MERCER CAPITAL
BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

Portfolio Valuation

Private Equity & Venture Capital Marks & Trends

First Quarter 2019

In This Issue

The sell-off in risk assets last year points to why some wag on Wall Street decades ago coined the adage that bull markets take the escalator up and bear markets take the freight elevator down. The sell-off in the fourth quarter was intense but not atypical. The unanswerable question then and today is whether the sell-off reflected the market discounting weaker earnings to come; illiquidity because heavy selling over the holidays was accentuated by the inability of large banks to commit capital via prop taking versus agency-based market making; or both fundamentals and liquidity.

The rebound in 2019 has been swifter than might be expected normally, but the rally in risk assets accelerated mid-quarter on the 180 degree pivot by Fed officials that further hikes to the Fed Funds target rate (and therefore 30/90-day LIBOR) are on hold until further notice.

While the sell-off was brutal, it was not long enough to materially clip private equity values because public market pricing is but one of several methods used to value privately held assets (M&A data and DCF are among the most common). As for credit, high yield has rallied sharply, too, after fears of the Fed hiking the economy into a recession eased. Plus, the global reach for yield is a long-running theme in the years since the GFC.

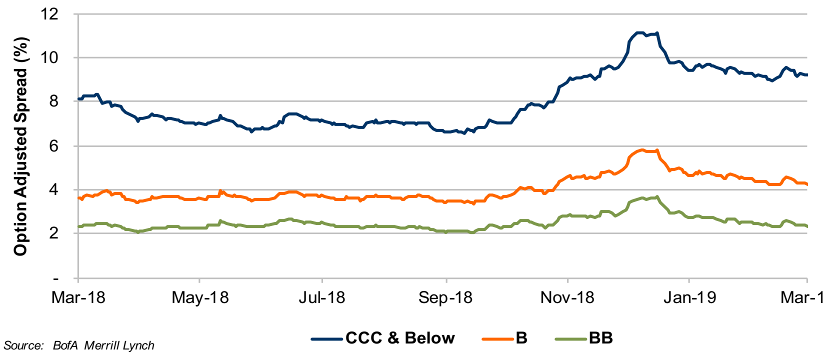
In short, 1Q19 was not a game changer for private equity and credit as seemed possible in December. Nonetheless, valuations may be subject to more scrutiny given a slowing economy and subdued M&A environment while a robust IPO calendar will allow public investors to have a say on how well (or not) private markets valued a number of high profile companies such as Lyft and Uber Technologies.

Private Credit and Equity

Debt Investments: High Yield Spreads by Credit Rating

As is typical in the late stages of a Fed tightening cycle, the Treasury and Libor/Swap curves flattened and partially inverted from rising short rates and easing long rates for the first time since 2007 on the eve of the financial crisis. Credit spreads widened sharply, too.

Yields on issues rated CCC & below widened 441 bps in the fourth quarter, compared to 231 bps and 150 bps of widening for B- and BB-rated credits. Since the Fed pivot in 1Q19 spreads have narrowed somewhat and the Treasury curve has steepened slightly with a rally in the short-end as investors have begun to price in the potential of a rate cut by year-end.

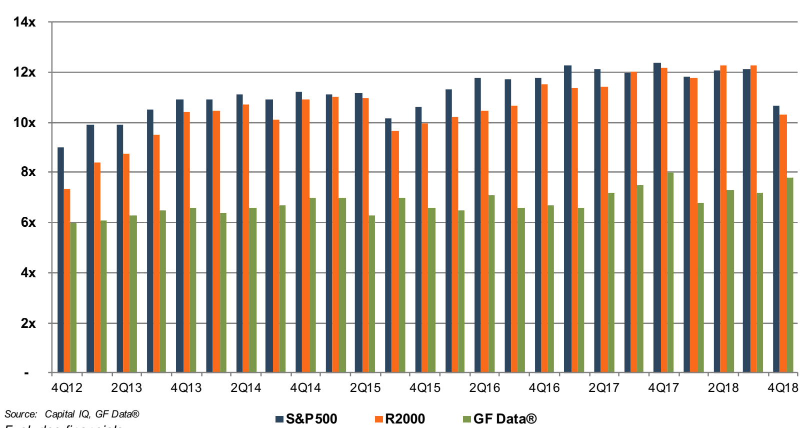


Source: BofA Merrill Lynch

Median EBITDA Multiple
Excludes financials

Equity Valuation: EBITDA Multiples over Time

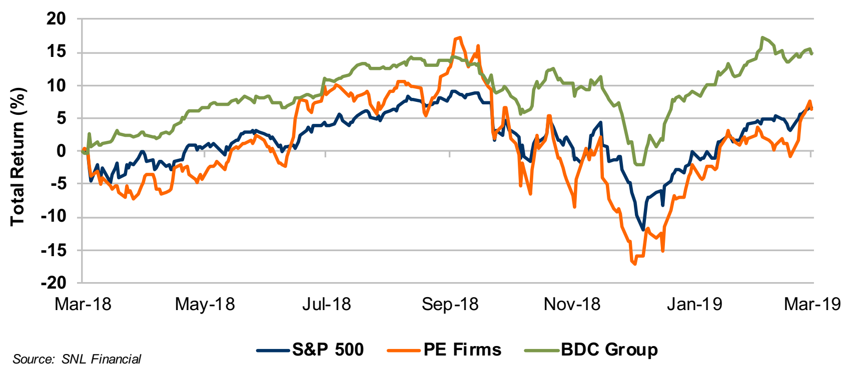
As of year-end 2018, non-financial companies that are included in the Russell 2000 traded for 10.3x EBITDA, down 16% from 3Q18 and at the lowest multiple since 1Q16. Perhaps due to a time lag, the median multiple for PE-backed deal tracked by GF Data® ticked up slightly to 7.8x in 4Q18.



Source: Capital IQ, GF Data®
Excludes financials

Stock Performance for Publicly Traded PE Sponsors: Total Returns (Trailing Twelve Months)

The shares of PE companies and BDCs during 4Q18 sold-off more sharply than the broad market as measured by the S&P 500 due to investor concerns about what a potential recession might mean for private equity and credit valuations; however, both private equity and credit (as represented by BDCs) rebounded sharply in 1Q19 as the Fed pivoted and indicated rate hikes are over for the time being.

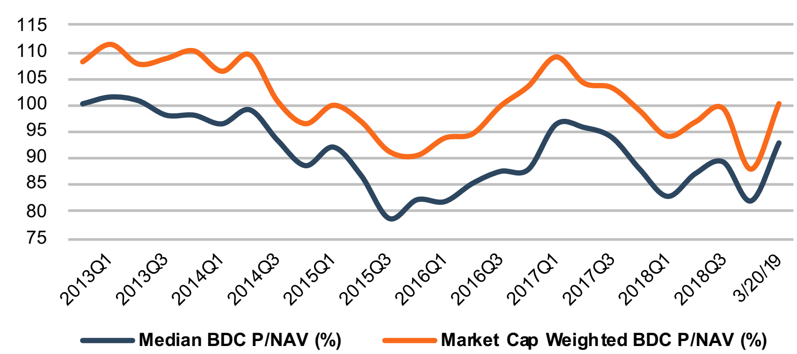


Source: SNL Financial

Publicly Traded Private Credit

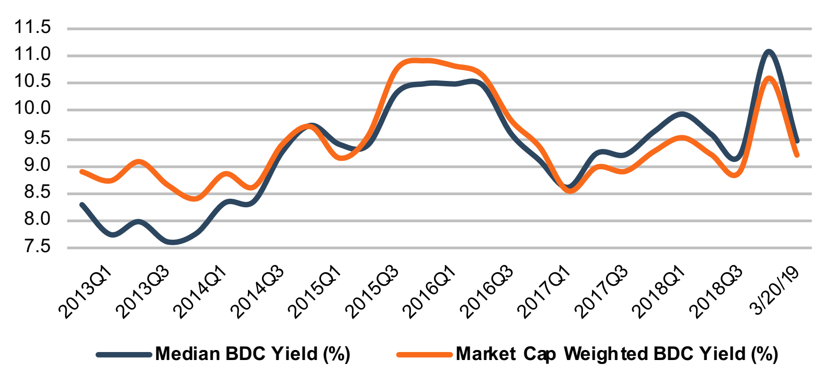
The median P/NAV for BDCs fell from 90% at the end of 3Q18 to 82% at year-end. By late March 2019, the rally in BDC stocks pushed the median P/NAV multiple to 93% and the median dividend yield to 9.5% from 11.1% at year-end.

Long-Term Business Development Companies P/NAV Trend



Source: S&P Global

Long-Term Dividend Yield Trend

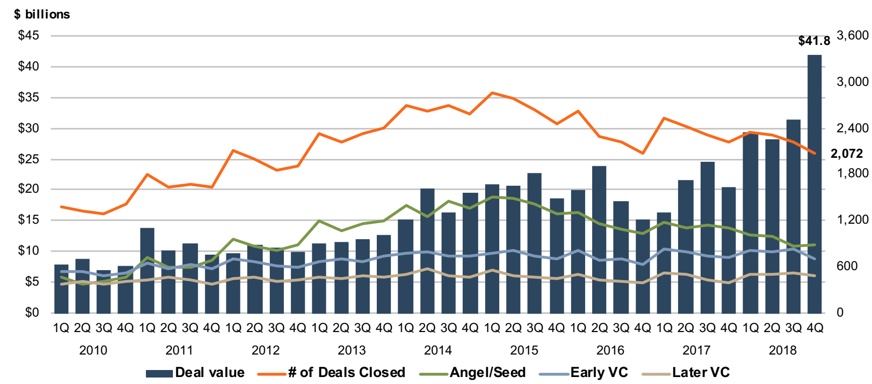


Source: S&P Global

Venture Capital

U.S. VC-Backed Funding Activity

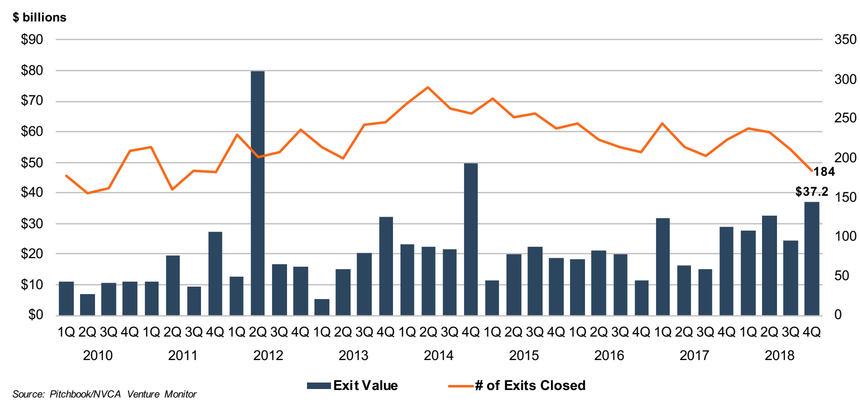
Funding activity met expectations for a record year in capital deployment. $41 billion was invested in just under 9,000 deals. The number of angel and seed stage deals funded during the year fell to just two-thirds of those funded in 2015.



Source: Pitchbook/NVCA Venture Monitor

U.S. VC-Backed Exit Activity

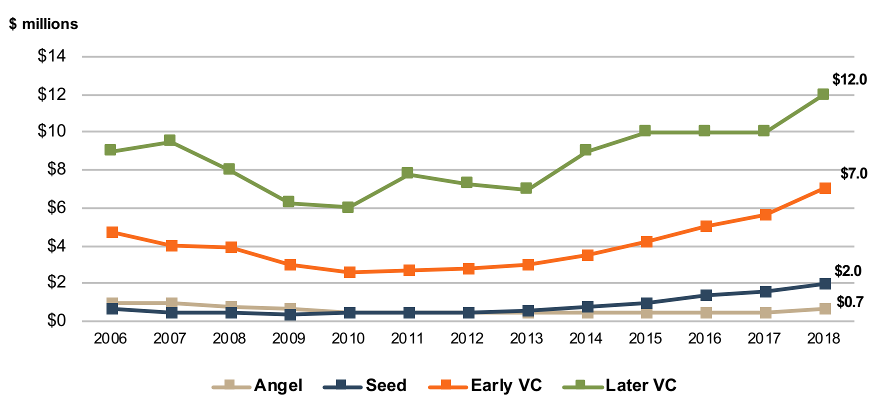
More than 50% of total value exited during 2018 was through a public offering even though IPOs accounted for only 10% of all exits. However, the most notable IPO news for the year revolved more around filings than actual offerings. Details of these potential offerings are still largely unknown, as companies are taking advantage of the ability to file confidentially.



Source: Pitchbook/NVCA Venture Monitor

Median Deal Size by Stage ($ millions)

The trend of growing median deal sizes held through the end of the year, with late stage deals cresting $12.0 million. Another notable trend is the divergence between median angel and seed stage deals. These two groups looked largely similar through 2014 before median seed deals took off on an upward trajectory.



Source: Pitchbook/NVCA Venture Monitor

On the Call

The following is a brief compendium of quotes from 4Q18 earnings season conference calls.

Josh Harris (APO, Co-Founder) – "But on the credit side certainly, the volatility in December provided us the opportunity to deploy a bunch of capital. It was short-lived in the sense that the credit markets rallied in January and have recovered a lot of what they had — and retraced some of the losses. And so we took advantage of it."

Scott Kleinman (APO, Co-President) – "So from a performance quarter, notwithstanding the equity market volatility, 4Q18 continued the trend that we had seen for much of the year, solid mid-single digits across the portfolio on average, sort of mid-single-digit revenue and EBITDA growth across the portfolio. The vast, vast majority of the companies are in very good shape. Look, as far as exit and monetization, it's pretty consistent with what we've been saying for the last few quarters, which is '19 should be — assuming there's not a massive market meltdown, '19 should be better than '18 and '20 will be better than '19."

Kipp DeVeer (ARCC, CEO) – "We believe that the big negative move that we saw in December was largely a technical event. As a result, during the fourth quarter, the broadly syndicated loan market experienced price weakness, but the buy-and-hold middle-market, where we are most active, demonstrated materially less price volatility. Since the start of this year, institutional money has returned and secondary prices in the broadly syndicated loan market have partially recovered."

Steve Schwarzman (BX, Chariman & CEO) – "As everybody knows, the fourth quarter was an extremely difficult period for markets. For the full year, for the first time in at least 15 years, every major traditional asset class had negative real returns after adjusting for inflation. Looking at the world today, we remain constructive on the U.S. economy. Employment trends remain strong. The consumer is healthy and there are no visible signs of a recession."

Jon Gray (BX, President & COO) – "But the underlying credit factors still look pretty good, particularly here in the U.S. There's been a lot of focus in the media around the leverage loan market in particular. And yet, when you look at that market, defaults are less than half of historic levels and interest coverage is the highest it's been since the crisis."

Kewsong Lee (CG, Co-CEO) – "High levels of dry powder in our industry, combined with slowing global growth and volatile markets, could affect both investment pace and realizations in 2019. Buyers to mark the market faster than sellers, and so there's a period of time that needs to happen for that recalibration to occur."

Curt Buser (CG, CFO) – "What we see on a go-forward basis is a continued high price environment. Every asset is expensive. We do see, potentially, some reduction in purchase prices, as Kew said, in the international arena."

David Golub (CG, President & CEO) – "We think there is a stronger case for interpreting the recent volatility as another tantrum where there really is not a set of fundamental changes in market conditions. A line I've often used is that the middle market is insulated from, but not immune from trends in the broadly syndicated market. By that I mean, the amount of capital that's been raised, the number of new players who've come in, the amount of money that's looking for a home in new middle-market loan assets. So we're seeing less volatility in the middle market for better or for worse."

Scott Nuttall (KKR, Co-President & Co-COO) – "The LPs take a longer-term perspective and the general view is that we're entering a lower-return environment for the markets more broadly. And in that context, we have a lot of discussions around clients feeling like they're going to need more alternatives, not less, in order to hit their target. We also think as the overall market return drops, the illiquidity premium that we're able to generate actually increases as a percentage of their overall return. And so that's meaningful for us too."

Art Penn (PNNT, Chairman & CEO) – "We focus, today, mostly on the self-originated middle-market, which generally doesn't really move. It's a much more placid environment. The U.S. economy is generally strong. I think we're seeing probably mid-single-digit EBITDA growth as a broad and general statement in the portfolio."

Source: All transcripts obtained from SNL.

MERCER CAPITAL
BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

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

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