loan’s fair value will decline. Other factors that influence value include the amount of collateral available relative to the amount of the loan and time to maturity.”

How do floating rate loan values change? “Spreads relative to the contractual cash flow is the key factor impacting value,” Levine said. “We consider broadly syndicated loans, the syndicated middle market, and the club market, which is the least volatile. Even amid December’s turmoil there was little change in the club market.”

What’s your outlook for spreads? “We expect loan volume to pick up from here. Over time, we also expect spreads to increase, given that they sit below historic averages.”

When there’s no mark, how do you determine price? “We assess conditions in public and private credit, with the help of our debt advisory group headed by Ron Kahn,” he said. “They give us great monthly color regarding deal flow, terms, spreads, etc.”

How will high leverage impact recoveries? “It’s complicated, given Ebitda adjustments and 20% covenant cushions. Borrowers will have longer runways to manage declines in performance. Ultimately every company’s situation is unique.

“What complicates private debt valuation,” Levine concluded, “is there are times of strong correlation among the BSL, middle market and club markets, and others of low correlation. Understanding relative attributes of these markets is a crucial dimension to determining a loan’s fair value.”