MERCER CAPITAL

BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

Portfolio Valuation

Private Equity and Credit

Fall 2024

In This Issue

MARKET TENOR

Perhaps it is back to an alternate future as the Dodgers defeated the Yankees in the World Series after losing to the Yankees in 1977, 1978, and 1996. The market tenor feels like 1996 rather than the high-rate, low P/E multiple markets of the stagflation 1970s. Markets offered a few curveballs and fastballs this fall that should be supportive of PE funds to pick-up the pace of asset monetization while credit funds apparently have less concern that interest income will be eviscerated through draconian Fed rate cuts.

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	11/29/24	8/29/24	11/29/23	Qtr Δ	Y/Y Δ
SOFR	4.59%	5.33%	5.31%	-74 bps	-72 bps
10-Year UST	4.25%	3.83%	4.43%	42 bps	-18 bps
BB Corp Bond Yield	5.80%	5.62%	6.77%	18 bps	-97 bps
B Corp Bond Yield	6.88%	6.64%	8.37%	24 bps	-149 bps
S&P 500	6032	5592	4551	7.9%	32.6%
NASDAQ	19218	17516	14258	9.7%	34.8%
Russell 2000	2435	2203	1804	10.5%	35.0%
Rolling Four Quarters	*3Q24*	*2Q24*	*3Q24*		
\$10-\$25M PE Deals	6.4x	6.3x	6.0x	0.1x	0.4x
\$25-\$50M PE Deals	6.8x	6.7x	7.0x	0.1x	-0.2x
\$50-\$100M PE Deals	8.3x	8.2x	7.8x	0.1x	0.5x
\$100-\$250M PE Deals	8.6x	9.1x	8.6x	-0.5x	0.0x
\$250-\$500M PE Deals	9.5x	10.2x	10.7x	-0.7x	-1.2x

Source: St. Louis Federal Reserve (FRED), S&P Global Market Intelligence, GF Data® (an ACG Company)

Market Tenor (cont.)

Among the Curveballs

- Historical precedents notwithstanding, a recession remains over the horizon even though the UST yield curve has been inverted for two years (10Yr – 3M).
- The Fed cut its short-term Fed Funds policy rate by 50bps on September 18 to 4.75% to 5.00% while the yield on the 10-year UST rose ~60bps from 3.6% to ~4.3% by November 7 when the Fed reduced its policy rate another 25bps.
- Markets make opinions, of course, so market participants as of early December are pricing in only four more 25bps rate cuts by year-end 2025 including a December 2024 cut that is not a sure bet.
- The leverage loan ("LL") and high yield ("HY") markets counterattacked the private credit market to regain share lost the past couple of years through price and term concessions that have allowed borrowers in all three markets to refinance at lower rates (or lower margins).

Among the Fastballs

- A bull market that has broadened as the laggard *Russell 2000* rallied 20% year-to-date with nearly half the rally occurring in November as compared to 27% and 6% for the *Russell 1000* (as of November 29).
- Multiple expansion for most industry sectors occurred as the advance in equity prices exceeds near-term expected earnings growth.
- Presumably there will be a more favorable M&A environment from a regulatory perspective given the Republican sweep in November that will see a new Chair of the FTC and head of the Antitrust Division of the DOJ who will review the 2023 Merger Guidelines.
- Credit markets are wide-open for M&A financing.

The mosaic of events is that 2025 should be a year in which PE investments can be more easily monetized than the past several years, though a more conducive environment does not guarantee exit prices will materially improve. Mercer Capital can assist with portfolio valuations and transaction related opinions of fairness and solvency.

Quality of Earnings Report for Would-Be PE Sellers

By: Timothy R. Lee, ASA

M&A deal flow was sidelined for much of 2022-2024, but the economy's soft landing, stabilizing interest rates, and pent-up M&A demand are expected to compel buyers and sellers to renew their efforts in 2025 and beyond.

As deal activity recovers, sellers need to be prepared to present their value proposition in a compelling manner. For many sellers, an independent Quality of Earnings ("QofE") analysis and report is vital to advancing and defending their asset's value in the marketplace. And it can be critical to the ensuing due diligence processes buyers apply to targets.

The scope of a QofE engagement can be tailored to the needs of the seller. Functionally, a QofE provider examines and assesses the relevant historical and prospective performance of a business. The process can encompass both the financial and operational attributes of the business.

In this article, we discuss five reasons sellers benefit from a QofE report when responding to an acquisition offer or preparing to take their businesses to market.

1 Maximize value by revealing adjusted and future sustainable profitability.

Sellers should leave no stone unturned when it comes to identifying the maximum achievable cash flow and profitability of their businesses. Every dollar affirmed brings value to sellers at the market multiple. Few investments yield as handsomely and as quickly as a thorough QofE report. A lack of preparation or confused responses to a buyer's due diligence will assuredly compromise the outcome of a transaction. The QofE process includes examining the relevant historical period (say two or three years) to adjust for discretionary and non-recurring income and expense events, as well as depicting the future (pro forma) financial potential from the perspective of likely buyers. The QofE process addresses the questions of why, when, and how future cash flow can benefit sellers and buyers. Sellers need this vital information for clear decision-making, fostering transparency, and instilling trust and credibility with their prospective buyers.

2 Promote command and control of transaction negotiations and deal terms.

Sellers who understand their objective historical performance and future prospects are better prepared to communicate and achieve their expectations during the transaction process. A robust QofE analysis can filter out bottom-dwelling opportunists while establishing the readiness of the seller to engage in efficient, meaningful negotiations on pricing and terms with qualified buyers. After core pricing is determined, other features of the transaction are established such as working capital, frameworks for roll-over ownership, thresholds for contingent consideration, and other important deal parameters. These seemingly lower-priority details can have a meaningful effect on closing cash and escrow requirements. The QofE process assists sellers and their advisors in building the high road and keeping the deal within its guardrails.

3 Cover the bases for board members, owners, and the advisory team and optimize their ability to contribute to the best outcome.

The financial and fiduciary risk of being underinformed in the transaction process is difficult to overcome and can have real consequences. Family businesses can be lovingly nurtured with operating excellence, sometimes over generations of ownership, only to suffer from a lack of preparation, underperformance from stakeholders who lack transactional expertise, and underrepresentation when it most matters. The QofE process is like training camp for athletes — it measures in realistic terms what the numbers and the key metrics are and helps sellers amplify strengths and mitigate weaknesses. Without proper preparation, sellers can falter when countering an offer, placing the optimal outcome at risk. In short, a QofE report helps position the seller's board members, managers, and external advisors to achieve the best outcome for shareholders.

4 Financial statements and tax returns are insufficient for sophisticated buyers.

Time and timing matter. A QofE report improves the efficiency of the transaction process for buyers and sellers. It provides a transparent platform for defining and addressing significant reporting and compliance issues. There is no better way to build a data set for all advisors and prospective buyers than the process of a properly administered QofE engagement. This can be particularly important for sellers whose level of financial reporting has been lacking, changing, outmoded due to growth, or contains intricacies that are easily misunderstood.

For sellers content to work their own deals with their neighbors and friendly rivals, a QofE engagement can provide some of the disciplines and organization typically delivered by a buy-side representative. While we hesitate to promote a DIY process in this increasingly complicated world, a QofE process can touch on many of the points that are required to negotiate a deal. Sellers who are busy running their businesses rarely have the turnkey skills to conduct an optimum exit process. A QofE engagement can be a powerful supporting tool.

5 In one form or another, buyers are going to conduct a QofE process – what about sellers?

Buyers are remarkably efficient at finding cracks in the financial facades of targets. Most QofE work is performed as part of the buy-side due diligence process and is often used by buyers to adjust their offering price (post-LOI) and design their terms. It is also used to facilitate their financing and satisfy the scrutiny of underlying financial and strategic investors. In the increasing arms race of the transaction environment, sellers need to equip themselves with a counteroffensive tool to stake their claim and defend their ground. If a buyer's LOI is "non-binding" and subject to change upon the completion of due diligence, sellers need to equip themselves with information to advance and hold their position.

The stakes are high in the transaction arena. Whether embarking on a sale process or responding to an unsolicited inquiry, sellers have precious few opportunities to set the tone. A QofE process equips sellers with the confidence of understanding their own position while engaging the buy-side with awareness and transparency that promotes a more efficient negotiating process and the best opportunity for a favorable outcome. If you are considering a sale, give one of our senior professionals a call to discuss how our QofE team can help maximize your results.

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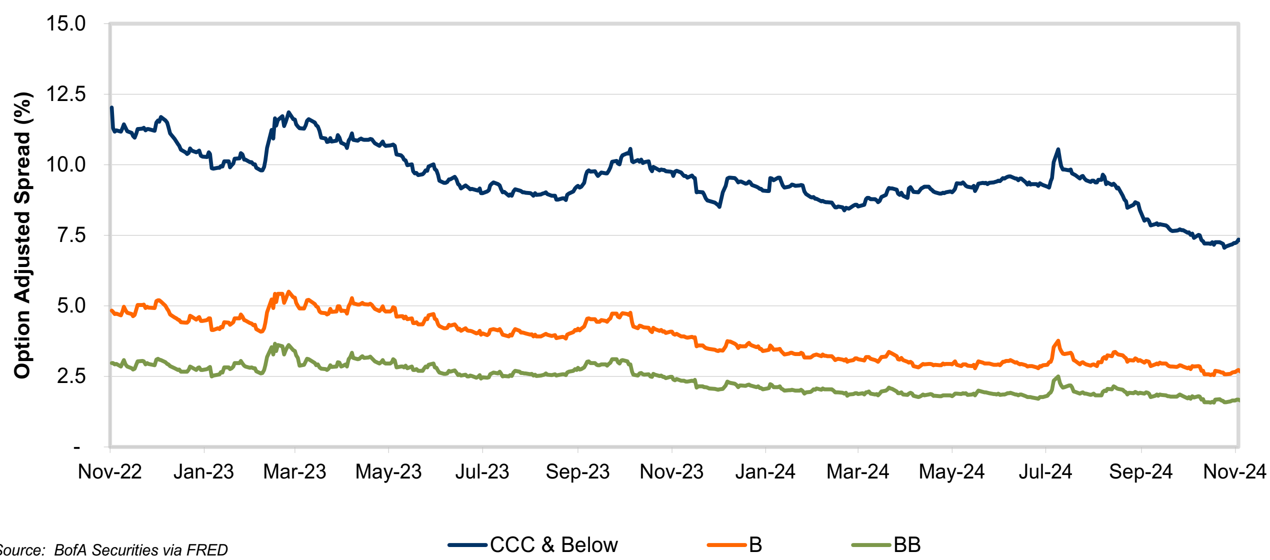
Private Credit and Equity

Richard Russell, the deceased editor of the *Dow Theory Letters* for 57 years, offered a widely quoted quip that "markets make opinions." Applied to the high-yield bond market, market participants do not see an imminent recession. The high yield, leverage loan and private credit markets in 2024 have been characterized by a flood of refinance activity via both new issues and price concessions in which levered borrowers have managed to refinance at tighter spreads following a tough 2H22-2023 when Fed rate hikes and fears of a recession weighed on markets. Also, the growth of private credit-especially the past two years as M&A activity plummeted--has supported spreads by taking supply from the HY and LL markets. Pitchbook reports that the share of B- rated credits in the LTSA index has declined to 25% from a recent peak of 30%, with much of the volume absorbed by private credit.

Debt Investments: High Yield Spreads by Credit Rating

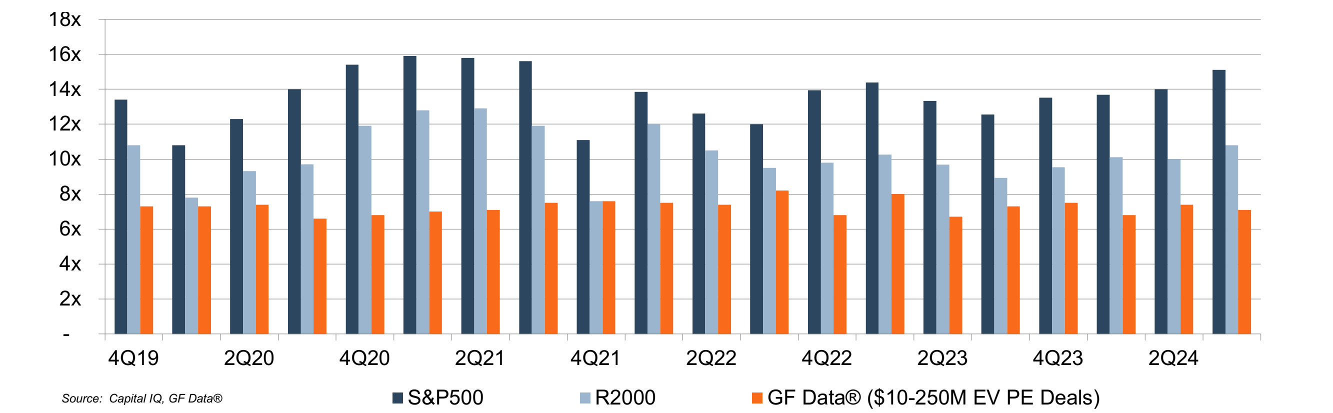


Source: BofA Securities via FRED

Multiples and earnings for both large cap stocks (*S&P 500*) and small cap stocks (*Russell 2000)* have generally risen the past six quarters as the indices continued to march ahead post-election (note both the S&P and R2000 data excluding the financial and real estate sectors). The *S&P 500* set many new all-time highs in 2024 while the *Russell 2000* finally recovered from the prior high-water mark set in 2Q21.

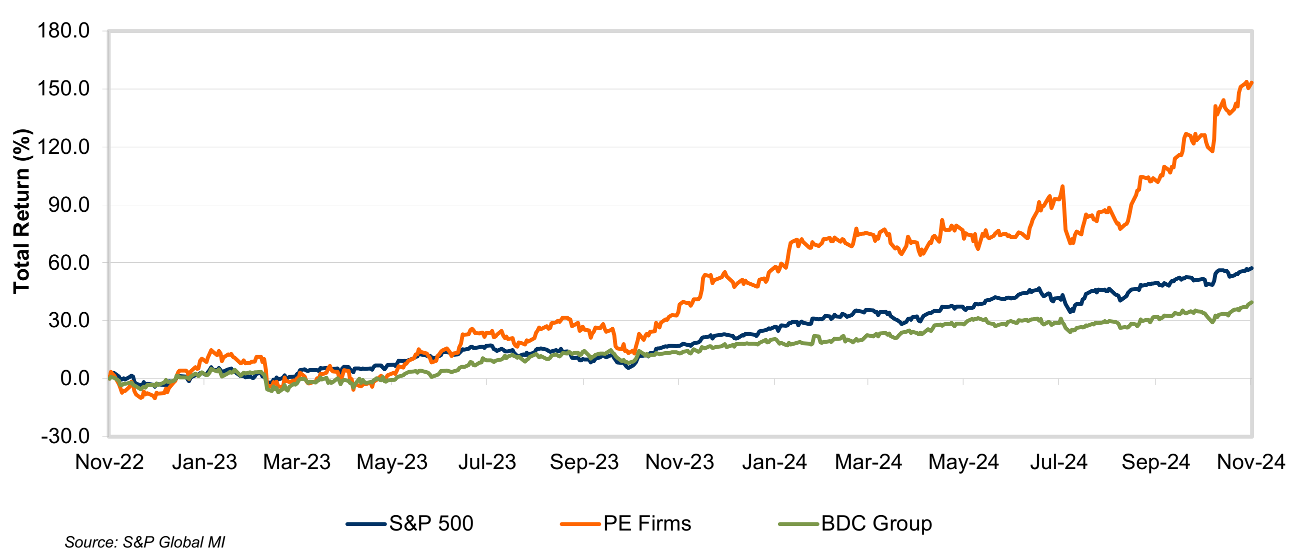
More interesting (to us) is the trend in lower middle market companies that are acquired by PE firms. ® *GF Data* has chronicled the sector for ~20 years with data provided by ~300 PE firms on a no-name basis with transactions sorted into six groups based upon enterprise value up to $500 million. The all-industry (NAICS) 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 3Q24, the overall median EV/EBITDA multiple compressed to 7.1x (70 deals) from 7.4x in 2Q24 and 7.3x in 3Q23. Deal multiples by transaction size ranged from 6.4x (EV of $10-25M) to 9.5x (EV of $250-$500M) in the YTD 9/24 period.

Equity Valuation: EBITDA Multiples Over Time



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 the market pullback was 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. Ares' net income for instance was $111 million in 3Q24 compared to $56 million in 3Q23 when the market was setting a low for the year and was a loss of $39 million in 3Q22 when the market bottomed in the bear market of 2022.

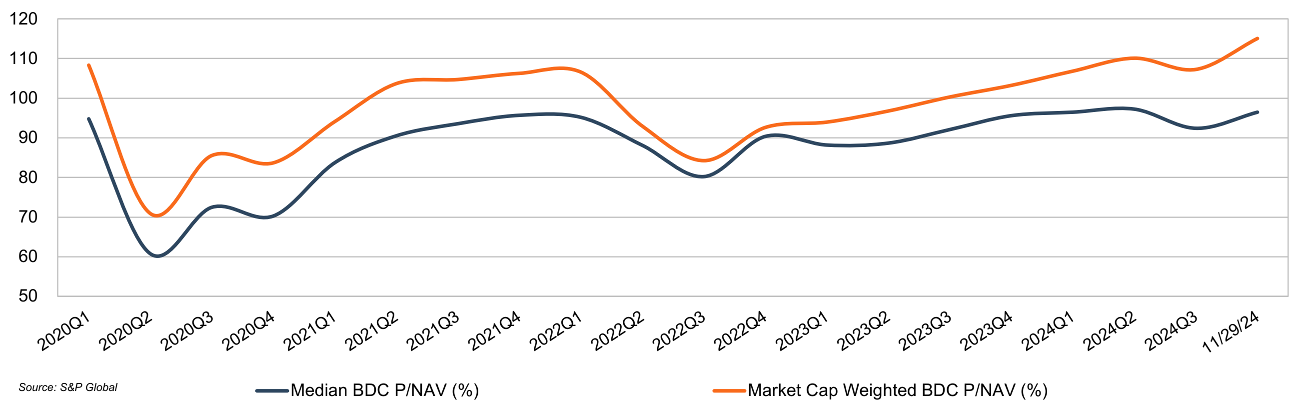
Stock Performance for Publicly Traded PE Sponsors: Total Returns (Trailing Twelve Months)



Publicly Traded Private Credit

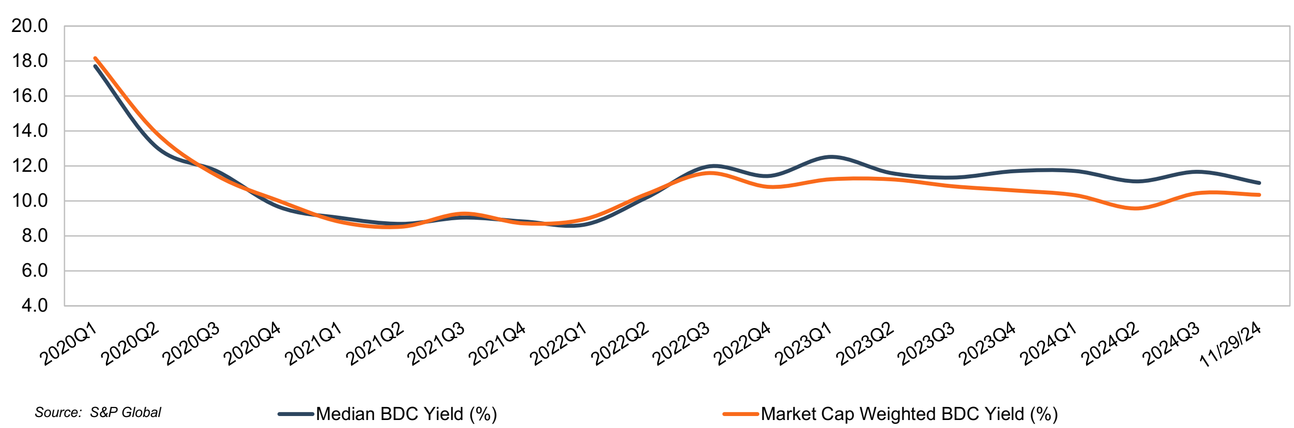
Like the high-yield and leverage loan market where spreads have tightened since the failure of SVB, BDC share prices are not pointing to investor concerns about material credit issues given that much of the sector trades near or above NAVs. The data is what it is, but some BDCs have begun to report a more notable increase in non-accruals, though.

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-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.

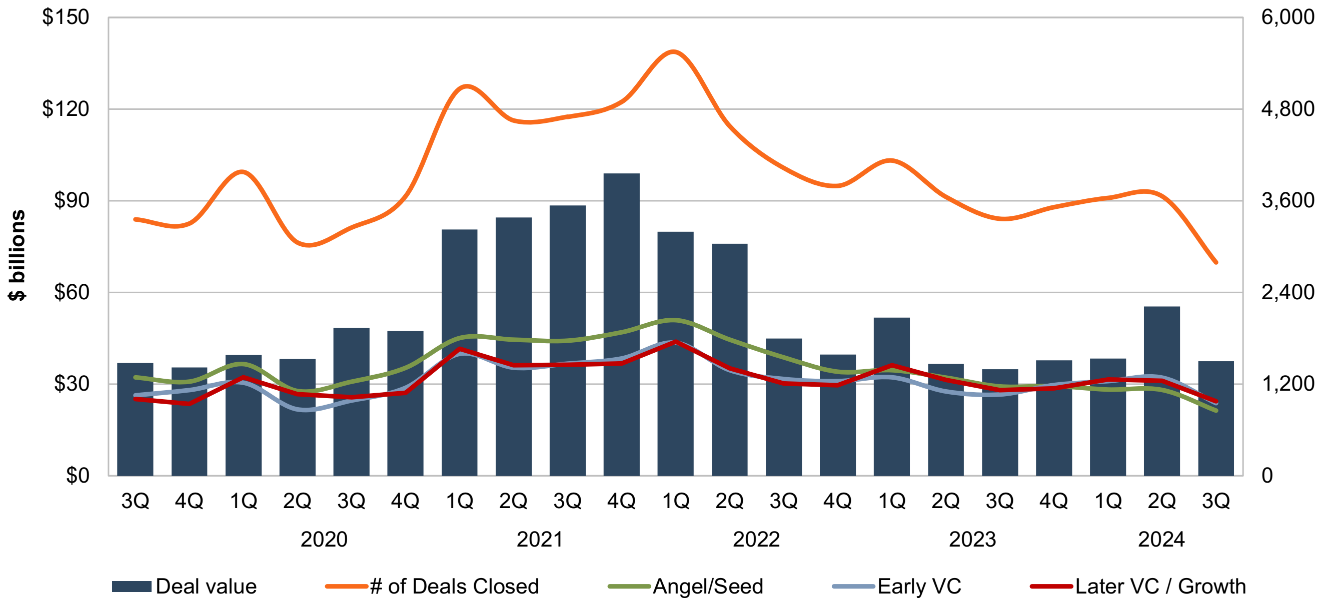
Long-Term Dividend Yield Trend



Venture Capital

While the *NASDAQ* bear market of 2022 is a distant memory given the tech-led rally in 2023 and 2024, VC funding activity remains well below the euphoric 2H20-1H22 era when monetary stimulus and federal government deficit spending were extreme. Aggregate deal value dipped in 3Q24 along with the number of deals closed.

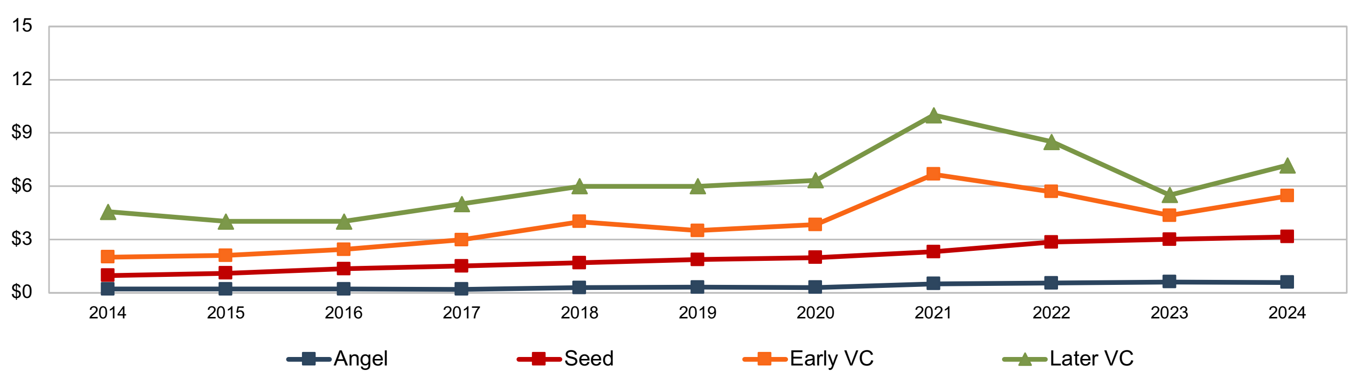
U.S. VC-Backed Funding Activity



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 declined during 2022 and 2023 but has nominally improved in 2024.

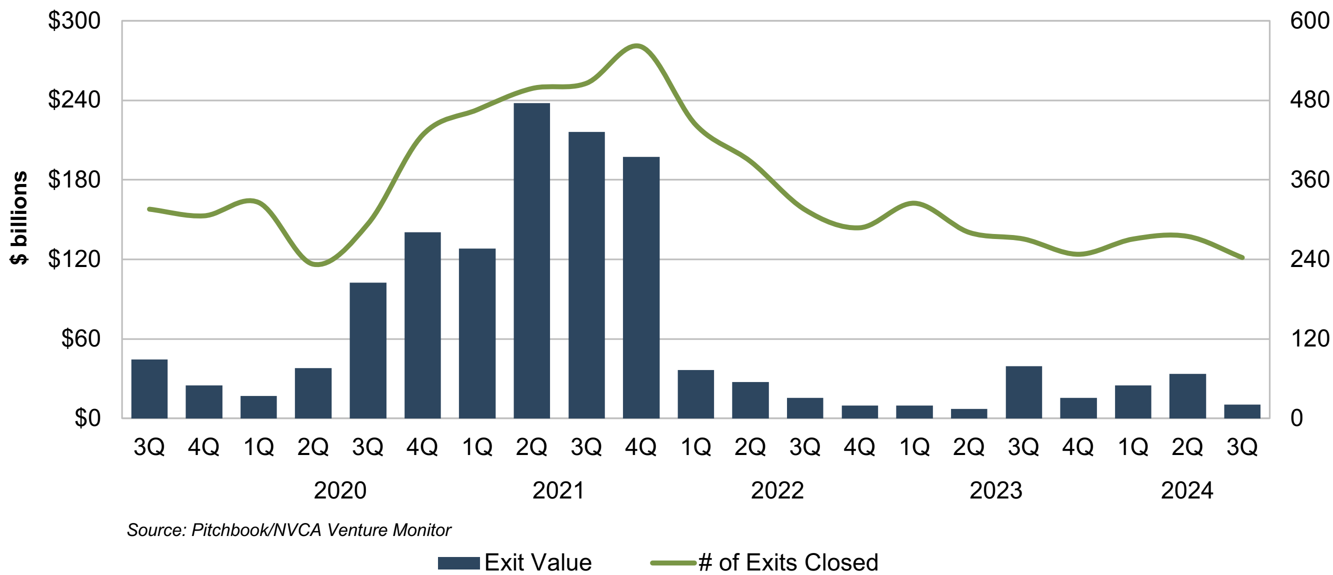
Median Funding by VC Stage ($ millions)



Source: Pitchbook/NVCA Venture Monitor

Although IPO activity has somewhat improved in 2024 from 2023, it remains subdued compared to 2H20-1H22. As such VC-backed exit activity is depressed (3Q24 marked a 2-year low) with many VC backed companies in survival mode given limited capital raising that previously was readily available to fund operating losses.

U.S. VC-Backed Exit Activity



Source: Pitchbook/NVCA Venture Monitor

Mercer Capital

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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

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

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