STEPSTONE

Equity as a shock absorber for lenders

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In periods of macroeconomic uncertainty, it becomes even more essential to increase scrutiny of portfolio companies' performance.

Earnings before interest, taxes, depreciation and amortization (EBITDA) growth serves as a reliable indicator of a firm's operational efficiency, affecting its valuation and perceived risk profile from a lender's viewpoint.

For lenders and investors, it is crucial to comprehend the implications of negative earnings growth for the company's leverage and its loan-to-value (LTV) ratio. This understanding helps one assess the remaining equity buffer, which is vital to determine the threshold at which lenders may begin to incur losses on their invested capital.

What is the impact of a decrease in EBITDA combined with EV multiple contraction on leverage and LTV ratio?

Figure 1 presents a simple comparison of a firm's financials over two periods. To analyze the effects of a decline in EBITDA, we assume a 10% decrease in the firm's revenue. For the sake of simplicity, this 10% reduction is applied to all components of EBITDA. Although certain elements, like SG&A, are typically fixed, this hypothetical decrease is realistic.

We also assume the firm's debt level and cash remain constant but that its valuation declines owing to underperformance, resulting in a 2.0x decrease in the EV multiple.

The combined effect of the 10% EBITDA decrease and the 2.0x reduction in the EV multiple leads to a 0.6x increase in the firm's leverage and a 14 percentage point rise in its LTV ratio, consequently worsening the company's risk profile as illustrated in **Figure 2**.

> Equity acts as a shock absorber in the event of EBITDA and valuation decrease, safeguarding debt holders' capital.

FIGURE 1: EBITDA, LTV, EV AND LEVERAGE

EBITDA	T	T+1
Revenue (1)	$350	$315
COGS (2)	$250	$225
Gross Profit (3) = (1) - (2)	$100	$90
SG&A (4)	$50	$45
EBITDA (5) = (3) - (4)	$50	$45

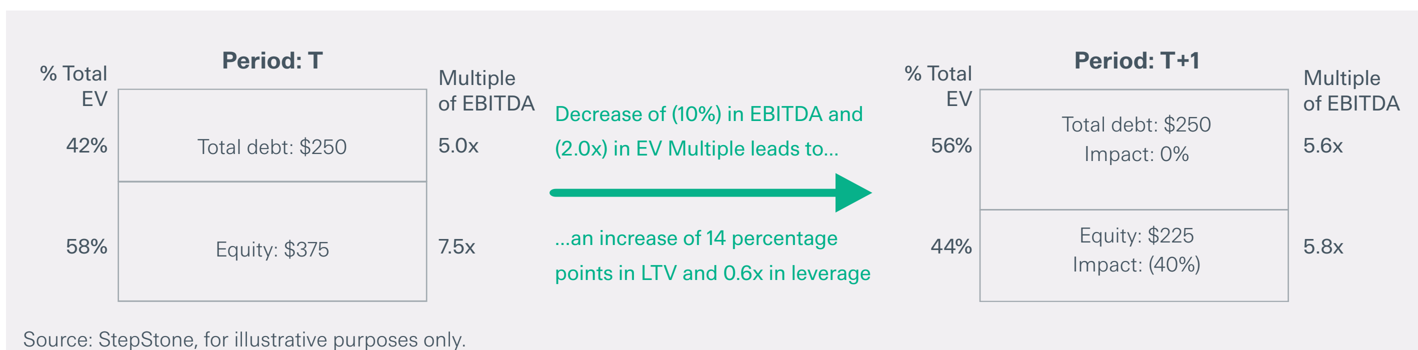
Balance sheet	T	T+1
Total Debt (6)	$250	$250
EV Multiple (7)	12.0x	10.0x
Enterprise Value (EV) (8) = (7) * (5)	$600	$450
Cash (9)	$25	$25
Equity (10) = (8) – (6) + (9)	$375	$225

Metrics	T	T+1
Leverage (10) = (6) / (5)	5.0x	5.6x
LTV (11) = (6) / (8)	42%	56%

Impact on	Equity	Debt
Change	(40%)	0%

Source: StepStone, for illustrative purposes only. COGS = Cost of goods sold; SG&A = Selling, general and administrative expenses.

FIGURE 2: IMPACT OF EBITDA ON LTV AND LEVERAGE



Source: StepStone, for illustrative purposes only.

Despite the elevated risk profile, the debt remains unaffected, as the impact is fully absorbed by the equity holders, who experience a 40% decrease in value. This underscores one of the benefits of direct lending in an uncertain macroeconomic environment.

Even though the value of debt remains the same in our example because of the lower equity buffer, credit risk and the probability of default go up. As a result, the firm is likely to encounter more stringent refinancing conditions because of lower valuations. Yet even with a 10% decline in EBITDA, and a 2.0x reduction in the EV multiple, there is still enough of an equity cushion to safeguard debt holders.

How far do the EBITDA and EV multiple need to drop for the lender to incur a loss?

In the scenario depicted in Figure 2, an EBITDA reduction exceeding 35% and a 4.0x drop in the EV multiple would be required in order to wipe out the equity buffer while keeping the debt intact. Such a scenario would be even more severe than what occurred during the Global Financial Crisis. Between 2007 and 2009, EBITDA decreases tended to be above 30%; however, EV multiple contractions were less severe, falling on average from 11.5x to 9.0x for S&P 500 companies.

The good news is that because of the close relationship between direct lenders and borrowers, even if such a scenario came to pass, default would not be inevitable.

When a firm's financial health deteriorates significantly, lenders do not sit back and await default. Instead, they act promptly to protect their LPs' capital and work with the borrower to devise a solution that steers the firm back onto a sustainable path.

In uncertain macroeconomic environments, direct lending loans sitting at the top of the capital structure remain attractive from a risk mitigation perspective. This placement ensures that equity serves as a buffer, safeguarding lenders against potential downturns. In scenarios where a firm would start underperforming, leading to lower valuation and adversely affecting leverage and LTV, this buffer becomes crucial. It provides a layer of security, mitigating the risk of losses for lenders and investors.

> A material amount of stress is needed before all equity is lost and realized losses on debt occur.

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