MERCER CAPITAL
BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

Portfolio Valuation

Private Equity and Credit

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MARKET TENOR

Although market conditions are difficult for venture-backed firms that require capital and PE-backed companies that need to refinance debt, the presumably imminent recession is not yet visible. Among the missing signposts are credit, which has yet to crack though corporate bankruptcies are up notably so far in 2023 vs the past several years. Credit spreads for BB and B-rated companies have widened a bit but have not gapped wider as would be expected six months or so before a recession really gets going. Only spreads on CCC-rated credits are circumspect, as high leverage and weak financial performance are not a great combination when interest rates are rising and the economy is slowing.

Ares Capital Corporation (NYSE: ARCC) CEO Kipp DeVeer offered a nuanced view of private credit on April 25 when the company released its 1st quarter earnings. The markets are tight, but Ares is prospering while awaiting the yet to develop recession. DeVeer noted that 95% of 1Q23 LBO financings were provided by private capital providers compared to 77% in 1Q22 and 57% in 1Q21. Owl Rock Capital Corporation (NYSE: ORCC) reported that the average mark on its debt portfolio was 97.6% as of March 31, 2023, up from 97.0% as of year-end. Portfolio company revenues and EBITDA were described as growing but at a slowing pace.

Nonetheless, market conditions are challenging in which equity raises generally require the issuer to accept a lower multiple and debt investors to accept a higher coupon. Through May 15, only $18 billion of registered common stock had been raised, down nearly 80% from the heady days of 2021 but not so much as 2022.

The Terminal Value

By: Jeff K. Davis, CFA

The valuation of portfolio companies usually is a straight forward process; however, it is more challenging in the current bear market following a period of wide-open monetary spigots that drove rich valuations for venture-backed firms. Capital raises were outwardly easy to complete as were richly valued exits via an IPO or M&A. For traditional PE-backed companies, low-cost debt financing was readily available, too, which often supported an extra turn or two of EBITDA for acquisitions and sometimes dividend recaps.

Now the hangover is in full swing.

The valuation process is intended to determine the fair value of an asset as of the valuation date. Stated differently, it is the market clearing price, not a price target based upon an investment thesis. The accounting profession provides more formality via ASC 820 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."

Current depressed market conditions make it difficult to utilize the recent bull market capital raise data without a fundamental adjustment for market conditions as well as differences between the subject and the comp data. The same applies to M&A and IPO pricing, too. What was is no more.

Depending upon the subject company, the Guideline Public Market Company Method (i.e., public comps) may be a suitable method to develop an indication of value, though often venture-backed companies may be too early in their life cycle to compare to public comps. But virtually all valuations will consider the Discounted Cash Flow Method ("DCF").

The DCF Method has three primary components: a) projected unlevered free cash flows that accrue to capital providers, b) a terminal value and c) weighted average cost of capital ("WACC") to discount the cash flows and terminal value to present values, the sum of which represents the enterprise value of the firm.

Most venture-backed firms and sometimes PE-owned companies can be described as long duration equities in which the value of the firm is in the out years rather than near-term cash flows as is the case for mature businesses with high profit margins. Like any model, terminal values have their sensitivities including and especially growth.

The terminal value represents the present value of all cash flows as of the end of the discrete forecast period. In our experience, the courts—especially in Delaware—and private equity analysts tend to favor an income approach to deriving a terminal value rather than a market approach based upon public company comps and/or M&A comps. An income approach to deriving the terminal value will rely upon the capitalization of earnings or free cash flow in which the multiple reflects a "build-up" of the components of capital costs less a long-term growth rate. Such an approach to deriving the terminal value excludes market data other than some of the capital cost components. Viewed from this perspective, the DCF method is a "pure" income approach to valuation as is the single-period (earnings or cash flow) capitalization method.

On the other hand, market participants tend to favor market multiples applied to one or more of the projected performance measures at the end of the forecast period to derive the terminal value. The courts may not favor this approach as a mixing of income- and market-based approaches, but viewing exit multiples in the context of market observations is not illogical.

It is important to note that a market-derived multiple used to determine a terminal value has an implicit growth expectation. All else equal, the higher the market multiple the higher the growth rate expectation. Stated differently, one should be judicious in selecting a market-based terminal value multiple. High growth rates tend to normalize in time with once high multiples compressing toward industry averages. Market multiples observed over the past several years may overstate future growth just as today's "low" multiples could understate future growth.

Figure 1 compares a market-based approach to determining a terminal value with a build-up approach. The illustration is intended to emphasize the delta that may exist presently between a market-based approach and a build-up. Firms that are projected to be marginally cash flow positive by the terminal year, all else equal, likely will not produce a substantial DCF value unless elevated market multiples are used to derive the terminal value. With the passing of the ultra-easy money era, that probably does not make sense unless the market observations were derived since interest rates returned to a "normal" level by late 2022.

An alternative to solely weighting the build-up multiple would be to weight both market-based and build-up multiples. That may make sense to bridge an evolving market, though if a court were to review the analysis it likely would solely weight the build-up multiple consistent with Delaware case law.

Another point to consider in calculating terminal values is relative valuation – does the terminal value as a multiple of earnings, revenues and whatever other metrics are relevant to the subject company's industry make sense? The resulting multiple may make sense, but one also has to question the terminal year earnings measure. If management projections reflect a "to the moon" trajectory, then the WACC probably should too.

Terminal values are sensitive to the assumptions, especially the growth rate of the terminal year earnings measure that is capitalized as shown in Figure 2 as it relates to a build-up method used in the single period capitalization method. The current outlook for lower economic growth and higher rates/cost of capital implies DCF values all else equal have (or will) decline.

Figure 1: Derivation of the DCF Terminal Value

	Market Based Multiples [1]		*Build-Up*	
Terminal Year Metric	**Revenue**	**EBITDA**	**Free CF** [2]	**Terminal Value**
Terminal Year Measure	$150,000	$33,000	$24,500	
WACC	na	na	15.0%	
Normalized Growth FCF	na	na	4.5%	
Multiple	2.5x	10.0x	9.5x [3]	
Indicated Values	$375,000	$330,000	$233,333	**$265,233**
Term Value / Revenue	*2.5x*	*2.2x*	*1.6x*	***1.8x***
Term Value / EBITDA	*11.4x*	*10.0x*	*7.1x*	***8.0x***
Term Value / FCFF	*15.3x*	*13.5x*	*9.5x*	***10.8x***
Terminal Value Weightings	0%	33%	67%	

1) Market based multiples may be derived from capital raise transactions, public market trading and/or M&A transactions

2) Free Cash Flow to the Firm = terminal year EBITDA x (1+g) - depreciation = EBIT; EBIT x (1-tax rate) + depreciation & amortization - ongoing capex - incremental working capital = FCFF

3) Build-Up multiple = 1 / (WACC - G) whereby WACC = the weighted average cost of capital and G = the estimated long-term growth rate in normalized FCFF at the end of the discrete projections

Figure 2: Sensitivity of the Build-Up Multiple re WACC vs Long-Term Growth of Earning Power

	18.0%	17.0%	16.0%	15.0%	14.0%	13.0%
3.0%	6.7x	7.1x	7.7x	8.3x	9.1x	10.0x
4.0%	7.1x	7.7x	8.3x	9.1x	10.0x	11.1x
5.0%	7.7x	8.3x	9.1x	10.0x	11.1x	12.5x
6.0%	8.3x	9.1x	10.0x	11.1x	12.5x	14.3x
7.0%	9.1x	10.0x	11.1x	12.5x	14.3x	16.7x
Hi vs Lo Δ	*36%*	*40%*	*44%*	*50%*	*57%*	*67%*

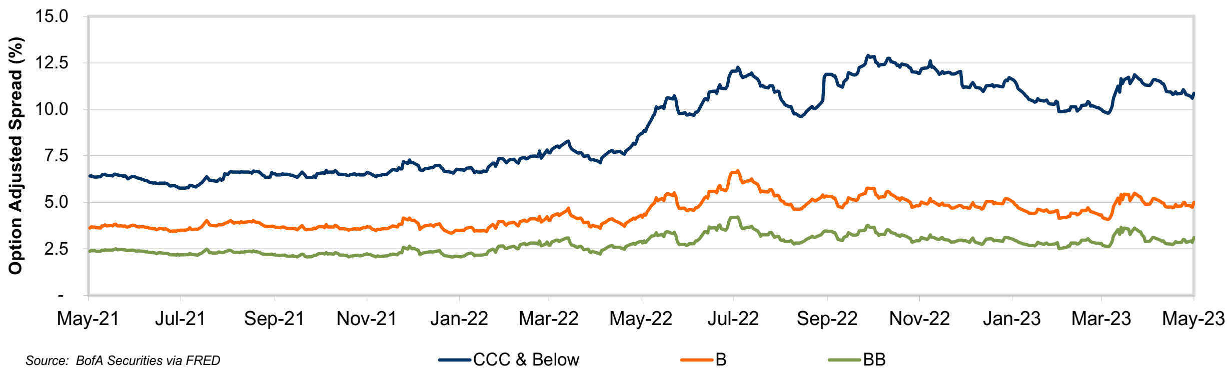
About Mercer Capital

Mercer Capital is an independent valuation and transaction advisory firm that was founded in 1982. We provide valuation, fairness and solvency opinions for a broad range of clients, including private equity and private credit funds. Please call if we can assist in establishing the fair value of your private equity and credit investments, or alternatively provide assurance opinions.

Private Credit and Equity

The high yield market is not warning of an imminent recession, perhaps because many issues were floated in 2H20 through 1Q22 which allowed issuers to obtain very low-rate, fixed rate financing generally for five to seven years. As for option adjusted spreads, BB and B rated bonds saw spreads peak in mid-Summer with limited tightening since OAS is not far from the long-term averages. CCC-rated bonds saw spreads peak in October at 1275bps and have since tightened to just under 1100bps compared to an average of 1126bps since 1996.

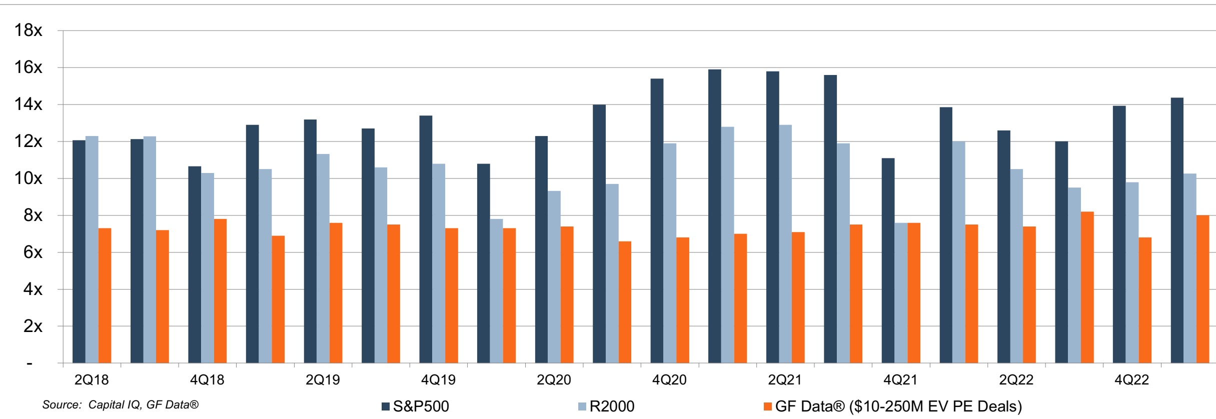
Debt Investments: High Yield Spreads by Credit Rating



There is no pronounced trend in the valuation of large cap stocks (S&P 500) or small cap stocks (Russell 2000) as both indices experienced sharp drawdowns over the period from roughly late 2021 through mid-2022. Since the beginning of the year, the S&P 500 has advanced about 7% through May 16, while the Russell 2000 has eased 2%. EBITDA multiples for the non-financial index stocks compressed with the sharp sell off in equities between November 2021 and June 2022 but since then have trended a bit higher.

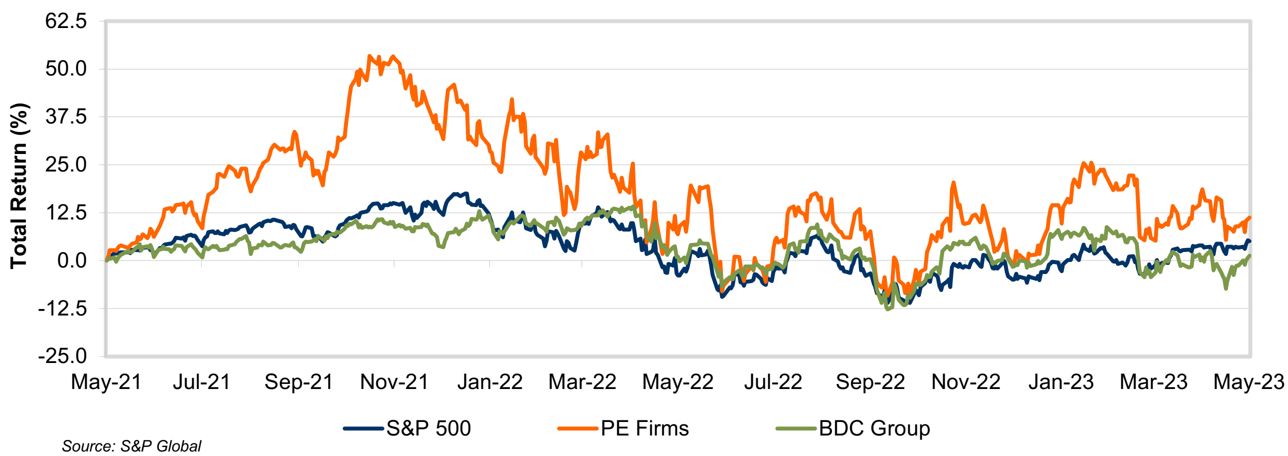
More interesting (to us) is the trend in lower middle market companies that are acquired by PE firms. GF Data ® has chronicled the sector for ~20 years with data provided by ~300 PE firms on a no-name basis with transactions sorted into five groups based upon enterprise value up to $250 million. The all-industry (NAICS) multiple tends to be flattish year-to-year with the smallest companies transacting around 6x vs 9x for the larger firms. During 1Q23, the overall median EV/EBITDA multiple rebounded to 8.0x based upon 70 transactions from 6.8x in 4Q22 (64), while the industry skew ranged from 6.5x for distribution to 9.5x for healthcare. Based upon EV, multiples ranged from 6.5x for $10-$25 million to 10.0x for $100-$250 million. GF Data ® added deals in the $250-$500 million category in 1Q23, which had a median multiple of 12.2x

Equity Valuation: EBITDA Multiples Over Time



PE Firms (APO, ARES, BX, KKR and CG) have exhibited more volatility than the S&P 500 and BDC stocks, but over the past two years are flattish. Absent a worse economic environment, PE investments generally have held their values as has been the case with private credit. The result is basically flat earnings (and stocks) for the PE firms.

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

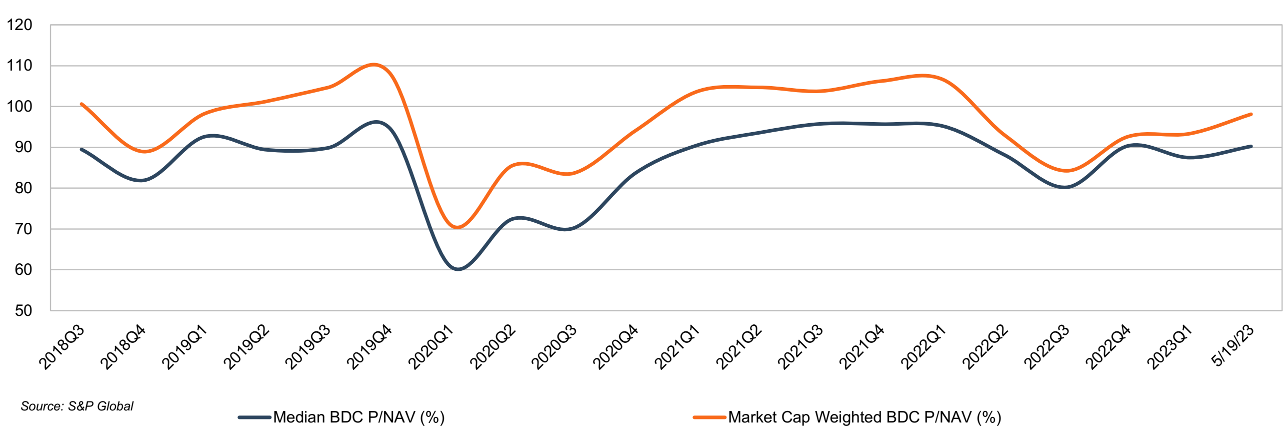


Source: S&P Global

Publicly Traded Private Credit

After declining through 3Q22, BDC prices have firmed—especially for larger companies as the market appears to imply a potential recession may not be as severe as feared. As of May 19, 2023, the median BDC P/NAV was 90% and the market cap weighted multiple was 98%.

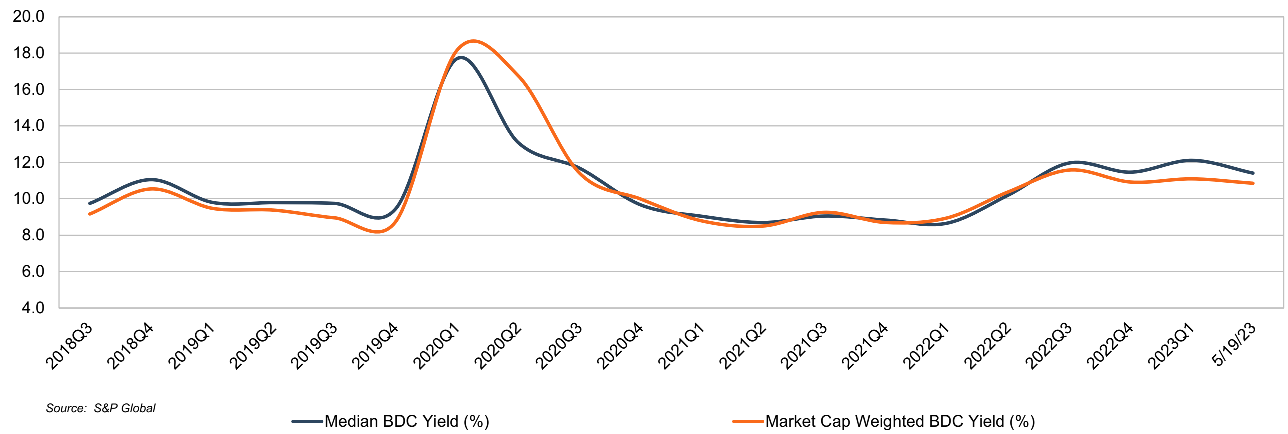
Price / NAV for Publicly Traded Business Development Companies



Source: S&P Global

BDC yields are the inverse of P/NAV multiples—yields expanded during 1H22 as prices fell in anticipation of a possible recession and resetting of the required yield as UST yields rose. Since mid-2022, yields have been in the vicinity of 11-12% with BDCs maintaining or increasing dividends as floating rate portfolios produced more income.

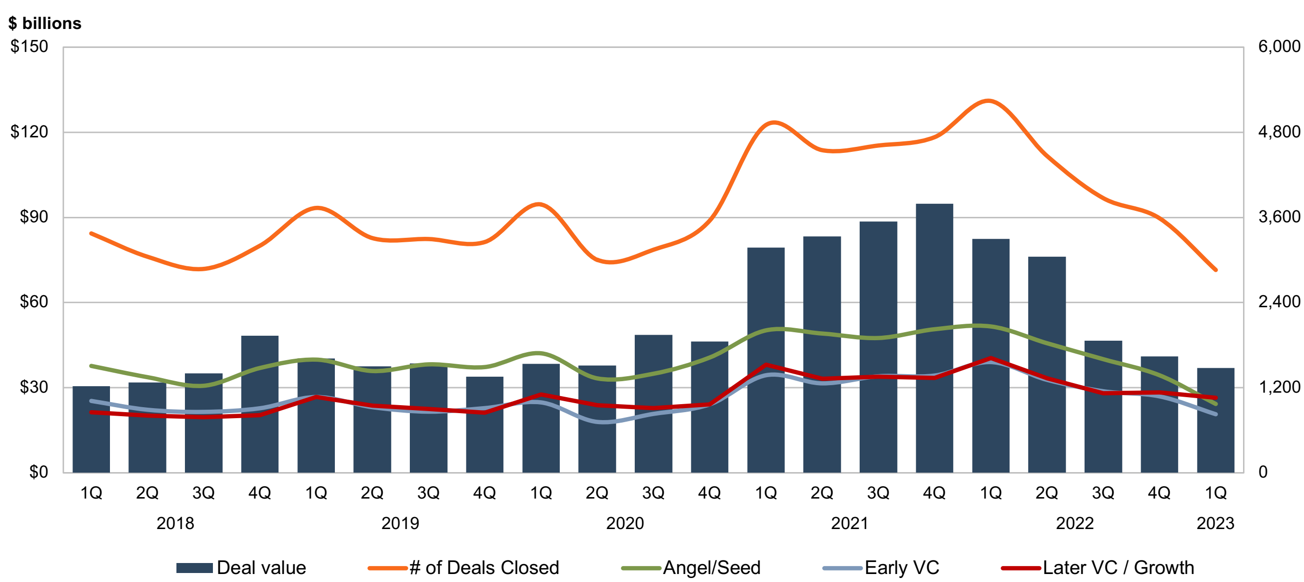
Long-Term Dividend Yield Trend



Venture Capital

Given the bear market of 2022 in which the NASDAQ declined 33%, it is not surprising that funding of VC-backed companies declined every quarter through 1Q23. However, with the rebound in large cap tech in 2023 that has pushed the NASDAQ 14% higher as of mid-May, we would not be surprised to see funding activity pick-up, especially if smaller cap tech companies are able to tap the market (x-PIPES) and if M&A picks-up.

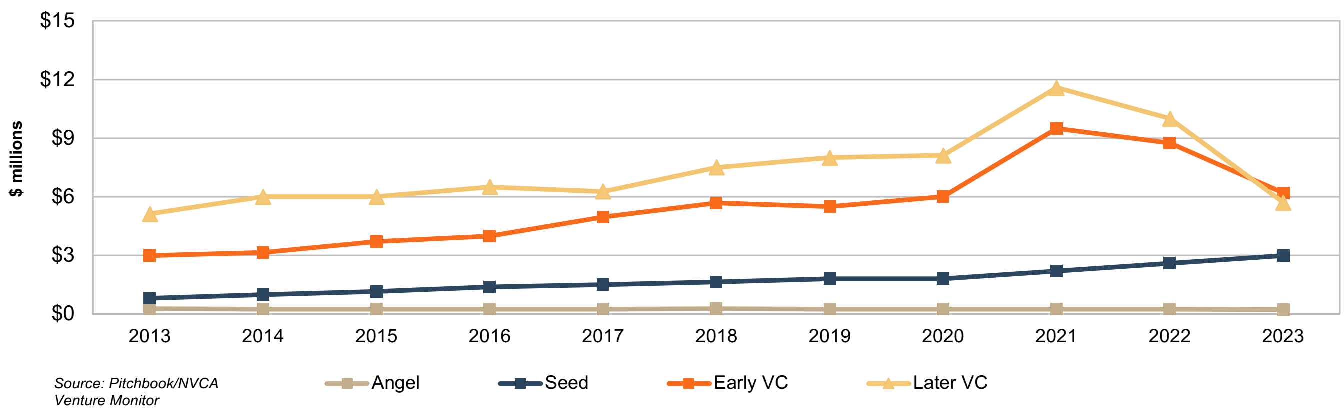
U.S. VC-Backed Funding Activity



Source: Pitchbook/NVCA Venture Monitor

With fewer exits, there is less capital to recycle into new fundraising rounds. As such the average raise for early and late stage VC companies has declined since 2021.

Median Funding by VC Stage ($ millions)



With depressed M&A activity and tight financing markets, exits for VC-backed companies are a fraction of the blockbuster quarters of 4Q20 through 4Q21; however, activity does continue as most exits are typically small while high profile IPOs at very high valuations await much better market conditions.

U.S. VC-Backed Exit Activity

Mercer Capital

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Services Provided

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- Purchase Price Allocations
- Goodwill Impairment
- Equity Compensation / 409(A)
- Buy-Sell Agreement Valuations

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