MERCER CAPITAL

BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

Portfolio Valuation

Private Equity and Credit

Fall 2023

In This Issue

MARKET TENOR

"Buy the rumor, sell the news" goes the long-time Wall Street saw that applies to publicly traded securities, but not private equity and credit.

We are generalizing here, but stocks have been supported by a soft consensus that the economy will avoid a hard landing and that the Fed may pivot to rate cuts in 2024 (i.e., the 2022 hope about 2023). Likewise, credit has benefited from the soft-landing narrative as credit spreads, especially CCC, have narrowed this year. Arguably, a lot of potential good news is already reflected in security prices.

Or is it?

As of November 29, the *S&P 500* and *NASDAQ* have gained 19% and 36%, respectively, year-to-date. Tech stocks anchor both indices. After a miserable 2022 for tech stocks, tech powered by the "magnificent seven" mega caps has pulled the market cap-weighted indices higher as many stocks have struggled. The equal-weighted *S&P 500* (+4%), *S&P 400* midcap (+5%), and *Russell 2000* small cap (+2%) indices have ground out nominal YTD gains after a tough first quarter.

The setup for year-end valuations of private equity and credit, in one sense, will be supported by stronger equity markets and tighter credit spreads. On the other hand, down round valuations for venture-backed companies that raised capital in 2023 and depressed M&A and IPO activity will weigh on the year-end marking process.

We expect the year-end marking process to be challenging, especially for companies that need to raise equity capital in 2024 to cover negative cash flow. Comp multiples are lower, discount rates are higher, and exit scenarios are fuzzier. Nonetheless, we think it is important to remember that 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.

Elon Musk on Fairness and Solvency Opinions

By: Jeff K. Davis, CFA

While corporate governance, compliance and fund reporting drive the valuation process for portfolio investments, sometimes transaction-related opinions are required in the form of fairness and solvency opinions. Both opinions require significant valuation and financial analysis, but such opinions also incorporate an examination of the process followed, case law, statutory law and the like as part of the analysis.

Because he provides so much fodder for business, economic, social, and political pundits, it is not surprising to us that an examination of Elon Musk's two biggest transactions — the acquisition of SolarCity by Tesla and Twitter by X Holdings — provides useful insights for parties that are contemplating a major transaction that require a fairness or solvency opinion. These insights apply to private equity and private credit funds, too — especially regarding real and perceived conflicts of interest.

Fairness of the Telsa-Solar City Merger

On July 31, 2016, the Board of Directors of Tesla Motors, Inc, and SolarCity Corporation entered into a merger agreement in which Tesla would acquire SolarCity via a share exchange ("Acquisition") that valued SolarCity at $2.6 billion and would result in SolarCity owning about 6.9% of Tesla's common shares upon consummation of the Acquisition.

Musk served as non-executive chairman of SolarCity since July 2006, and at the time of the merger served as CEO and Chairman of Tesla. He owned ~22% of Tesla's common shares and ~22% of SolarCity's common shares. Tesla Director Anthony Gracias served on the SolarCity Board, too. Excluding Musk, the SolarCity Board owned about 13% of SolarCity's shares of which ~8% was attributable to cousins Peter and Lyndon Rive. The Tesla Board owned less than 1% of Tesla's shares excluding Musk although three institutional shareholders collectively owned ~20% of the shares.

Not surprisingly, some Telsa shareholders sued alleging Musk browbeat the board into a deal to bailout SolarCity which incinerated cash. Our presentation provides a background on the merger, financial performance of the companies, relative valuation and other factors that one would expect in a fairness analysis.

Surprising to us and others was the resounding victory Musk won in Delaware's Court of Chancery in April 2022. Follow this link below for a full presentation of the various issues and how Chancellor Sights ruled in favor of Musk.

Tesla Walks the Entirely Fair Line with Solar City

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Solvency of X Holdings Post Twitter

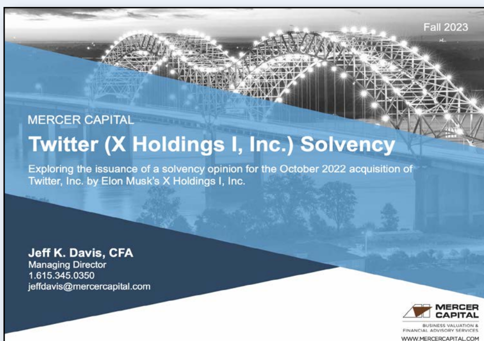
The acquisition of Twitter by Musk has amplified his reach; however, the steep drop in Twitter's revenues since the acquisition occurred combined with a heavily leveraged purchase has raised the prospect of a bankruptcy filing if Musk cannot turnaround the financial performance and/or if he does not inject additional capital.

The acquisition had plenty of drama (impulse purchase, buyer's remorse, litigation in Delaware again), but it would never have happened if Musk had not obtained the backing of Morgan Stanley, Bank of America and other banks to secure $13 billion of financing that is now hung on their balance sheets. With Twitter's finances apparently in tatters, Musk may have the upper hand with the banks.

While the proxy statement provides a roadmap for the deal history, including fairness opinions issued by Twitter's financial advisors, there is no such disclosure for X Holdings; nor is there any mention of a solvency opinion X Holdings may have obtained as part of its "solvency representation" in the borrowing agreement.

This presentation reviews the transaction from the perspective of issuing a (shadow) solvency opinion.

Twitter (X Holdings I, Inc.) Solvency



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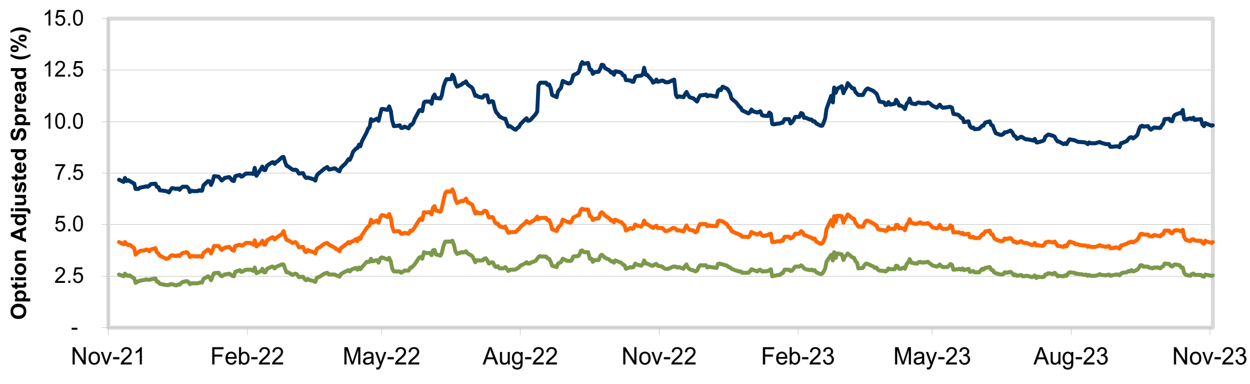
About Mercer Capital

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 imminient recession, perhaps because many issues were floated in 2H20 through 1Q22 which allowed issuers to generally obtain very low-rate, fixed rate financing for five to seven years. As for option adjusted spreads, BB and B rated bonds saw spreads peak in mid-Summer with limited tightening such that 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 1000bps compared to an average of ~1125bps since 1996.

Debt Investments: High Yield Spreads by Credit Rating

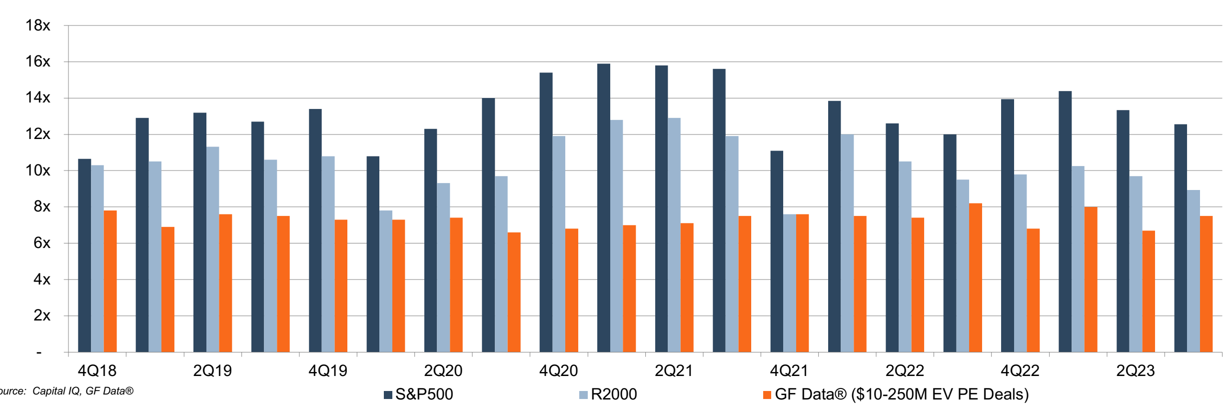


Source: BofA Securities via FRED

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 roughly over the period from late 2021 through mid-2022. Since the beginning of the year, the *S&P 500* has advanced about 20% through November 27 while the *Russell 2000* has ticked up ~3%. EBITDA multiples for the non-financial index stocks compressed in 2Q23 and 3Q23 as earnings generally improved and stocks rallied.

More interesting (to us) is the trend in lower middle market companies that are acquired by PE firms. *GF Data* ® chronicles 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 $500 million. The all-industry (NACIS) multiple tends to be flattish year-to-year with the smallest companies transacting around 6x vs 9x for the larger firms. During 3Q23, the overall median EV/EBITDA multiple rebounded to 7.5x based upon 56 transactions from 6.7x in 2Q23 (63), while the industry skew ranged from 6.0x for retail to 9.4x for healthcare in the YTD period. Deal multiples ranged from 6.1x (EV of $10-25M) to 11.1x (EV of $100-250M) in 3Q23.

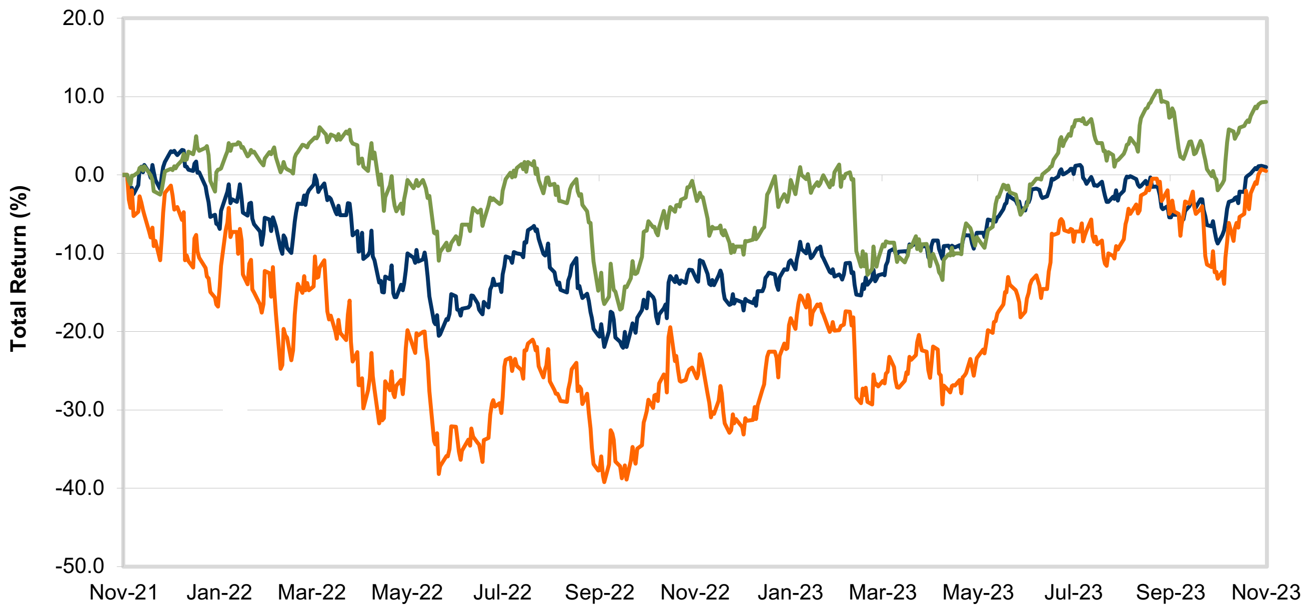
Equity Valuation: EBITDA Multiples Over Time



Source: Capital IQ, GF Data®

PE Firms (APO, ARES, BX, KKR and CG) have exhibited more volatility than the *S&P 500* and BDC stocks, but the past two years are flattish while a sizeable rally has occurred since market lows were recorded in 3Q22. Investment income generally increased in 2Q and 3Q as values increased similar to to the rise public markets; the result is increased earnings (and stocks) for the PE firms.

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

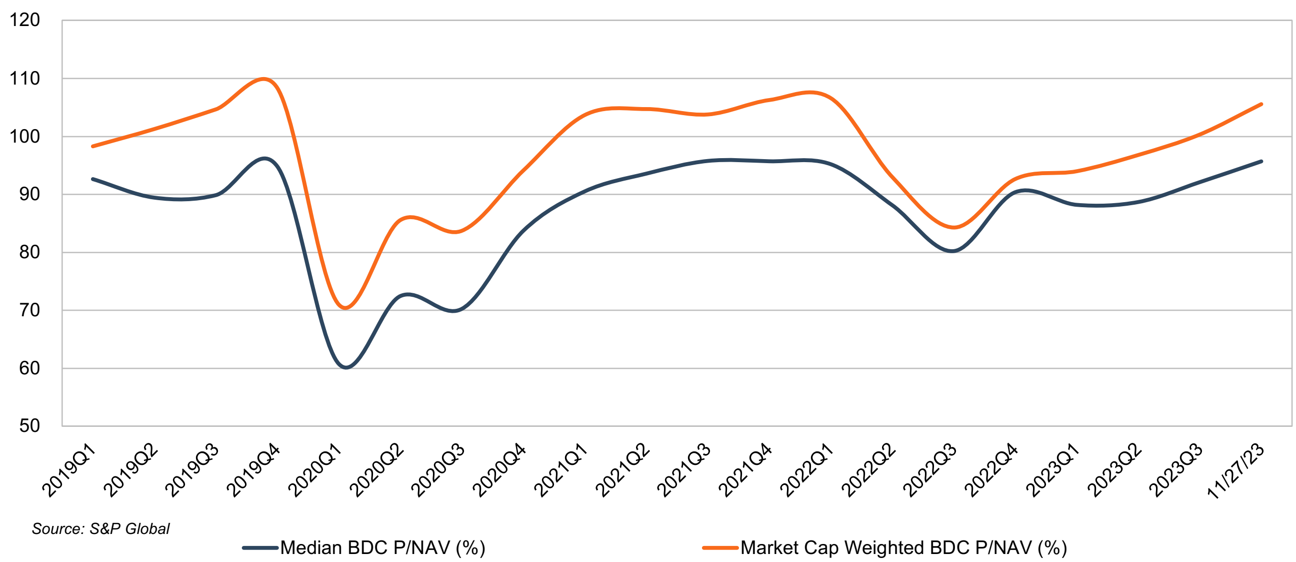


Source: S&P Global MI

Publicly Traded Private Credit

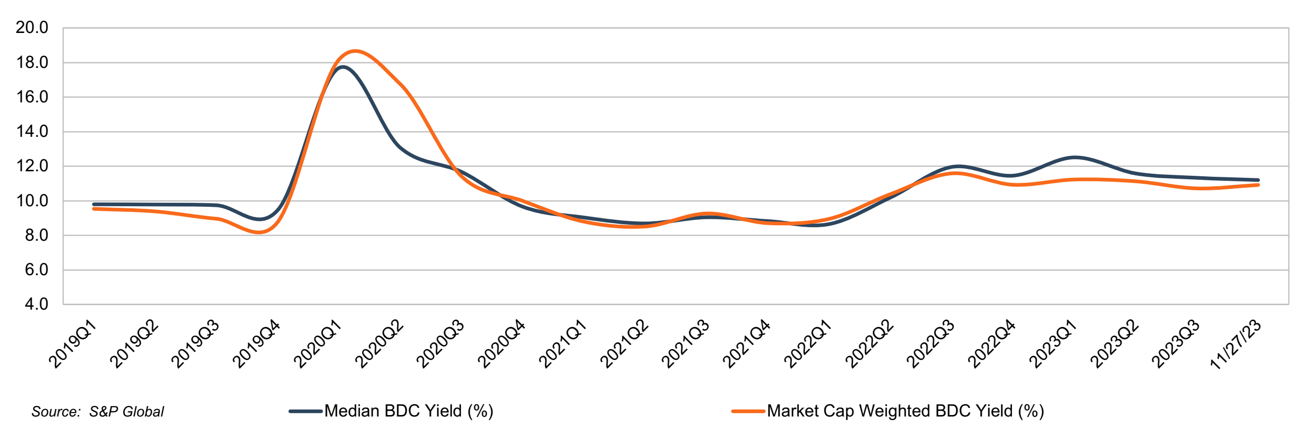
After declining through 3Q22, BDC prices have firmed — especially for larger companies as the market appears to imply a potential recession may not be as severe as feared. As of November 27, 2023, the median BDC P/NAV was 96% and the market cap weighted multiple was 106%.

Price / NAV for Publicly Traded Business Development Companies



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 flattish in the vicinity of 11-12% with BDCs maintaining or increasing dividends as floating rate portfolios produced more income.

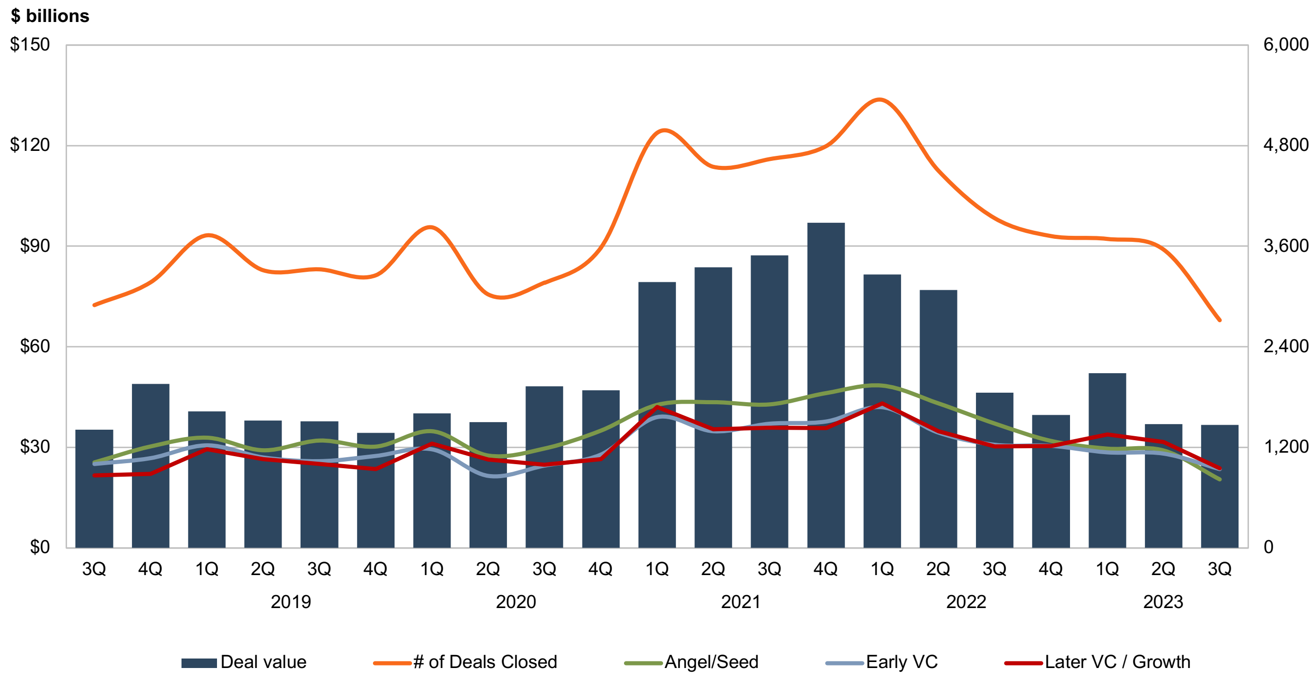
Long-Term Dividend Yield Trend



Venture Capital

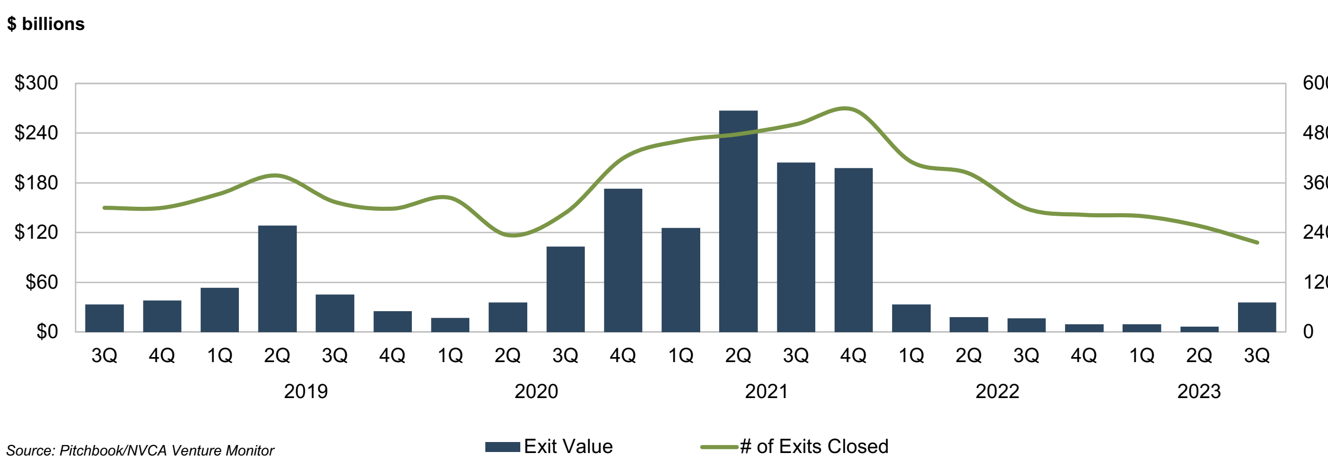
While the *NASDAQ* rallied in 2023, it still remained approximately 10-20% below highs set around year-end 2021. Deal activity, volume and count, continued its decline in 2Q23 and 3Q23 as rates remained stubbornly high. If the *NASDAQ* continues its rally, we would not be surprised to see funding activity pick-up, especially if smaller cap tech companies are able to tap the market (x-PIPES) and M&A picks-up.

U.S. VC-Backed Funding Activity



Source: Pitchbook/NVCA Venture Monitor

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.

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