Portfolio Valuation

Private Equity and Credit

Fourth Quarter 2020

In This Issue

Market Tenor

What an odd year 2020 has been. Public equity, high yield and leverage loan markets crashed in March for a reason—the economic calamity related to COVID-19. Private equity and private credit were especially challenged because illiquid assets could not be sold if there was a desire to do so, and capital initiatives were focused on making sure portfolio companies had liquidity to survive. Then a rally started in late March that has seen only a few interruptions since.

As year-end approaches, VC and private equity will celebrate the biggest IPO year since 1999 with over $150 billion of equity raised. Part of the haul is attributable to large IPOs, including Airbnb Inc. M&A has started to rebound, too. Salesforce.com is set to acquire Slack Technologies. The monetization of many investments will allow sponsors to reinvest in new ventures and provide capital to portfolio companies if needed.

Credit has rallied sharply, too. The option adjusted spread ("OAS") on the ICE BofA High Yield Index peaked on March 23 at ~1100bps then narrowed to~400bps by early December. The 10-year and 20-year average OAS are 493bps and 576pbs with the differential indicative of the severity of the 2007-2009 meltdown and the soothing influence of Fed "support" the past decade.

The strong market for credit has supported a rebound in another form of equity monetization: dividend recaps. In this issue of Portfolio Valuation we review the concept of fraudulent conveyance and how solvency opinions can address the issue before something goes awry after a dividend recap occurs or other significant transaction that leaves a company more indebted and/or less heavily capitalized with equity.

Fraudulent Conveyance and Solvency Opinions

By Jeff K. Davis, CFA

The Business Judgment Rule, an English case law doctrine followed in the U.S., Australia and Canada, provides directors with great latitude in running the affairs of a corporation, provided directors do not breach their fiduciary duties to act in good faith, loyalty and care. However, there are instances when state law prohibits certain actions, including the fraudulent transfer of assets that would leave a company insolvent.

Fraudulent Conveyance- *Common Law to Codification*

Fraudulent conveyance involves an asset transfer beyond the reach of creditors that can be voided by a court in a civil or bankruptcy proceeding. The concept originated in early Rome and was codified in 16th century England. The concept was adopted in the U.S. through common law precedent cases until model acts were adopted by most states in the early 20th century.

Generally, creditors in the U.S. will bring actions under the *Uniform Voidable Transaction Act* ("UVTA") or the Uniform *Fraudulent Transfer Act* ("UFTA") that most states and U.S. territories have adopted.

The U.S. Bankruptcy Code also addresses fraudulent transactions via §548 and §550; however, the statute of limitations is only two years and is more narrow in scope than state law with four year limitations. Therefore, most actions seeking to void a transaction including those sought by a bankruptcy trustee are brought under state law.

There is a two pronged test to determine if an asset transfer is a fraudulent conveyance:

Was the asset transferred with the intent to hinder, delay, or defraud a creditor (actual fraud)?
Or
Was the asset transferred without adequate consideration (i.e., constructive fraud)?

Constructive fraud does not require an intent to defraud for a transaction to be voided.

A bankruptcy trustee can void a transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property or any obligation incurred by the debtor within two years before the filing of a petition if:

a) the transfer was made with an intent to hinder, delay or defraud; or

b) the debtor received less than a reasonably equivalent value in exchange for such transfer or obligation; and

1. was insolvent on the date that the transfer occurred, or became insolvent as a result of the transaction;
2. was engaged in a business or a transaction for which the debtor was left with an unreasonably small capital;
3. intended to incur, or believed the debtor would incur, debts that would be beyond its ability to pay as they came due; or
4. transferred to or for the benefit of an insider or incurred such obligation for the benefit of an insider.

Evidence of actual intent to defraud can be difficult to prove; therefore, courts look to circumstantial evidence of fraud ("badges of fraud") and the financial condition of the debtor immediately before and after when the transaction or transfer occurred.

Solvency Opinions and Indebted Corporate America

No corporate board or private equity owners seeks to enter into a transaction that might one day be deemed fraudulent. Nonetheless, a lot of leveraged transactions that occurred pre-COVID and subsequently resulted in a bankruptcy filing are going to be scrutinized. **Neiman Marcus** is an example in which its PE owners were forced to surrender much of their interest in a valuable e commerce unit (MyTheresa.com) that was distributed to the owners in 2018.

This straightforward statutory prescription, not to engage in transactions that in hindsight might be judged to leave a company insolvent, has taken on more meaning over the past decade because Corporate America has significantly increased its use of debt given very low interest rates. Investors have been willing to fund the increase because negligible rates on "safe" assets have pushed individuals and institutions out the risk curve to produce income.

Transactions that may meaningfully alter the capitalization of a company include, leveraged dividend recapitalizations, leveraged buyouts, significant share repurchases, and special dividends funded with existing assets. Often a board contemplating such actions will be required to obtain a solvency opinion at the direction of its lenders or corporate counsel to provide evidence that the board exercised its duty of care to make an informed decision should the decision later be challenged.

A solvency opinion addresses four questions, the first three of which are addressed in §548 of the Bankruptcy Code:

- Does the fair value of the company's assets exceed its liabilities after giving effect to the proposed action?
- Will the company be able to pay its debts (or refinance them) as they mature?
- Will the company be left with inadequate capital?
- Does the fair value of the company's assets exceed its liabilities and surplus to fund the transaction?

A solvency opinion is typically performed by a financial advisor who is independent, meaning the advisor has not arranged financing or provided other services related to the contemplated transaction. The opinion is based upon financial analysis to address the valuation of the corporation and its cash flow potential to assess its debt service capacity.

Also, the opinion is just that—it is an informed opinion. It is not a pseudo statement of fact predicated upon the "known" future performance of the Company. It provides a reasonable perspective concerning the future performance of the Company while neither promising to stakeholders that those projections will be met, nor obligating the Company to meet those projections.

Test 1: The Balance Sheet Test

The balance sheet test asks*: Does the fair value and present fair salable value of the Company's total assets exceed the Company's total liabilities, including all identified contingent liabilities?*

The balance sheet test is a valuation test in which the value of the company's liabilities are subtracted not from the assets recorded on the balance sheet, but rather the fair market value of the firm on a total invested capital basis. The value of the firm on a debt-free basis is estimated via traditional valuation methodologies, including Discounted Cash Flow ("DCF"), Guideline Public Company and Guideline Transactions (M&A) Methods. In some instances, the Net Asset Value ("NAV") Method may be appropriate for certain types of holding companies in which assets can be marked-to-market.

Test 2: The Cash Flow Test

Will the Company be able to pay its liabilities, including any identified contingent liabilities, as they become due or mature?

This question addresses whether projected cash flows are sufficient for debt service. A more nuanced view evaluates the question along three general dimensions:

- **Revolver Capacity:** If financial results approximate the forecast, does the Company have sufficient capacity, relying upon its revolving credit facility if necessary, to manage cash flow needs through each year?

- **Covenant Violations:** Does the projected financial performance imply that the Company will violate covenants of the credit or loan agreement, or the terms of any other credit facility currently in place or under consideration as part of the subject transaction?
- **Ability to Refinance:** Is it likely that the Company will be able to refinance any remaining balance at maturity?

Test 3: The Capital Adequacy Test

*Does the Company have **unreasonably small capital** with which to operate the business in which it is engaged, as management has indicated such businesses are now conducted and as management has indicated such businesses are proposed to be conducted following the transaction?*

The capital adequacy test is related to the cash flow test. A company may be projected to service its debt as they come due, but a proposed transaction may leave the margin to do so too thin—something many companies discovered this year in which they were able to operate with high leverage as long as business conditions were good.

There is no bright line test for what "unreasonably small capital" means. We typically evaluate this concept based upon pro forma and projected leverage multiples (Debt/EBITDA and EBITDA/Interest Expense) relative to public market comps and rating agency benchmarks. While management's projections represent a baseline scenario, alternative downside scenarios are constructed to asses the "unreasonably small capital" question in the same way downside scenario analyses are constructed to address the question of whether debts can be paid or refinanced when they come due.

Test 4: The Capital Surplus Test

Does the fair value of the Company's assets exceed the sum of (a) its total liabilities (including identified contingent liabilities) and (b) its capital (as such capital is calculated pursuant to Section 154 of the Delaware General Corporation Law)

The capital surplus test replicates the valuation analysis prescribed under the balance sheet test, but also includes the Company's capital in the subtrahend (Hey! There is a word we haven't seen since early primary school. The subtrahend is the value being subtracted.)

Section 154 of the Delaware General Corporation Law defines statutory capital as (a) the par value of the stock; or in stances when there is no par value as (b) the entire consideration received for the issuance of the stock. Capital as defined here is nuanced. Often it may be a small amount if par is some nominal amount such as a penny a share, but that may not always be the case. What is excluded is retained earnings (or deficit) from the equity account.

The Mosaic of Solvency

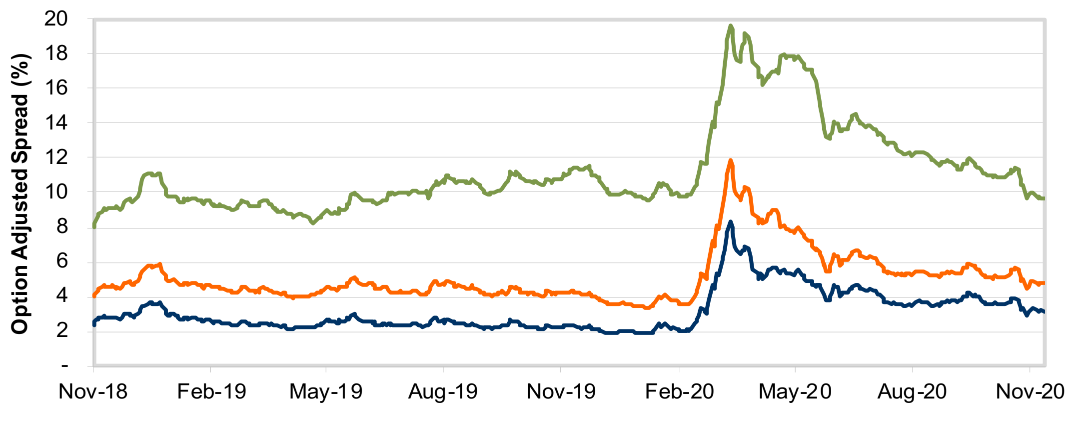
The tests described above are straightforward. Sometimes proposed transactions are straightforward regarding solvency, but often it is less clear—especially when the subject company operates in a cyclical industry. Every solvency analysis is unique to the subject transaction and company under review and requires an objective perspective to address the solvency issue.

Mercer Capital renders solvency opinions on behalf of private equity, corporations, lenders and other stakeholders that are contemplating a transaction in which a significant amount of debt is assumed to fund shareholder dividends, an LBO, acquisition or other such transaction that materially levers the company's capital structure.

Private Credit and Equity

After widening dramatically during late February and March, credit spreads have been grinding tighter as liquidity has returned to the market with Fed intervention. As of 9/30 BB OAS narrowed to 400bps from 641bps at March 31 after having gapped from ~200bps at YE19. The 10-and 25-year average OAS both approximate 325bps. At the other end of the high yield spectrum, CCC (i.e. "triple hook") OAS was 1152bps compared to 1794bps at 3/31, 1008bps at year-end and the 25-year average of 930bps.

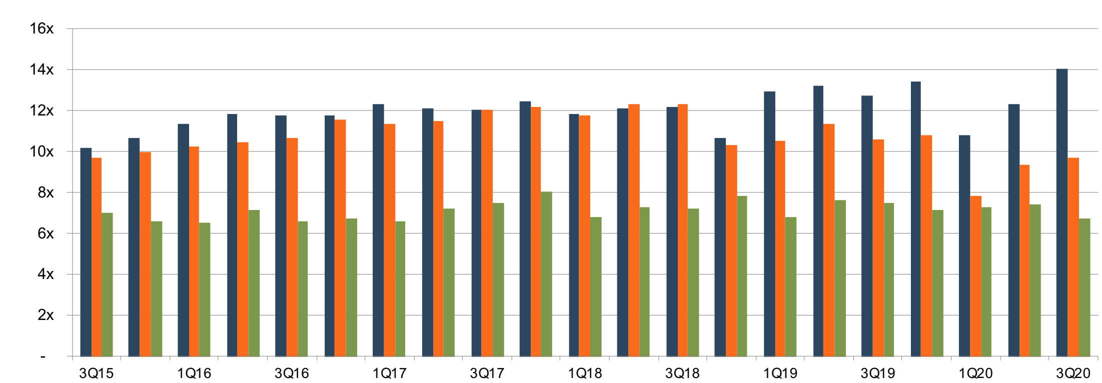
Debt Investments: High Yield Spreads by Credit Rating



Source: BofA Securities via FRED

The EBITDA valuation gap between non-financial small cap and large cap stocks widened to 4.3x at September 30 from about 3x at June 30 and March 31. Prior to 2019 gaps wider than 1x tended to be associated with strong relative performance by the Russell 2000. During the past two years, the S&P 500 has been supported by strong performance of its constituent large cap tech companies that in turn presumably reflects the secular transition to a digitized US economy. As for PE-backed lower- and middle-market transactions, GF Data® for 3Q20 reflected a reduction in the median transaction multiple to 6.7x from 7.1x to 7.4x in the prior five quarters. The number of transactions increased to 50 from 34 in 2Q20 which in turn was well below the pre-COVID quarterly average of about 75 transactions.

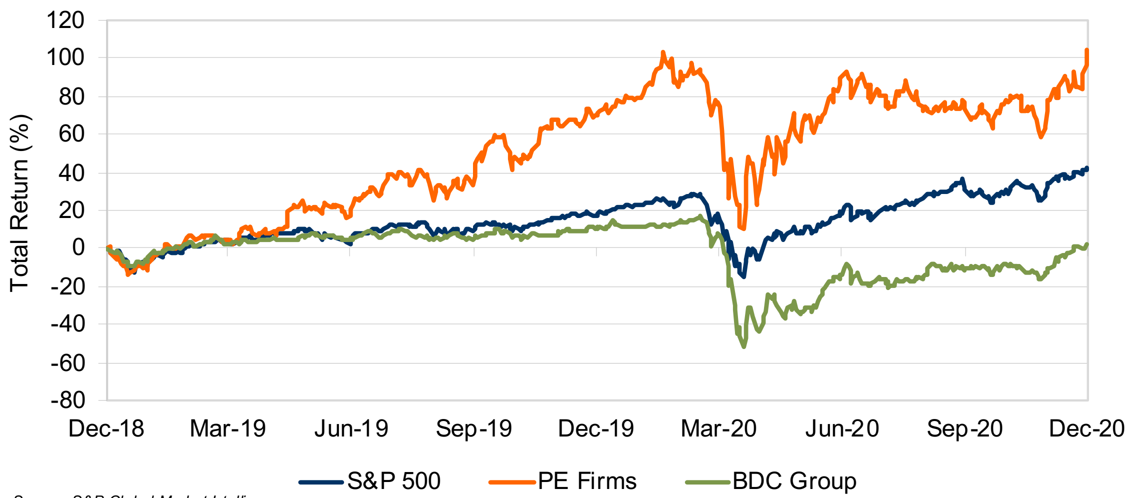
Equity Valuation: EBITDA Multiples Over Time



Source: Capital IQ, GF Data®

The graph below illustrates Wall Street saying - *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 unfair.

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

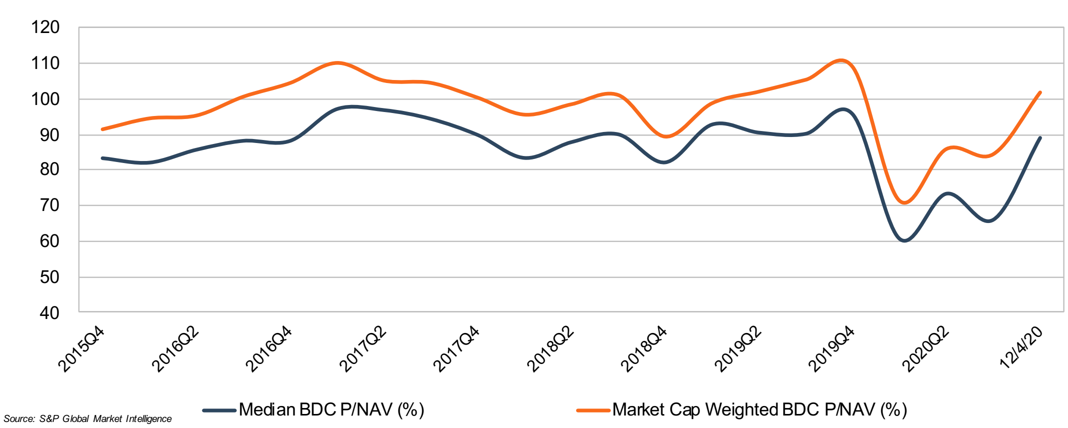


Source: S&P Global Market Intelligence

Publicly Traded Private Credit

What crisis? BDC prices rebounded somewhat during 2Q20 and strongly since mid 3Q20 through November as investors dismissed the worst outcomes from the spring recession (or depression) and also chased yield in a low yield environment. The data in the chart below points to the bi-furcation among BDCs in which the largest BDCs that presumably have superior asset quality trade at a notable premium to smaller BDCs as reflected in the delta between the market cap and equal weighted indices.

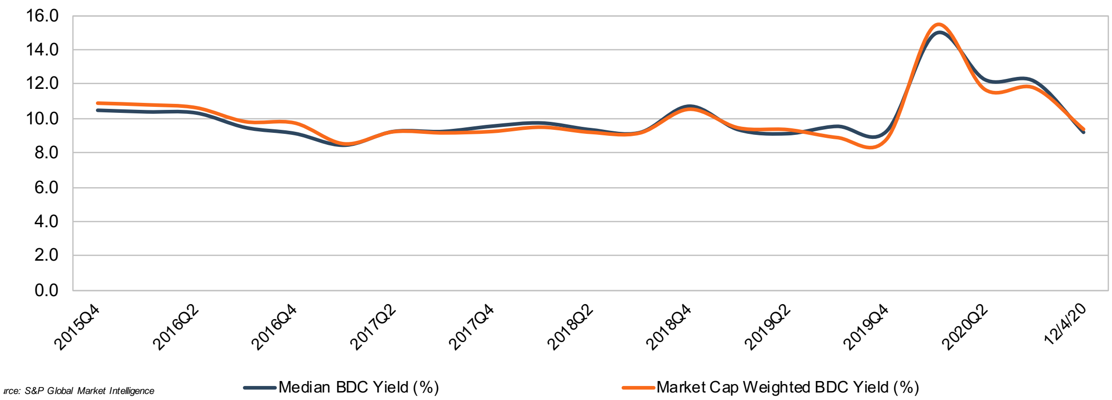
Price / NAV for Publicly Traded Business Development Companies



Source: S&P Global Market Intelligence

BDC yields were elevated around 12% as of September 30 compared to 15% at March 31 and ~9% for each quarter-end in 2019. However, yields arguably returned to "normal" by mid November. Nonetheless, realized and projected dividend cuts in addition to the reliability of NAV estimates are expected to be a likely 2021 theme for BDC investors.

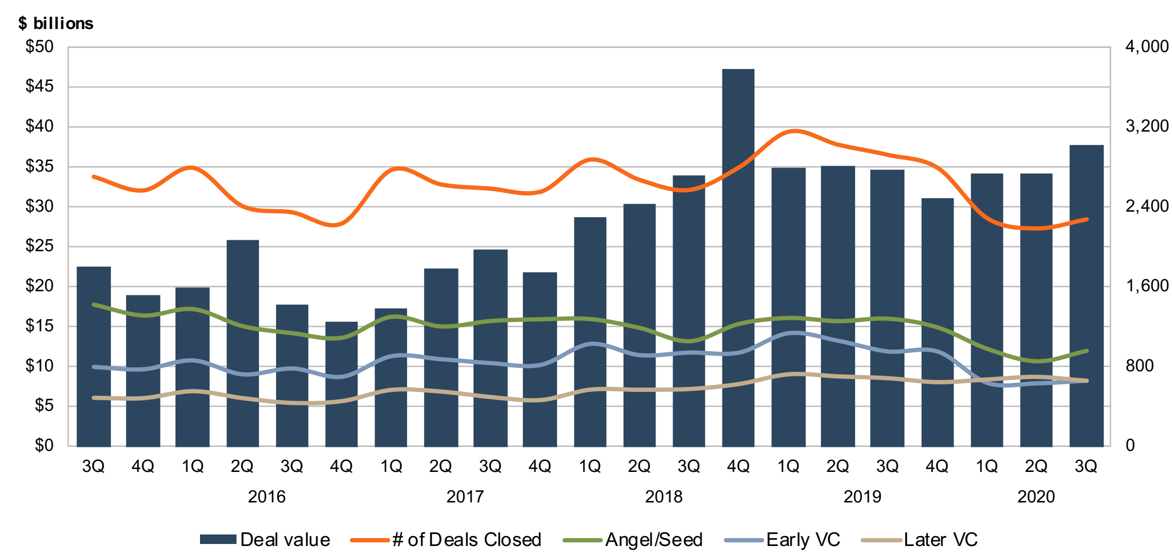
Long-Term Dividend Yield Trend



Venture Capital

VC funding increased in 3Q20 to $37.8 billion, the second highest quarterly total during the past decade, from approximately $34 billion in the prior two quarters and the year ago quarter. The average funding increased to $16.5 million from $13.1 million in 2Q20 and $12.8 million in 3Q19. Given the significant amount of harvesting that has occurred since mid-year through a revived IPO market, new venture financings may remain elevated because funds will have capital to redeploy to the extent it does not have to be returned to investors.

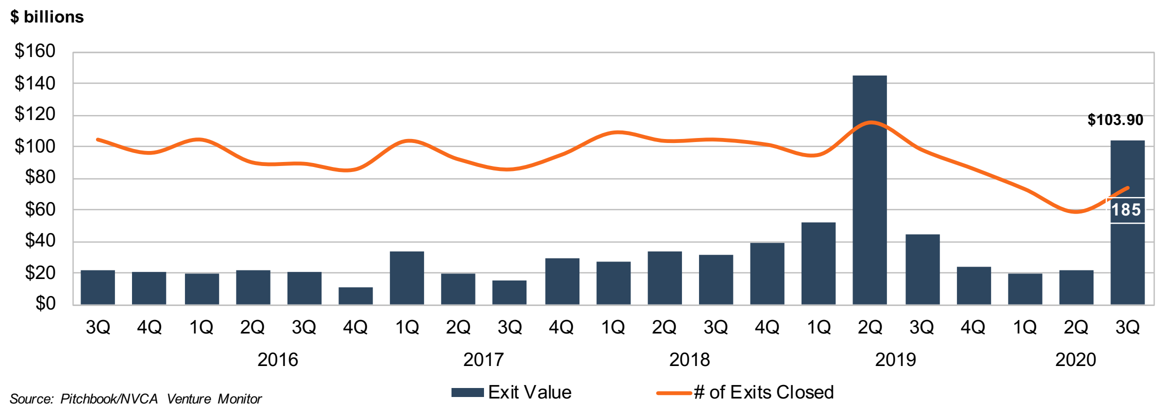
U.S. VC-Backed Funding Activity



Source: Pitchbook/NVCA Venture Monitor

3Q20 exit exploded with over $100 billion of exits as the IPO market roared back to life compared to $21.2 billion and $19.3 billion exits in 2Q20 and 1Q20. The prior exit peak occurred in 2Q19 when several large IPOs pushed VC exits to $145 billion. The number of exits nearly doubled in 3Q20 to 75 from 2Q20 but was well below the 2019 quarterly average of about 225 exits. The number of IPOs increased to 37 in 3Q20 from 16 in 2Q20. Buyout exits increased to 38 from 22 in the prior quarter.

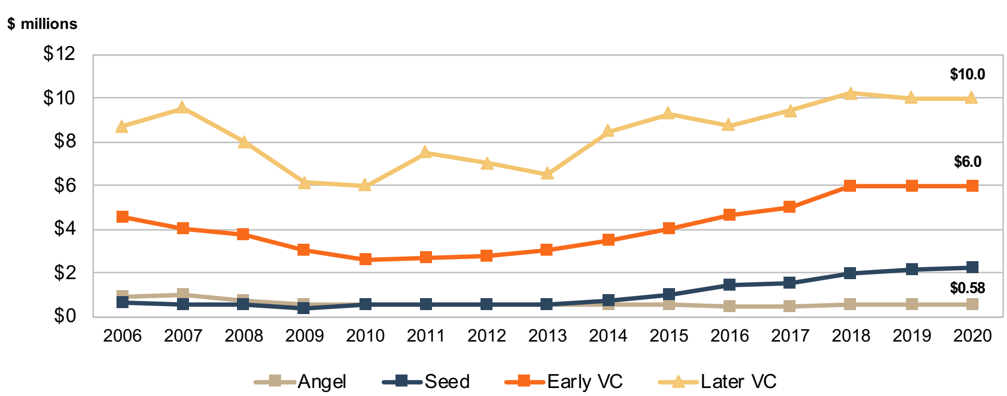
U.S. VC-Backed Exit Activity



Source: Pitchbook/NVCA Venture Monitor

Median deal size showed mixed results YTD. Later stage VC deals averaged about $10 million, the same as the prior two years. Angel, Seed and Early VC deals were flattish as well.

Median Funding by VC Stage ($ millions)



Source: Pitchbook/NVCA Venture Monitor

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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 is a valuation and transaction advisory firm. Over four decades we have valued tens of thousands of equity and credit investments in virtually every industry and sub-industry grouping that exist in a variety of markets. We also have significant M&A experience. Please call if we can assist in the valuation of your portfolio companies

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- Purchase Price Allocations
- Goodwill Impairment
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