Portfolio Valuation

Private Equity & Venture Capital Marks & Trends

Second Quarter 2019

In This Issue

As the second quarter draws to a close, two seemingly disparate cross currents are evident that have implications for private equity and credit. One is a market in which capital flows are generous. The IPO market is red-hot like (sort of) 1999, while the market for middle market and broadly syndicated credits entails little pushback from lenders.

The other trend is the drop in interest rates. As this newsletter is being penned, the entire U.S. Treasury curve, with the exception of the 30-year, yields less than the Fed Funds target rate of 2.25% to 2.50%. It is not a new development. Rates have been trending lower since last November, and the forward 90-day LIBOR curve first inverted in June 2018.

To the extent curve inversion points to an oncoming recession, the credit markets are not yet reflecting it. High yield credit spreads are slightly higher than September 30, 2018, but are lower than year-end 2018.

Some believe the Eurodollar market is pointing to funding issues outside the U.S. that have been building for a year and have created a scramble for "good" repo collateral (i.e., U.S. Treasuries). That may be true, but as Ares Capital CEO Kipp DeVeers notes, the existing demand for assets outstrips supply in a world where yields are low and M&A and buybacks reduce the float of public equities.

If economic conditions do not change much and the market remains robust, then marks applied to private equity and credit investments probably will not change much over the balance of the year. Nonetheless, the bond market is credited with calling the economy well before equities and the Fed's PhDs. Time will tell if the bond market is right again.

Does the Public Market Believe in Unicorns?

by Jeff K. Davis and Megan E. Richards

The IPO market is hot thanks to the intersection of investor enthusiasm and a new crop of venture capital-backed, and in some instances traditional private equity-backed, firms that have gone public. Unicorns (pre-IPO valuation of $1 billion or more) in particular have caught investors' attention.

There is nothing new about a hot IPO cycle in the U.S. IPO activity waxes and wanes with markets. The last massive wave occurred in 1999 when a mania swept through markets as then internet and other technology-focused companies captured investors' imaginations.

1999 vs. 2019

Why has 2019 become the year of the unicorn IPO? It could be a matter of timing and monetary policy. After a nearly ten-year bull market, private equity is monetizing while the IPO window remains open after it more or less closed in the fourth quarter of 2018. Also, easy money policies the past decade arguably have incented investors to shower capital on growth-focused tech companies. With the Fed likely to begin cutting rates again in 2019, capital flows may intensify again.

Nonetheless, the current IPO wave is different from 1999 and other peaks on three related counts. One is the length of time most venture-backed companies have remained private before going public. The other is the staggering amount of losses incurred even on an "adjusted" basis before going public.

The link between the two differences has been the willingness of deep-pocketed investors, such as SoftBank, to fund losses through multiple capital raises. The link gives rise to the third difference: staggeringly large private market valuations for some.

Looking at how several of the big name public offerings have fared this year (**see charts on page 3**), we can't help but wonder:

- Do current losses matter to public market investors?
- Did the private market overvalue these unicorns?
- What does all of this mean for other unicorns planning to go public in 2019?

The short answers are: perhaps, probably, and hurry.

Sentiment Toward Recent Unicorns

Public investors seemingly have been more discerning about losses than private investors who pushed valuations higher for many companies with successive funding rounds. Price performance in the post-IPO market has been uneven as would be expected, but it points to less tolerance among public market investors to the extent big money losers such as Lyft and Uber have much lower valuations today than expected when their IPO roadshows were launched. Blue Apron is a poster child for a disaster post-IPO stock, but it is not alone.

Lyft and Uber point to the more critical view public investors have taken of each company's business model as it relates to future earnings. Lyft priced near the high end of the range targeted initially by lead underwriter JPMorgan and then saw strong first day performance; however, it now trades about 15% below the IPO price.

Uber has traded down modestly from the IPO price, but lead underwriter Morgan Stanley had to sharply reduce the IPO price from when the roadshow started with price talk of a $90 billion to $100 billion post-raise valuation compared to about $73 billion presently.

Uber and Lyft posted the highest revenue growth over the prior three years, but also the largest losses. The losses didn't prohibit the companies from going public, but the uncertainty of a future path to profitability has led to disappointing performance relative to the hype that has surrounded the companies.

Perhaps investors see a better outlook for Slack Technologies, which went public via a direct listing on the NYSE in mid-June. Although the company is not yet profitable, the shares rose nearly 50% on the first day of trading as either investors see a path to profitability or too few shares were floated.

On the other hand, both Tradeweb and Zoom among a number of newly minted tech companies have performed well since their respective IPOs. Both were profitable in the year prior to the IPO, which is more in line with the kind of pre-offering financials that public investors are used to seeing. The market has rewarded the two companies accordingly.

The next big name to test investors' willingness to fund sizable losses is The We Company. The company confidentially filed for an IPO at the end of 2018 and is expected to begin a roadshow soon. The We Company may be the ultimate unicorn to test the market. It is minting losses. Only through the company's defined term "community adjusted" EBITDA, which is akin to a twice-adjusted EBITDA, does the company post positive EBITDA. Also, the company has a huge $45 billion valuation based upon its last fundraising round; yet, its business model may be suspect in that it entails acquiring expensive real estate that generally is leased under short-term arrangements. Presumably, in a recession, lease rates would plummet as vacancies soar.

Some have raised legitimate questions about valuation processes employed by private equity and VC firms and whether private market valuations are too high. Others have noted investors can, in effect, mark-up the value of prior investments by investing in follow-on capital raises for a given company at a higher valuation.

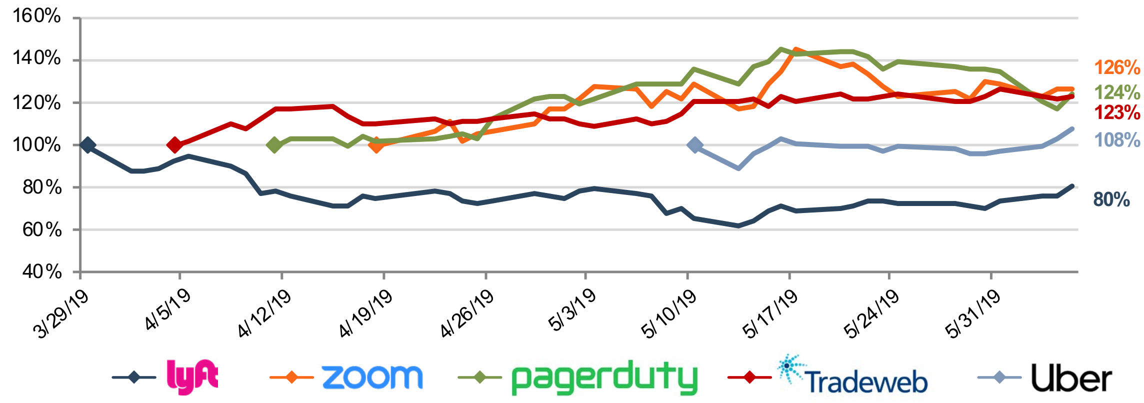
Conclusion

We do not mean to disparage anyone with the issues raised in this article. We respect markets and the pricing information that is conveyed. The prices at which assets transact in private and public markets are critical observations; however, so too are a subject company's underlying fundamentals, especially the ability to produce positive operating cash flow and a return on capital that at least approximates the cost of capital provided.

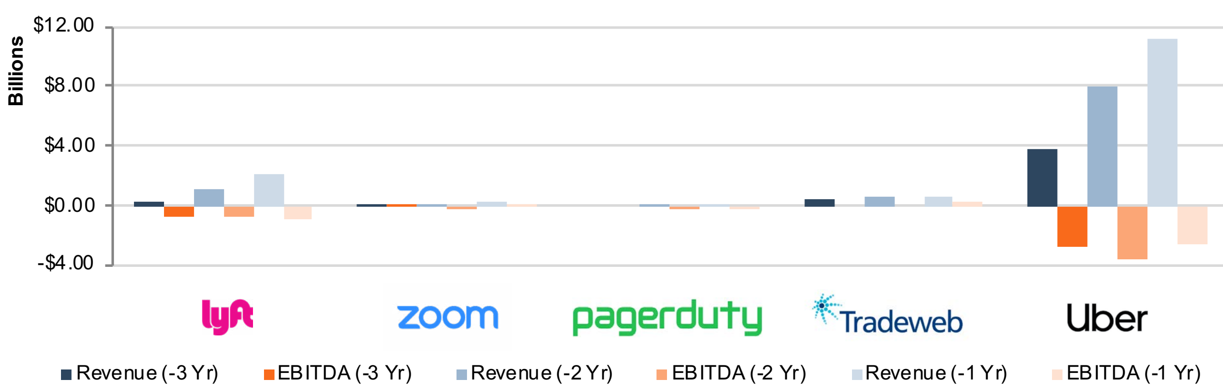
At Mercer Capital we have been valuing private equity and private credit securities for nearly four decades and have deep experience in most industries. If we can help you establish the value of securities held in your fund or offer a second opinion, please call. We would be glad to assist.

	LYFT	Zoom	PagerDuty	Tradeweb	Uber
Ticker	LYFT	ZM	PD	TW	UBER
Exchange	NASDAQ	NASDAQ	NYSE	NASDAQ	NYSE
Date	3/29/19	4/18/19	4/11/19	4/4/19	5/10/19
Initial Price	$72.00	$36.00	$24.00	$27.00	$45.00
First Day Close	$78.29	$62.00	$38.25	$35.74	$41.57
First Day Price Premium	9%	72%	59%	32%	-8%
6/20/19 Close	$62.84	$102.30	$53.79	$42.95	$43.86
% Change from IPO Price	-12.7%	184.2%	124.1%	59.1%	-2.5%
IPO Amt Raised ($M)	$2,340	$751	$218	$1,080	$8,100
Last Private Valuation ($M)	$23,400	$5,000	$1,800	$1,100	$82,400
IPO Market Cap	$20,583	$9,230	$1,767	$6,000	$75,713
6/20/19 Market Cap	$18,262	$27,872	$4,093	$9,544	$74,367

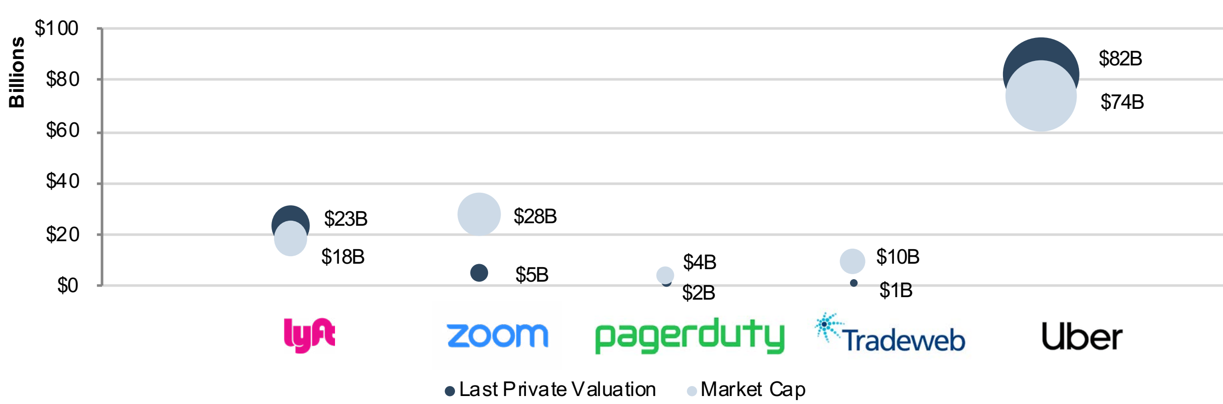
Stock Performance Since IPO (Pricing as of 6/20/19)



Three Year Financial Performance



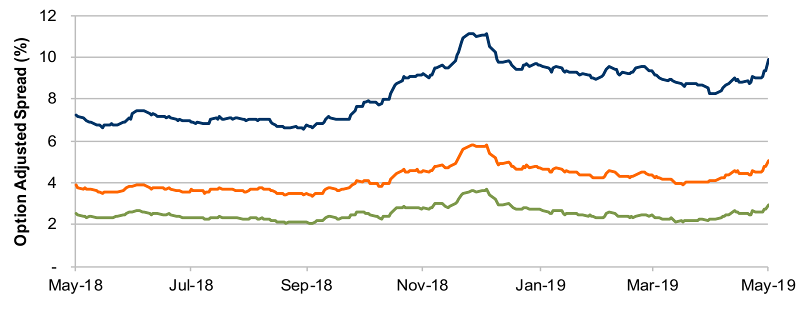
Private vs. Public Valuation (Pricing as of 6/20/19)



Private Credit and Equity

Debt Investments: High Yield Spreads by Credit Rating

High yield credit spreads ticked up in May as the outlook for U.S. economic conditions weakened. 2018 rate hikes seem to be slowing the economy in 2019 beyond weakness seen in traditional rate sensitive industries such as home building and autos. Year-over-year, credit spreads have widen by 40 bps among B-rated credits, 117 bps for BB, and 171 for CCC.



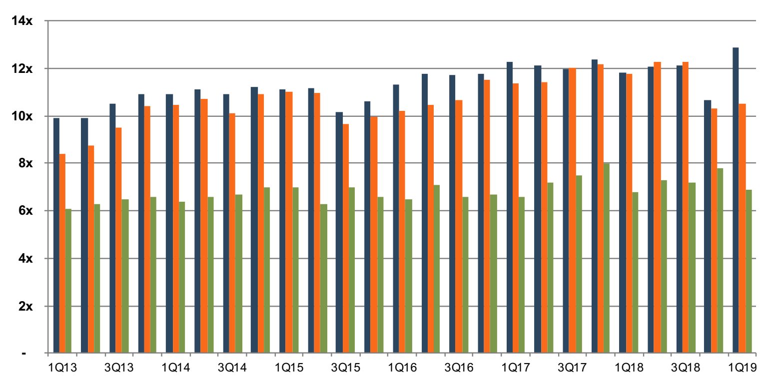
Source: BofA Merrill Lynch

Median EBITDA Multiple
Excludes financials

Equity Valuation: EBITDA Multiples Over Time

In the first quarter of 2019, the valuation gap between small cap and large cap stocks widened as the rebound in equity markets this year has been focused on large cap stocks (a corollary being the Russell 2000 has materially lagged the S&P 500 YTD).

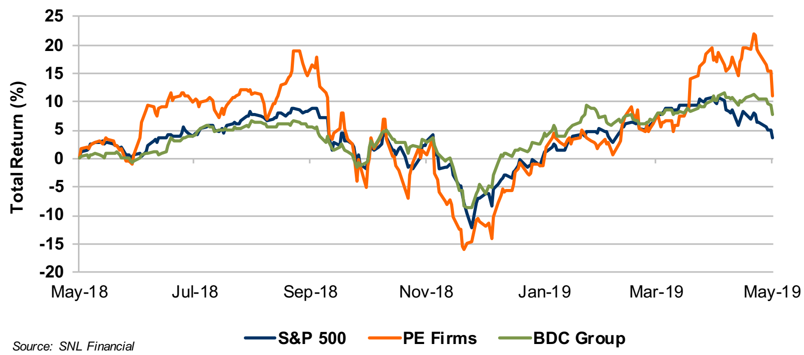
The median EBITDA multiple for PE-sponsored transactions in the lower middle-market as compiled by GF Data® was 6.9x, which represented the first sub-7x quarter since the first quarter of 2018.



Source: Capital IQ, GF Data®
Excludes financials

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

The U.S. economy remains relatively strong in comparison to the rest of the world. However, markets fell in the latter part of May as the outlook for 2019 deteriorated due to a slowing global economy that has been accentuated by deepening trade tensions between the U.S. and China. Nonetheless, PE stocks and the BDC group outperformed the broader market in the trailing twelve month period.

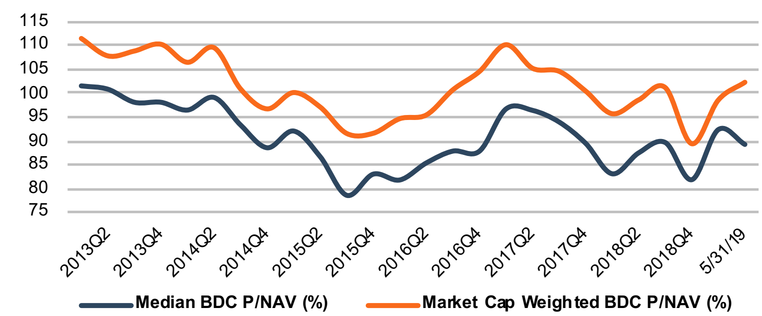


Source: SNL Financial

Publicly Traded Private Credit

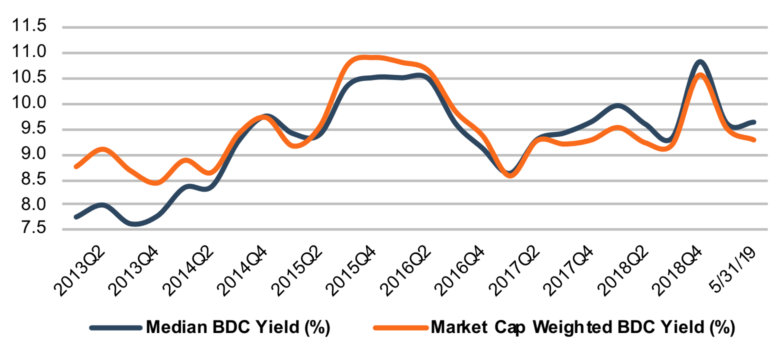
The median P/NAV for BDCs eased from 93% at the end of the first quarter of 2019 to 90% at the end of May, while the median dividend yield declined to 9.3% from 9.5%.

Long-Term Business Development Companies P/NAV Trend



Source: S&P Global

Long-Term Dividend Yield Trend

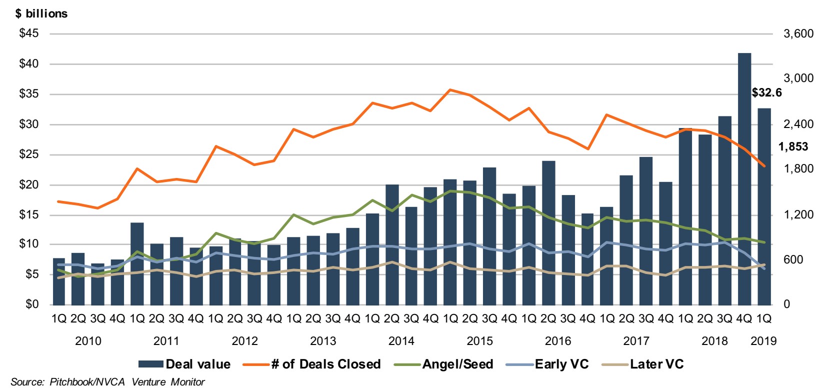


Source: S&P Global

Venture Capital

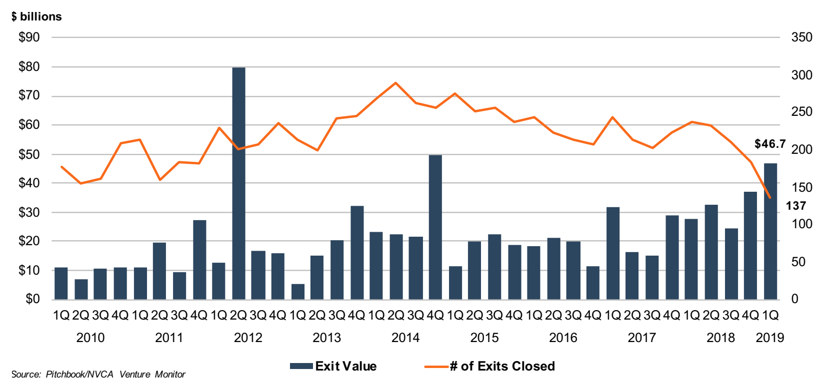
U.S. VC-Backed Funding Activity

First quarter VC funding at $32.6 billion is up 9% from 1Q18 and is double the amount raised in 1Q17. The number of deals continued to decline, however, falling to 1,853 in 1Q19 from 2,338 in 1Q18 and 2,536 in 1Q17.



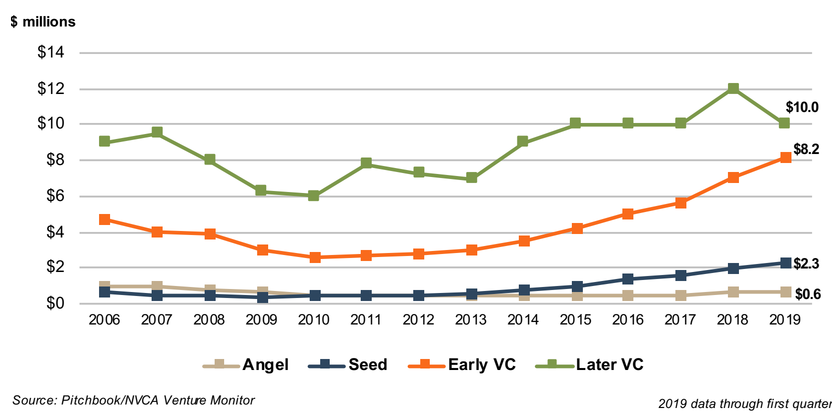
U.S. VC-Backed Exit Activity

First quarter 2019 saw public offerings from several notable unicorns, albeit with mixed post-IPO performance. Despite some unicorn IPOs pricing below their last private valuations, registrations continue to pour in as VC and PE funds seek to monetize private investments in a receptive public market.



Median Deal Size by Stage ($ millions)

The median deal size for late stage funding fell for the first time in several years to $10 million while early stage funding continued to climb.



On the Call

The following is a brief compendium of quotes from 1Q19 earnings season conference calls.

Jim Zelter (APO, Chief Investment Officer-Credit) – "It's going to continue through the rest of the year. Lower rates, probably muted inflation, (we) look forward to opportunities with market dislocations, but we probably prefer private opportunities than public."

Kipp DeVeer (ARCC, CEO) – "Let me transition to some thoughts on the rebound in the leveraged finance market. Following tremendous market volatility at the end of 2018 in the broadly syndicated market, things have rebounded quickly but this volatility did leave some aftereffects. The most significant is that transaction volume continues to be lower across the board, and the existing demand for assets has outstripped the supply of deal flow.

We continue to believe that we're late in the credit cycle. With this, we continue to see better risk/reward for investment opportunities in the middle market. The lower middle market remains quite crowded in our opinion with competitors that lack differentiation and a real ability to compete."

Jon Gray (BX, President & COO) – "What's interesting in private equity is, if you look at the data and you went back to say 2006, now 13 years ago and the number of large buyout funds, call it $15 billion or more, I think that number is unchanged and yet during that time, the Global market cap has more than doubled. So what we've seen is lots of capital move into the middle market private equity area and a lot less capital move into these larger transactions."

David Golub (GBDC, President & CEO) – "The piece I see as least attractive would be banking companies (as lenders) that are in the $10 million to $25 million EBITDA range where we're finding that the combination of pricing and terms and leverage that's being offered frequently leave the lender in a situation where the risk/reward is not attractive."

Scott Nuttall (KKR, Co-President & Co-COO) – "So on the first, the question about the banks reentering the lending space, we haven't seen a big impact thus far on our efforts from that. In terms of the second question, the traditional asset managers moving into alternatives, there has been some activity in the space. It's received quite a bit of attention. It has not had an impact on our business to-date."

Art Penn (PNNT, Chairman & CEO) – "At this point in time, our underlying portfolio indicates a strong U.S. economy and no signs of recession. (But) the LIBOR floor question is a great question. I think we all (ought to) start looking at it again.

People say, 'Gee, middle-market M&A levels activity has been a little bit lighter so far in 2019 than it was in '18.' Obviously, you typically had the seasonality in the first quarter, but it has been lighter. And we think, in part, it is because buyers and financiers are being more skeptical of the pro forma adjustments."

Source: All transcripts obtained from SNL.

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.

Contact Us

Jeff K. Davis, CFA
615.345.0350
jeffdavis@mercercapital.com

J. David Smith, ASA, CFA
713.239.1005
smithd@mercercapital.com

Mary Grace Arehart
901.322.9720
arehartm@mercercapital.com

Travis W. Harms, CFA, CPA/ABV
901.322.9760
harmst@mercercapital.com

Bryce Erickson, ASA, MRICS
214.468.8400
ericksonb@mercercapital.com

Megan E. Richards
901.322.9767
richardsm@mercercapital.com

MERCER CAPITAL

www.mercercapital.com