MERCER CAPITAL
BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

Portfolio Valuation

Private Equity & Venture Capital Marks & Trends

Third Quarter 2019

In This Issue

Context is Important When Considering Transaction Data Relevance	1
Private Credit and Equity	3
Publicly Traded Private Credit	4
Venture Capital	5
On the Call	6
About Mercer Capital	7

An emerging issue for investors this year is liquidity, or potentially the lack of it. Liquidity and illiquidity always have been key considerations in any market.

In the years since the global financial crisis (GFC), liquidity has become a pseudo-asset class. Due to very low or even negative yields on "safe" assets, investors have been forced further out the risk curve to generate returns. Tremendous growth in the private equity and credit markets since the GFC largely is attributed to investors willing to accept illiquidity in order to obtain additional return.

Regulation has been a driver too, as banks were forced to exit some riskier types of lending. Also, regulation (e.g., Sarbanes-Oxley), plenty of private capital and Wall Street's quarterly reporting game have made the public equity markets less attractive to some companies.

A byproduct of investors' willingness to accept illiquidity to enhance returns has been asset inflation. Unicorns and the ability of so many money-losing companies to raise vast sums of capital at ever higher valuations did not occur in a vacuum.

Now some are concerned that liquidity, like leverage, is a two-way street. Its absence is not a problem when asset values are rising, but a negative feedback loop may develop if asset prices begin to decline. Investors may demand the return of capital from funds that lack drawbridges or indirectly sell illiquid assets that are held in a liquid wrapper (e.g., leverage loan ETFs).

It is just speculation as of early October, but the implications could be profound for private equity and credit fund marks if liquidity truly becomes a valuation issue.

Context is Important When Considering Transaction Data Relevance

by Jeff K. Davis, CFA

A Look at WeWork's Failed IPO

In last quarter's issue of **Portfolio Valuation** we raised the issue as to whether public market investors are more critical (or discerning) in establishing value than private equity investors. The evidence this year largely is, yes—at least for companies where there is skepticism as to whether meaningful profitability can be achieved.

Lyft, SmileDirectClub and Uber are examples of unicorns that saw share prices marked sharply lower after the IPO (Lyft, SDC) or during the roadshow (Uber); and The We Company's planned IPO never occurred due to pushback by investors. At the other extreme is Beyond Meat, which as of early October had risen about six-fold from its May IPO.

The We Company's (formerly "WeWork" and will be refered to in this article as WeWork) valuation journey is interesting (maybe even fascinating).

WeWork, which was founded in 2010, is a real estate company that signs long-term leases for pricey real estate that it refurbishes then releases the space short-term. The company describes itself somewhat differently as a "community company committed to maximum global impact."

The S-1 disclosed not only massive losses, but also significant corporate governance issues. Year-to-date revenues through June 30, 2019 doubled to $1.5 billion from the comparable period in 2018, but the operating loss also doubled to $1.4 billion. EBITDA for the six months was negative $511 million, while capex totaled $1.3 billion.

That is a big hole to fill every six months before factoring in rapid growth to be financed. Cash as of June 30 totaled $2.5 billion, while the capital structure entails a lot of debt and negative equity.

From a valuation perspective, WeWork is problematic because operating cash flows are deep in the red with little prospect of turning positive anytime soon. Nonetheless, the increase in value private equity investors placed on the company was astounding.

The company pierced the unicorn threshold in early 2014 when affiliates of JPMorgan invested $150 million in the fourth funding at a post-raise $1.5 billion valuation. T. Rowe Price and Goldman Sachs invested $434 million in late 2014, which resulted in a post raise valuation of $10 billion.

The 7th and 8th funding rounds are where the valuation really gets interesting. In August 2017 SoftBank Vision Fund invested $3.1 billion, which implied a valuation of $21 billion. SoftBank Group Corp., which sponsors the Vision Fund, invested $4.0 billion in January 2019 at an implied valuation of $47 billion.

When the underwriters were forced to pull the plug on the IPO the targeted post-raise valuation reportedly was $10 billion to $15 billion—a value the company apparently was willing to accept because it needs the cash.

We do not know exactly how private equity investors valued the company. Presumably discounted cash flow (DCF), guideline public company and guideline transaction methods were used, perhaps overlaid with a Monte Carlo simulation.

The valuation history raises an important question: how was a stupendous valuation achieved in the private markets by a cash incinerator such as WeWork? A similar question could be asked about many high-profile PE-backed investments.

The short answer is that Softbank thinks the valuation increased significantly even though the company's fundamentals argue otherwise.

Prospective investors such as the public ones who were offered WeWork shares in an IPO could prepare their own DCF forecast to value the company. They also could examine past transactions in the company for relevant valuation information.

Likewise, they could examine capital transactions in similar companies. Both sets of data fall under the guideline transaction method.

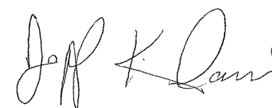
A transaction in a privately held company infers a meaningful data point about value to investors, but there are a couple of caveats. One is an assumption that both parties are fully-informed and neither is forced to transact. Great values were realized by those willing to buy during the 2008 meltdown because there were so many forced sellers that ran the gamut from levered credit investors forced to dump bonds to the likes of Wachovia Corporation and National City Corporation. The price data was legitimate, but many sellers faced margin calls and had to dump assets into an illiquid market. Is the valuation data relevant if "normal" market conditions prevail?

The second issue relates to private equity valuation generally, but especially those where start-up losses and ongoing capital requirements can be huge. The valuation issue relates to using transaction data from investments in other money losing enterprises. Is it always valid to apply multiples paid by investors in a funding round of a money-losing business to value another money-losing business? The valuation data may be factual, but it may be nonsense when weighed against the business' operating and financial performance.

One can question Softbank's motives. Did Softbank need a higher valuation to offset losses in other parts of the portfolio in order to maintain investor and lender confidence? Was a higher valuation necessary to support upcoming capital raises? We do not know, but prospective public investors were dismissive of Softbank's valuations and they appear to be dismissive of the prior two raises given how low the price talk had fallen by the time the IPO was pulled.

We at Mercer Capital 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.

Mercer Capital can assist with the valuation of your portfolio companies. We value hundreds of debt and equity securities of privately held companies every year and have been doing so for nearly four decades. Please call if we can assist in the valuation of your portfolio companies.

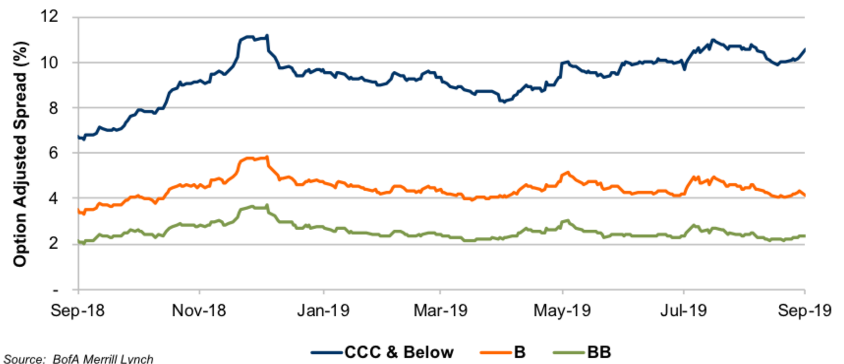


Jeff K. Davis, CFA
(615) 345-0350
jeffdavis@mercercapital.com

Private Credit and Equity

Debt Investments: High Yield Spreads by Credit Rating

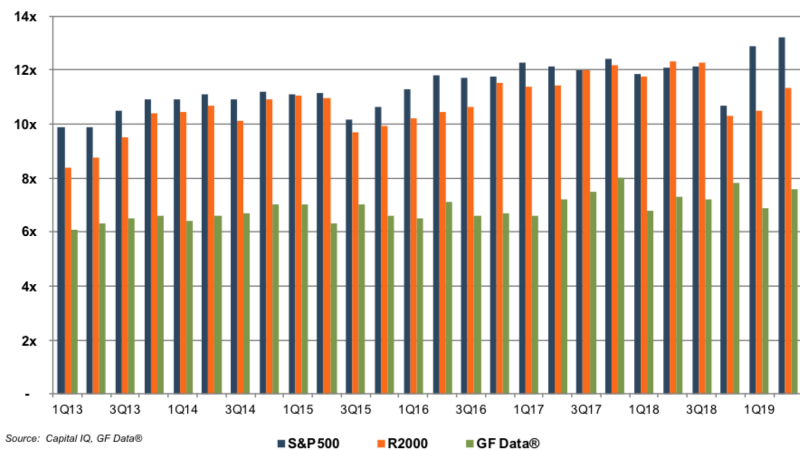
Yields on issues rated CCC & below widened 62 bps in the third quarter of 2019 while yields on B- and BB-rated credits tightened modestly. One intrepretation is that only the lowest rated companies ("triple hooks") face rising credit issues as the economy slows. An alternate view is that ongoing liquidity flows into leverage loans and high yield bonds has caused B and BB spreads to tighten rather than improving credit fundamentals per se.



Source: BofA Merrill Lynch

Equity Valuation: EBITDA Multiples Over Time

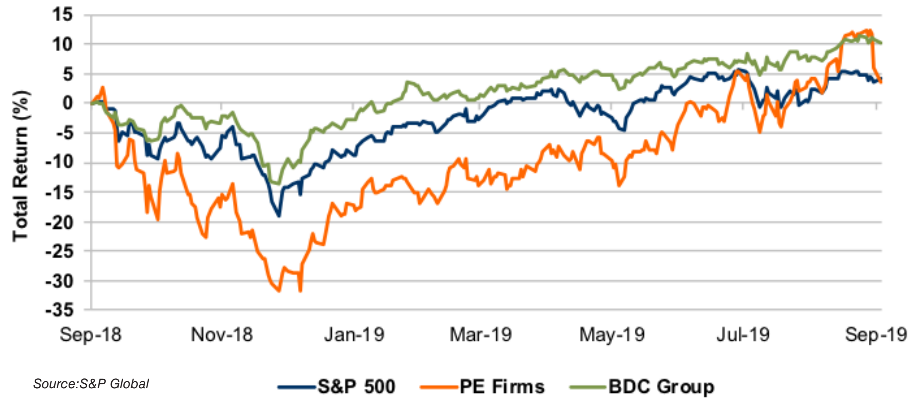
The gap between small cap and large cap stocks narrowed in the second quarter of 2019 relative to the end of 1Q19. The median EBITDA multiple for PE-sponsored transactions in the lower middl-market as compiled by GF Data ® was 7.6x.



Source: Capital IQ, GF Data®

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

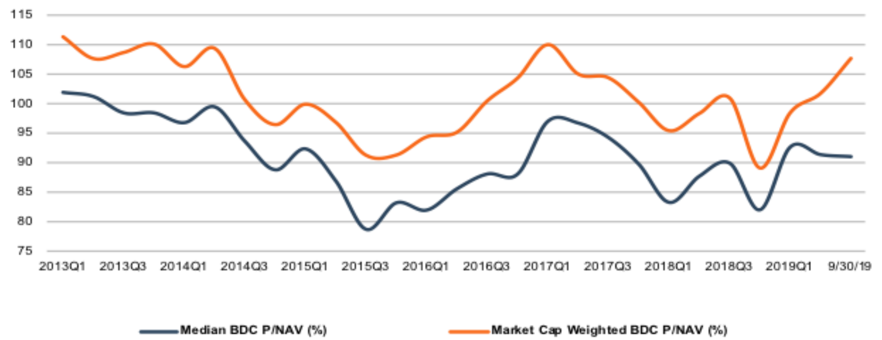
In response to growing concerns over the global economic slowdown and trade tensions between the U.S. and China, the Federal Reserve cut its benchmark interest rate two times in the third quarter of 2019. The S&P 500 index closed out a volatile quarter up 1.7% from the end of 2Q and up 21% for the year. PE stocks and the BDC group outperformed the broader market in the trailing twelve month period.



Publicly Traded Private Credit

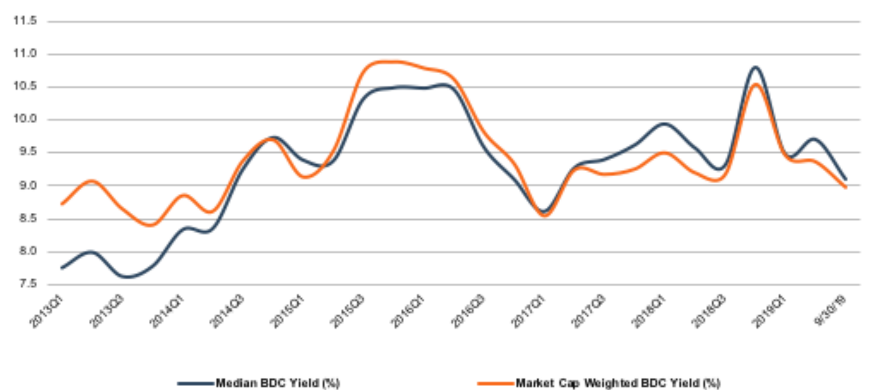
Larger BDCs as reflected in the market cap weighted group posted solid performance during the third quarter in which P/NAV rose and the dividend yield declined as capital flows generally favored higher quality yield plays. Some smaller BDCs continue to struggle with weak P/NAV multiples and periodic dividend cuts.

Long-Term Business Development Companies P/NAV Trend



Source:S&P Global

Long-Term Dividend Yield Trend

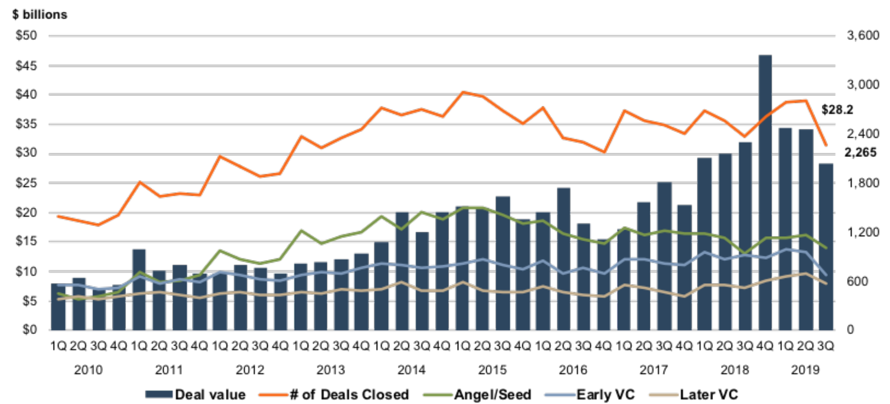


Source:S&P Global

Venture Capital

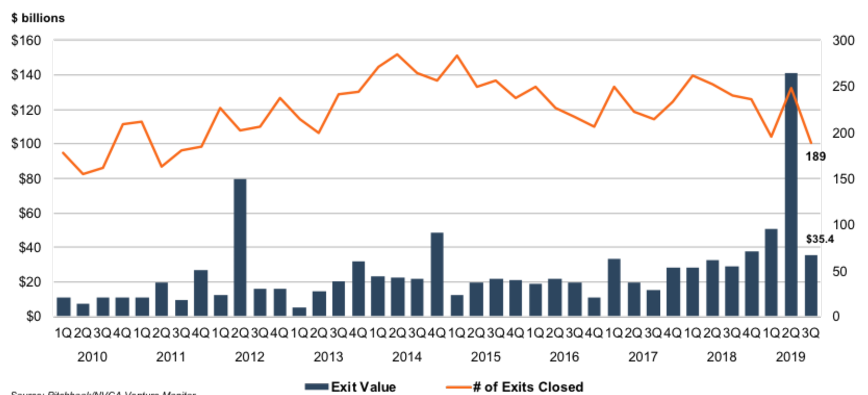
U.S. VC-Backed Funding Activity

In 3Q19, deal flow slowed to the lowest level since 4Q17 based on total deal value and the number of deals closed. Although 2019 appears unlikely to exceed the record setting amount of capital deployed in 2018, investment activity remains robust with total deal value set to surpass $100 billion for the second year in a row.



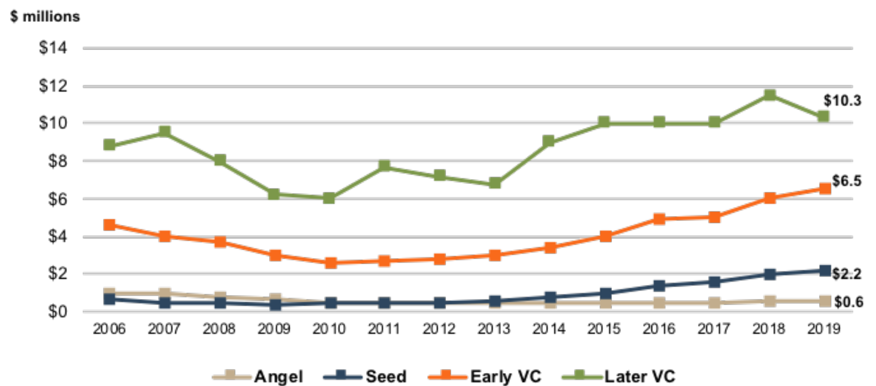
U.S. VC-Backed Exit Activity

Many notable companies made initial public offerings during the first half of the year, though with mixed responses from the public markets. Exits in second quarter 2019 totaled over $141 billion, more than exit value for all four quarter of 2018 combined. In third quarter 2019, exit activity stablized as 189 deals closed for a total of $35 billion. In the year-to-date period, total exit value topped $200 billion, a record setting level for VC exits.



Median Funding by VC Stage ($ millions)

Deal sizes moderated across nearly all stages, with the median late stage capital raise actually declining to $10.3 million. This doesn't mean that mega-deals are over, however. Median deal sizes across all categories remain well over those observed five or ten years ago.



On the Call

The following is a brief compendium of quotes from 3Q19 earnings season conference calls.

Kipp DeVeer (CEO, Ares Capital Corporation) "However, (private credit) volumes do remain well below the prior year's levels. The market remains competitive, supported by continued inflows of capital, and this is increasingly leading to more aggressive lending behavior by other market participants. I think the question will be if rates do go materially lower, will spreads widen to compensate. The same way that you don't get the full benefit of LIBOR increases on the way up; you tend to get some offsetting spread widening as rates go down. So we'll see."

David Golub (President & CEO, Golub Capital BDC) "So if you look at the situation in documentation land, I would characterize it as falling into 2 buckets. There's one bucket that we could call financial covenants and there's one – a second bucket that we could call (asset collateral) leakage-related provisions. […] I think we're seeing a lot of signs that the market is getting smarter about leakage provisions. And I'm pleased to see that because I think the documentation terms in the broadly syndicated market, in particular, around leakage provisions were under very significant pressure earlier this year and were moving in a direction that was bad for the industry. […] I don't see the same phenomenon on the financial covenants front and I don't anticipate that we're going to see it for larger-sized transactions. In the broadly syndicated market, covenant-lite has become a norm. In the middle-market, less so."

Art Penn (Chairman & CEO, PennantPark Investment Corp.) "We just did a portfolio review internally last week. And it looks like on average, EBITDA, on average, is up 5% to 8%. Obviously, there's some there that are doing a little bit better, some that are doing a little bit worse. And that's our latest kind of monthly snapshot. We can't predict where we are going to be 6 months from today, but we do track this stuff monthly. And based on that, we're feeling fine about the economy at this point.

Asset side, it's going to be interesting as LIBOR has gone down, how much the market prices on spread versus absolute, our spreads are going to widen, or our spreads are going to stay the same, and absolute yield is going to come down. We don't have a clear picture at this point other than as far as the first lien business we're doing, it is kind of stable from a spread standpoint over LIBOR. We're not seeing any tightening. The question is are we going to see widening if people priced to an absolute yield. But at this point, spreads have not tightened but absolute yields, of course, have."

Scott Nuttall (Co-President & Co-COO, KKR & Co.) "I think the market […] -- it's become a bit of a have, have-nots market. And I think if a company has real growth or is in certain sectors and has a really simple story, they tend to get a high multiple and there's a lot of capital goes that direction. If there's some complexity, if it's lower growth, if there is more explaining needs to be done, there's a lot of companies that get left behind. And so we are seeing this bifurcated market develop and I do think that is leading to more interest on the part of management teams to consider going private transactions. So that's clearly creating opportunities for us."

Source: All transcripts obtained from SNL.

MERCER CAPITAL
BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

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, CFA
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

MERCER CAPITAL

www.mercercapital.com

Copyright © 2019 Mercer Capital Management, Inc. All rights reserved. It is illegal under Federal law to reproduce this publication or any portion of its contents without the publisher's permission. Media quotations with source attribution are encouraged. Reporters requesting additional information or editorial comment should contact Barbara Walters Price at 901.685.2120. Mercer Capital's *Portfolio Valuation* is published quarterly and does not constitute legal or financial consulting advice. It is offered as an information service to our clients and friends. Those interested in specific guidance for legal or accounting matters should seek competent professional advice. Inquiries to discuss specific valuation matters are welcomed. To add your name to our mailing list to receive this complimentary publication, visit our web site at www.mercercapital.com.