MERCER CAPITAL
BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

Portfolio Valuation

Private Equity and Credit

First Quarter 2022

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Solvency of the Sponsor

Jeff K. Davis, CFA

Solvency Opinions: Due Care and Adequate Consideration

Last year—2021—was a spectacular year for leverage finance, a once obscure area of the capital markets that has morphed into a stand-alone asset class and money machine for the banks that arrange it. According to *S&P Global Market Intelligence*, leverage loans issued topped $800 billion with over $600 billion absorbed by institutional investors while high-yield bond issuances exceeded $460 billion. Both totals were records, though a significant amount was used to refinance existing debt.

Solvency opinions may not be top of mind when one considers the big year most private equity and credit funds had in 2021; however, the use of significant leverage to fund acquisitions and dividend recaps creates a contingent liability if the subject company struggles to service its debts. The risk to sponsors, sellers, directors, and new secured lenders is that a bankruptcy court determines a leveraged transaction entailed fraudulent conveyance. If so, a court may seek to ammend the transaction at considerable exposure to those found liable.

Solvency opinions mitigate the risk by addressing two legal concepts: the duty of care (informed decision making by directors) and “adequate consideration” or “reasonably equivalent value” in a corporate transaction.

Solvency of the Sponsor (cont.)

The *Business Judgment Rule*, an English case law doctrine followed in the U.S., U.K., Canada and Australia, provides directors with great latitude in running the affairs of a corporation provided directors do not breach one or more of their fiduciary duties of a) loyalty; b) care; and c) to act in good faith. Delaware and other state courts generally will not second guess business decisions as long as the duties are not violated.

However, there are instances when state law prohibits certain actions including the fraudulent transfer of assets to stockholders that would leave a company insolvent. State statues precluding this generally are codified under the *Uniform Fraudulent Transfer Act* while §548 of the U.S. Bankruptcy Code addresses Federal bankruptcy laws. The concept of unwinding a fraudulent transaction was first codified via the *Fraudulent Conveyances Act of 1571* that was enacted by Parliament in England.

U.S. Courts will deem a transaction to be fraudulent if there was a) actual fraud; or b) constructive fraud in which a transaction occurred without adequate consideration. Significant emphasis will be placed on the financial condition of the company before and after the transaction. Courts will examine the three primary tests (four in Delaware) that form the basis for a solvency opinion to determine whether the subject transaction entailed adequate consideration.

- 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 saleable 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

The cash flow test asks: *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

The capital adequacy test asks: *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

The capital surplus test asks: *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.

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.

Recent Representative Transaction

KYZEN Corporation
Nashville, TN

Cash-Out Merger

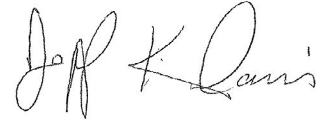
Mercer Capital served as financial advisor to the board of directors to establish a range of value at which certain shareholders would receive cash and rendered a fairness opinion in a go-private transaction

— **August 2021** —

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, independent committees, 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.



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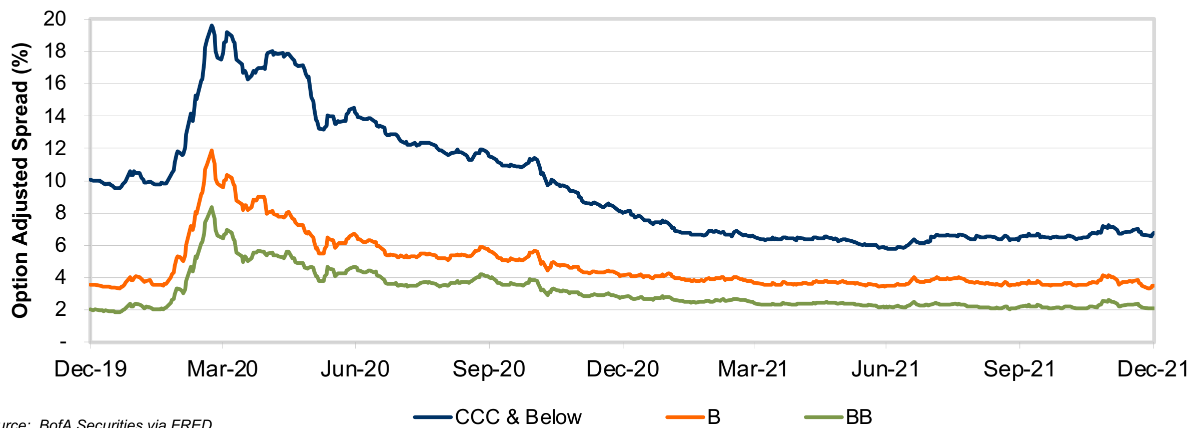
Private Credit and Equity

CCC-rated high yield bonds ("triple-hook") posted the strongest performance in 2021 as CCC spreads narrowed by about 150bps from year-end 2020 though at one point in September the spread had narrowed about 180bps. The outperformance of CCC was not surprising given the reopening of the economy and strong risk-on environment in the first half of the year. It appears lower rated credits may underperform in 2022 as the Fed appears poised to tighten financial conditions

Debt Investments: High Yield Spreads by Credit Rating

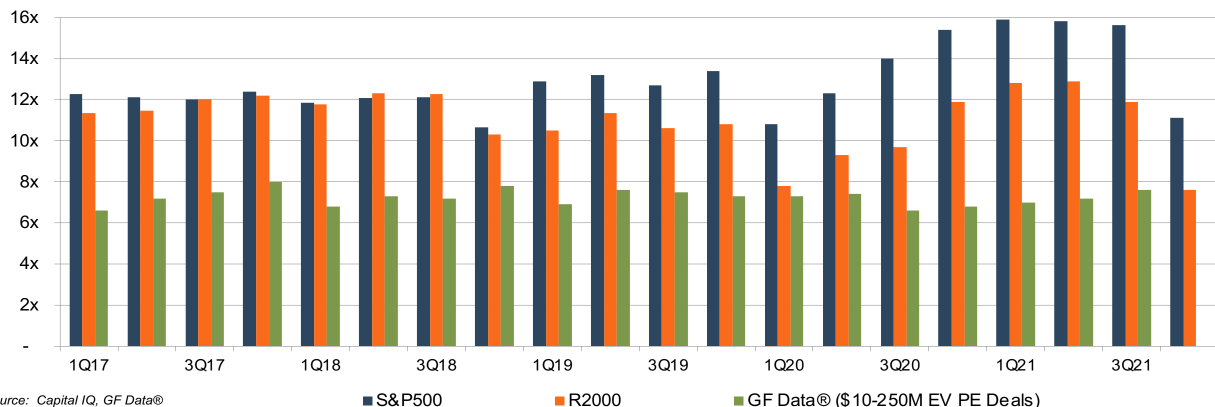


Source: BofA Securities via FRED

The reduction in the EBITDA multiple for both the S&P 500 and Russell 2000 (x-financials) from mid-year 2021 reflects strong corporate profitability that rising stock prices during 2H20 and 1H21 presumably were forecasting.

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 fourth quarter; however, given improving economic conditions and buoyant markets, we suspect the multiple may drift a bit higher. Acquisition multiples expanded 0.4x from the second quarter, while debt increased to 4.1x from 3.6x, implying that PE acquirers for the GF dataset were able to slightly reduce the equity contribution. On a YTD basis, the average acquisition multiple was 7.2x from compared to 7.0x in 2020 and 2019. Not surprisingly, larger deals entailed a higher multiple at 8.9x YTD for deals valued at $100-$250 million vs 6.0x for deals in the $10-$25 million range.

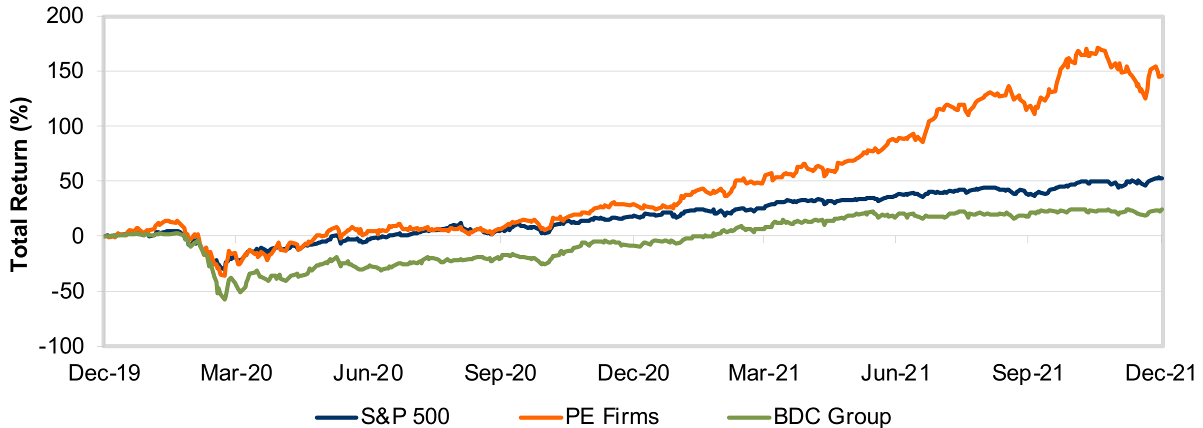
Equity Valuation: EBITDA Multiples Over Time



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)

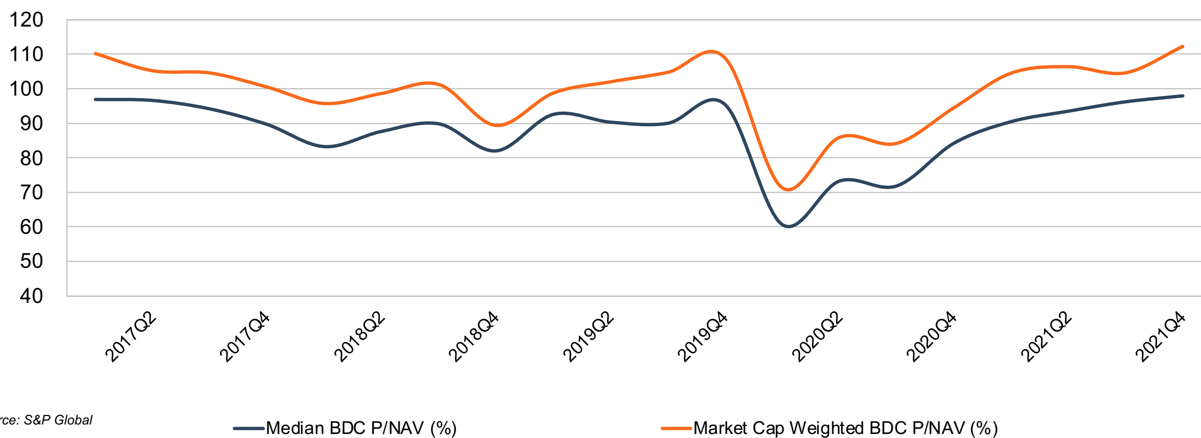


Source: S&P Global MI

Publicly Traded Private Credit

BDC prices improved a bit further in 4Q21. As of year-end 2021 the median BDC P/NAV was 98% and the market cap weighted multiple was 112%--valuations that were last recorded at year-end 2019 when the median P/NAV was 96% and market cap weighted multiiple was 109%.

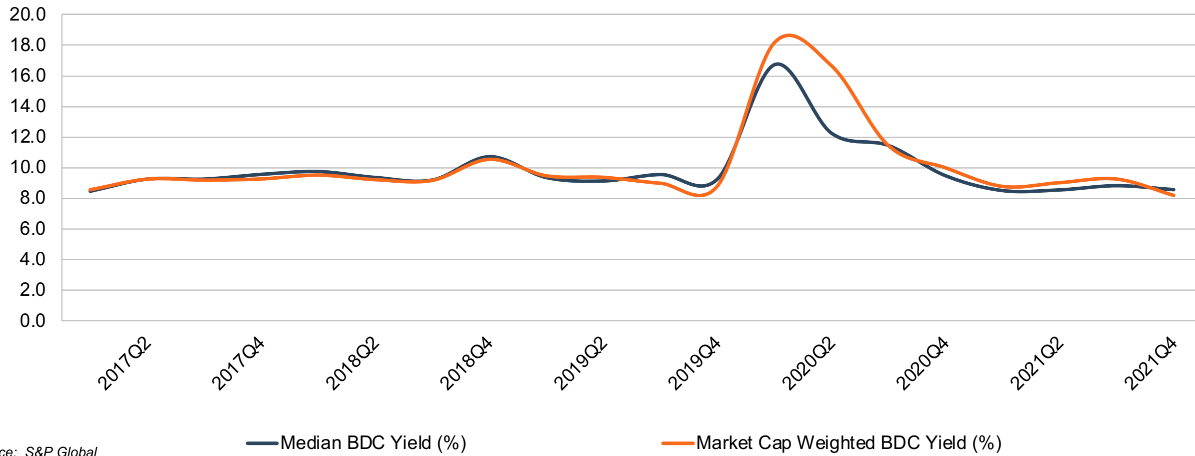
Price / NAV for Publicly Traded Business Development Companies



Source: S&P Global

BDC yields have fallen by about 50% from the March 2020 panic highs to just above 8% as of year-end 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

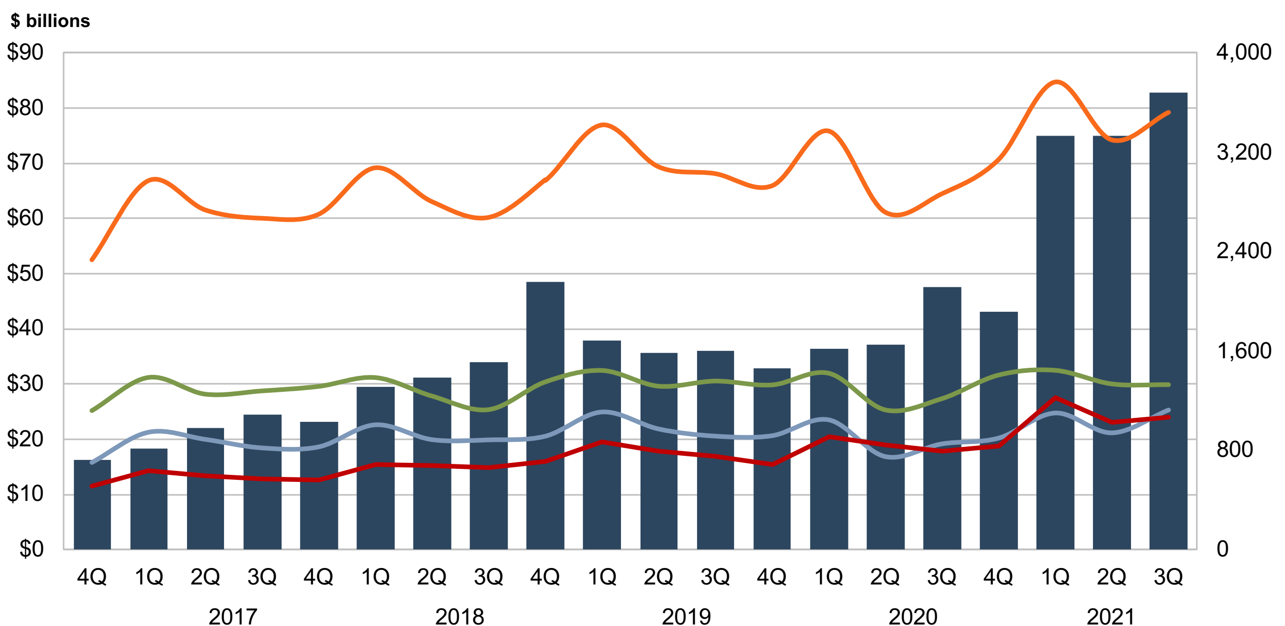


Source: S&P Global

Venture Capital

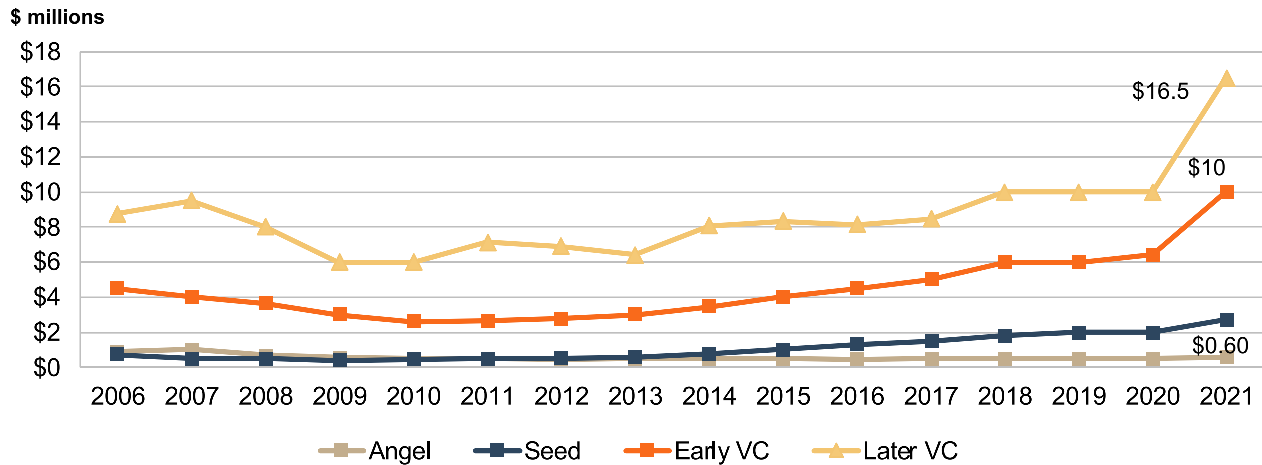
3Q21 venture funding rose to $81 billion from prior quarterly records of ~$75 billion in 1Q21 and 2Q21; both were significant records relative to the past several years when quarterly fundings ranged from $20 billion to $40 billion. The average funding per transaction increased to $24 million from $23 million in 2Q21, $20 million in 1Q21 and $14 million in 4Q20.

U.S. VC-Backed Funding Activity



Whether transitory or a new paradigm, venture-backed companies have seen a surge in the median capital raise based upon data through 3Q21 that ranged from 20% for angel investments to 65% for late-stage raises. Capital markets that are 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)

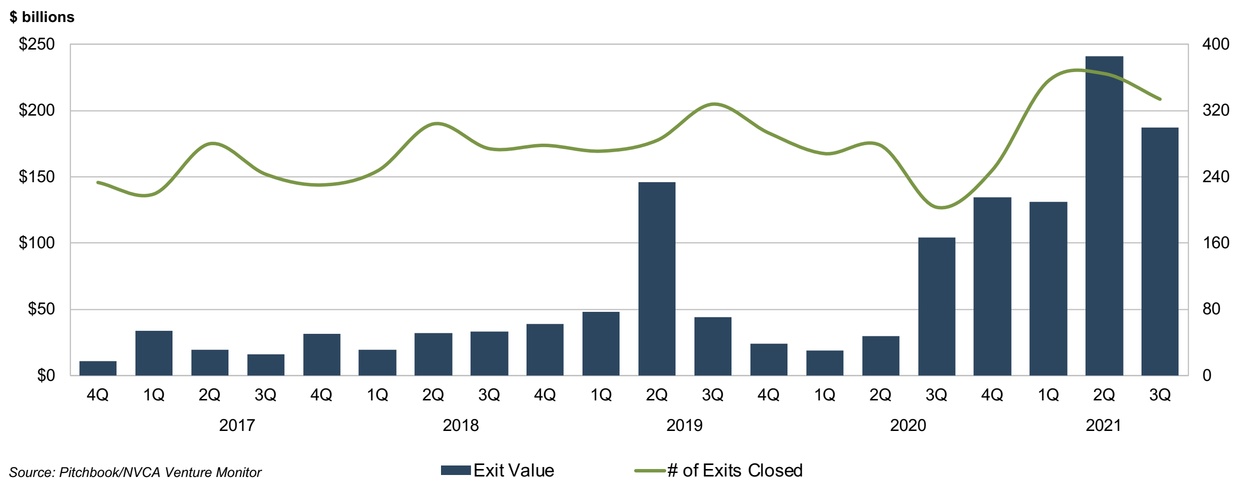


Source: Pitchbook/NVCA Venture Monitor

3Q21 exits tumbled from $240 billion in 2Q21 to $187 billion, an amount that was still comfortably above the third highest quarterly level. The July 2021 IPO of Robinhood Markets in which the company raised $2 billion and realized a value of ~$35 billion was a sizable contributor to the quarter. Exit data the next few quarters may decline given the sharp reduction in public market prices for many venture-backed companies the past few months.

Also of note is the number of investments relative to exits. Success attracts capital. YTD there were 11.2 investments for each exit compared to 9.1 in 2011 and 6.2 in 2006. IPOs accounted for 88% of YTD exits based upon dollars compared to 71% in 2020.

U.S. VC-Backed Exit Activity



Source: Pitchbook/NVCA Venture Monitor

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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 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

Contact a Mercer Capital professional to discuss your needs in confidence.

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