Portfolio Valuation

Private Equity and Credit

Summer 2024

In This Issue

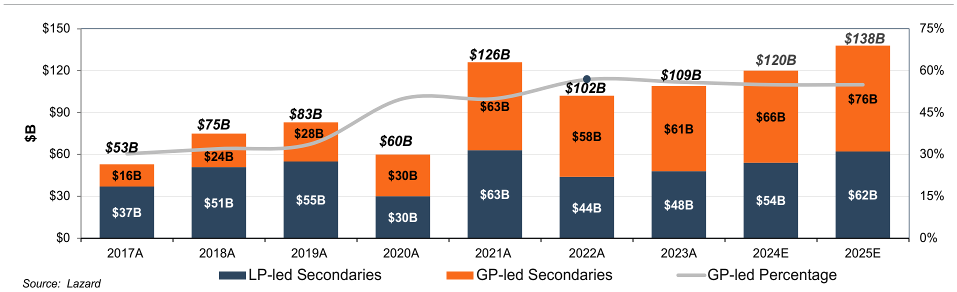
SEC Fairness Opinion Requirement Has Not Slowed GP-Led Secondaries

Rising regulatory burdens contributed to the stunning growth in private equity the last two decades and private credit in recent years. PE investors ultimately require liquidity, however.

Subdued M&A and IPO markets since mid-2022 have spurred growth for private equity secondaries, which mostly consists of GP-initiated transactions for continuation funds and LP-initiated transactions for portfolio interests.

As shown in Figure 1, secondary transactions rose to $109 billion in 2023 from $102 billion in 2022 based upon data compiled by Lazard as volume soared 57% in 2H23 to $67 billion following depressed activity of about $43 billion in 2H22 and 1H23. Lazard expects secondary volume will improve further in 2024 and 2025 as the investor base for secondaries expands and buoyant markets support narrower bid-ask spreads.

Figure 1



(Article continued on next page)

SEC Fairness Opinion Requirement Has Not Slowed GP-Led Secondaries

(continued from previous page)

The need for LP liquidity also has driven the rise of NAV lending in which the GP arranges for a fund-level loan to fund distributions and/or acquisitions.

Lazard reports that LP secondaries of buyout funds realized ~88% of NAV whereas LPs realized only ~60% of NAV for interests in funds focused on early stage venture capital assuming NAV was not materially overestimated. LPs averaged 85% for interest in private credit funds, which is less than we would have guessed.

LP investors can decide whether it makes sense to transact at a price that is less than NAV and thereby convey to the buyer additional return from investing in an illiquid asset. The LP investor will weigh the cost against the expected return from the current investment, the need for liquidity, and the opportunity to deploy the returned capital in new ventures.

GP-led transactions for continuation funds create a corporate governance can of worms because the GP sits on both sides of the transaction as adviser to the fund that is selling an asset and as adviser to the fund that will buy it. LPs can choose liquidity on the terms offered, or they can roll their interest into the continuation fund. Whether a single asset or multi asset investment, presumably the GP is using a continuation vehicle because the exit price for an attractive asset is presently unattractive.

The SEC addressed the issue through adopting **Rule 211(h)(2)-2** in August 2023 which requires the GP adviser to: (a) obtain a fairness opinion or valuation from an independent valuation firm; and (b) disclose any material business relationships between the GP and opinion provider. Given the increase in GP-led secondaries to $31 billion in 2H23 from $17 billion in 1H23, the SEC governance requirement has not slowed the market.

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.

The 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 rule is a regulatory means to address the issue of loyalty.

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 over four decades of experience as an independent valuation and financial advisory firm in valuing illiquid equity and credit, assessing transactions and issuing fairness opinions. Please call if we can be of assistance in valuing your funds private equity and credit investments or evaluating a proposed GP-led transaction.

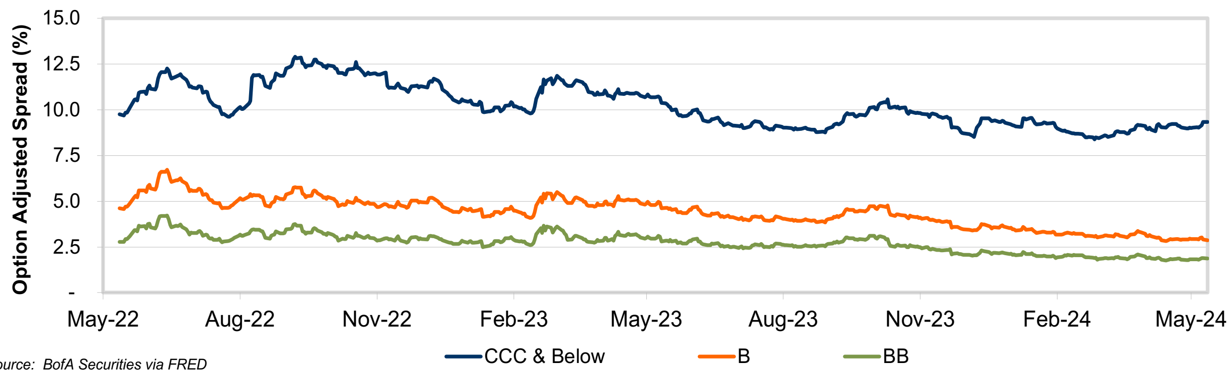
Jeff K. Davis

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

Private Credit and Equity

The high yield market is not warning of an imminent recession, perhaps because markets reopened in 2024 after a tough 2H22 and 2023 when rising rates curtailed HY bond and leverage loan issuances while private credit remained active and took share from the public markets. Since late 2023 when Chair Powell offered a verbal pivot of coming rate cuts, public markets have reopened, which has resulted in significant refinancing activity and some market share regained from private credit as ample capital in the absence of an M&A financing wave has led to tightening spreads in both the public and private markets.

Debt Investments: High Yield Spreads by Credit Rating

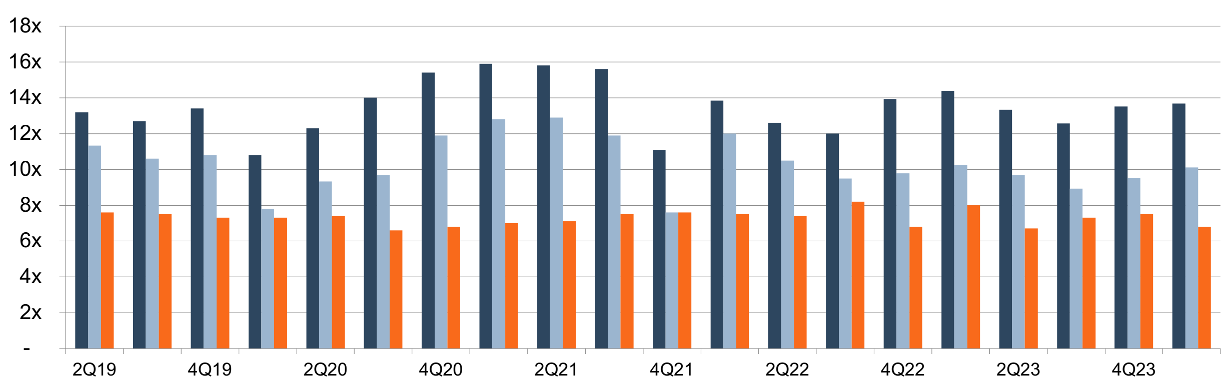


Source: BofA Securities via FRED

There is no pronounced trend in the valuation of large cap stocks (S&P 500) or small cap stocks (Russell 2000) the past six quarters as earnings among index constituents have more or less climbed with the indices such that the EBITDA multiples have not changed dramatically (note both the S&P and R2000 data exclude the financial sectors).

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 six groups based upon enterprise value up to $500 million. The all-industry (NACIS) multiple tends to be flattish on a year-to-year basis with the smallest companies transacting around 6x vs 10x for the largest firms. During 1Q24, the overall median EV/EBITDA multiple declined to 6.8x based upon 72 transactions from 7.5x in 4Q23 (72). Deal multiples by transaction size ranged from 6.3x (EV of $10-25M) to 8.3x (EV of $100-250M; $250-$500M EV multiple was skewed by few deals) in 1Q24. Since 1Q23, the range is 6.1x for $10-$25M to 10.2x for $250-$500M.

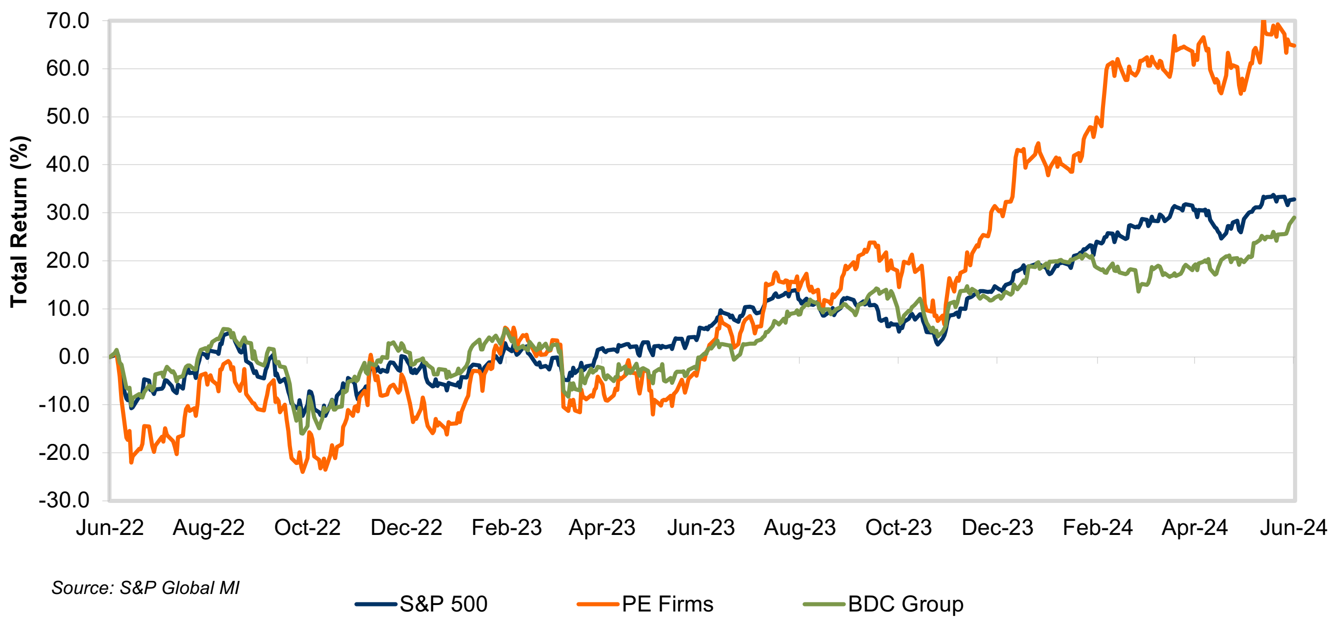
Equity Valuation: EBITDA Multiples Over Time



Source: Capital IQ, GF Data®

PE/PC Firms (APO, ARES, BX, KKR and CG) have exhibited more volatility than the S&P 500 and BDC stocks while a sizable rally has occurred since market lows were recorded in 3Q23. Strong growth in private credit management fees and a rebound in private equity values generally account for the outperformance of the PE/PC firms here. Apollo's net income for instance was $1.8 billion in 1Q24 compared to $636 million in 3Q23 when the market was setting a low for the year and was a loss of $887 million in 3Q22 when the market bottomed in the bear market of 2022.

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

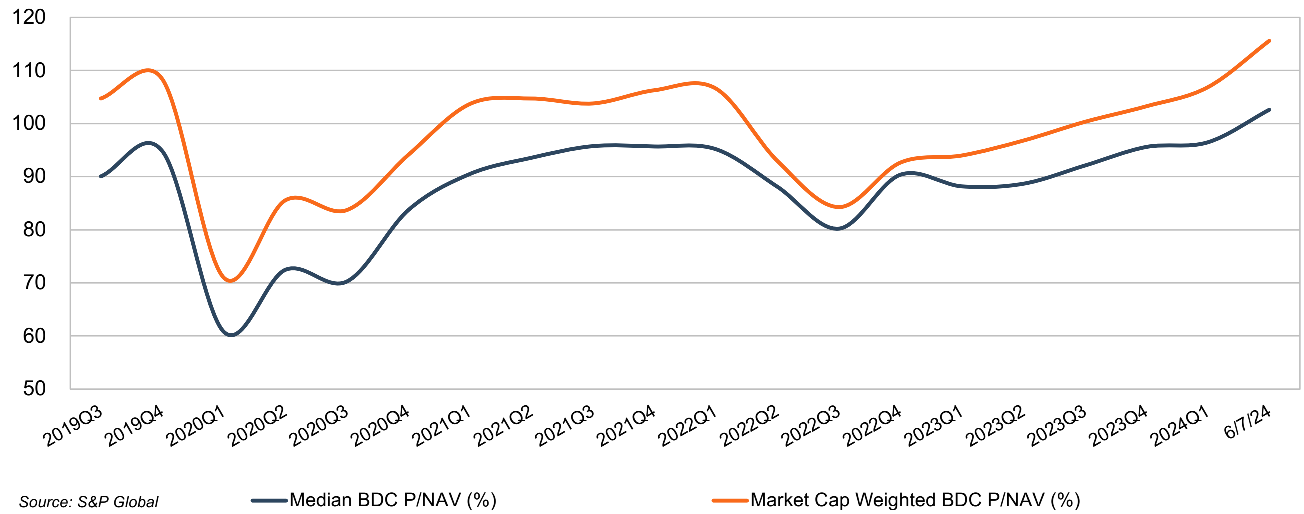


Source: S&P Global MI

Publicly Traded Private Credit

Like the high yield and leverage loan market where spreads have tightened since the failure of SVB, BDC share prices are not pointing to investor concerns about material credit issues given that much of the sector trades near or above NAVs.

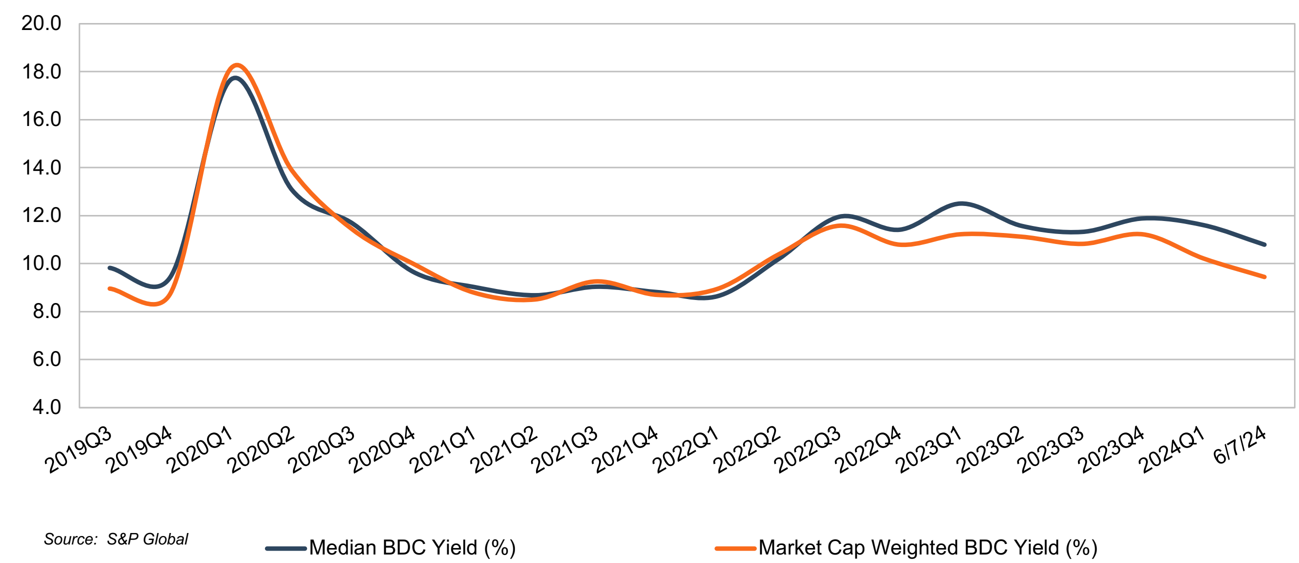
Price / NAV for Publicly Traded Business Development Companies



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-2023, yields have trended modestly lower to 10-11% as prices have risen and in some cases risen more than dividend payments were hiked such that yields still declined.

Long-Term Dividend Yield Trend

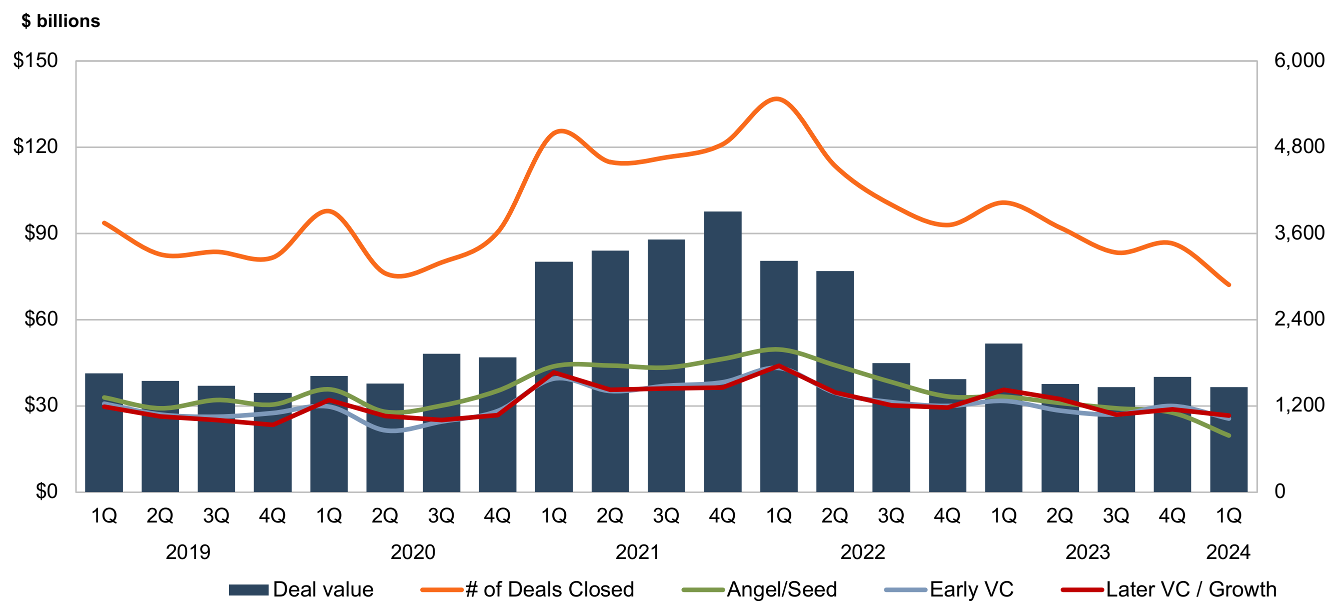


Source: S&P Global

Venture Capital

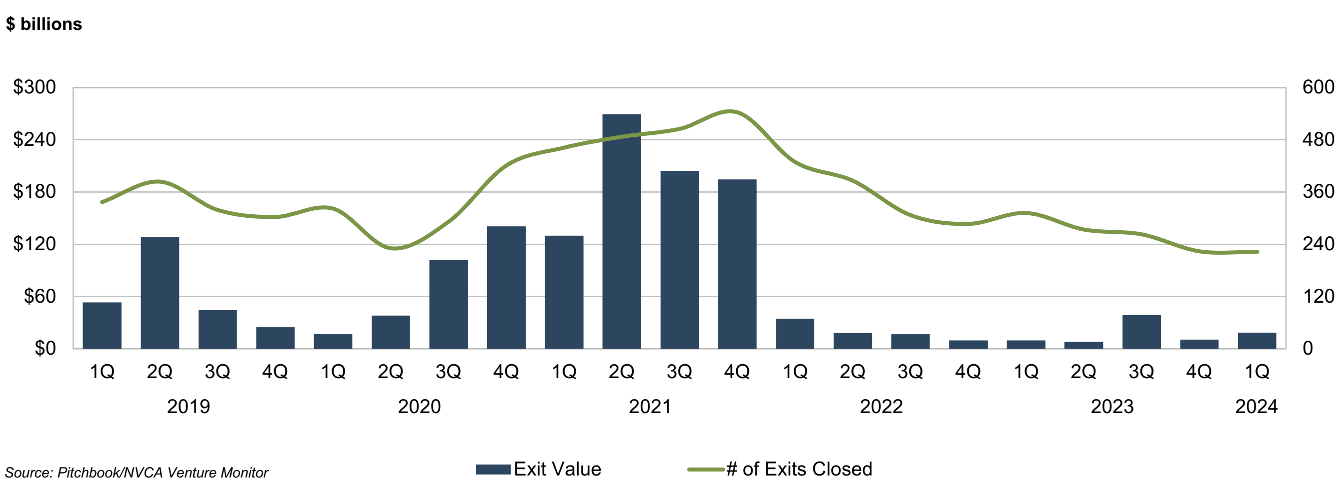
While the NASDAQ bear market of 2022 is a distant memory given the tech-led rally in 2023 and 1Q24, VC funding activity remains well below the euphoric 2H20-1H22 era when monetary stimulus and federal government deficit spending were extreme.

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

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

Lucas Parris, CFA, ASA-BV/IA
901.322.9784
parrisl@mercercapital.com

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

MERCER CAPITAL

www.mercercapital.com