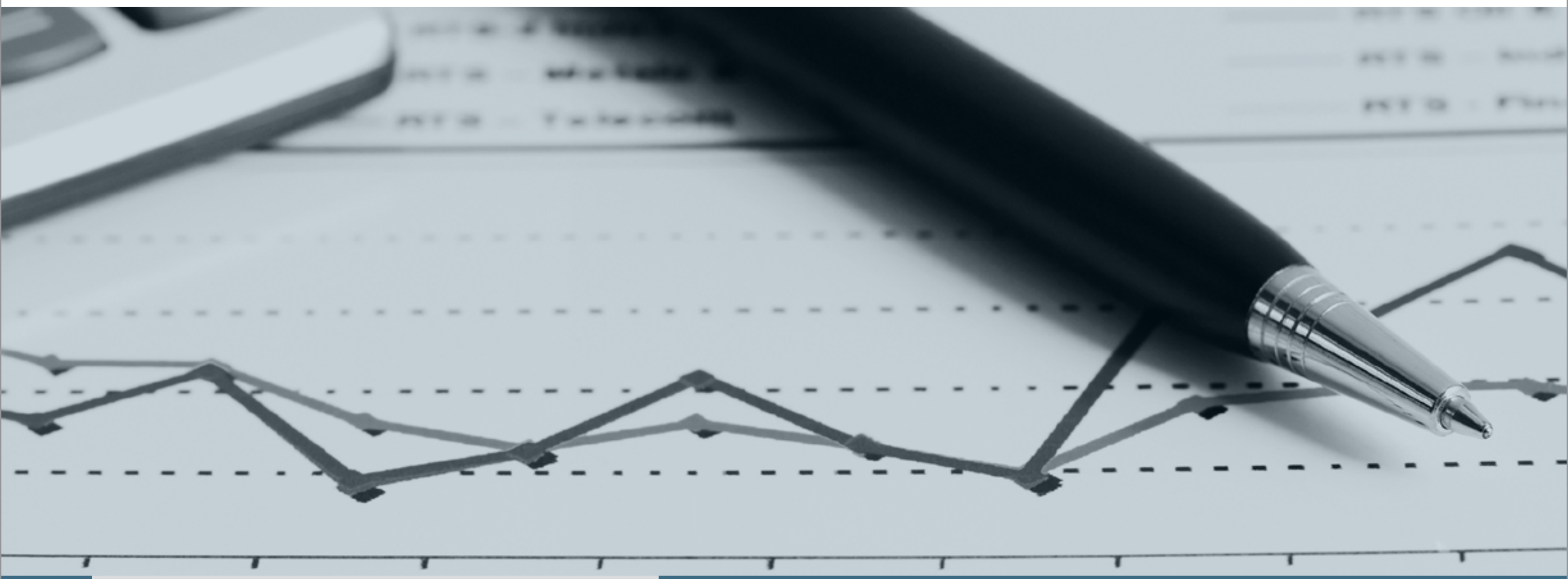
MERCER CAPITAL

Portfolio Valuation

Private Equity Marks & Trends



Second Quarter 2016

www.mercercapital.com

How to Value Venture Capital Portfolio Investments

The chart to the right outlines our process when providing periodic fair value marks for venture capital fund investments in pre-public companies.

Examine the Most Recent Financing Round Economics

The transaction underlying the initiation of an investment position can provide three critical pieces of information from a valuation perspective:

- Size of the aggregate investment and per share price.
- Rights and protections accorded to the newest round of securities.
- Usually, but not always, an indication of the underlying enterprise value from the investor's perspective.

Deal terms commonly reported in the press (**example**) focus on the size of the aggregate investment and per share price. The term "valuation" is usually a headline-shorthand for implied post-money value that assumes all equity securities in the company's capital structure have identical rights and protections. While elegant, this approach glosses over the fact that for pre-public companies, securities with **differing rights and protections should and do command different prices**.

The option pricing method (OPM) is an alternative that explicitly models the rights of each equity class and makes generalized assumptions about the future trajectory of the company to deduce values for the various securities. Valuation specialists can also use the probability-weighted expected return method (PWERM) to evaluate potential proceeds from, and the likelihood of, several exit scenarios for a company. Total proceeds from each scenario would then be allocated to the various classes of equity based on their relative rights. The use of PWERM is particularly viable if there is sufficient visibility into the future exit prospects for the company.

The economics of the most recent financing round helps calibrate inputs used in both the OPM and PWERM.

Under the OPM, a backsolve procedure provides indications of total equity and enterprise value based on the pricing and terms the most recent financing round. The indicated enterprise value and a set of future cash flow projections, taken together, imply a rate of return (discount rate) that may be reasonable for the company. Multiples implied by the indicated enterprise value, juxtaposed with information from publicly traded companies or related transactions, can yield valuation-useful inferences.

1 Examine Most Recent Financing Round Economics

"Simple" Pre- and Post- Money → **Calibrate Valuation Methods to Implied EV**

OPM Backsolve

↓
DCF
PWERM
Market Multiples
Transaction Multiples

2 Adjust Valuation Inputs to Measurement Date

Company Performance Relative to Most Recent Round
↓
Financial Results
Forecast Changes
Interest from Potential Acquirers

Market Conditions Relative to Most Recent Round
↓
Public Multiples
IPOs
Transactions
General VC Performance & Investment Activity

3 Measure Fair Value

Valuation of Subject Interest at Measurement Date
↓
OPM
PWERM

4 Reconciliation and Tests of Reasonableness

RECENT TRANSACTION

Simmons First National Corporation Agrees to Acquire Citizens National Bank

Regarding the merger, Paul Willson, CEO and Chairman of Citizens, said, "We have worked with Mercer Capital for a number of years and Jeff Davis the past several years. Our Board and I appreciate their thoughtful insight about shareholder value creation, the banking industry, and the public and M&A markets for banks."

Learn More about our Transaction Advisory Services at **www.mercercapital.com**.

Simmons First National Corp.
Pine Bluff, Arkansas

has agreed to acquire

CITIZENS NATIONAL BANK
Athens, Tennessee

Mercer Capital served as a financial advisor & rendered a fairness opinion on behalf of Citizens National Bancorp, Inc.

May 2016

Under the PWERM, in addition to informing discount rates and providing comparisons with market multiples, the most recent financing round can inform the relative likelihood of the various exit scenarios.

When available, indications of enterprise value from the investor's perspectives can further inform the inputs used in the various valuation methods.

In addition to the quantitative inputs enumerated above, discussions and documentation around the recent financing round can **provide critical qualitative information**, as well.

Adjust Valuation Inputs to Measurement Date

Between a funding round and subsequent measurement dates, the performance of the company and changes in market conditions can provide context for any adjustments that may be warranted for the valuation inputs. Deterioration in actual financial projections may warrant revisiting the set of projected cash flows, while improvements in market multiples for similar companies may suggest better pricing may be available for the company at exit. Interest from potential acquirers (or withdrawal of prior interest) and general IPO trends can inform inputs related to the relative likelihood of the various exit scenarios.

Measure Fair Value

Measuring fair value of the subject security entails using the OPM and PWERM, as appropriate and viable, in conjunction with valuation inputs that are relevant at the measurement date. ASC 820 defines fair value 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."

Reconciliation and Tests of Reasonableness

A sanity check to scrutinize fair value outputs is **an important element of the measurement process**. Specifically as it relates to venture capital investments in pre-public companies, such a check would reconcile a fair value indication at the current measurement date with a mark from the prior period in light of both changes in the subject company, and changes in market conditions.

Mercer Capital assists a range of alternative investment funds, including venture capital firms, in periodically measuring the fair value of portfolio assets for financial reporting purposes to the satisfaction of the general partners and fund auditors. Call us – we would like to work with you to define appropriate fund valuation policies and procedures, and provide independent opinions of value.

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On the Call

The following is a brief compendium of quotes from 2Q16 earnings season conference calls.

Leon Black (APO) – "We are poised to benefit from a number of secular tailwinds, including the deleveraging of the banks and re-regulation of financial institutions, coupled with persistently low rates that are forcing institutional and retail investors alike to scour the globe for yield."

Tony James (Blackstone) – "I think people are kind of maybe focusing a little too much on this, but historically, it's been pretty consistent, because we mark, right? Market [goes] down, we mark it down. But historically, it's been pretty consistent and we never, if we have a public stock, for example, we've got a mark to where the public stock is, but if we find a strategic buyer, they usually pay a premium over whatever the stock price happens to be at the time."

Kipp deVeer (ARCC) – "From our vantage point, we're having trouble reconciling this strong global demand for direct lending assets and the attractive returns they provide, versus the tepid demand for investing in high quality BDCs holding similar assets."

Stephen Schwarzman (BX) – "I would expect significant cash flows to U.S. markets as interest rates remain globally depressed."

David Golub (GBDC) – "What we determined is that in many cases if we're dealing with a very high quality company, making a one-stop loan at 5.5 times or 6 times leverage for that kind of company is actually meaningfully less risky than making a one-stop loan to a less well-positioned company at a meaningfully lower leverage level. So leverage levels in itself, they tell part of the picture, but not all of the picture."

Scott Nuttal (KRR) – "It is a very tricky environment for investing. The world is not used to ever having a period of time where there is $10 trillion of negative yielding assets. And we are spending a lot of time with our limited partners, both long-standing and newer ones and prospects, talking about this investing environment. And I think they are having a hard time figuring out where to put their capital to generate attractive returns."

Source: All transcripts obtained from SNL.

2016 Mid-Year Market Review of Public and Private Equity

The first six months of 2016 were eventful for U.S. markets. Worldwide, markets dealt with the continued blight within the oil industry and the shockwave of United Kingdom's decision to leave the European Union. In the U.S., investors worried over potential Fed interest rate hikes and the inflated unicorn valuations. It appears that no market was safe from turbulence. At the halfway mark of 2016, we review the state of public and private equity markets.

Public Markets

Equity market performance in the first half of 2016 may be best described as volatile. The year began with large movements in the S&P 500 during the first quarter. The index dove 10% to a low of 1,829 in mid-February as the price of oil reached its lowest level in 10 years. Gains appeared likely during 2Q16 until the index took yet another downturn following the results of the Brexit vote. The S&P 500 fell 4.1% in the week after the plebiscite as the potential ramifications spurred global market uncertainty (Chart 1).

Although overall stock market returns were modest during 1H16, the energy sector began showing improvement. The S&P Energy Select Sector Index was up 16% at mid-year, as the prices of oil and natural gas increased more than 25% over prices at the beginning of the year. Industrials and consumer staples also showed steady gains, while financial services and healthcare posted negative returns.

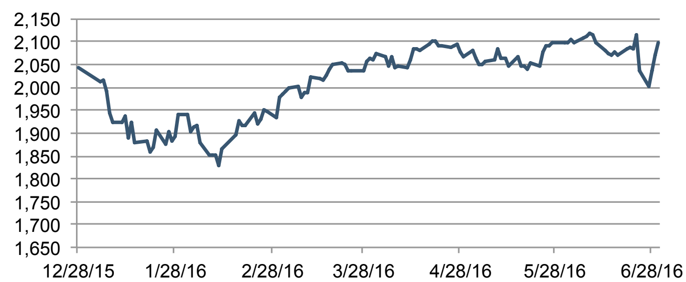
Uncertainty in the public equity markets makes initial public offering (IPO) potentially less attractive to a private company seeking to raise capital. The number of private companies going public began slowing in 2015, ending the year at just 162 IPOs compared to 245 in 2014. Continuing this trend, the 42 IPOs completed in the first half of 2016 were less than half of the number of IPOs during 1H15. Healthcare remained the most active sector, accounting for half of the companies that went public this year. Companies in the financial sector accounted for approximately 26% of total IPOs, while information technology and industrials accounted for 7% each (Table 1).

Merger and acquisition activity during the first half of the year was marked by announcements – and cancellations – of deals between large industry players. According to data compiled by S&P Capital IQ, approximately 5,200 transactions with U.S.-based targets have been announced so far this year, with consumer discretionary and information technology companies accounting for nearly 40% of the deals. Total deal value is estimated at $751 billion, with an average deal size of just over $600 million. We have also seen the dissolution of large deals announced during the prior year, including the $160 billion merger between Pfizer and Allergan. Cancellations have also spilled over to the new deals. The largest potential transaction of 2016, Honeywell International's $112 billion offer for United Technologies Corporation, was cancelled just a month after the announcement due to anticipated regulatory scrutiny (Table 2 on page 4).

Private Equity

Private capital markets (venture and private equity) saw an influx of investor funding in the first half of 2016. Over $12 billion of newly raised capital in the first quarter has 2016 on track to be the third consecutive year in which more than $10 billion in venture capital were raised each quarter. **The National Venture Capital Association** attributes part of this

Chart 1: S&P 500 Index Performance



Source: Yahoo Finance

Table 1: Initial Public Offerings (1/1/2016 – 6/30/2016)

Count	Sector	Trans. Value	Median EV (excl. Fin.)	Median EV / Revenue	Median EV / EBITDA
1	Consumer Discretionary	531.4	4,549.0	3.32	9.9
2	Consumer Staples	1,076.2	5,266.9	1.43	11.0
0	Energy	0.0	nm	nm	nm
11	Financials	2,666.5	nm	na	na
21	Healthcare	1,355.2	159.2	26.70	11.2
3	Industrials	549.0	1,523.3	1.07	14.1
3	Information Technology	365.5	1,323.3	4.79	23.4
0	Materials	0.0	nm	nm	nm
0	Telecommunication Services	0.0	nm	nm	nm
1	Utilities	7.3	269.0	8.64	19.4
42	**Grand Total**	**6,551.0**	**362.5**	**7.75**	**11.3**

Source: S&P Capital IQ

Table 2: Ten Largest M&A Deals (1/1/2016 – 6/30/2016)

Date Announced	Target/Issuer	Transaction Status	Total Trans. Value ($M)	Buyers/Investors
02/23/2016	United Technologies Corporation	Cancelled	$111,702.18	Honeywell International Inc.
05/18/2016	Monsanto Company	Announced	62,322.09	Bayer AG
01/11/2016	Baxalta Incorporated	Closed	36,219.87	Shire plc
04/28/2016	St. Jude Medical Inc.	Announced	30,174.83	Abbott Laboratories
06/13/2016	LinkedIn Corporation	Announced	29,350.56	Microsoft Corporation
06/30/2016	The Hershey Company	Announced	25,470.78	Mondelez International, Inc.
01/25/2016	Tyco International plc	Announced	16,757.98	Johnson Controls Inc.
03/14/2016	Starwood Hotels & Resorts Worldwide Inc.	Cancelled	16,326.88	J.C. Flowers & Co. LLC, et al.
03/17/2016	Columbia Pipeline Group, Inc.	Closed	14,006.81	Transcanada Pipeline USA Ltd.
05/03/2016	IMS Health Holdings, Inc.	Announced	13,548.54	Quintiles Transnational Holdings Inc.

Source: S&P Capital IQ

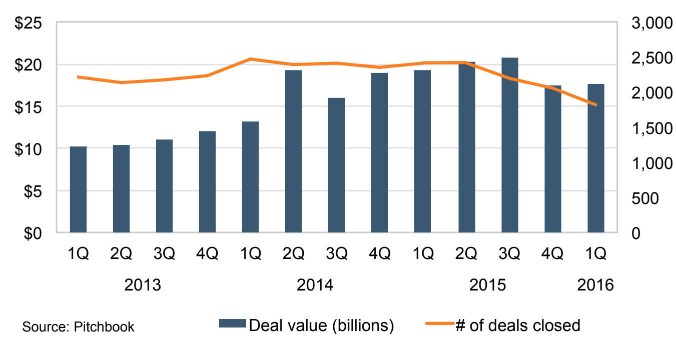
increase to the healthy state of the venture capital environment. With the Federal Reserve delaying another interest rate increase, higher potential risk-adjusted returns from the asset class could continue to appeal to investors.

The increase in venture capital fundraising activity during the year has not necessarily trickled down to the investments into the average startup company, however. According to **Pitchbook**, although $22.3 billion was invested in the second quarter of 2016, a large funding round for rideshare company Uber accounted for 28% of the total. Pitchbook also noted that although venture capital investments appear to be rising annually, large fundraising rounds by unicorn companies have accounted for the majority of the increase. In fact, the amount of capital invested in non-unicorn companies has actually declined since 4Q14 (Chart 2).

Investors appear to be losing interest even faster in earlier-stage startups. The number of seed deals grew rapidly from 2007 to 2014 before making a large downward turn in 2015. At mid-year, 2016 is positioned to continue the downslide—as the number of seed deals and follow-on investments remain at a quarter of the comparable number from 2014. The 7.4% follow-on rate for seed deals in 2015 was the lowest point in the prior decade. With just 1.2% of seed deals receiving follow-on investments in the first half of 2016, startup funding this year appears even bleaker.

Private equity has slowed in general, with both deal count and aggregate value falling in the first half of the year. However, capital raises and average fund size have increased, indicating that investors may have plans for more investment in the near future. According to **Pitchbook**, private equity-backed exits in the first quarter totaled $59 billion, with the most exits occurring in the healthcare, information technology, and financial services sectors. The materials & resources and energy industries showed the smallest success in private equity exits as natural resources businesses continue to struggle.

Chart 2: Venture Capital Investments



Conclusion

As we enter the second half of the year, as always, it is difficult to predict how markets will continue to perform. The outcome will likely depend greatly on the outcomes of various political and economic uncertainties faced in the U.S. and globally. How industries/sectors perform will also affect the activity and financial reporting needs of individual companies. For industries that demonstrate continued growth and attractiveness, we could see an increase in acquisition and investment activity. For those that continue to be challenged, the potential for goodwill impairment charges and restructurings loom. At Mercer Capital we work with companies on both ends of the spectrum, and it will be interesting to see what the next six months have in store.

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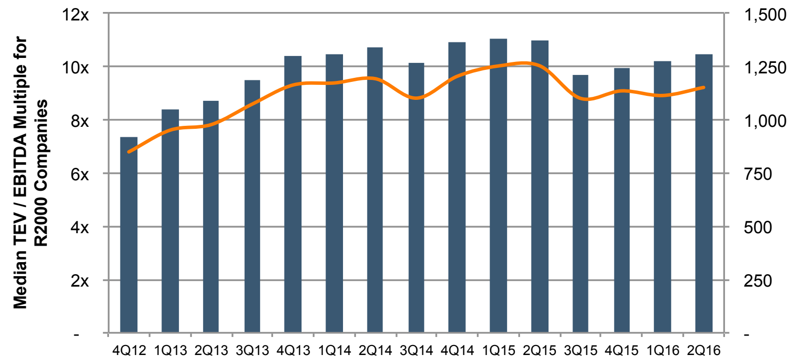
Equity Valuation

Russell 2000 Index Values and EBITDA Multiples

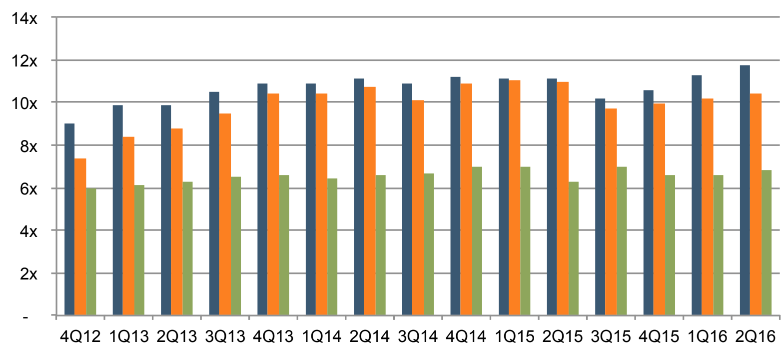
Following the sharp decline in 3Q15, public market EBITDA multiples resumed their steady march back toward peak levels during 2Q16, with the median multiple for the Russell 2000 universe reaching 10.4x, compared to 9.7x at the most recent trough.



Source: Capital IQ
Median EBITDA Multiple (ex-financials)

EBITDA Multiples over Time

The improvement in small cap multiples has lagged that of the large cap names as the median EBITDA multiple for S&P 500 companies approached 12.0x for the first time over the period analyzed. Middle market transactions saw an uptick in both pricing and volume during the quarter. The size effect is also evident within the middle market, as observed multiples for transactions between $50 million and $250 million (8.1x) exceeded those on transactions between $10 million and $50 million by more than two turns.

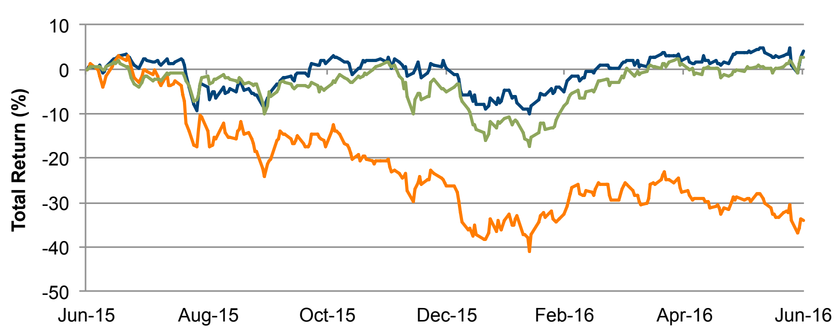


Source: Capital IQ, GF Data
Excludes financials

Stock Performance for Publicly Traded PE Sponsors

Total Returns (Trailing Twelve Months)

Total returns for business development companies kept pace with the broader equity markets during 2Q16 while shares of private equity firms continued to lag on the heels of generally soft earnings reports.

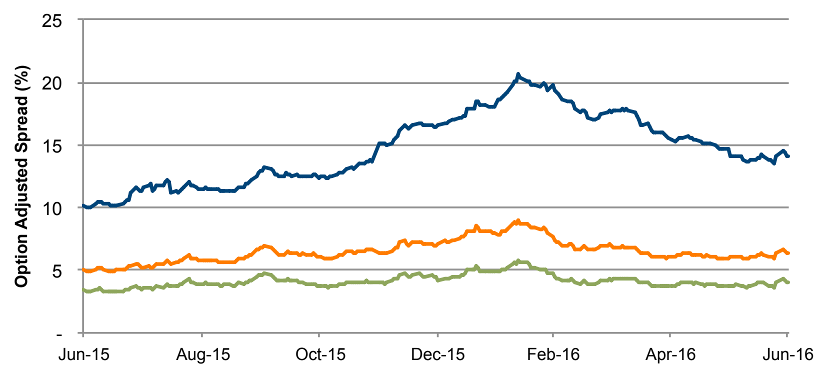


Source: SNL Financial

Debt Investments

High Yield Spreads by Credit Rating

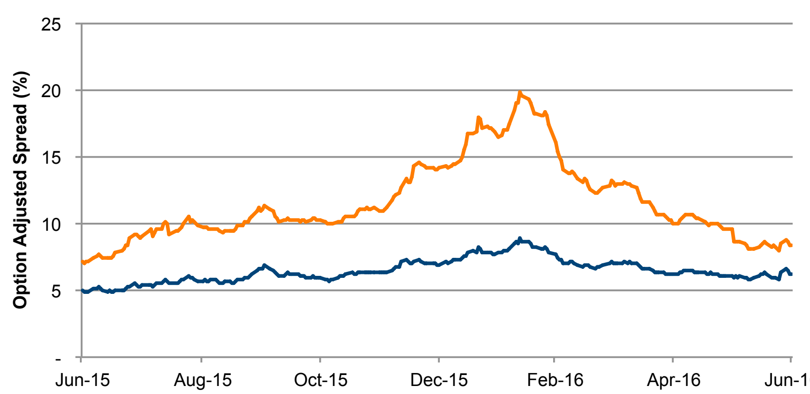
Steady spreads continued to buoy the price of credit assets during 2Q16 as expectations for a meaningful negative turn in the credit cycle continue to be deferred. Appetite for the most speculative credits increased during the quarter as spreads on credits rated CCC or below fell more than 350 basis points.



Source: BofA Merrill Lynch

Impact of Energy Sector on High Yield Spreads

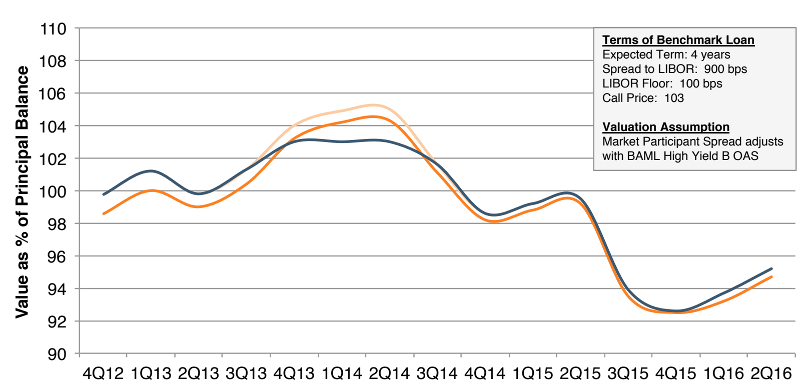
Credit spreads continued to tighten during 2Q16 following the short-lived credit scare of January and February. Some of the energy sector jitters have also subsided, as the energy premium relative to the rest of the high yield market has narrowed to its lowest level in nearly a year.



Source: BofA Merrill Lynch

Fair Value of Benchmark Debt Instrument

Further spread tightening among B-rated credits provided continued lift for our benchmark loan, with fair value increasing to 94.7, compared to 92.6 at December 31, 2015. With the current yield curve, spreads would need to contract another 150 basis points for fair value to approach 100.



Source: Mercer Capital analysis

Mercer Capital

Private Equity Firms & Other Financial Sponsors

Mercer Capital provides business valuation and financial advisory services to private equity firms and other financial sponsors.

Mercer Capital provides financial and advisory services to help our clients minimize risk and maximize value. For financial sponsors providing debt and equity capital to the middle market, Mercer Capital provides a comprehensive suite of financial advisory services.

Services Provided

- Portfolio Valuation
- Solvency Opinions
- Fairness Opinions
- Purchase Price Allocations
- Goodwill Impairment
- Equity Compensation / 409(A)
- Buy-Sell Agreement Valuations

Contact a Mercer Capital professional to discuss your needs in confidence.

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