MERCER CAPITAL

BUSINESS VALUATION &
FINANCIAL ADVISORY SERVICES

Portfolio Valuation

Private Equity and Credit

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Fairness Opinions for GP-Led Secondaries

A Good Practice Regardless of SEC Rulemaking

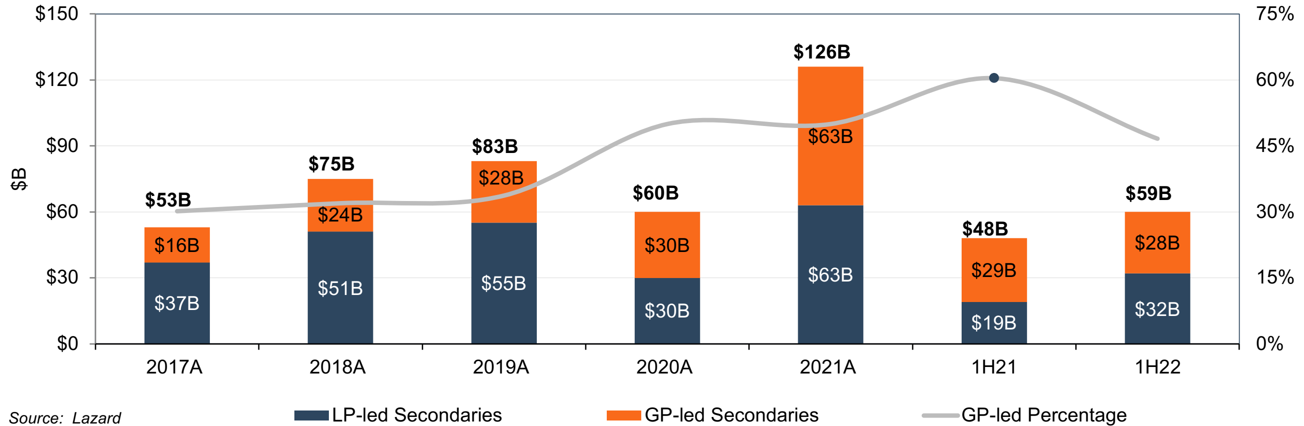
Although not mandated by law, fairness opinions for significant corporate transactions effectively have been required since 1985 when the Delaware Supreme Court ruled in *Smith v. Van Gorkom*, (*Trans Union*), (488 A. 2d Del. 1985) that directors were grossly negligent for approving a merger without sufficient inquiry. The Court suggested directors could have addressed their duty of care (informed decision making) by obtaining a fairness opinion.

Private equity (and credit) advisors sometimes obtain fairness opinions, too. Regulation rather than case law is poised to make fairness opinions required for general partner-led ("GP") secondary transactions.

On February 9, 2022 the Securities and Exchange Commission proposed changes to the *Investment Advisors Act* of 1940 ("Advisors Act") that if finalized would, among other things, require advisor-led secondary transactions to "distribute to investors a fairness opinion and a written summary of certain material business relationships between the advisor and the opinion provider." A link to the proposal can be found **here**.

Years ago, investing in an institution backed partnership was equivalent to buying a bond and holding it to maturity; not anymore. Limited partners ("LP") can obtain liquidity before a fund is liquidated via a secondary market transaction.

Figure 1: GP vs. LP-Led Secondaries



Source: Lazard

Prior to 2020, the most common liquidity transaction would be for an LP to find a buyer for the interest with the consent of the GP and meet other partnership agreement requirements. In a GP-led deal, the GP initiates a transaction. A common transaction involves a "continuation" fund in which a newly established fund acquires an asset that is not ready to be monetized from a fund that is near the end of its life. LP investors are offered the option to cash out or roll their interest into the continuation fund.

Over the past decade, the ability of LP investors to realize liquidity in a secondary market transaction has risen dramatically with the advent of large secondary funds. As shown in Figure 1, global secondary volume more than doubled in 2021 to $126 billion from $60 billion per estimates compiled by Lazard. Volume could conceivably top 2021 this year based upon a sharp slowdown in M&A and IPO activity as LPs and GPs look to the secondary market for liquidity.

Given the position of GPs on both sides of these transactions, the SEC position is not surprising. It is analogous to the requirement that an independent broker-dealer be used to sell/buy an asset among mutual funds within the same family of funds.

The proposed SEC rule takes aim at the corporate duty of loyalty, which with the duty of care and good faith form the triad that underpins the Business Judgement Rule in which courts defer to the decision making of directors provided they have not violated one of their duties. As far as we know, there has been no widespread finger pointing that GP-led transactions have intentionally disadvantaged LPs. Nonetheless, the SEC proposal is a regulatory means to address the issue of loyalty.

For more information about this topic or to discuss your needs in confidence, don't hesitate to contact us.

Jeff K. Davis, CFA
jeffdavis@mercercapital.com | 615.345.0350

Liquidity May Not Always Favor All Stockholders

Although not directly related to the SEC pronouncements for GP-led deals, a recent ruling from the Delaware Court of Chancery addresses conflicts of interest between the GP and minority investors and how fairness opinions can help boards navigate such issues.

In *Manti Holdings*, *LLC v. CGI* (C.A. No. 2020-0657-SG, Del. Ch. June 3, 2022) minority stockholder plaintiffs contested the 2017 sale of portfolio company Authentix Acquisition Company, Inc. even though the stockholders agreement required stockholders not to oppose any sale approved by the board and a majority of shareholders. The plaintiffs argued the directors breached their fiduciary duties by selling at an inopportune time that did not maximize value in order to wind down a fund and thereby gained a "unique benefit."

Further, the preferred equity owned by the private equity fund received $70 million, which represented the bulk of the transaction consideration with the residual distributed to the common shareholders, which included the private equity fund. While the investment banker had expected a sale to bring in excess of $200 million, pending contract renewals for key customers resulted in a process that yielded far less. Plaintiffs argued the transaction enriched the PE owner and impoverished the minority common shareholders.

The Court ruled that the language in the stockholder agreement related to waiving breach of duty claims was not sufficiently clear to approve the defendants motion to dismiss, and the Court agreed with the Plaintiffs that the transaction should be reviewed under the tougher entire fairness standard of review (i.e., fair price and fair dealing) given the alleged controller transaction and because the sale was not approved by an independent disinterested board or independent committee thereof.

Ironically, a GP-led continuation fund seemingly would have circumvented the issues raised by the minority stockholders by delaying the sale until conditions were more favorable, cashing out the preferred equity and extending an option to the common shareholders to roll their equity or receive a distribution.

The Court did not address whether a fairness opinion was provided by the investment banker and/or an independent third party. The facts and circumstances might not support the issuance of an opinion; however, the case demonstrates why third-party fairness opinions can help boards address their duty of care.

Fairness opinions involve a review of a transaction from a financial point of view that considers value (as a range concept) and the process the board followed. Due diligence work is crucial to the development of the opinion because there is no bright line test that consideration to be received or paid is fair or not.

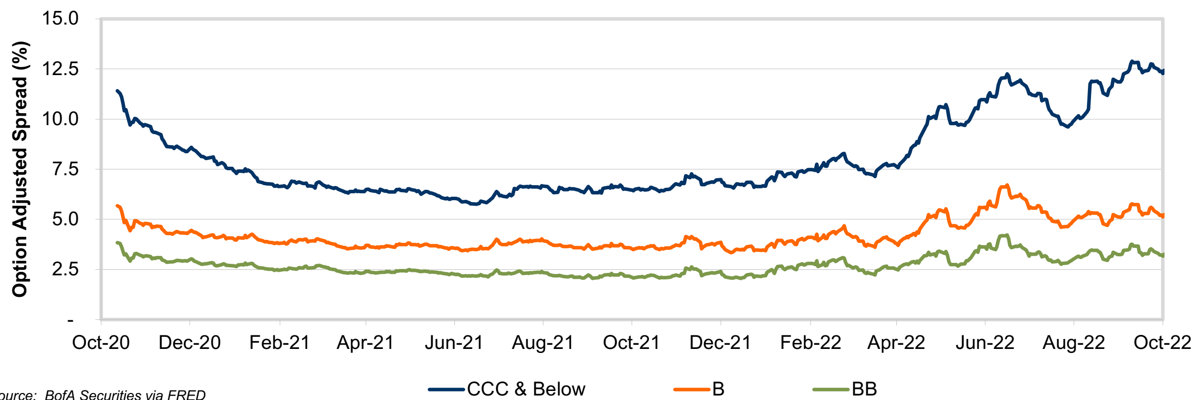
Mercer Capital has nearly four decades of experience in assessing transactions and issuing fairness opinions. Please call if we can be of assistance.

Jeff K. Davis, CFA
jeffdavis@mercercapital.com | 615.345.0350

Private Credit and Equity

CCC-rated high yield bonds ("triple-hook") have seen the most widening in 2022 given growing investor concerns about a recession as the Fed has been forced to hike short-term policy rates more aggressively to contain inflation. CCC spreads were 1200bps as of October 31, 2022 compared to 678bps as of year-end 2021. B- and BB-rated high yield bonds widened 131bps and 84bps, respectively from year-end.

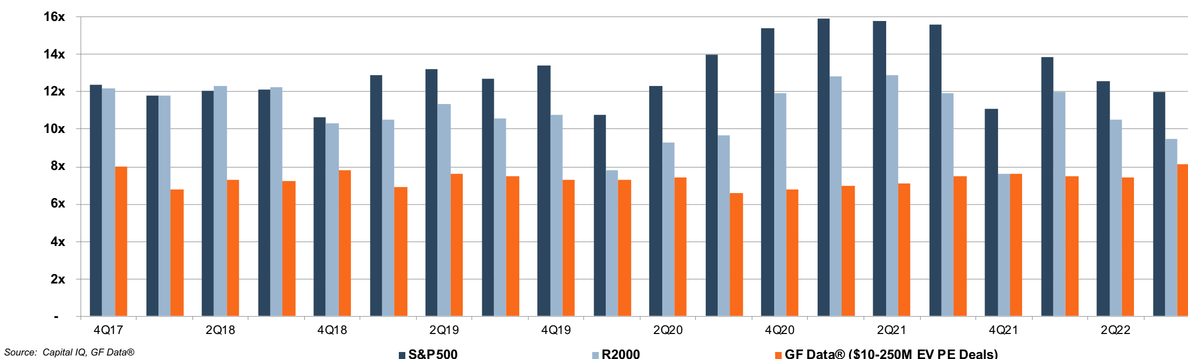
Debt Investments: High Yield Spreads by Credit Rating



The reduction in the LTM EBITDA multiple for both the S&P 500 and Russell 2000 (x-financials) from year-end 2021 reflects declining index values, though recent deterioration in corporate earnings may set the stage for some expansion by year-end absent further reduction in the indicies. The notable exception is the energy sector where earnings are booming due, in part, to government efforts to restrict supplies.

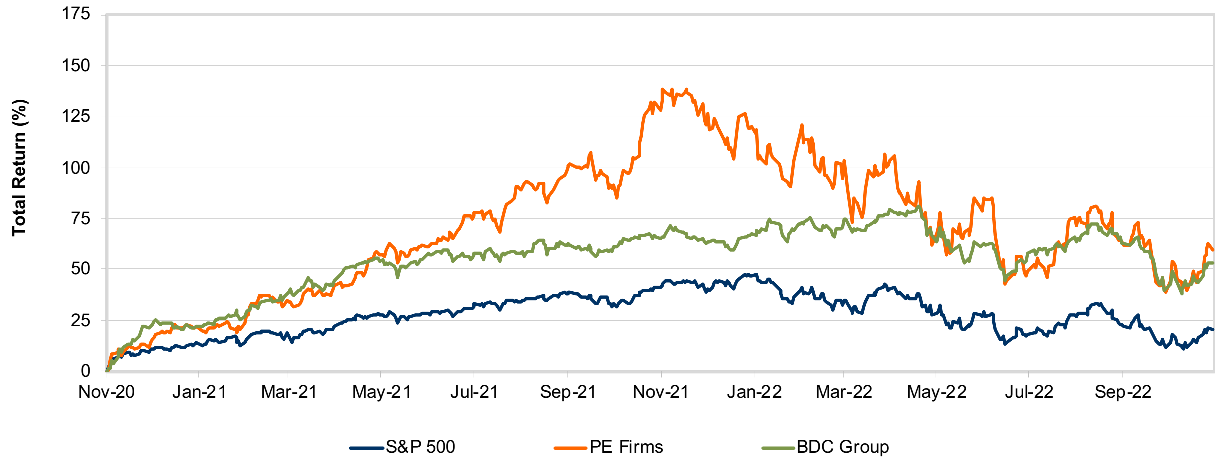
As for PE-backed transactions, GF Data® reports that for multiples paid by firms for companies with an enterprise value of $10 million to $250 million had been relatively stable the past four quarters through June 30 at ~7.5x; however, the average multiple rose to 8.1x in 3Q22 as some larger transactions and other unusual factors skewed the average multiple upwards to a 20-year high and what may prove to be a post-COVID cycle high. Given growth in asset values generally, GF Data has expanded its dataset to capture deals in the $250 to $500 million range. Preliminary data indicates the median multiple of adjusted (core) LTM EBITDA to be 10.1x. This is consistent with years of data in which higher multiples are obtained generally for larger transactions and when the seller has superior financial characteristics as measured by growth and margin.

Equity Valuation: EBITDA Multiples Over Time



PE Firms (APO, ARES, BX, KKR and CG) posted stellar returns from June 30, 2020 through Thanksgiving 2022 with an average total return for the five companies of 125% compared to "only" ~60% for the S&P 500. Blackstone (BX) and KKR were notable standouts with peak gains in excess of 150%. Since then, the group has underperformed the market by giving up all of its 2H21 levitation as the prospect of a slowing economy, higher rates and lower equity values reduce unrealized gains and potential realized gains.

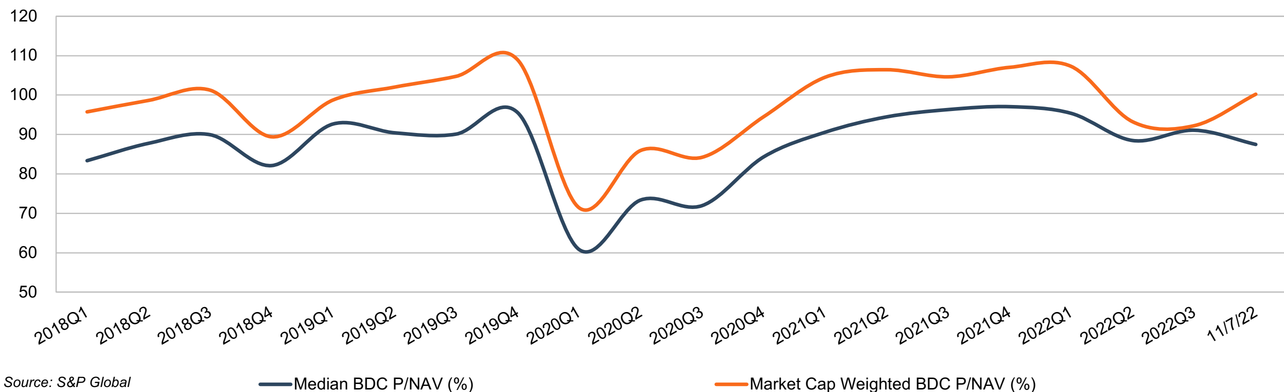
Stock Performance for Publicly Traded PE Sponsors: Total Returns (Trailing Twelve Months)



Publicly Traded Private Credit

After declining during the first half of 2022, BDC prices have firmed—especially for larger companies—since June as the market appears to imply a potential recession may not be as severe as feared. As of November 17, 2022, the median BDC P/NAV was 87% and the market cap weighted multiple was 100%.

Price / NAV for Publicly Traded Business Development Companies



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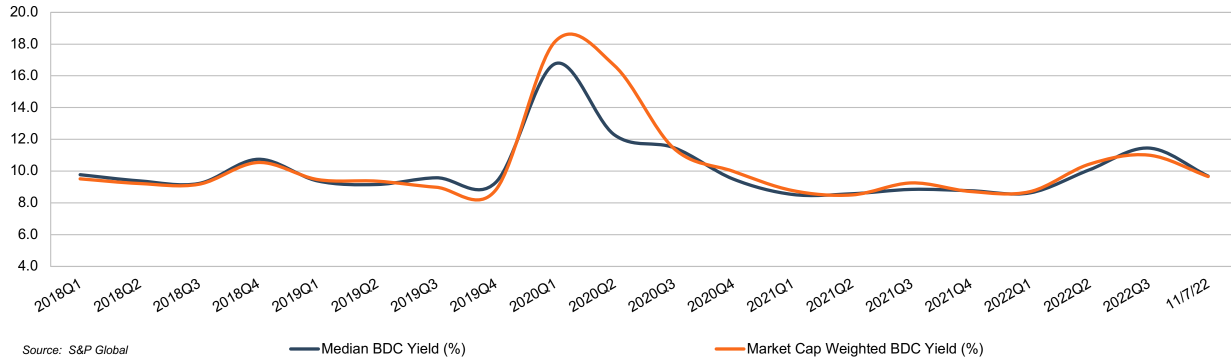
BDC yields are the inverse of NAVs—yields expanded during 1H22 as NAVs fell and investors became "risk-off" in anticipation of a recession. Since June, a mild rally in risk assets has reduced BDC yields to around 10%.

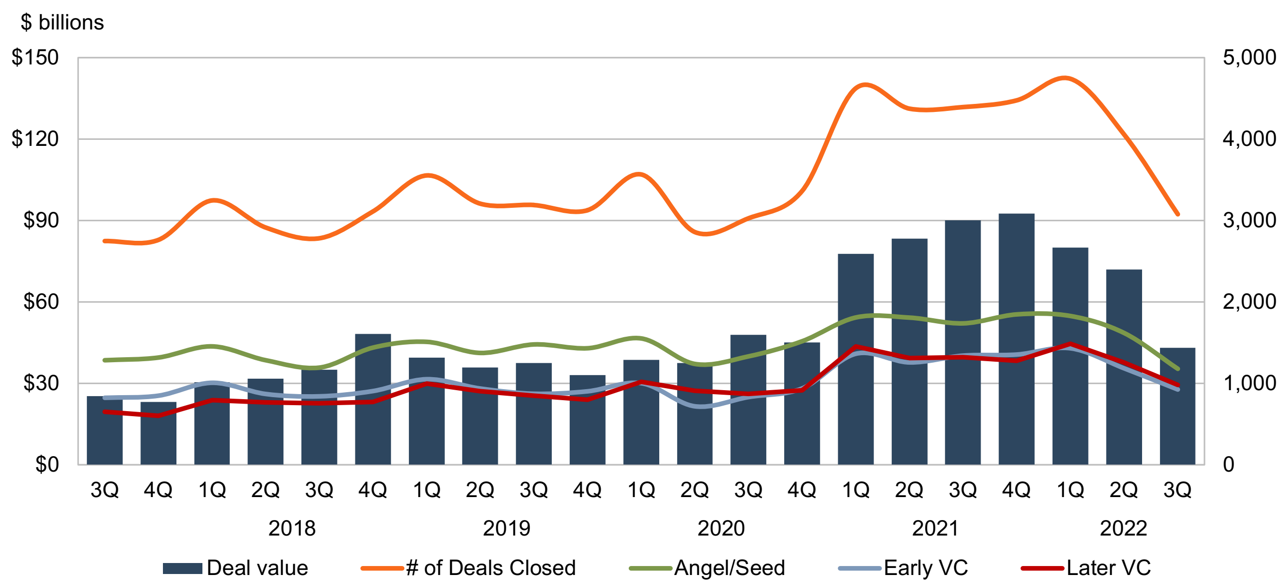
Long-Term Dividend Yield Trend



Venture Capital

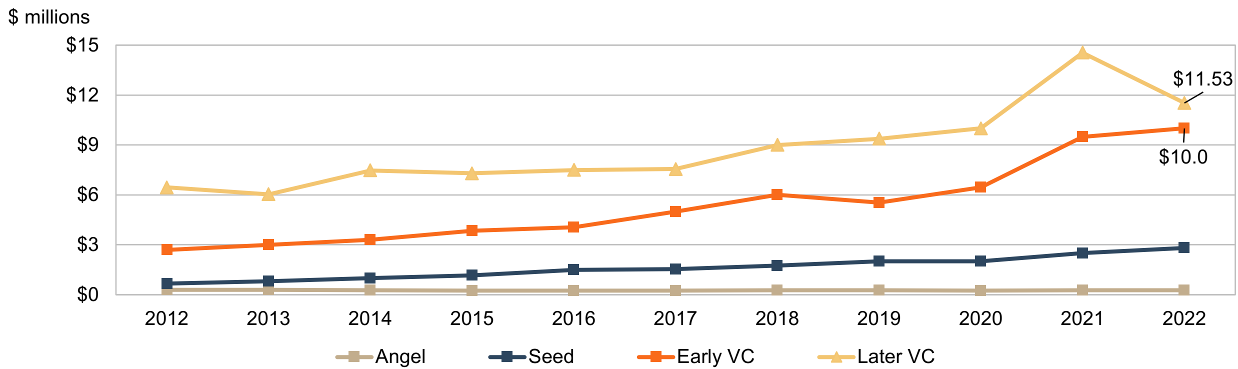
Given the sharp correction in the NASDAQ (down ~34% YTD through November 8) it is not surprising that VC-backed funding activity and VC-exits have declined for three sequential quarters. While market conditions are tough—especially for ventures that require periodic capital raises to fund operating losses—activity levels seem to be returning to pre-COVID levels. However, the vast number of new ventures that have been funded during what may be an anomaly in 2020-2021 require more capital and more exits all else equal.

U.S. VC-Backed Funding Activity



The bear market that has developed in the public markets is reflected in a ~34% reduction in the NASDAQ through November 8. Presumably it will eventually impact venture funding as exit multiples—for now—are less favorable than in 2021. Plus, M&A has slowed dramatically.

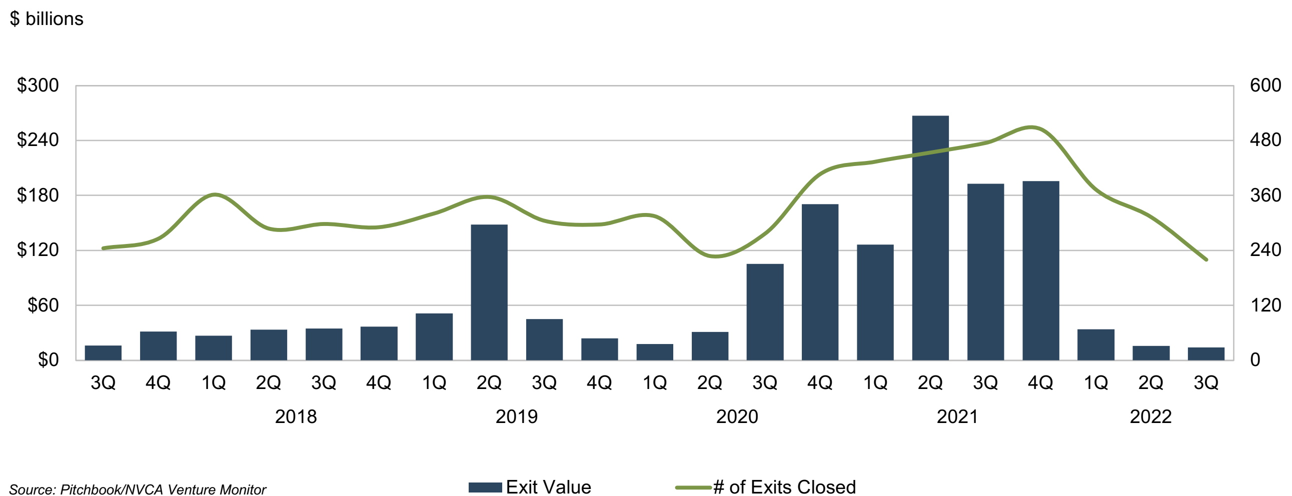
Median Funding by VC Stage ($ millions)



Source: Pitchbook/NVCA Venture Monitor

3Q22 exits declined nominally to $14 billion from $16 billion, while the number of transactions fell 30% to 220 from 313. LTM exits totaled $259 billion ($67 billion YTD) from $756 billion in the LTM period ended September 30, 2022. Exit data may remain subdued until the Fed pauses rate increases, at which point liquidity may return to the market to support somewhat higher activity.

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

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

Contact Us

Jeff K. Davis, CFA
615.345.0350
jeffdavis@mercercapital.com

J. David Smith, ASA, CFA
832.432.1011
smithd@mercercapital.com

Heath A. Hamby, CFA
615.457.8723
hambyh@mercercapital.com

Sujan Rajbhandary, CFA, ABV
901.322.9749
sujanr@mercercapital.com

Bryce Erickson, ASA, MRICS
214.468.8400
ericksonb@mercercapital.com

Zachary M. Barber, CPA/ABV
901.322.9718
barberz@mercercapital.com

MERCER CAPITAL

www.mercercapital.com

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