# Portfolio Valuation

## Private Equity Marks & Trends

### First Quarter 2016



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# Shaking Things Up: ARCC and ACAS Combine

On May 23, Ares Capital (**ARCC**) **announced the acquisition** of fellow business development company, or BDC, American Capital (**ACAS**) in a cash and stock deal valued at $4.0 billion. The deal is notable from several perspectives. First, the transaction brings closure to the ACAS saga. Second, the deal includes third-party support from ARCC's management company. Finally, the transaction structure allowed ARCC to raise nearly $2.0 billion in new equity without diluting NAV per share, despite ARCC shares trading at an 8% discount to NAV prior to the announcement.

## Culmination of the ACAS Experiment

Prior to the 2008 recession, ACAS was one of the two largest BDCs. The other, Allied Capital, **was acquired by ARCC** in 2010. As shown in Figure 1, ACAS' share price was (literally) decimated during the recession, losing over 90% of its value during 2008 and 2009 (Figure 1).

During 2011, **ACAS elected** to be taxed as a C corporation rather than a registered investment company, or RIC. No longer subject to RIC distribution requirements, ACAS embarked on an aggressive strategy of asset rationalization, debt reduction, and share repurchases. Having suspended dividend payments in 2010, reported NAV per share increased from $10.71 at the end of 2010 to $20.14 at March 31, 2016 (an annualized growth rate of 12.8%, Figure 2).

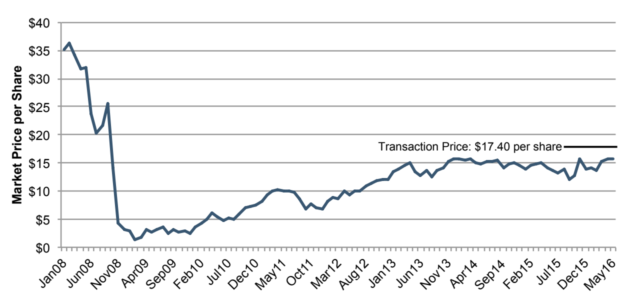
Over that period, the price/NAV ratio for the shares increased from 70.6% to 77.6%, resulting in a compound annual return for shareholders of 14.8% via a combination of growth in NAV and multiple expansion. The announced purchase price of $17.40 per share, an 11.4% premium to the May 20 closing price, brings the compound annual return up to 17.2%. As shown in Figure 2, the increase in NAV per share reflected not only undistributed operating earnings and asset gains, but also the accretive impact of share repurchases below NAV (cumulative impact of $3.19 per share). With shares trading at persistent discounts to NAV, ACAS repurchased nearly 35% of its outstanding float during the period.

In sum, the positive shareholder returns for ACAS over the period, which beat those of ARCC and its peer BDCs, is a reminder that growth is not the only route to generating shareholder returns. While the company's investment portfolio shrunk nearly 40%, pursuit of the best risk-adjusted returns delivered a positive outcome for ACAS shareholders.

## (I Get By) With a Little Help from My Friends…

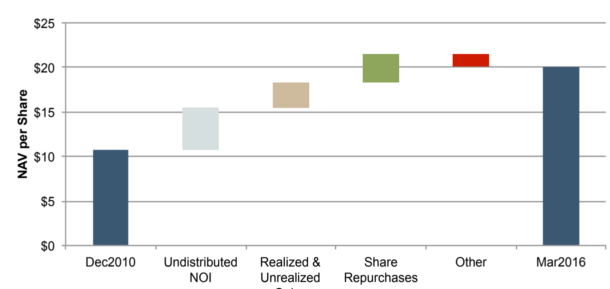
The total reported transaction consideration of $17.40 per ACAS share includes $2.45 per share from the sale of the company's American Capital Mortgage Management subsidiary prior to transaction close. Of the net purchase price

**Figure 1: ACAS Share Price History**




*Source: Yahoo! Finance*

**Figure 2: Change in ACAS NAV per Share**




*Source: Company filings, Mercer Capital analysis* of $14.95, ARCC is providing only $13.75, with the BDC's external manager Ares Management (ARES) picking up the remaining $1.20 per ACAS share, or $275 million. In addition, ARES pledged to a management fee waiver of $10 million per quarter for the ten quarters following the transaction close. The waiver works out to approximately 0.725% of ACAS' reported assets of $5.5 billion, or half of ARES' base management fee of 1.45%. The present value of the fee waiver (at a 12% discount rate) is approximately $86 million, and will accrue to the benefit of both ARCC and ACAS shareholders.

The topic of BDC management fees has been **the subject of much comment** over the past few years. The transaction structure for this deal highlights the attractiveness of the anticipated management fee stream to ARES (as well as, potentially, other strategic benefits accruing to the broader Ares platform as a result of the transaction).

From the perspective of ARCC shareholders, the contribution by ARES represents approximately $0.65 per share of NAV accretion, and makes the economics of the transaction considerably more palatable. Relative to the pro forma investment portfolio of $13.2 billion, the prospective fee concession represents approximately 30 basis points of incremental return on assets and 55 basis points of incremental return on equity.

## Unlocking Incremental Capital

New share issuance is the only sustainable growth mechanism available to BDCs. With share prices mired at discounts to NAV for almost two years, BDCs have been generally been unable to issue new shares absent shareholder authorization, resulting in stagnant balance sheets given leverage restrictions and a statutory requirement to distribute at least 90% of taxable income as RICs. With depository institutions less inclined – or able – **to make the sort of leveraged loans** that BDCs specialize in, the perceived opportunities for BDCs are potentially substantial, but without access to fresh capital, BDCs have been unable to capitalize.

Prior to the transaction announcement, ARCC

**Figure 3: Calculation of Pro Forma NAV per Share**

| | ARCC | ACAS | Pro Form Adjustments | Notes | Pro Forma |
|---|---|---|---|---|---|
| Investment Portfolio | 9,072 | 4,737 | (562) | A | 13,247 |
| Other Assets | 293 | 778 | (409) | B | 662 |
| Total Assets | $9,366 | $5,515 | ($971) | | $13,910 |
| | | | | | |
| Debt | 3,985 | 887 | 1,470 | C | 6,342 |
| Other Liabilities | 201 | 148 | 0 | | 349 |
| Total Liabilities | $4,186 | $1,035 | $1,470 | | $6,691 |
| | | | | | |
| Stockholders' Equity | $5,180 | $4,480 | ($2,441) | D | $7,219 |
| | | | | | |
| Shares Outstanding | 313.9 | 222.4 | | E | 424.7 |
| NAV per Share | $16.50 | $20.14 | | | $17.00 |
| Pre-Announce Market Price | $15.19 | $15.62 | | | |
| Price / NAV | 92.1% | 77.6% | | | |
| Liabilities / Equity | 80.8% | 23.1% | | | 92.7% |

**Notes regarding pro forma adjustments**

A - Expected proceeds from sale of American Capital Mortgage Management, LLC prior to close of transaction
B - Sum of deferred tax asset writeoff ($212) and transaction costs & expenses ($197)
C - Cash portion of purchase price payable by ARCC
D - Assumes that excess FV of assets acquired over FV of consideration recognized as a gain on purchase at close
E - Pro forma shares sum of existing ARCC shares (313.9) and to-be-issued shares (110.8)

*Source - Company presentation and Mercer Capital Analysis* shares traded at 92% of NAV, compared to 78% for ACAS. ARCC shareholders would likely have been disinclined to approve a dilutive issuance of 110.8 million shares (which would have resulted in a dilutive impact of $0.34 per share). However, since the shares were issued in exchange for ACAS shares trading at a yet deeper discount, the issuance looks to be potentially accretive to NAV per share. (ACAS management indicated that it may take a couple quarters for NAV per share accretion to be realized).

With no obvious triggers for share prices to resume trading at premiums to NAV beyond a pick-up in the economy and a corresponding narrowing of credit spreads, acquisitions like this may be the best available strategy for more favored BDCs to unlock incremental capital and generate balance sheet growth.

## Conclusion

At the close of trading on the first day following the announcement, market response to the transaction has been uninspiring, with ARCC shares trading down 2.4%, and ACAS shares closing at $15.72 per share, or nearly 10% below the nominal deal value of $17.40 per share. Whether this reflects uncertainty regarding the deal actually closing or a lack of enthusiasm for ARCC shares as currency, investors seem unimpressed thus far. A cynic might point out that ARES shareholders (up $0.02) seem unfazed, suggesting that the

## On the Call

The following is a brief compendium of quotes from 1Q16 earnings season conference calls. In general, deal volume and portfolio values were negatively impacted by volatility across global markets.

**Kipp deVeer (Ares)** – "We continue to see a slowdown in transaction flow, in the broader loan and the high-yield markets, as well as the middle market… we believe this recovery is largely technical and without a meaningful change in fundamentals, our attitude and our approach is generally unchanged."

**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."

**Steve Schwarzman (Blackstone)** – "Blackstone is regulated by the SEC. The SEC has a variety of opinions on how to value things, and so we have certain constraints on how we value things as a result of that. The fact that historically they turn out to be really conservative is not something we can do much about."

**Todd Owens (Fifth Street Finance Corp)** – "Several factors contributed to the slowdown in the March quarter, including volatility in the energy and commodity sectors as well as in the credit markets generally, slowing global growth and an uncertain economic outlook. Many of our private equity sponsors took a wait and see approach in the quarter given the lack of quality deals and lofty valuations."

**Scott Nuttall (KKR)** – "We did see further write-downs this quarter in our energy portfolio. With natural gas and crude prices declining three to four years out on the forward curve, DCF values were negatively impacted. And as a result, we saw a little over $100 million in unrealized losses from our energy portfolio."

**Vince Foster (Main Street Capital Corporation)** – "We are a little agnostic about these exits. It's nice to have our strategies and our valuations validated, et cetera, when an exit happens. On the other hand, we end up with the reinvestment risk and having to go try to put the money in a company that realistically might not be as nice as the company that was sold because the companies that are sold typically are first quartile companies, right? They are kind of good news, bad news."

**Steven Lilly (Triangle Capital Corporation)** – "As we move further into the later stages of the current economic cycle, we expect these fees and dividends will be more modest as fewer financial sponsors pursue dividend recaps and as repayments in our portfolio return to a more historic level."

Source: All transcripts obtained from SNL.

value of the incremental management fee stream outweighs the deal contribution and prospective fee concession.

The Ares management team has proven adept at managing through various credit cycles and has the experience of folding in the substantial Allied acquisition in 2010. If this deal closes, the pro forma company will be in a class of its own as measured by size, at approximately twice the size of the next largest BDC. Whether the envisioned benefits of scale will accrue to the ARCC shareholders remains to be seen.

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# Higher Standards for Fair Value

Over the last several years, various officials at the SEC **have expressed concern** about the broadening application of fair value measurement and its impact on the reliability and consistency of valuations performed for U.S. public companies. Some of these concerns included a perceived lack of consistency in the valuation work product, lack of a unified identity of valuation experts, lack of consistent qualifications/experience for valuation credentials, and a lack of consistent enforcement/disciplinary mechanisms for valuation specialists.

Criticism related to fair value is not limited to just the valuation specialist. In a 2015 survey of deficiency findings in audits, **nearly 20%** of such deficiencies relate to fair value measurements. These deficiencies included cases of failure to sufficiently test source data, failure to assess the reasonableness of assumptions, and lack of consideration of contrary/inconsistent evidence, where available. **As previously noted on our *Financial Reporting Blog***, the PCAOB continues to be concerned with the auditing of fair value measurements, especially after finding that over 40% of issues it identified were related to accounting for business combinations (ASC 805).

But what about valuation specialists? In 2014, representatives from the American Institute of Certified Public Accountants (AICPA), American Society of Appraisers (ASA), Royal Institution of Chartered Surveyors (RICS), and The Appraisal Foundation (TAF), along with global valuation leaders from several large accounting firms and the International Valuation Standards Council (IVSC), began formal discussions regarding proposed solutions to the concerns expressed by the SEC. In early 2015, **a joint statement** was issued by AICPA, ASA, and RICS to their members outlining the steps that would be taken to "strengthen the valuation infrastructure in the U.S., particularly in the area for fair value measurements related to business and intangible asset valuations for financial reporting."

Since that time, these participating valuation professional organizations (VPOs) have been working to develop a new shared professional credential that would demonstrate the competence of business valuation professionals providing valuation services for financial reporting purposes. The VPOs have been working along **three major workstreams** (performance requirements, qualifications, and quality control). The performance framework is slated to be ready in early 2016 for public consultation. The exact qualifications requirements to attain this credential have yet to be finalized.

It is our understanding that the new fair value credential will be issued under **a common framework**, but the individual will be bound by the issuing group's professional and ethics standards (AICPA, ASA, or RICS). The new credential will initially focus on business valuation and intangible asset valuations for financial reporting (ASC 820, ASC 805, ASC 350, and ASC 718). It is expected that a second credential would be developed to focus on fair value measurement for financial instruments.

At Mercer Capital, we have always prioritized and valued the personal development and credentialing of our professionals. We will continue to monitor developments surrounding this new professional credential and believe that it will ultimately benefit our clients and their stakeholders via a higher level of consistency and quality in the work product.

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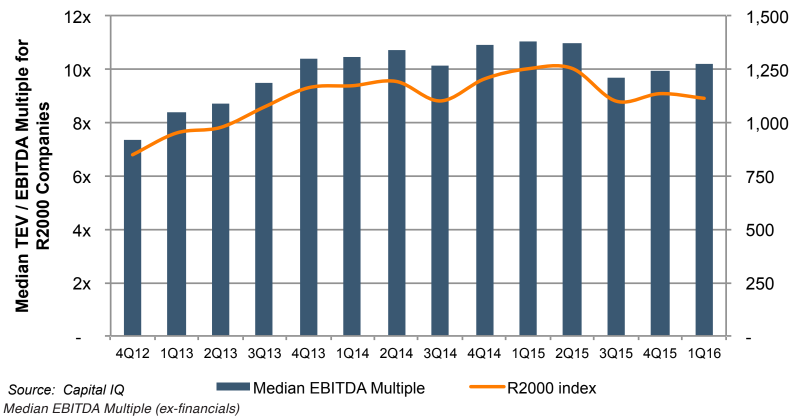
## Equity Valuation

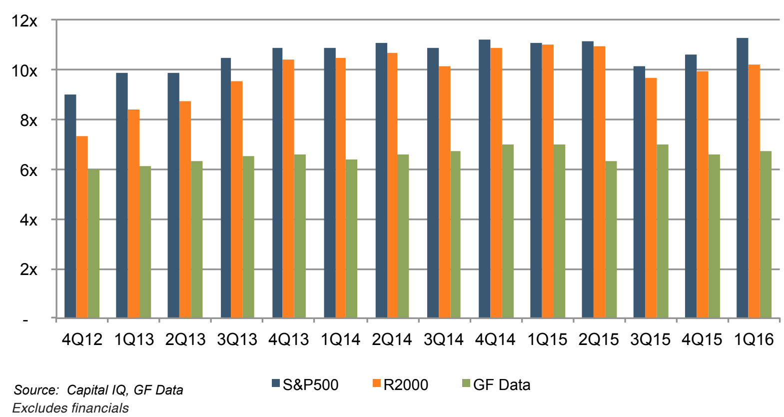
### Russell 2000 Index Values and EBITDA Multiples

After a brutal start to 2016, small cap stocks made a strong bid to recover in the second half of the quarter, with the index ending the period 1.9% off of year-end 2015 levels. Despite the general downdraft in share prices, the median EBITDA multiple ticked up modestly, to 10.2x.




### EBITDA Multiples over Time

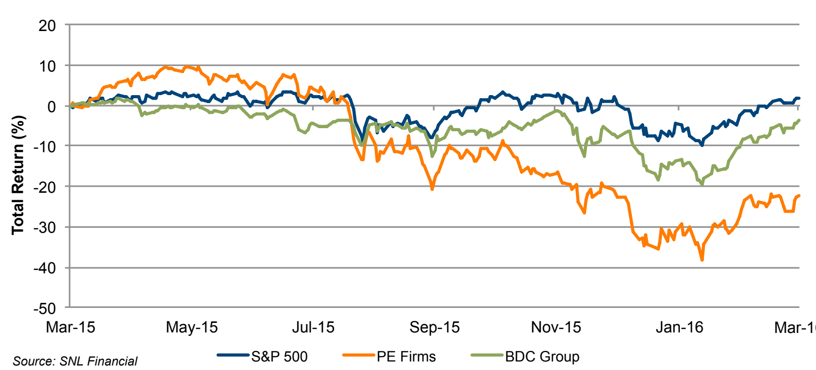
The gap between multiples for small cap (Russell 2000) and large cap (S&P 500) public companies widened in the first quarter of 2016 to a level not seen since the second quarter of 2013 amidst volatile markets and investor uncertainty driven by slowing economic growth and falling oil prices. Lower middle market multiples tracked by GF Data are sensitive to available deal flow and financing conditions in addition to public market multiples.




## Stock Performance for Publicly Traded PE Sponsors

### Total Returns (Trailing Twelve Months)

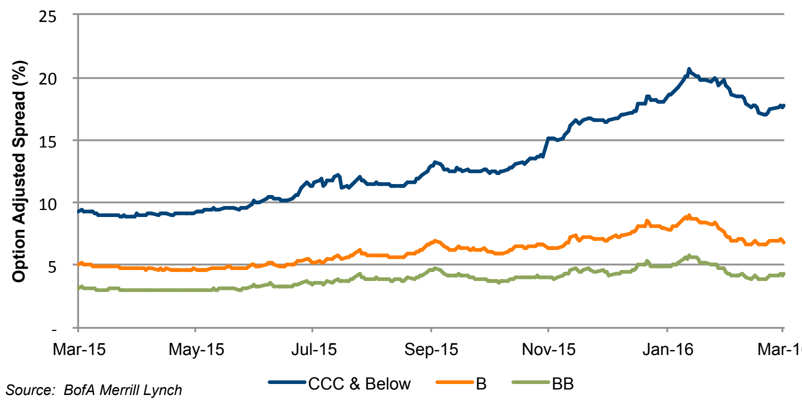
Markets plummeted in January and the first part of February 2016 amidst concerns over economic growth, falling oil prices, weak profit growth, and uncertainty about Fed policy. A mid-quarter rally tempered losses, and the S&P was essentially flat year-over-year.



## Debt Investments

### High Yield Spreads by Credit Rating

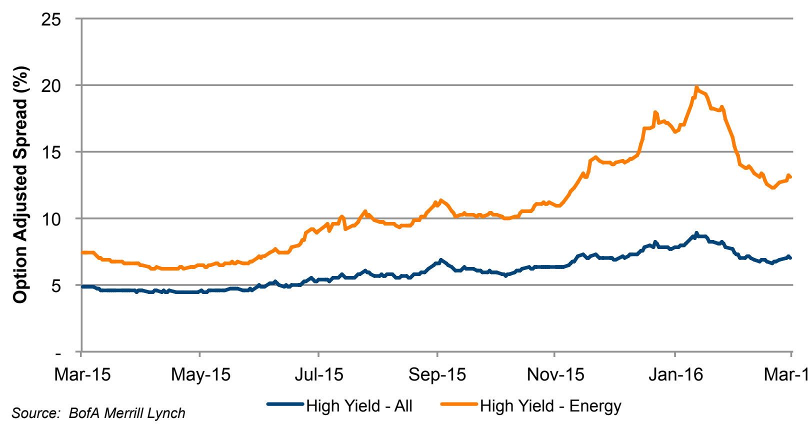
Credit spreads had a wild ride in the first quarter of 2016, widening dramatically into mid-February before resettling at levels modestly below year-end observations. Nonetheless, spreads remain elevated relative to year-ago levels, with CCC & below credits experiencing the most dramatic widening, from 935 bps to 1777 bps.




*Source: BofA Merrill Lynch*

### Impact of Energy Sector on High Yield Spreads

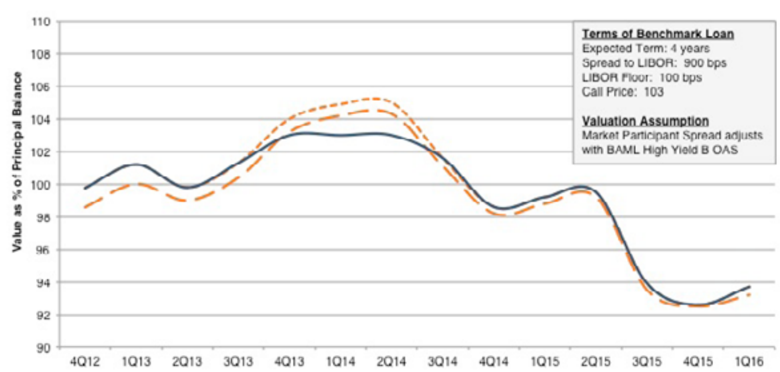
Recent turmoil in oil markets have pushed spreads on energy credits even wider, which is contributing to the overall market trend. During the first quarter of 2016, high yield energy spreads peaked in mid-February at 1,984 bps before contracting to 1,282 bps by quarter-end as markets rallied on steady economic data and softening of the Fed's rate-hiking stance.




*Source: BofA Merrill Lynch*

### Fair Value of Benchmark Debt Instrument

After bottoming out at the end of 2015, the fair value of our benchmark loan edged up with a 30 bps contraction in the BofA Merrill Lynch US High Yield B Option-Adjusted Spread.




*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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