Portfolio Valuation

Private Equity and Credit

First Quarter 2020

In This Issue

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Market Tenor

Lenin is credited with saying, "There are decades where nothing happens; and there are weeks where decades happen." March 2020 was the latter for Wall Street and Main Street. The government mandated shutdown of the economy to fight COVID-19 has produced a recession or possibly depression of unknown depth and duration. Of course, crises create opportunities; and rarely is the aftermath as bad as feared.

Liquidity and sometimes solvency are today's crises to be navigated by private equity and credit-backed companies. A similar test occurred in 2008-2009 as the Great Financial Crisis ("GFC1") unfolded, but the industry—especially private credit—has grown dramatically since then.

One big change we expect sponsors and investors to embrace is an emphasis on realism—i.e. what is compared to a proforma of what could be that characterized private investing in recent years.

Another is an intense focus on liquidity. We highlighted liquidity in our 3Q19 newsletter as a growing risk for the industry. In recent years investors accepted greater illiquidity and leverage to pad returns. Both travel on a two-way street that magnify returns when prices rise, and crush returns when forced selling occurs.

Private equity and credit rarely are forced sellers given the nature of the investment vehicles. But liquidity risk exists, and it may be acute as it relates to terminal values in which the pre-COVID era allowed funds to monetize investments at fantastic values through IPOs, M&A and dividend recaps. The post-COVID era likely will entail exit capital that is harder to source with pricing that absolutely favors investors.

Always Cash Flow and Earning Power

By Jeff K. Davis, CFA

We recognize what matters today for many funds is helping portfolio companies survive a sharp drop in revenues rather than discerning how much first quarter marks may fall from the last valuation.

Scooter rental firm Lime reportedly is trying to raise capital at a valuation that is 80% below its last raise. Dilution and a valuation mark-down may be a bitter pill for existing investors, but for many money losing enterprises with dwindling cash such as Lime, it is unavoidable if the firm is to survive.

Marking to Models and Unhinged Markets

Our focus is on valuing illiquid securities, not sourcing capital. One of our colleagues once said that valuing private equity and credit portfolios is about marking as close to market as possible; it is not marking to a price target predicated on an investment thesis.

The accountants provide perspective and guidance, but not precision beyond the preference hierarchy of Level 1 vs. Level 2 vs. Level 3 valuation inputs. ASC 820-10-20 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." Fair value from the accountant's perspective represents the exit price of the subject asset for a market participant in the principal or most advantageous market.

Exit multiples are a theoretical concept today in which private equity and credit markets are frozen, but that will not always be the case. One never knows how much price dislocation is due to illiquidity vs. the market's reassessment of fundamentals. Time will tell, but the impact of the governments response to COVID-19 on the economy is unlikely to be transitory.

As it relates to marking private equity and credit to market or some semblance thereof, we offer these initial thoughts:

- Guideline M&A and capital raise transaction data observed prior to February 2020 are not as informative because markets and businesses are adjusting to an emerging recession that may be very deep.
- Guideline public company data provides a market assessment of how much value has been impacted but observed multiples convey less information because earnings do not yet reflect any post-COVID results.
- Analyst estimates are hypothesized guesses.
- Other than early-to-intermediate stage VC-type investments, there will be little tolerance or interest in portfolio companies that incinerate cash.
- Additional capital will be limited to growth opportunities that produce value rather than infusions to cover operating deficits or to just grow revenues.
- Investment horizons have extended because it likely will take time for the IPO and M&A market to reopen without distressed pricing.
- EBITDA add-backs for equity and credit investments will be limited to those that truly reflect non-recurring items and will be more likely to exclude "what could be" adjustments based upon future actions to be taken.

Primacy of Cash Flow

So how does one value private equity and credit in a developing recession or depression that may be very deep and of an unknown duration? Our view is that investors will be more focused than ever on cash flow and earning power because the era of ridiculous valuations on flimsy pro-forma EBITDA is over.

Table 1 (on the next page) provides a sample overview of the template we use at Mercer Capital. The process is not intended to create an alternate reality; rather, it is designed to shed light on core trends about where the company has been and where it may be headed. Adjustments are intended to strip-out non-recurring items and items that are not related to the operations of the business.

In addition, EBITDA is but one measure to be examined because EBITDA is a good base earnings measure, but it does not measure cash flow. Capex, working capital and debt service requirements are to be considered, too.

The adjusted earnings history should create a bridge to next year's budget, and the budget a bridge to multi-year projections. The basic question to be addressed: *Does the historical trend in adjusted earnings lead one to conclude that the budget and multi-year projections are reasonable with the underlying premise that the adjustments applied are reasonable?*

The analysis also is to be used to derive earning power. Earning power represents a base earning measure that is representative through the firm's (or industry's) business cycle and therefore requires examination of earnings over an entire business cycle. If the company has grown such that adjusted earnings several years ago are less relevant, then earning power can be derived from the product of a representative revenue measure such as the latest 12 months or even the budget and an average EBITDA margin over the business cycle.

Modest Terminal Values

Terminal values like cash flow will be subjected to more scrutiny, too. As noted previously, guideline transaction data is not as informative today given the change to the economy that has occurred. That is not to say guideline company and transaction data is not relevant, but probably requires a larger than normal haircut for fundamental adjustment.

Alternatively, the build-up method in which current earning power and the terminal value cash flow in a DCF model are capitalized may provide a better estimate of fair value than pre-COVID transaction data.

Table 2 presents a perspective on why market participants may often times conclude the multiple applicable to a given company should be lower in the post-COVID-19 world.

The process will lead to lower values than would have been derived prior to February 2020 because earning power and cash flow projections will be lower; risk premium applied to develop a weighted average cost of capital will be greater; and the expected long-term growth rate in earning power will be lower.

That may change over time as risk premia recede and business cash flows rebound, but that is not the world that exists today as it relates to marking-to-market (or model).

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Table 1

	Budget	LTM	For the Fiscal Years Ended December 31				
Core Earnings Analysis	**2020**	**03/30/20**	**2019**	**2018**	**2017**	**2016**	**2016**
Units	1,474	1,414	1,390	1,321	1,223	1,267	1,221
x Average Price	$9.65	$9.55	$9.50	$9.35	$9.20	$9.25	$9.00
Reported Net Sales	$14,224	$13,500	$13,205	$12,351	$11,252	$11,720	$10,989
Adj (1) Acme Surcharge	0	(120)	(150)	(175)	0	0	0
Adjusted Net Sales	**$14,224**	**$13,680**	**$13,055**	**$12,176**	**$11,252**	**$11,720**	**$10,989**
Reported Cost of Sales	9,175	8,654	8,438	7,775	7,145	7,395	6,868
Adj (2) None	0	0	0	0	0	0	0
Adjusted Cost of Sales	9,175	8,654	8,438	7,775	7,145	7,395	6,868
Adjusted Gross Profit	**5,049**	**4,727**	**4,617**	**4,401**	**4,107**	**4,325**	**4,121**
Reported Operating Expense	2,550	2,425	2,448	2,295	2,225	2,115	2,025
Adj (3) Facility Closure	0	0	(90)	(15)	0	0	0
Adj (4) Litigation Expense	0	0	0	0	(35)	0	0
Adj (5) Rebate Settlement	0	35	0	0	0	0	0
Adjusted Operating Expense	**2,550**	**2,460**	**2,358**	**2,280**	**2,190**	**2,115**	**2,025**
Adjusted Operating Income	**2,499**	**2,267**	**2,259**	**2,121**	**1,917**	**2,210**	**2,096**
Reported Other Inc/(Exp)	(530)	(450)	(410)	(370)	(360)	(350)	(345)
Adj (6) Loss/(Gain) on Asset Sale	0	(95)	(75)	50	120	(20)	65
Adjusted Other Inc/(Exp)	(530)	(545)	(485)	(320)	(240)	(370)	(280)
Adjusted Pre-Tax Income	**$1,969**	**$1,722**	**$1,774**	**$1,801**	**$1,677**	**$1,840**	**$1,816**
EBIT, EBITDA & CapEx							
Adjusted Pre-Tax Income	$1,969	$1,722	$1,774	$1,801	$1,677	$1,840	$1,816
- Interest Income	(27)	(23)	(21)	(19)	(18)	(18)	(17)
+ Interest Expense	477	405	369	333	324	315	311
Adjusted EBIT	**2,420**	**2,104**	**2,123**	**2,116**	**1,983**	**2,137**	**2,109**
+ Depreciation & Amortization	710	680	660	620	560	590	550
Adjusted EBITDA	**$3,130**	**$2,784**	**$2,783**	**$2,736**	**$2,543**	**$2,727**	**$2,659**
Reported Capital Expenditures	780	740	730	680	620	640	600
Adjusted EBITDA less CapEx	**$2,350**	**$2,044**	**$2,053**	**$2,056**	**$1,923**	**$2,087**	**$2,059**
Incremental Working Capital	**127**	**49**	**132**	**139**	**(70)**	**110**	**50**
Adj EBITDA less CapEx & WC	**$2,223**	**$1,995**	**$1,921**	**$1,917**	**$1,993**	**$1,977**	**$2,009**
Adjusted Margins							
Adjusted EBIT	17.0%	15.7%	16.3%	17.4%	17.6%	18.2%	19.2%
Adjusted EBITDA	22.0%	20.8%	21.3%	22.5%	22.6%	23.3%	24.2%
Adjusted EBITDA less CapEx	16.5%	15.3%	15.7%	16.9%	17.1%	17.8%	18.7%
Adj EBITDA less CapEx & WC	15.6%	14.9%	14.7%	15.7%	17.7%	16.9%	18.3%
Period-to-Period Growth							
Adjusted EBIT	15.0%	-0.9%	0.3%	6.7%	-7.2%	1.3%	
Adjusted EBITDA	12.4%	0.1%	1.7%	7.6%	-6.8%	2.6%	
Adjusted EBITDA less CapEx	15.0%	-0.4%	-0.2%	6.9%	-7.9%	1.4%	
Adj EBITDA less CapEx & WC	11.4%	3.9%	0.2%	-3.8%	0.8%	-1.6%	

Table 2

Derivation of Capitalization Factor		**Pre-Crisis Multiple**		**Post-Crisis Multiple**	
Risk-Free Rate		2.00%	2.00%	1.00%	1.00%
Equity Premium (Beta = 1.0)		5.50%	5.50%	7.00%	7.00%
Size Premium		3.50%	3.50%	3.50%	3.50%
Specific Company Risk Premium		2.00%	3.00%	2.50%	3.50%
Equity Discount Rate		**13.00%**	**14.00%**	**14.00%**	**15.00%**
Cost of Debt Financing		5.50%	5.50%	5.00%	5.00%
After-Tax Cost of Debt	25.0%	**4.13%**	**4.13%**	**3.75%**	**3.75%**
WACC with Equity Financing	75%	**10.78%**	**11.53%**	**11.44%**	**12.19%**
- Earning Power Growth Rate		3.00%	5.00%	2.00%	4.00%
Capitalization Rate		7.78%	6.53%	9.44%	8.19%
Capitalization Factor (1/Cap Rate)		**12.9x**	**15.3x**	**10.6x**	**12.2x**

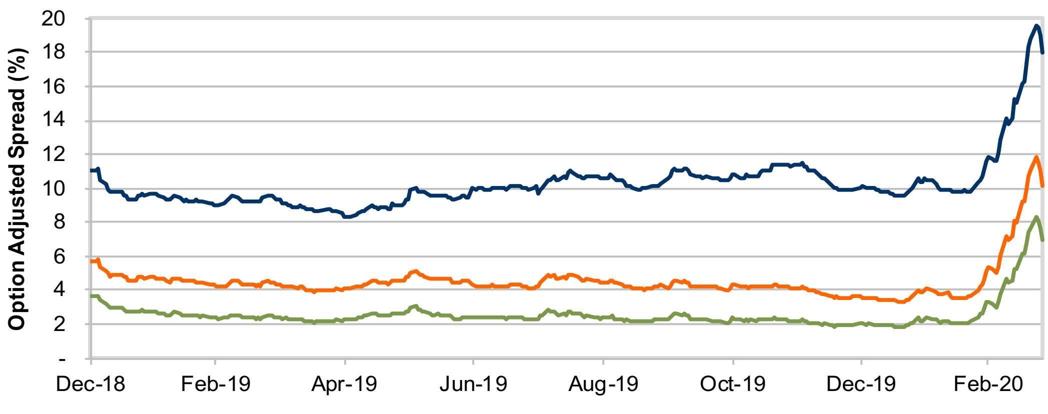
Determination of Value		**Pre-Crisis Earning Power**		**Post-Crisis Earning Power**	
Revenues		$150,000	$150,000	$135,000	$135,000
EBITDA		30,000	30,000	25,000	25,000
EBITDA Margin		20.0%	20.0%	18.5%	18.5%
Depreciation Expense		1,000	1,000	1,000	1,000
EBIT		29,000	29,000	24,000	24,000
Taxes / (Benefit)	25.0%		7,250	6,000	6,000
After-Tax Income		21,750	21,750	18,000	18,000
Add: Depreciation		1,000	1,000	1,000	1,000
Less: Capex		(1,000)	(1,000)	(1,000)	(1,000)
Incremental Working Capital		(1,500)	(1,500)	(1,350)	(1,350)
Net Op Profit After-Tax (NOPAT)		**$20,250**	**$20,250**	**$16,650**	**$16,650**
Capitalization Factor (1/Cap Rate)		12.9x	15.3x	10.6x	12.2x
Capitalized Enterprise Value		**$260,000**	**$310,000**	**$176,000**	**$203,000**

Ent Value / pre-crisis EBITDA	**$30,000**	**8.7x**	**10.3x**		
Ent Value / post-crisis EBITDA	**$25,000**			**7.0x**	**8.1x**

Private Credit and Equity

The feared implosion in credit due to signs of excess everywhere (rising leverage, generous EBITDA "addbacks", proliferation of new private credit managers, etc.) occurred in March 2020 after a period of tight spreads abruptly ended. As of March 27 BB OAS rose to 692bps from about 200bps at year-end and exceeded Jan 2016 (~500bps) when energy prices last collapsed but was well below Nov 2008 (~1400bps). CCC (i.e. "triple hook") OAS on March 27 was 1802bps compared to ~1800bps in Jan 2016 and ~3700bps in Nov 2008

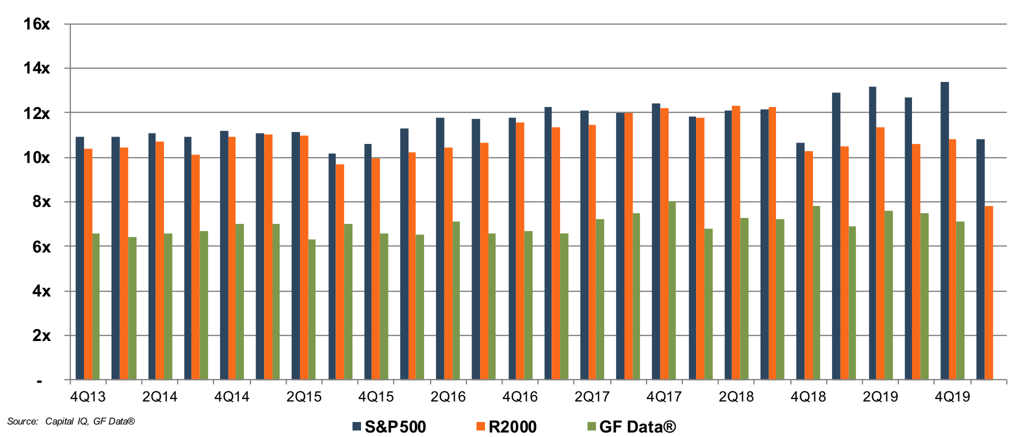
Debt Investments: High Yield Spreads by Credit Rating



Source: BofA Securities via FRED

The valuation gap that has existed since the third quarter of 2018 between non-financial small cap and large cap publicly-traded stocks widened further in the first quarter of 2020. Stated differently, small cap stocks have underperformed. GF Data® for 1Q20 is not available and may not show much change in the small/mid-sized private equity deals at ~7x once available given the late quarter impact of COVID-19. GF's mid-February update of 4Q19 activity noted, "Completed deal activity in the fourth quarter reflected the same conditions .... valuation and debt multiples remain at historic highs."

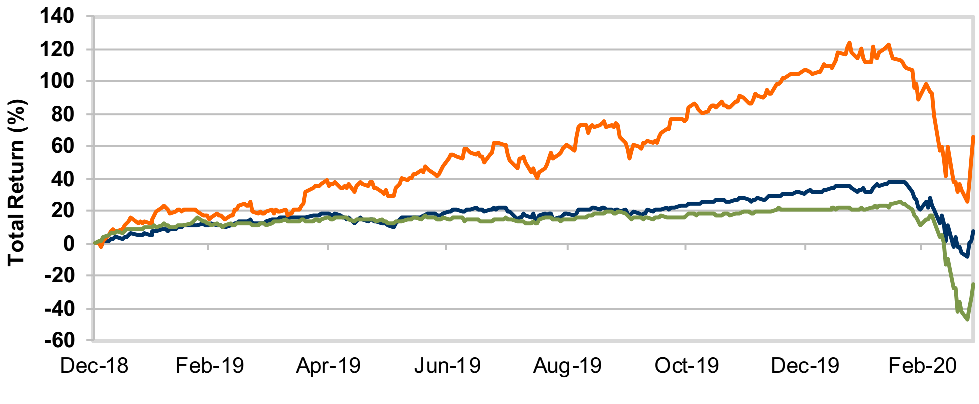
Equity Valuation: EBITDA Multiples Over Time



Source: Capital IQ, GF Data®

The graph illustrates the Wall Street saying that bull markets take the escalator up and the freight elevator down. Depending upon the time span for measurement, a small group of large cap tech stocks (e.g., FANG, Microsoft, etc.) account for about one-third of the market gains for the S&P 500. As such the comparison of the S&P 500 with publicly traded PE funds and credit-focused BDCs may be somewhat skewed.

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

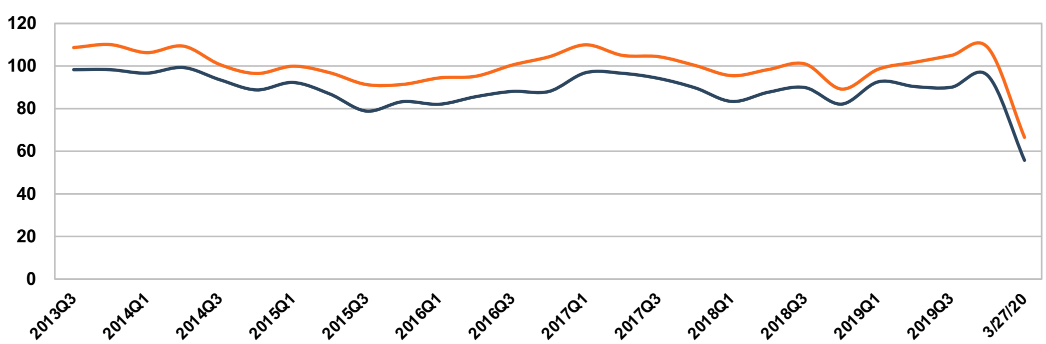


Source: S&P Global MI

Publicly Traded Private Credit

It is never clear how much sharp price drops reflect illiquidity vs fundamentals--something which is especially true during March 2020; however, the sharp drop in BDC prices reflect the market's verdict that BDCs likely will incur significant credit loses in coming quarters.

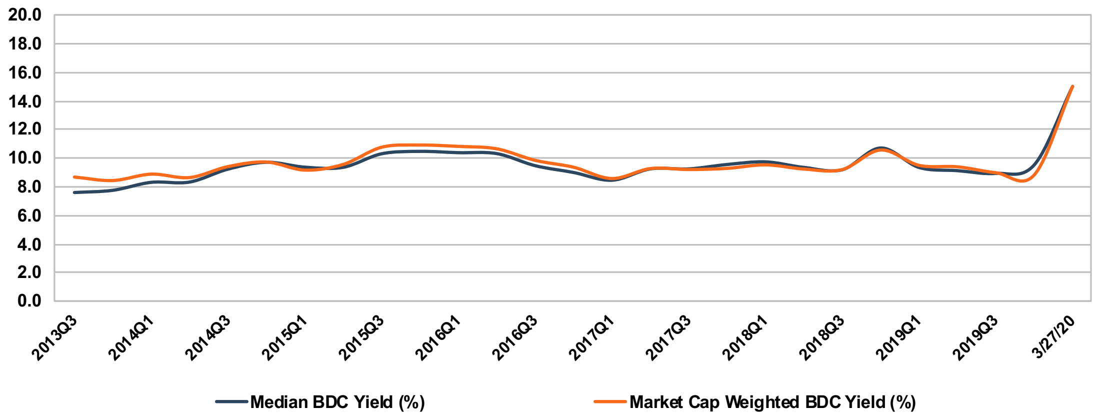
Price / NAV for Publicly-Traded Business Development Companies



Source:S&P Global

The market is also forecasting many BDCs will be forced to reduce dividends given the sharp reduction in the group's P/NAV multiple and spike in dividend yields to the mid-teens as of late March.

Long-Term Dividend Yield Trend

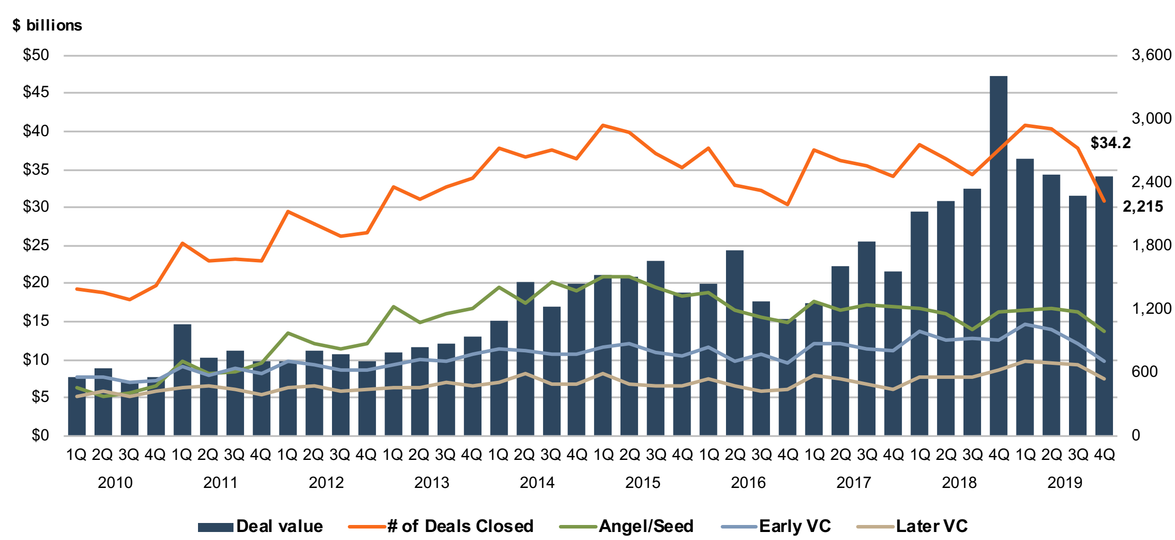


Source:S&P Global

Venture Capital

1Q20 funding detail will not be available for a month or so, but very likely will be lower than 4Q19 given the impact of COVID-19 on markets. And it seems reasonable 2Q20 funding will fall further because markets did not become unhinged until March. As it relates to 4Q19 activity, fundings increased 8% to $34.2 billion while the number of deals closed decreased for the third consecutive quarter. This results in a 33% increase in average deal size when compared to the third quarter of 2019. Although capital deployed in 2019 was less than in 2018, investment activity was robust with over $100 billion of deals closed for the second year in a row.

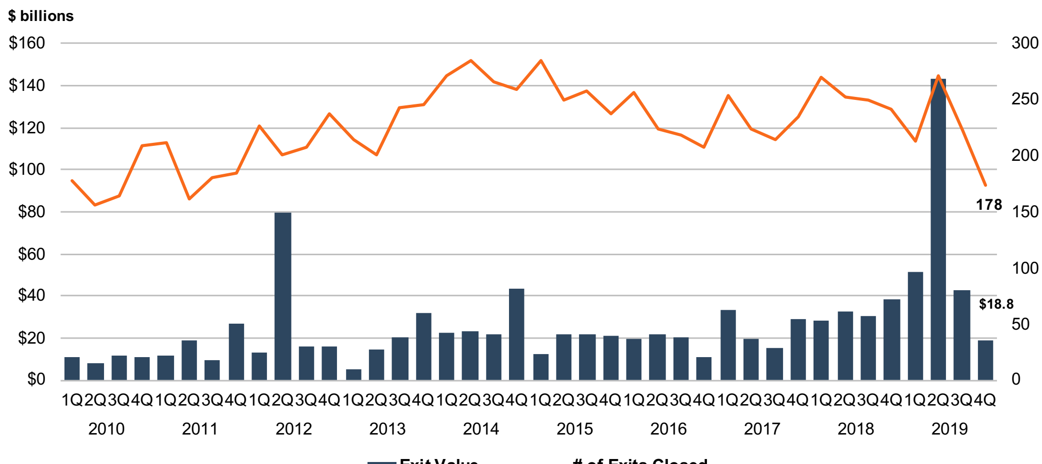
U.S. VC-Backed Funding Activity



Source: Pitchbook/NVCA Venture Monitor

1Q20 exit activity once available will show a reduction from recent quarters given frozen capital markets that existed during March. As it relates to 2019, IPO activity was significant until 3Q19 when the WeWork IPO failed to launch and the public market performance of some (but not all) recent IPOs disappointed. VC-baced exits in 4Q19 declined to $19 billion. This was the lowest level of quarterly activity since 3Q17. Exits for the year totaled $256 billion due to a historic second quarter of $142 billion.

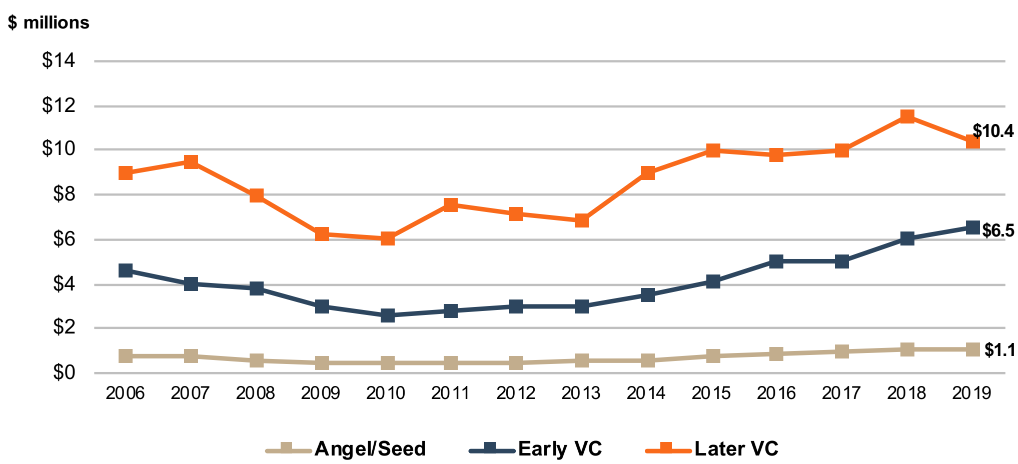
U.S. VC-Backed Exit Activity



Source: Pitchbook/NVCA Venture Monitor

Median deal size showed mixed results for 4Q19. Later VC deals decreased in size 10% to $10.4 million while Early VC deals increased 8% to $6.5 million. Angel/Seed remained consistent in 2019 with a $1.1 million median deal size.

Median Funding by VC Stage ($ millions)



Source: Pitchbook/NVCA Venture Monitor

On the Call

BDC reporting season provided a real-time management view of the potential impact of COVID-19 on publicly traded PE firms because the BDCs generally report results later in the quarter. Below are a few excerpts we founding to be interesting.

We are in active conversations with sponsors and issuers on a regular basis now as we have tried to understand the impact across our portfolio investments. We don't know what is going to happen yet within the U.S.—you probably won't see impact until the issuers report 1Q and 2Q numbers. **–Bain Capital Specialty Finance (BCSF; 2/27/20)**

Larger issuers will have more exposure to a global revenue source and more exposure to a global supplier source; however, middle market issuers, while they have a more US centric revenue source, they also have less resources to adjust towards potential challenges. **–Barings BDC (BBDC; 2/28/20)**

We are hoping this is just a 1Q-2Q issue and everybody can get back to business in 2Q. This is not going to translate into a P&L issue right away for most issuers. It translates into a liquidity issue for most borrowers. If the company is within their leverage covenants, the lender will extend additional credit. If the borrower is at the covenant, then the PE sponsor will have to step-up and provide a bridge. **–Monroe Capital (MRCC; 3/5/20)**

We have invested (at) the top of the capital stack with limited exposure to commodity and cyclical sectors with energy at only 4% of the portfolio. Sometimes the best opportunities exist during periods of elevated volatility and credit market dislocation. TSLX has significant dry powder across the Sixth Street platform. **–TPG Specialty Lending (TSLX; 3/16/20)**

We believe that the recent market volatility has highlighted many important virtues of the publicly listed BDC vehicle structure. For example, while open-end investment vehicles are forced to sell assets due to net capital outflows, the long duration of permanent capital vehicles such as GSBD make them well positioned to withstand market volatility. **–Goldman Sachs BDC (GBDC; 3/19/20)**

Source: All transcripts obtained from SNL.

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