Portfolio Valuation

Private Equity Marks & Trends

First Quarter 2015

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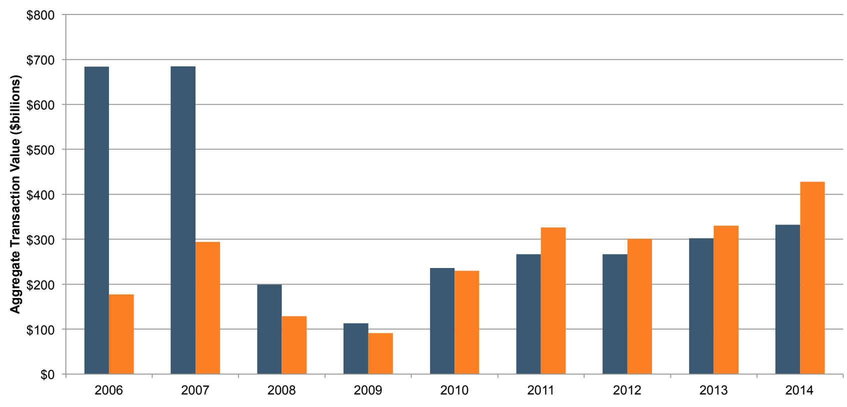
Overview

For private equity fund sponsors, reasonable, defensible, and timely fair value marks for portfolio investments are increasingly demanded by existing and prospective investors, auditors, and regulators. In this, our inaugural issue of *Portfolio Valuation*, we will provide a brief digest and commentary of some of the most relevant market trends influencing the fair value regarding private equity portfolio investments.

Global Private Equity Transaction Value

Valuation is likely to get trickier in 2015. As noted in the chart, private equity investors have been taking advantage of favorable exit markets, with portfolio dispositions exceeding portfolio acquisitions for the fourth consecutive year in 2014. A steady deal flow at generally attractive multiples provides fund managers with a good contemporaneous set of comparable transactions for determining fair value. In contrast, measuring fair value is much more difficult in less liquid market environments, such as were endured in 2008 and 2009.



Source: Preqin

What is Fair Value?

Fair value has a very specific meaning, and must be measured accordingly; fair value is not simply a reflection of the asset owner's investment thesis.

Fair value is defined in the relevant accounting standards as:

> "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

In this context, the price is based upon a hypothetical transaction for the subject asset or liability at the measurement date, considered from the perspective of a market participant. A market participant is defined as 1) an unrelated party, 2) knowledgeable of the subject asset, 3) able to transact, and 4) motivated but not compelled to transact.

When measured as the price that would be received to sell an asset, fair value essentially represents the exit price of the subject asset for a market participant in the principal or most advantageous market. Specification of the principal or most advantageous market provides boundaries for the assumed collection of market participants; fair value is determined within the context of the most active market for a given asset, or in the absence of such a market, the market within which one could expect to maximize the amount received for the asset.

ASC 820 states that valuation techniques consistent with the market approach, income approach, and/or cost approach should be used to measure fair value. Inputs to the various valuation techniques may be either observable or unobservable, implemented according to the FASB fair value hierarchy which prioritizes inputs into three broad levels.

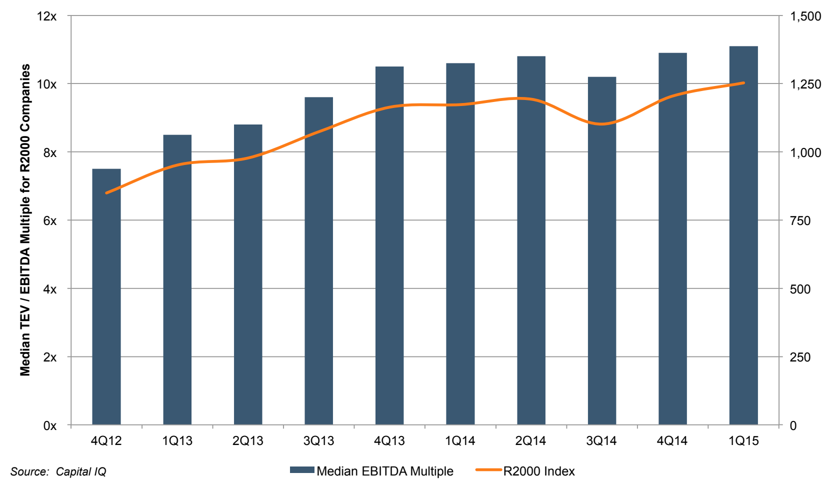
- **Level 1** inputs are observable quoted prices in active markets for identical assets. Few private equity assets rely on Level 1 inputs.
- **Level 2** inputs generally include observable quoted prices for similar assets in active markets or quoted prices for identical assets in markets that are not active. Broadly syndicated loans are often Level 2 assets.
- **Level 3** inputs are unobservable inputs that are developed based upon the best information available under the circumstances, which might include the reporting entity's own data. Most private equity fair value marks rely on Level 3 inputs, which include cash flow forecasts, cost of capital assumptions, and comparisons to peer multiples.

Unobservable inputs should reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability.

Equity Valuation

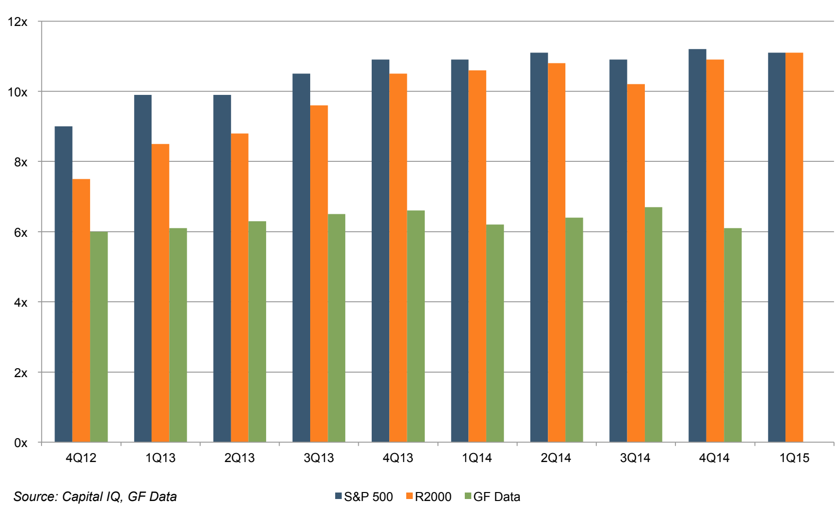
Russell 2000 Index Values and EBITDA Multiples

Favorable equity market returns during the year over the past two years have been driven in large part through multiple expansion (a likely consequence of the Fed's zero-interest rate policy).



EBITDA Multiples over Time

As noted, smaller middle market deal multiples reported by GFData tend to be less sensitive to changes in public comps. For such companies (having an enterprise value of less than $250 million), financing conditions (with respect to availability, leverage, and cost) can influence transaction multiples nearly as much as trends in public market multiples.

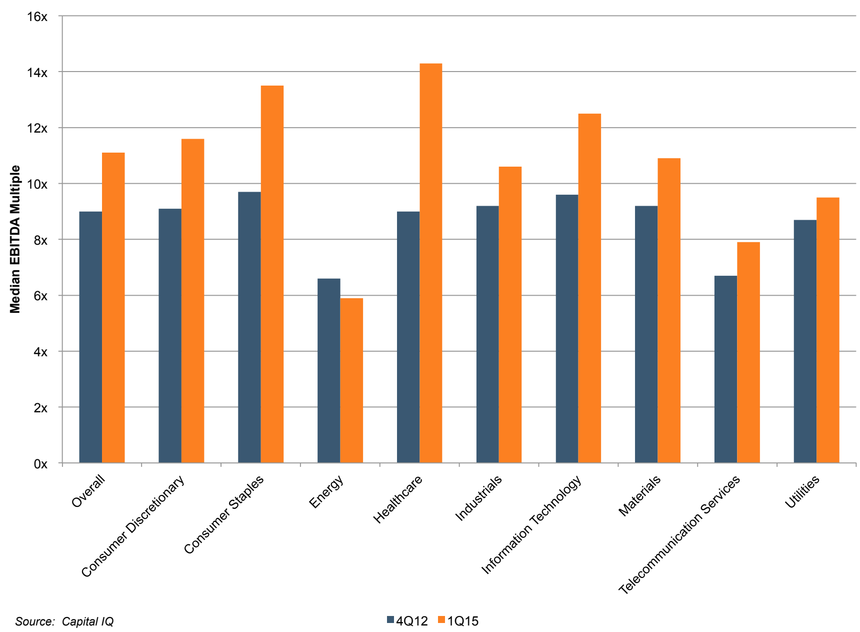


Equity Valuation (continued)

Median EBITDA Multiples by Industry (S&P 500)

The multiple expansion has been broad-based, with only the energy sector seeing multiples contract over the past two years. Numerous private equity firms have identified the market dislocation caused by declining oil prices as an opportunity for generating outsized returns, raising specific funds to invest in the space.

The increase in public company multiples has fostered a generally favorable environment for private equity portfolio marks since 2012. A slowing – or even reversal – of this trend would likely increase the scrutiny on fair value measurement.

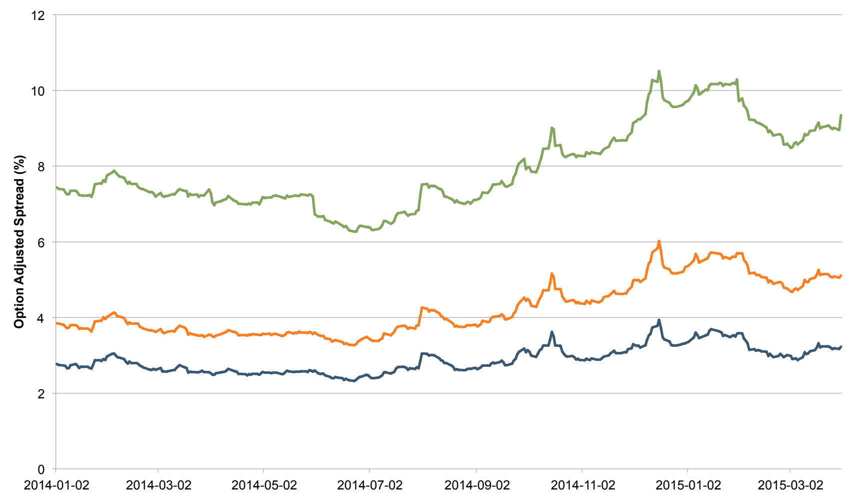


Source: Capital IQ

Debt Investments

High Yield Spreads by Credit Rating

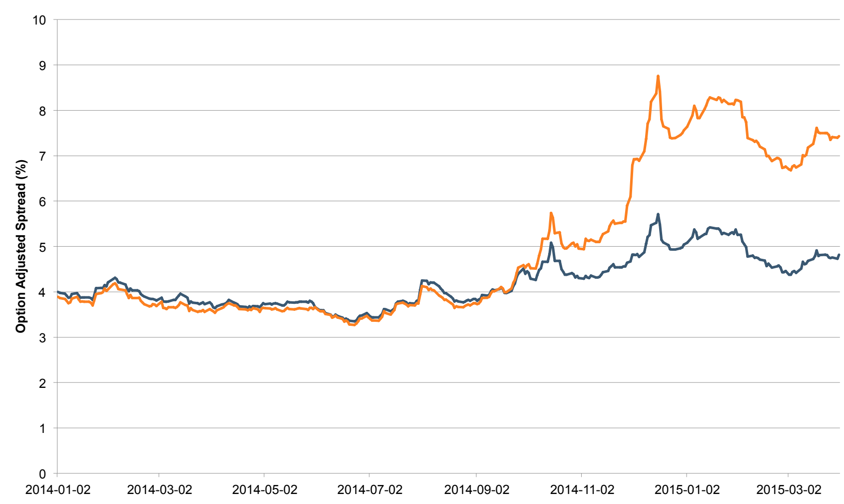
The sustained compression in high yield credit spreads dating from mid-2012 came to an end in June 2014 as observed spreads bottomed out across the credit spectrum. Over the second half of the year, spreads widened back to mid-2013 levels.



Source: BofA Merrill Lynch

Impact of Energy Sector on High Yield Spreads

While a market-wide phenomenon, the spread widening observed in the major indices was exaggerated by the challenging energy sector. For credits unaffected by falling oil prices, the negative impact of wider spreads was considerably muted. Through the first quarter of 2015, spreads generally trended downward from year-end levels.



Source: BofA Merrill Lynch

Debt Investments (continued)

As shown in the following chart, we have tracked the fair value of a benchmark loan on a quarterly basis over the past two years. The chart illustrates how common structural features of loans and the overall credit markets can influence private equity loan marks.

- Many floating-rate loans have LIBOR floors. As seen on the chart, the favorable impact of rate floors on fair value is most pronounced when the forward yield curve is relatively flat (as was the case through much of 2013). Even though LIBOR has been essentially unchanged over the period analyzed, the forward curve has become markedly steeper, reducing the value increment associated with the LIBOR floor.

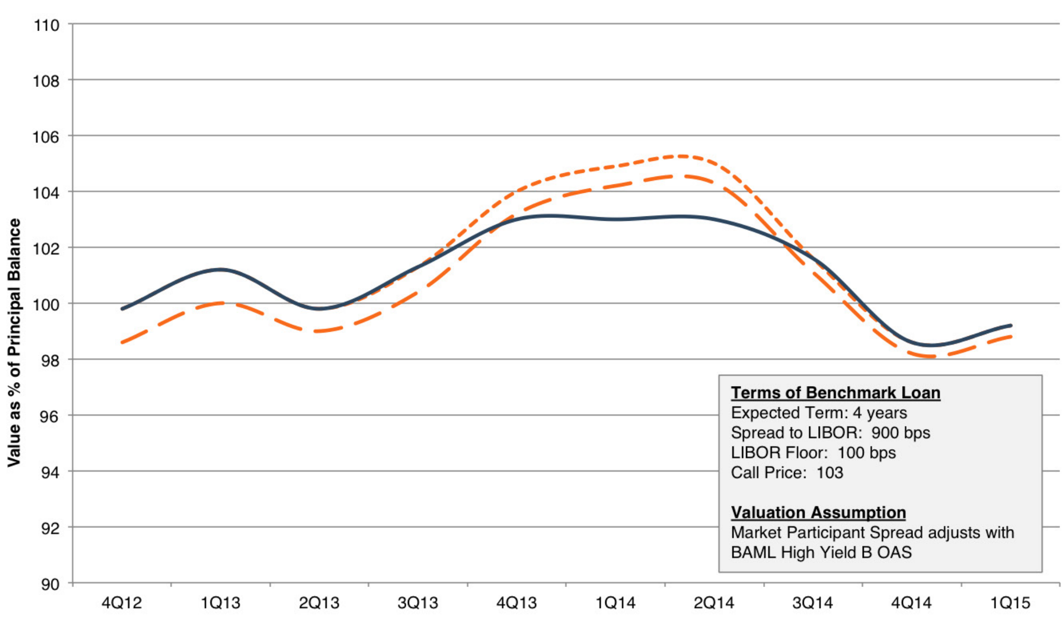
- Call provisions are common loan features. Callable loans exhibit "negative convexity" – while widening spreads reduce loan values, the value benefit of spread tightening is constrained by the likelihood that the loan will be prepaid in such an environment. The dampening effect of the call provision on loan value was evident in the first half of 2014.

- Two additional factors which influence the fair value of actual loans are not reflected in the benchmark loan. First, the actual credit spread appropriate for a particular fair value measurement will reflect changes in both market spreads and borrower-specific factors (improving leverage ratios, changing industry outlook, acquisitions and other strategic changes). For example, as noted previously, the amount of spread widening appropriate to a borrower with no negative exposure to falling oil prices is likely a good bit less than that observed for the overall market. The benchmark loan fair value marks do not include any borrower-specific considerations.

- Second, actual loans have fixed maturity dates, and some have period amortization provisions. As a result, the duration of the loan decreases with the passage of time, diminishing the sensitivity of loan value to changes in interest rates. In contrast, the benchmark loan is modeled with a constant maturity of four years with no principal amortization.

The fair value of the benchmark loan rallied modestly during 1Q15, tracking generally favorable returns for credit investors during the quarter.

Fair Value of Benchmark Debt Instrument

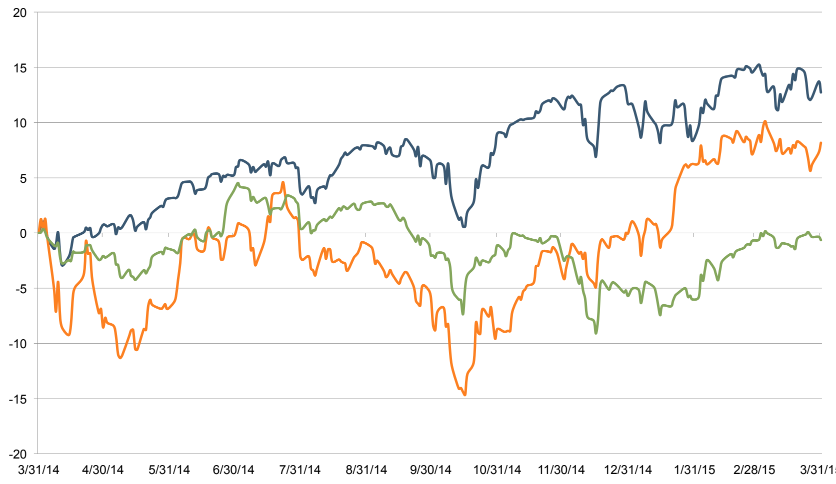


Source: Mercer Capital analysis

Stock Performance for Publicly Traded PE Sponsors

Total Returns (Trailing Twelve Months)

The chart summarizes total return performance for publicly traded PE firms and BDCs over the last twelve months. Returns for the private equity sponsors returned to positive territory during 1Q15 following a bout of investor skepticism during much of 2014. Returns for BDCs, which tend to be smaller and more credit-focused, tend to track high-yield credit spreads fairly closely. Doubts regarding the sustainability of dividend payouts for the BDCs have weighed on stock returns in recent months, and a number of BDCs announced material dividend adjustments in 1Q15. Both indices lagged the broader equity markets, as measured by the S&P 500.



Source: SNL Financial

Mercer Capital

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