New Year Brings Hot Valuation Topics To The Forefront

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There is a well-known saying: "There are decades where nothing happens; and there are weeks where decades happen." Clearly, this is an accurate reflection of market participants in the illiquid credit and equity markets during 2020.

As alternative investment funds, both private credit and equity, complete their financial statements for 2020, Lincoln's Valuations & Opinions Group (VOG) provide our insights into four themes we believe market participants should be particularly focused on at year end. These include:

1. *The impact of market illiquidity on fair value;*
2. *Market volatility and its influence on valuations of level 3 financial instruments;*
3. *Assessing unique and new 2020 accounting and financial issues; and,*
4. *Proactively preparing for new valuation and auditing guidance issued from major regulatory organizations, specifically the SEC, PCAOB and AICPA.*

The number and complexity of these issues will keep fund management, boards and accounting and valuation professionals quite busy throughout 2021.

The impact of market illiquidity on fair value

It is easy to demonstrate the impact of illiquidity in 2020. For example, in the broadly syndicated loan market, the LPC 100, an index of the 100 largest and most liquid corporate loans was 98.7% of par on December 31, 2019 and troughed at 77.9% on March 23, 2020. As of December 29, 2020, the index value was only 1.0% lower than the start of the year, ending at 97.7% of par. Loans that were liquid at the beginning of the year, rapidly became illiquid during the first quarter only to become liquid again by the third quarter.

From a valuation point of view, for larger companies whose commercial loans or debt are actively traded, it is common to fair value their debt based on its actively traded price or apply the actively traded price and yield as a reference point for valuing a credit obligation that is less liquid. However, as liquidity declined during portions of 2020, the ability to use this valuation method diminished as illiquidity increased.

In addition, the SEC has recently weighed in on instances in which the amount of valuation reliance that can be placed on single broker quotes, particularly those based on evaluated prices predicated on infrequent transactions. It is the SEC's perspective, as well as FASB's, that evaluated prices based on single broker quotes derived from illiquid markets does not reflect the fair value of a security and, therefore, should not be used as a sole valuation approach.

At the center of all evaluated prices are the related concepts of market depth and market liquidity. Market depth refers to the number of market participants willing to purchase or sell a security and market liquidity relates to a market's ability to withstand a purchase or a sale of the security without a significant impact to its price. Together these concepts consider the number of market participants willing and able to trade a security, overall level and breadth of open orders, and bids and offers, including trading of an individual security.

What is certain is that as the number of market participants and buy and sell orders increase for a particular security, this greater depth and liquidity of the market for the security creates confidence that the observable price is reliable as an indication of fair value. However, the opposite is equally true; that as market participants and buy and sell orders decrease fair value estimates based on such prices become increasingly unreliable. It is, therefore, unambiguous that fair value estimates based on illiquid transactions cannot be solely relied on as a fair value measurement.

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Valuation Implications:

2020 clearly illustrated the power of liquidity. Markets that were liquid, such as the broadly syndicated loan market, quickly became illiquid.

- While hard to measure, market illiquidity premiums increased dramatically at the start of the pandemic. In these instances, market prices quickly became unreliable estimates of fair value.

It is important to assess whether there is sufficient security level depth and liquidity and that the broker quote is binding and actionable prior to relying on the quote to determine fair value for a debt instrument.

It is apparent that illiquid loan prices derived from a market with de minimis depth and liquidity are not reliable fair value measurements.

- In these circumstances, GAAP requires that additional valuation methods be employed, converting what was a level 2 valuation measurement into a level 3 measurement given that marking to a model is required.

Market volatility and its influence on valuations of level 3 financial instruments

While it is hard to believe in light of the turmoil evidenced in 2020, major credit and stock market indices will experience year over year valuation gains (or at a minimum, just small declines in fair value). Simply looking at values on January 1, 2020 and December 31, 2020 ignore the volatility that occurred throughout the year. As examples, based on Lincoln's proprietary data from thousands of private middle-market companies (primarily owned by private equity groups) valued by us indicate that:

Enterprise value multiples were 9.8 times trailing twelve-month EBITDA as of December 31, 2019, declined to 9.1 times EBITDA as of March 31, 2020 while rising to 10.4 times EBITDA by September 30, 2020. We expect enterprise value multiples to increase for the fourth quarter once we have the opportunity to process fourth quarter financial performance.

Senior debt fair values were 98.7% of par as of December 31, 2019, declined to 94.5% of par as of March 31, 2020 and rose to 96.8% of par by September 30, 2020. Similarly, once the data is available, we expect many debt and equity investments will have increases in fair value by December 31, 2020, or, at a minimum, relatively small year over year declines.

COVID has created a wide variance between industries and within industry sub-sectors. For example, comparing nine months 2020 versus nine months 2019 EBITDA indicates that:

Comparisons between industries:

- EBITDA has actually increased 4.7% for healthcare companies and 3.5% for technology companies.
- However, the industrial sector has experienced declines of -4.3% while consumer companies have declined by -6.8%.

Comparisons within industry sub-sectors:

- Within the industrials sector, aerospace and defense companies EBITDA declined -2.0% while the automotive and truck sector declined -19.0%.
- Within the consumer sector, food and beverage companies actually increased 2.7% while restaurants and traditional retail declined nearly -40.0%.

Valuation Implications:

While averages provide perspective on the overall market, they overlook the impact to specific industries and companies. Moderate to severe COVID impacted companies and industries have not recovered nearly to the same extent as low impacted companies and industries.

- As a result of the adverse effects from the COVID-19 pandemic, traditional valuation correlations have weakened, and across industries and companies we are observing a much wider variation of performance and value than is typical in other years.

Excluding health care and technology sectors, in general, we expect most other industries will experience year over year earnings declines.

- However, from a valuation point of view, and excluding the most highly COVID impacted sectors, we believe that 2020 earnings declines combined with increasing forward looking earnings and higher market valuation multiples will result in stable, if not increasing, debt and equity valuations year over year.

Assessing unique and new 2020 accounting and financial issues

The pandemic has created several unique accounting and financial issues that will become readily apparent upon the release of 2020 financial statements as well as at the end of 2021.

Potential for Goodwill Impairments

Many analysts are expecting that the pandemic's impact on earnings will have the potential to create a significant number of impairments to goodwill once year end results are tabulated. If companies have not already, by the time the 2020 audit is released, significant COVID impacted businesses are expected to report material goodwill impairments.

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Under current GAAP, goodwill must be tested for impairment when a triggering event occurs that indicates that it is more likely than not that the fair value of the reporting unit is below its carrying value. Companies are required to monitor and evaluate goodwill triggering events as they occur throughout the year.

In what has the potential to be a significant accounting event and currently under fast-track consideration by FASB is a proposal (with comments due January 20, 2021) that would allow private companies that only report goodwill to perform a goodwill triggering event assessment on the annual reporting date only. Therefore, it would eliminate the requirement for companies that elect this alternative to perform this assessment as triggering events occur to limiting impairment testing only at the annual reporting date.

Valuation Implications:

Year-end company disclosures regarding goodwill impairment will be a strong signal to market participants about management's view of near-term and intermediate-term company prospects.

The potential change to the goodwill impairment test, from the current method of assessing impairment throughout the course of the year - upon a triggering event - versus just an annual year end test, provides an interesting accounting contrast.

- Had the proposed rule been effective in 2020, performing the impairment test in April 2020 when earnings expectations were at their trough versus December 2020 as earnings outlook improved would lead to very different impairment test results simply based upon the date of the impairment test computation.

Continuing Likelihood of Portfolio Company Covenant Breaches and Amendments

As the adverse earnings impact of COVID continue to permeate earnings, we have previously reported that approximately 13% of companies Lincoln valued in 2020 Q3 breached covenants, down from 16% in 2020 Q2, but above the 10% levels in 2019 Q4.

Valuation Implications:

We expect the percent of companies reporting covenant breaches to continue to range in the low-to-mid-teen levels through the first quarter of 2021 as the earnings trauma of the first and second quarters of 2020 cycle though annual earnings.

The good news is that we have observed credit funds continuing to be flexible executing COVID related amendments as earnings and cash flow clarity emerges and private equity-sponsored companies proactively implement long-term solutions.

Change in GAAP Treatment of Leases

While not related to the pandemic, GAAP ASC 842, effective at the end of 2021, will require private companies that lease to capitalize the lease on their balance sheet. Under a newly implemented accounting standard, ASC 842, all leases will create assets and liabilities for lessees. There will be a right-of-use (ROU) asset representing the right to use an underlying asset for the lease term and a lease liability representing the obligation to make lease payments. The ROU asset and lease liability measured as the present value of the lease payments discounted at the rate implicit in the lease or the lessee's incremental borrowing rate will typically offset at lease inception.

Financial analysts will need to be cognizant that the income statement and balance sheets will be impacted differently by ASC 842; specifically:

Balance sheet – assuming leases are material, balance sheet's will be impacted as the right-of-use asset and the lease liability will be recorded on the balance sheet. All other things being equal, total assets and liabilities will increase by the quantity of the related operating lease asset and liability.

Income statement – in contrast with the impact to the balance sheet, there is no income statement effect. However:

- Nomenclature confusion will occur as financial analysts need to be cognizant that EBITDA and EBITDAR (EBITDA after and before lease rental payments, respectively) have the potential to be quite different. In other words, analysts should be careful with the term "EBITDA" as some may believe it is "EBITDA with operating lease rent added back" and others may think it is "standard" EBITDA.
- Analysts should understand how data aggregators (i.e., Capital IQ, Fact Set, Bloomberg, etc.) calculate EBITDA and EBITDA margins. Some data aggregators calculate "standard" EBITDA and EBITDA margins while others will compute EBITDA prior to annual operating lease costs (i.e., EBITDAR).

Enterprise value – enterprise value can be calculated two ways, with and without the impact of operating leases. To distinguish between the two differing calculations (i.e., with and without the impact of operating leases), the traditional definition of enterprise value may be referred to as "net EV" (NEV, net of lease liabilities) and enterprise value inclusive of operating lease liabilities referred to as "gross EV" (GEV, gross of lease liabilities).

- Depending on the quantity of operating leases the difference in the two enterprise values can be significant.

Finally, and yes, we recognize GAAP made something as simple as calculating EBITDA and enterprise value quite confusing.

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Valuation Implications:

Consistency is important. Depending on the quantity of operating leases the differences between EBITDA and EBITDAR and net and gross enterprise value can be significant.

Users of financial statements will need to be alert to the computation of: (a) EBITDA and EBITDAR; and, (b) enterprise value with and without the inclusion of operating leases. To distinguish between the two differing but similar terms (i.e., earnings and enterprise value computed with and without the impact of operating leases), one will need to be cognizant of the difference between EBITDA and EBITDAR as well as net and gross enterprise value.

The guideline public company method is a commonly employed valuation method. This method assumes that EBITDA and enterprise value of the company being value to be consistent with the guideline public companies. The important point is that enterprise value and EBITDA must be determined congruently - either before or after the accounting treatment of leases – in order to ensure consistency between the subject company and guideline public companies.

LIBOR Transition

LIBOR has been referred to as the "world's most important number." By the end of 2021 commercial loans using LIBOR as the reference rate will have to migrate to an alternative reference rate, the Secured Overnight Financing Rate (SOFR). SOFR is LIBOR's replacement and is based on transactions in the US Treasury repurchase market where banks and investors borrow or lend treasuries overnight.

It was announced in November 2020 that the cessation of the 1, 3, 6, and 12-month LIBOR rate has been delayed to June 2023. Regardless, by the end of 2021, all new loans will need priced relative to SOFR while existing loans currently using LIBOR will need to terminate LIBOR as the reference rate by June 2023.

Valuation Implications:

As the reference rates of LIBOR and SOFR will not equal, there will be a spread adjustment factor required to offset the difference in the base rate levels between LIBOR and SOFR.

New valuation and auditing guidance issued from the SEC, PCAOB and AICPA

Recently there has been new valuation guidance issued by the SEC in its Rule (2a-5) - Good Faith Determination of Fair Value release as well as new auditing guidance for fair value measurements issued by the PCAOB and AICPA. In total, these three new standards update outdated auditing and valuation guidance.

Valuation Implications:

The SEC regulation clarifies how fund boards of directors and management satisfy their valuation responsibilities via a consistent framework for fair value and standard of practices.

The PCAOB and AICPA auditing pronouncements require auditors to update their audit procedures relative to fair value measurements. The standards are designed to provide a more uniform, risk-based approach to auditing fair value estimates. The focus of these auditing standards are to identify and assess the risk of material misstatement and perform procedures to determine if the auditor has sufficient appropriate audit evidence to support the fair value estimate.

Given the new valuation and auditing guidance combined with the 2020 market volatility, we expect that auditors will be laser focused on fiscal year end level 3 debt and equity valuations.

Conclusion:

Maintaining an active dialogue with our clients is very important to us. We would like to hear from you regarding your valuation thoughts for 2021. We are always available to exchange valuation perspectives.

2020 has been a year that feels like a decade's worth of events occurred in just 52 weeks. The pandemic, unfortunately, continues. Even though the brightest minds in the world have been focused on developing a vaccine, under the best timelines, it most likely will not be widely available in the United States and in Europe, until mid-2021.

We are hopeful that 2021 will prove to be a year of strong economic reversion and expansion. Or, at a minimum, a year nothing quite like the tremendous upheaval we experienced in 2020 happens again.