MERCER CAPITAL

BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

Portfolio Valuation

Private Equity and Credit

Third Quarter 2021

In This Issue

Market Tenor

The third quarter is off to a great start for private equity and credit. Public market and acquisition markets are strong; debt capital is plentiful and available at record low yields. SPAC IPOs have slowed (~$120 billion YTD) but SPACs have lots of capital to deploy and have become another liquidity option for VC-backed companies that by-pass a traditional IPO.

A buoyant environment for harvesting assets at high prices and often high realized returns creates a virtuous cycle to raise more capital based upon those returns. Arguably investing new capital today at high multiples sets the stage for low returns later, but the future is unknowable.

We will stay away from generalizations such as VC-backed private companies and freshly minted public ones are overvalued. Rather, we look to accounting guidance to marking private equity and credit positions. Fair value has a very specific meaning and must be measured accordingly; fair value is not the asset owner's investment thesis.

Fair value is defined in the relevant accounting standards 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."*

Accounting definitions notwithstanding, the "exit market" is hot. Robinhood Markets is a good example. Its July IPO was one of the larger fintech IPOs in which $2 billion was raised in an IPO that valued the company at $32 billion. A few weeks later the market cap is nearing $50 billion.

High or not, there is nothing like transaction data to validate valuation marks for private assets.

The SEC Adopts New Rule 2a-5 for Valuation of Fund Portfolio Investments

Sujan Rajbhandary, CFA

Summary

In December 2020, the Securities and Exchange Commission ("SEC") adopted a new rule 2a-5 to update the regulatory framework around valuations of investments held by a registered investment company or business development company ("fund").[1] Boards of directors of funds are obligated to determine fair value of investments without readily available market quotations in good faith under the Investment Company Act of 1940 ("Act").

Rule 2a-5 specifies requirements to fulfill these obligations. Concurrently, the SEC also adopted rule 31a-4, which provides record keeping requirements related to fair value determinations. Rule 2a-5 was effective as of March 2021, and funds are required to be compliant upon the conclusion of an 18-month transition period following the effective date (voluntary early compliance allowed).

Valuation Framework

Prior to adopting rule 2a-5, the SEC last addressed valuation practices under the Act more than 50 years ago. Over the intervening period, the variety of securities and other instruments held by investment funds has proliferated. The volume and type of data used in valuations have also increased. Funds increasingly use third-party services to provide pricing information, especially for relatively illiquid or otherwise complex assets. In addition, accounting standards and regulatory requirements have advanced including developments related to ASC 820, Fair Value Measurement.

Against this backdrop, rule 2a-5 establishes a framework consisting of four primary functions required to determine fair value in good faith. A fund board may choose to determine fair value by executing the functions. Rule 2a-5 also allows a fund board to designate these functions to a "valuation designee." The required functions are:

1. **Periodically assess and manage valuation risks, including conflicts of interest.** The rule does not prescribe a required minimum frequency for re-assessing valuation risks, instead stating that different frequencies may be appropriate for different funds or risks. Re-assessment of valuation risks should generally consider changes in fund investments, significant changes in investment strategies or policies, market events, and other relevant factors.

2. **Establish and apply fair value methodologies.** Satisfying this function will require selecting and applying appropriate valuation methodologies, periodically reviewing the appropriateness and accuracy of the methodologies (and making any necessary changes or adjustments), and monitoring for circumstances that may necessitate the use of fair value. A fund board or the valuation designee is required to specify key inputs and assumptions used in the valuation of particular asset classes or portfolio holdings. Appropriate valuation methodologies for investments may vary, even within the same asset class. However, these methodologies are expected to be applied consistently to minimize the risks of selecting methodologies to achieve a specific outcome. Further, the rule states that appropriate methodologies must be consistent with the principles outlined in ASC 820.

3. **Test fair value methodologies for appropriateness and accuracy.** This function is intended to ensure the selected valuation methodologies are appropriate and adjustments are made as necessary. The fund board or the valuation designee should identify the testing methods and the minimum frequency with which such methods will be used. However, the rule does not prescribe any particular testing method or specific minimum testing frequency. Examples of testing methods include calibration and back-testing against valuations obtained from observed transactions.

[1] See "SEC Modernizes Framework for Fund Valuation Practices" at https://www.sec.gov/news/press-release/2020-302. Final rule available at https://www.sec.gov/rules/final/2020/ic-34128.pdf

4. Oversight and evaluation of pricing services. The fund board or the valuation designee must establish a process for approving, monitoring, and evaluating pricing service providers. A process to initiate pricing challenges, as appropriate, is also required. Pricing services are described as third parties that regularly provide funds with information on evaluated prices, matrix prices, price opinions, or similar pricing estimates or information to assist in determining fair value of fund investments. The rule discusses the possibility of conflicts of interest on the part of the pricing services, arising from the need to maintain continuing business relationships with the fund board or valuation designee. Accordingly, the oversight function is intended to ensure the fund board or the valuation designee has a reasonable basis to use the pricing information it receives as inputs in performing valuations.

Valuation Designees

When fair value determinations are made by a valuation designee, which can be the fund adviser or an officer of an internally managed fund, the board is required to actively oversee the valuation designee's work and compliance with the rule. In general, rule 2a-5 limits possible designees to entities that have a fiduciary duty to the fund. While the adviser may have some conflicts, the fiduciary obligation to the fund would ensure that the valuation designee acts in the fund's best interest and mitigates or discloses conflicts. The rule states that fund boards should approach oversight of the valuation designee's work with a skeptical and objective view that considers valuation risks, the appropriateness of the valuation process, and the skill and resources devoted to the endeavor. In order to assist the fund board in its oversight function, a valuation designee is required to present both annual and quarterly written reports to the board.

Quarterly reports should include:

- Items requested by the board related to the fair value of investments or the valuation process.
- A summary or description of material fair value matters that occurred in the prior quarter, including any significant changes in valuation risks, fair value methodologies, and the process for selecting and overseeing pricing services.

Annual reports should include:

- An assessment of the valuation process, including a summary of the results of the testing of fair value methodologies.
- An assessment of the adequacy of resources allocated to the valuation process.

In addition to periodic reporting to the fund board, the valuation designee is required to state the titles of the persons responsible for the valuation of portfolio investments. The valuation designee should also reasonably segregate fair value determinations from the portfolio management of the fund so that the portfolio manager does not determine or exert influence on the valuation of portfolio investments.

Conclusion

Rule 2a-5 updates decades-old valuation guidance from the SEC for investment funds. Fund boards have the primary responsibility to adhere to the valuation framework outlined in the rule. When a valuation designee performs these functions, active oversight is required by the board. The rule prescribes a framework that emphasizes understanding and managing risks around conflicts of interest and promotes a principles-based valuation regime that aligns with recent accounting and regulatory developments, notably ASC 820.

Mercer Capital provides portfolio valuation services for private equity firms, business development companies, and other financial sponsors.

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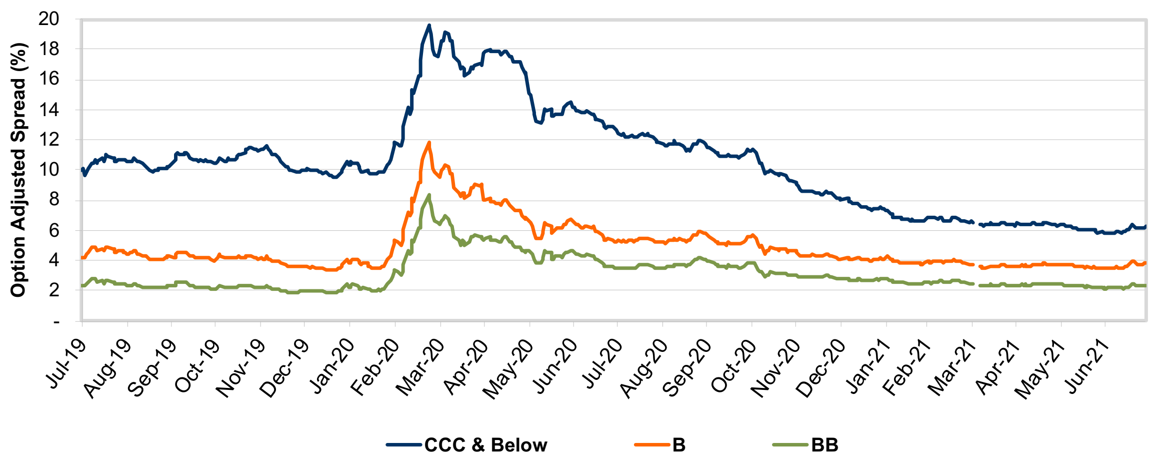
Private Credit and Equity

The rally in spreads continued in 2Q21 as would be expected given the strong economic backdrop. The OAS spread for CCC-rated bonds ("triple hooks") narrowed 73bps to 5.77% while B-rated bonds saw OAS narrow 18bps to 3.49% and BB narrowed 35bps to 2.16%. All spreads widened modestly during July when financial markets were choppy. Notably, the yield on BB- and B-rated high yield bonds is below the current inflation rate as measured both by the CPI and PCE.

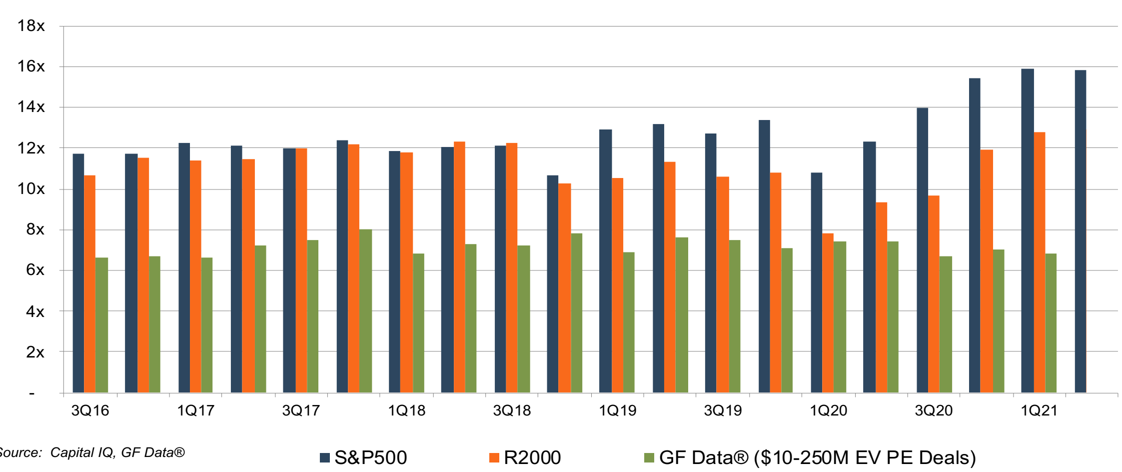
Debt Investments: High Yield Spreads by Credit Rating



Source: BofA Securities via FRED

The expansion in the EBITDA multiple of non-financial companies in the S&P 500 to nearly 16x the past several quarters reflects a combination of an increase in stock prices and depressed trailing 12 month EBITDA. The same is true for the small-cap Russell 2000 index at over 12x. As of June 30 the S&P multiple was 122% of the Russell 2000 multiple compared to the 10-year average of 112%. GF Data ® for multiples paid by private equity firms for companies with an enterprise value of $10 million to $250 million is not yet available for the second quarter; however, given improving economic conditions and buoyant markets, we suspect the multiple will be above 7x compared to a ten-year range of 6.0x to 8.0x. During the past ten years the Russell 2000 EBITDA multiple has averaged 153% of the GF median buy-out multiple, which equates to 8.4x based upon the Russell's 12.9x multiple as of June 30.

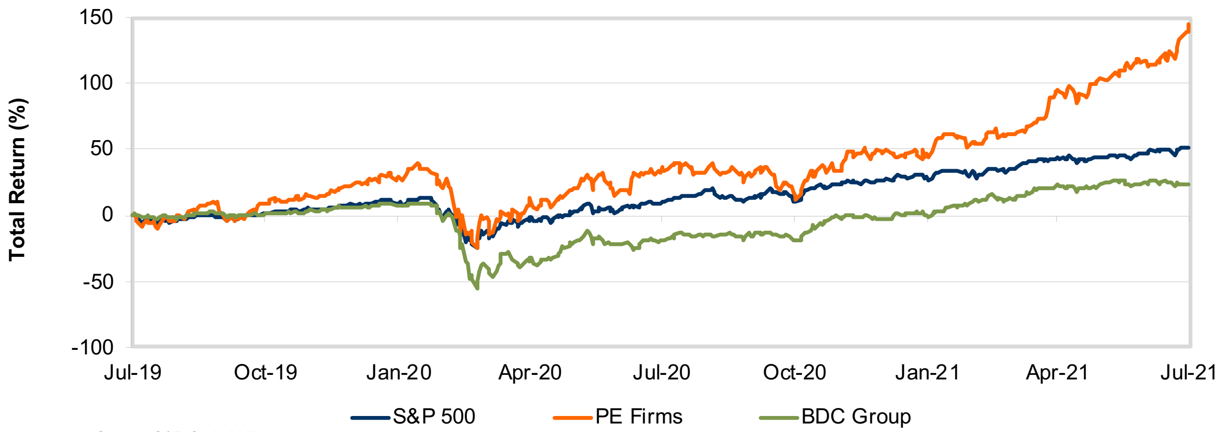
Equity Valuation: EBITDA Multiples Over Time



Source: Capital IQ, GF Data®

The March 2020 panic looks like a speed bump in hindsight given strong market gains since then as a result of easy money from the Fed and strong corporate earnings attributable to a reopening of the economy. PE firms as a group have outperformed the S&P 500 because the operating environment has been favorable to harvest significant gains and to raise new capital to invest on which asset management fees are generated.

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

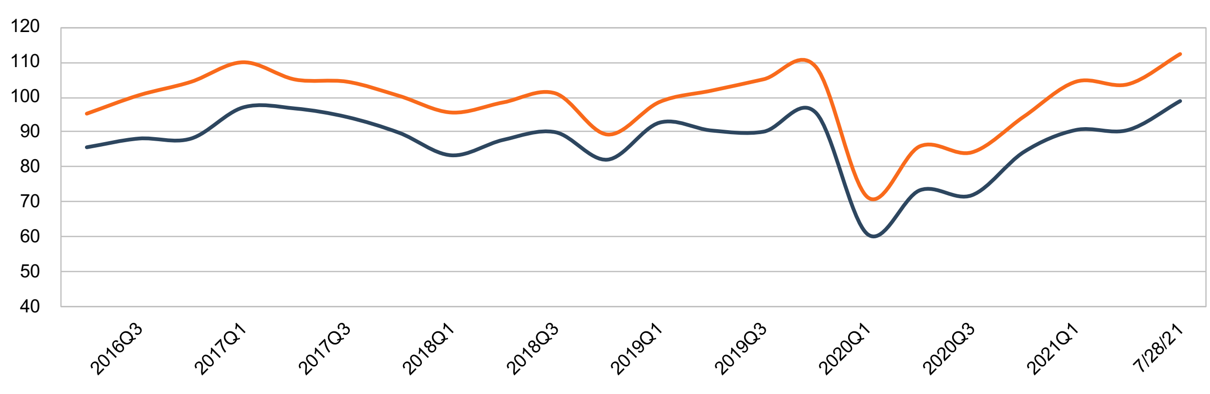


Source: S&P Global MI

Publicly Traded Private Credit

BDC prices continued to rebound in 2Q21 and into July when the median BDC P/NAV was 99% and the market cap weighted multiple was 113%--valuations that were last recorded at year-end 2019 when the median P/NAV was 96% and market cap weighted multiple was 109%.

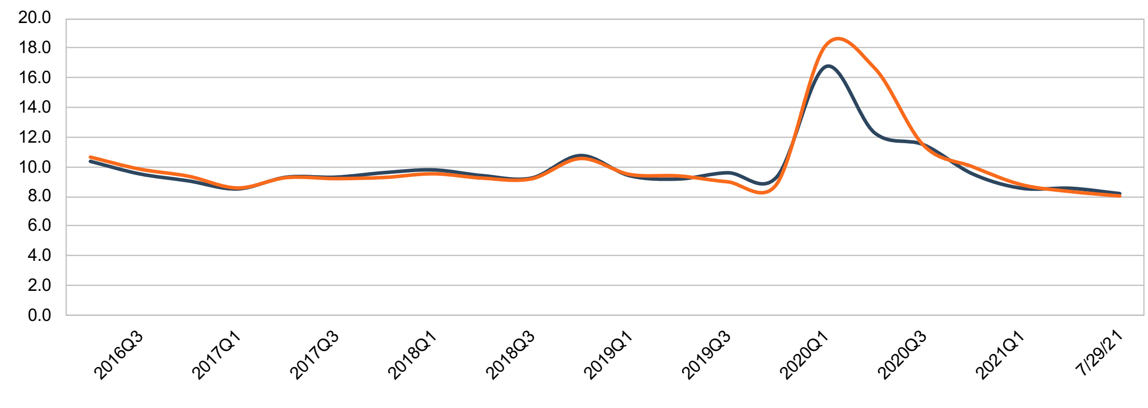
Price / NAV for Publicly Traded Business Development Companies



Source: S&P Global

BDC yields have fallen by about 50% from the March 2020 panic highs to about 8% as of late July 2021. Yields are comparable to 2013 and 2014 when the economy had largely recovered from the GFC yet short-term rates like today were near zero.

Long-Term Dividend Yield Trend

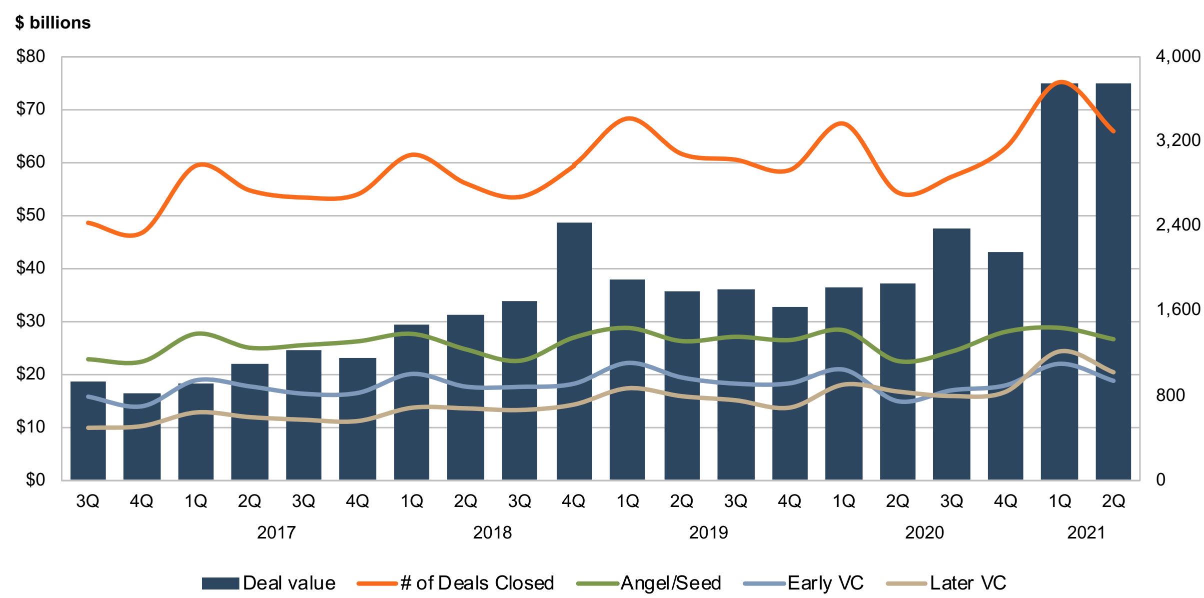


Source: S&P Global

Venture Capital

2Q21 venture funding was little changed from 1Q21 at ~$75 billion; both were significant records relative to the past several years when quarterly fundings ranged from $20 billion to $40 billion. The average funding per transaction increased to $23 million from $20 million in 1Q21, $14 million in 4Q20 and $16.7 million in 3Q20.

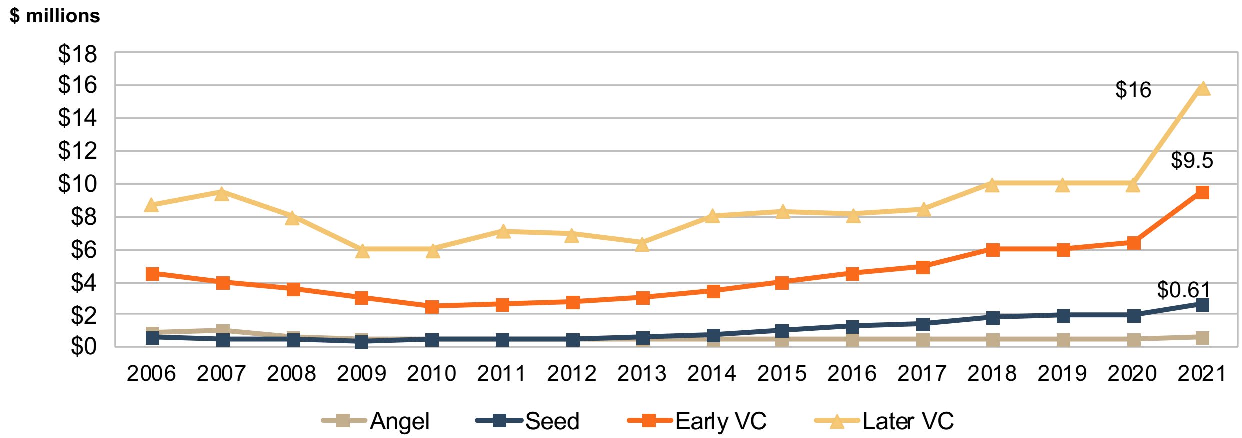
U.S. VC-Backed Funding Activity



Source: Pitchbook/NVCA Venture Monitor

Whether transitory or a new paradigm, venture-backed companies have seen a surge in the median capital raise based upon data through mid-year 2021 that ranged from 22% for angel investments to 60% for late-stage raises. Capital markets that are exceptionally receptive to IPOs and SPAC-enabled M&A provide a favorable environment for VC capital raises given (current) prospects for favorable exits.

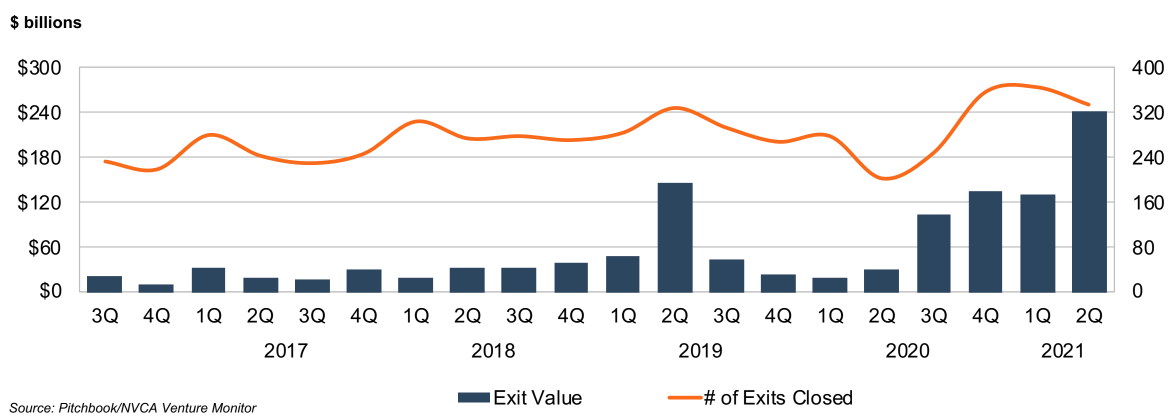
Median Funding by VC Stage ($ millions)



Source: Pitchbook/NVCA Venture Monitor

2Q21 VC-backed company exits reflected a record $241 billion of value, roughly double near record exits recorded in 4Q20 and 1Q21. The July 2021 IPO of Robinhood Markets in which the company raised $2 billion and realized a value of ~$35 billion ensures that third quarter will be robust, too. The amounts are stunning though it is unknowable how much is attributable to the Fed's easy-money policies with short-term policy rates near zero and how much is attributable to new technologies and business models that should be highly valued even in the absence of current profitability.

U.S. VC-Backed Exit Activity



Source: Pitchbook/NVCA Venture Monitor

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 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

Services Provided

- Portfolio Valuation
- Solvency Opinions
- Fairness Opinions
- Purchase Price Allocations
- Goodwill Impairment
- Equity Compensation / 409(A)
- Buy-Sell Agreement Valuations

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