Houlihan Lokey

Portfolio Valuation and Fund Advisory Services

India Private Credit Update

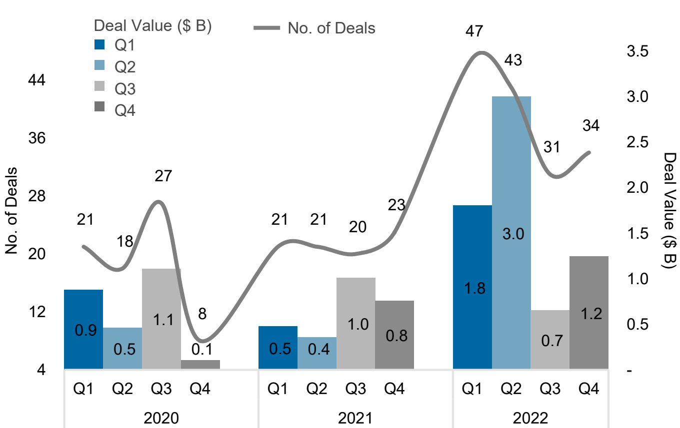
MARKET UPDATE **SUMMER 2023**

India Private Credit Update—Summer 2023

Private Credit Is Going Mainstream

- The maturation of the alternative asset market in India has been fertile ground for private credit—an asset class in the midst of a major breakthrough. Private credit solutions from global and domestic alternative investment funds (AIFs) are emerging from the shadows of traditional lenders such as banks and nonbanking financial companies (NBFCs) in India, demonstrating a new environment of underwriting, asset management, and long-term investor alignment. For the purposes of this white paper, we will concern ourselves with private credit from AIFs and use the term “private credit” in that context.
- Now in their second decade in India, private credit AIFs are coalescing significantly more domestic and foreign capital toward this asset class, with positive results despite several regulatory and macro challenges. Investing activity in private credit is seeing a surge as this asset class promises to deliver fixed-income returns for sophisticated investors comfortable with the risk-reward profile.
- For those not already familiar, private credit lending is characterized by the speed, flexibility, and bespoke nature of the product, which is very different from the flow nature of collateral-heavy traditional lending from banks and NBFCs. Even as banks have largely cleaned up their balance sheets and posted record profits in India, there continues to be a large underserved middle market that is willing to raise more expensive private credit capital from AIFs if the credit provides a flexible solution for the borrower at its stage in its lifecycle.
- While India is a unique market offering diverse opportunities for the private credit use case, it is worth seeing how far mainstream private credit has proliferated in other markets. In 2010, private credit raised in the U.S. started primarily in the distressed and special situations space, with little mezzanine and direct lending strategies.

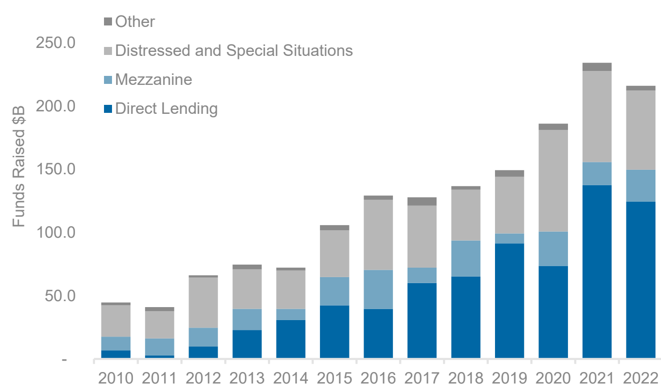
Private Credit Investment Activity in India



Source: IVCA.

- Fast forward to 2022, direct lending constituted nearly two-thirds of a market that has grown at a 10% CAGR since 2010. In aggregate, U.S. private credit AUM has surpassed $1.5 trillion, sizing up in line with the broadly syndicated loan and high-yield markets, and is the leading choice for acquisition financing. The private credit “golden moment” in the U.S. has come with its fair share of reasons to be wary, including deteriorating credit quality in light of higher interest rates, declining earnings growth, and potential negative cash flows.

Evolution of U.S. Private Credit



Sources: Financial Times, “The private credit ‘golden moment’”; Preqin; Goldman Sachs Investment Research.

- While lenders continue to target borrowers in India with relatively low leverage and steady growth, India offers a diversification strategy for lenders in a largely underserved market, regardless of the current interest rate environment in developed markets.
- This paper will examine the fundraising and valuation environment in private credit in India, matching perspectives aligned to the specialized knowledge on sourcing, underwriting, and managing the various underlying strategies involved in tracking and reporting returns. All AIFs, whether private credit or other asset classes, are tasked with reporting fair value to their investors. Enhanced valuation processes are required beyond accounting or regulatory approaches to not only provide reliable information but to also signal unlikely credit events before they are inevitable and ultimately ex-post communications.

Private Credit Valuation Perspectives by Strategy

Direct Lending / Performing Credit

Private and public credit are often viewed as similar asset classes, yet they have distinct characteristics and differences resulting in **unique valuation considerations**. Understanding the differences between private and public credit is crucial when valuing these securities. In recent years, particularly in the U.S., the rise of direct lending has accelerated due to its **greater certainty** of execution and **speed** of close compared to a traditional bank process. Gaps left by traditional lenders, and an appreciation for the features of private credit, have led to their proliferation across all sizes of borrowers in India.

Understanding the Issuer and Terms

- It is important to consider all terms and features when valuing a loan as well as any fundamental differences between the subject security and the public comparable benchmark being used.
- Although it is common practice to consider public credit benchmarks, as private loans do not have readily observable market spreads and yields, private loan spreads and yields **do not always move in lockstep** with that of public credit.

Valuation Methodology

- When cash flows are highly predictable, loans are typically valued via a discounted cash flow analysis whereby expected future cash flows are present valued at a **risk-adjusted discount rate**.
- Estimating the fair value of a loan subsequent to origination involves calculating the implied spread and yield at the time of underwriting and then calibrating that yield or spread at the measurement date by taking into account various qualitative and quantitative factors.
- Assumptions regarding key inputs used in valuing private credit should consider and be consistent with those observed in **similar new investments** in the private market.

Analyze key credit metrics

- When valuing private loans at subsequent measurement dates, it is important to monitor changes in credit metrics and the credit profile of the borrower, in addition to the changes in observed market spreads and yields.
- Key **financial covenants** such as leverage ratios, interest coverage ratios, loan-to-value ratios, etc., should be monitored and appropriately benchmarked to comparable public credits.

<u>Takeaways</u>: A comprehensive set of valuation skills with a specific understanding of the asset class and assessment of the changes in credit quality and market conditions are needed to determine the fair value of a private credit position as of a measurement date. It is generally not sufficient to default to par based solely on the coverage, as fair value should be the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. The relatively young private credit markets, correlation to the public markets, and availability of information for borrowers in India further expand the need for a high-touch, local understanding of events surrounding cash flows and their timing.

Special Situations

Special situations peaked as an investment strategy during the last economic cycle as banks saw mounting nonperforming loans and NBFCs ran aground. Private credit saw opportunities for credit funds to lend to cash-strapped borrowers facing structural and nonoperational situations such as restructurings, mergers and acquisitions, carve-outs, turnarounds, buybacks, bridge financing to IPOs, etc. While mostly nondilutive, the higher returns targeted are often valid only during a bridge situation pre-dating the borrower's eligibility and willingness to pay down or refinance via cheaper collateral-based credit from traditional lenders.

Valuation Methodology

- Special situations investments may need to be valued adopting a similar but modified approach, in line with the widely accepted valuation guidelines.
- Thoughtful **scenario analyses**, where applicable, can help identify upside possibilities and provide comfort to downside scenarios.
- An attractive feature of special situations investing is **low correlation** of this asset class with the general credit markets.

Recoverability/ Credit Risk

- Investor **base case returns** often assume key corporate events. Any **known and knowable** deviations from these assumptions should be considered in the valuation.

Unit of Account

- There might be situations where an investor holds multiple types of investments within a company, such as NCDs, CCDs, CCPS, and OCRPS.[(1)] It is important to ascertain the **unit of account** for the valuation. The subject security may no longer be performing (e.g., in default), or otherwise not fully expected to be recovered under its legal terms of repayment.
- Whether the investments need to be **aggregated or disaggregated** for valuation considerations needs to reflect the unit of account and market participant perspectives in addition to the investors' underwriting assumptions.

<u>Takeaways</u>: The selection of valuation methodologies for a special situations investment can be wide-ranging from a modified income approach to a waterfall approach. Fair value continues to be the standard required under accounting rules. Combining technical expertise with an understanding of what is taking place on the ground in a valuation requires an understanding of and diligence around the deal, investment features, and underlying business.

(1) NCDs = nonconvertible debentures; CCDs = compulsorily convertible debentures; CCPS = compulsorily convertible preference shares; OCRPS = optionally convertible redeemable preference shares.

Private Credit Valuation Perspectives by Strategy (cont.)

Venture Debt

India added a record 44 unicorns in 2021, which was followed by another 23 unicorns in 2022. As **the funding environment witnessed a slowdown** post mid-2022, startup founders increasingly took on venture debt financing. Founders have become more financially sophisticated and are focusing on venture debt raises to provide near-term liquidity while not adversely impacting the existing shareholders.

Understanding the Issuer and Terms

- With the IPO market effectively closed and valuations down materially from their 2021–2022 peak levels, venture debt represented **a lower cost of capital** than equity and allowed a borrower to **extend its cash runway** and bridge to the next round of financing.
- Unlike other debt investments, venture debt investment is characterized by a blend of coupon-paying/interest-accruing debt investment with an equity kicker (either by way of equity warrants or options).
- Understanding the terms of equity upside **and bifurcating the value of debt and equity upside** at the investment date is critical in order to capture the true value of the investment over the holding period.

Investment Coverage

- Venture debt is often provided to unprofitable businesses as they continually **invest to drive revenue growth**.
- In such situations, loan coverage is critical and metrics such as customer retention, customer acquisition costs, and recurring revenues are considered to understand the business fundamentals that drive longer-term prospects.

Valuation Considerations

- Companies that secure venture debt typically have strong sponsor support and have completed multiple rounds of financing. These rounds can provide a starting point for calibration of the valuation of any equity upside; a **scenario-based approach or equity allocation techniques** may also be appropriate to capture this value.

Takeaways: Too often we see venture debt modeled as straight debt, with valuers assuming the equity kicker to be effectively zero or de minimus as a default. A valuer should instead build a framework backing into a balanced scenario for the equity kicker at the time of underwriting. This requires an understanding of all features of the security, the economic payoffs, realistic expectations of outcomes, and how these ultimately need to be captured in the fair value as of a measurement date.

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2022 M&A Advisory Rankings
Global Transactions Under $1 Billion

	Advisor	Deals
1	**Houlihan Lokey**	**381**
2	Rothschild & Co	369
3	JP Morgan	217
4	Lazard	206
5	Goldman Sachs & Co	203

Source: Refinitiv. Excludes accounting firms and brokers.

No. 1 Global M&A Advisor Under $1 Billion

Leading Capital Markets Advisor

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2022 Global Distressed Debt & Bankruptcy Restructuring Rankings

	Advisor	Deals
1	**Houlihan Lokey**	**58**
2	PJT Partners Inc	30
3	Lazard	29
4	Rothschild & Co	25
5	Moelis & Co	21

Source: Refinitiv.

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	Advisor	Deals
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2	JP Morgan	1,030
3	Duff & Phelps, A Kroll Business	938
4	Morgan Stanley	725
5	BofA Securities Inc	710

Source: Refinitiv. Announced or completed transactions.

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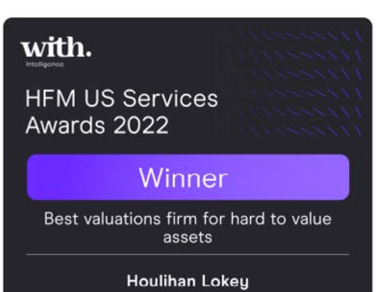

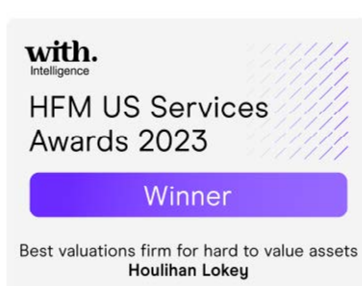

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- Fair Valuation for Financial Reporting
- Securitization and Regulatory Compliance
- Portfolio Acquisition and Divestiture Services
- GP and Fund Manager Valuation
- Valuation Governance and Best Practices
- Structured Products Valuation Advisory
- Derivatives Valuation and Risk Management
- Fund Recapitalization and Transaction Opinions

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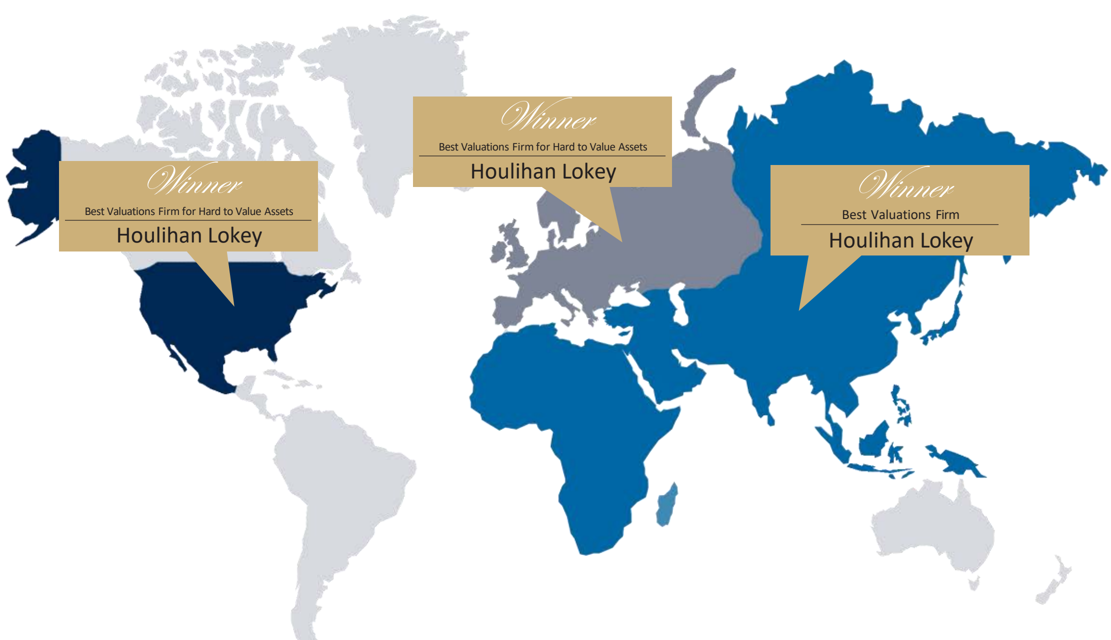

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