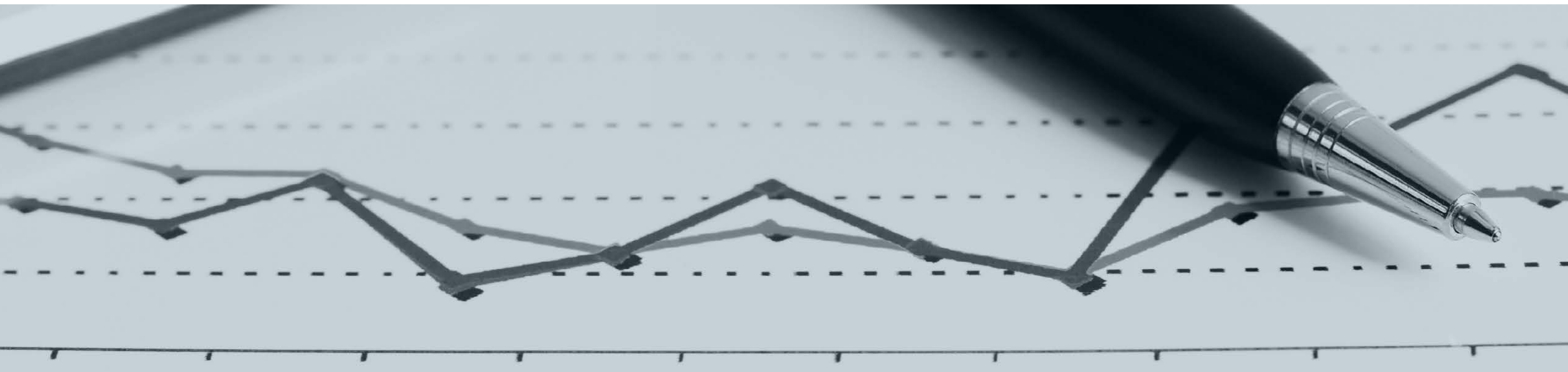
Portfolio Valuation

Private Equity & Venture Capital Marks & Trends

First Quarter 2018



Executive Summary

Private Equity

According to PitchBook total U.S.-based private equity activity in 2017 was relatively consistent with 2016, despite record-breaking levels of available capital. PE firms invested a total of $538 billion across 4,053 deals in 2017 in spite of high pricing and an alleged lack of quality targets. The median M&A EBITDA multiple was flattish for large deals at 10.5x (vs. higher for middle market and small deals); however, median leverage employed increased to 54% from 50% in 2016. The number of PE-backed companies in the U.S. climbed to 7,250, in part because exit volume fell 11% in 2017.

Leverage Lending

According to Thomson Reuters leverage loan issuance soared to a record $1.4 trillion in 2017, up 60% from 2016 and 24% higher than the previous peak of $1.1 trillion in 2013. The uptick in activity was driven by investor demand for yield as capital returned to the sector following a rout during 4Q15-1H16 when credit spreads widen dramatically. As a result, refinancing volumes surged to $933 billion. Institutional investors accounted for two-thirds of the market in 2017, while just one-third of originated credits were retained by banks. During 2016 banks accounted for a larger share of a smaller market because institutional investors grappled with redemptions.

Venture Capital

4Q17 further emphasized a growing divide in startup funding with larger ventures attracting capital while smaller ventures struggled because investors were less enamored with new opportunities and instead focused on exit strategies. More capital was deployed than any other quarter in the past decade (as was the case for the full year), but it went to the fewest deals of any quarter in the past five years. Exit activity was muted in 2017; however, a prospective increase in IPOs in 2018 may result in returned capital being recycled into new ventures.

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Corporate Venture Capital and ASU 2016-01

Best Practices for Equity Instruments

While private equity and venture firms have long been required to provide periodic fair value measurements to their investors, the investments made by corporate venture arms largely have been excluded from such requirements. However, an accounting standards update that took effect at the end of 2017 could cause big changes for corporate investors. The following is an excerpt from our recently published whitepaper that addresses the rise of corporate venture capital and the implications of this accounting update on corporate investment reporting. To download the whitepaper visit **mer.cr/2kTKwOK**.

Corporate venture capital has increased as an investment activity for large corporations in recent years. By one count, the top ten corporate venture capital groups made 1,640 investments between 2010 and 2016 (Figure 1).

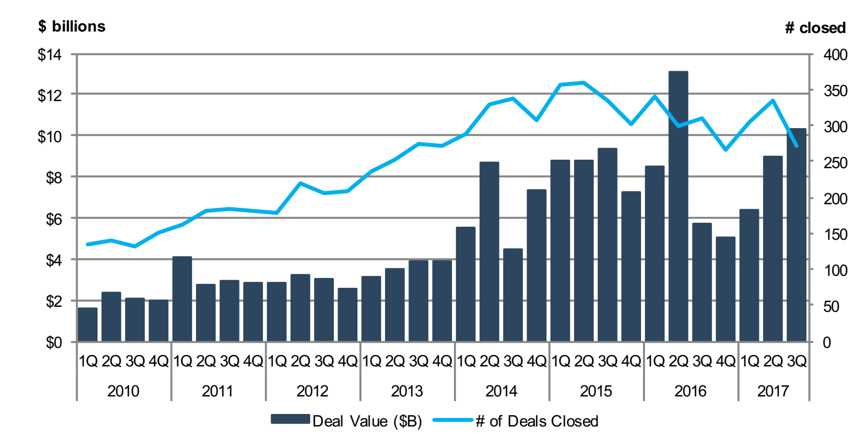
Intel Capital, the most active corporate venture capital investor over the past six years, made investments in 34 new companies totaling $455 million in 2016 alone (Figure 2 on page 2).

With corporate venture capital activity on the rise, a keen eye is being turned to public company reporting of equity holdings, as well. Valuations of VC-backed startups have grown rapidly in recent years, making many early venture investments worth well in excess of original cost. For example, Google Ventures (GV) invested in AirBnB in late 2010 at a valuation of $71.8 million. In March 2017, less than seven years later, AirBnB completed a $448 million financing round at a reported valuation of $29.3 billion, an increase in post-money value of more than 400x since the 2010 investment. [Source: VC Experts]

Yet, many corporate balance sheets carry minority investments at cost – the value originally paid for the interest. Current U.S. GAAP does not require disclosure of the gains (and occasional losses) attributable to minority investments held at cost. While the incumbent accounting methodologies provide some information about deterioration in investment value, large valuation increases remain largely hidden from view. Unlike an asset for which replacement cost similar to the original outlay may be a reasonable estimate of worth, the value of investments in fledgling investee startups can change dramatically as these companies develop into successful businesses. With startups remaining private longer in the absence of exit events like IPOs, rising valuations of the underlying companies can diverge significantly from the cost basis of early investments.

ASU 2016-01 seeks to provide more transparency and relevance to financial statement users, as well as decrease

Figure 1: Corporate Venture Capital Participation



Source: 3Q 2017 Pitchbook-NVCA Venture Monitor

Figure 2: Most Active Corporate VC Investors (2010 through 2016)

	Venture Arm	# Investments
1	Intel Capital	395
2	Google Ventures	314
3	Qualcomm Ventures	189
4	Salesforce Ventures	141
5	SoftBank Capital	115

	Venture Arm	# Investments
6	Caixa Capital Risc	109
7	GE Ventures	95
8	Comcast Ventures	95
9	Cisco Investments	94
10	Samsung Venture Investment	93

Source: Pitchbook

the complexity of equity investment impairment testing for financial statement preparers. The guidance applies to all equity investments that are not consolidated with the investor or accounted for under the equity method.[1] That is, investments that represent less than 20% ownership or for which the owner lacks influence over investee operations. While the update has applications to both financial assets and financial liabilities, in this whitepaper we focus on the former, specifically minority equity interests. The update divides these investments into securities with readily determinable fair values and those without readily determinable fair values.

Under current GAAP, unconsolidated equity investments are accounted for using either the cost or equity method. Investments with a readily determinable fair value (such as a share of public company stock) will be carried at fair value.

For equity investments without a readily determinable fair value, entities can choose to apply a new Measurement Alternative. "An entity may elect to measure an equity security without a readily determinable fair value [and that does not qualify for the ASC 820 practical expedient[2]] at its cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer."[3] Elections to measure a security using this guidance may be made on an investment-by-investment basis. However, once an entity elects to measure an equity security using the Measurement Alternatively, it should be applied consistently unless the alternative is no longer permitted.

Observable price changes mean those resulting from orderly transactions, including those that are known or can reasonably be known at the date of measurement. However, it is important to note that the transactions must involve identical or similar investments from the same issuer. Determining the similarity of a new security issuance to one held by the reporting company should take into consideration the specific rights and obligations of the issuance, such as voting rights, distribution rights and preferences, and conversion features.

While simplifying the process of determining changes (both upward and downward) to the reported value of equity investments, the Measurement Alternative does not eliminate the need to test for impairment. However, it does allow for the use of a single-step qualitative assessment at each reporting period. Qualitative indications of impairment include, but are not limited to, the following.[4]

- A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee.
- A significant adverse change in the regulatory, economic, or technological environment of the investee.
- A significant adverse change in the general market condition of either the geographical area or the industry in which the investee operates.

1 The guidance does not apply to entities in industries that already account for substantially all investments at fair value, such as broker-dealers, post-retirement benefit plans, and investment companies.

2 The ASC 820 practical expedient allows reporting entities to measure certain investments at their net asset value (NAV) per share if (1) the investment doesn't have a readily determinable fair value and (2) the investee is an investment company within the scope of ASC 946, Financial Services-Investment Companies.

3 ASC 321-10-35-2

4 ASC 321-10-35-3

- A bona fide offer to purchase, an offer by the investee to sell, or a completed auction process for the same or similar investment for an amount less than the carrying amount of that investment.
- Factors that raise significant concerns about the investee's ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

If a qualitative impairment is identified, the reporting entity should estimate the fair value of the investment and recognize an impairment loss equal to the difference between the carrying amount of the investment and its fair value.

Although the intended result of ASU 2016-01 is to increase the scope of decision-useful information reported on corporate balance sheets, it also has the potential to complicate reporting for entities with investments in venture-backed startups. Re-measuring fair value of ownership interests in companies that have become significantly more valuable since the reporting entity's initial investment could result in higher volatility of reported income (from non-core business sources). Beginning in their quarterly 2017 filings, a few major corporate investors – including Google, Salesforce, and Cisco – acknowledged an increase in income and expense volatility is expected as a result of this transition.

The portion of the investment landscape inhabited by corporate venture players continues to increase. Industry participants have begun adapting to the resulting changes of corporate participation. Both founders and investors will likely keep close watch as industry changes continue to unfurl and as corporate VCs begin to adopt these new requirements.

On the Call

The following is a brief compendium of quotes from 4Q17 earnings season conference calls.

Josh Harris (APO) – "But at the end of the day, certainly, the after-tax cash flows, the tax reform act was positive overall for our portfolio. And certainly, we are modeling all the nuances of all of that stuff into every investment decision. And so we are definitely taking account of it and it's very complicated."

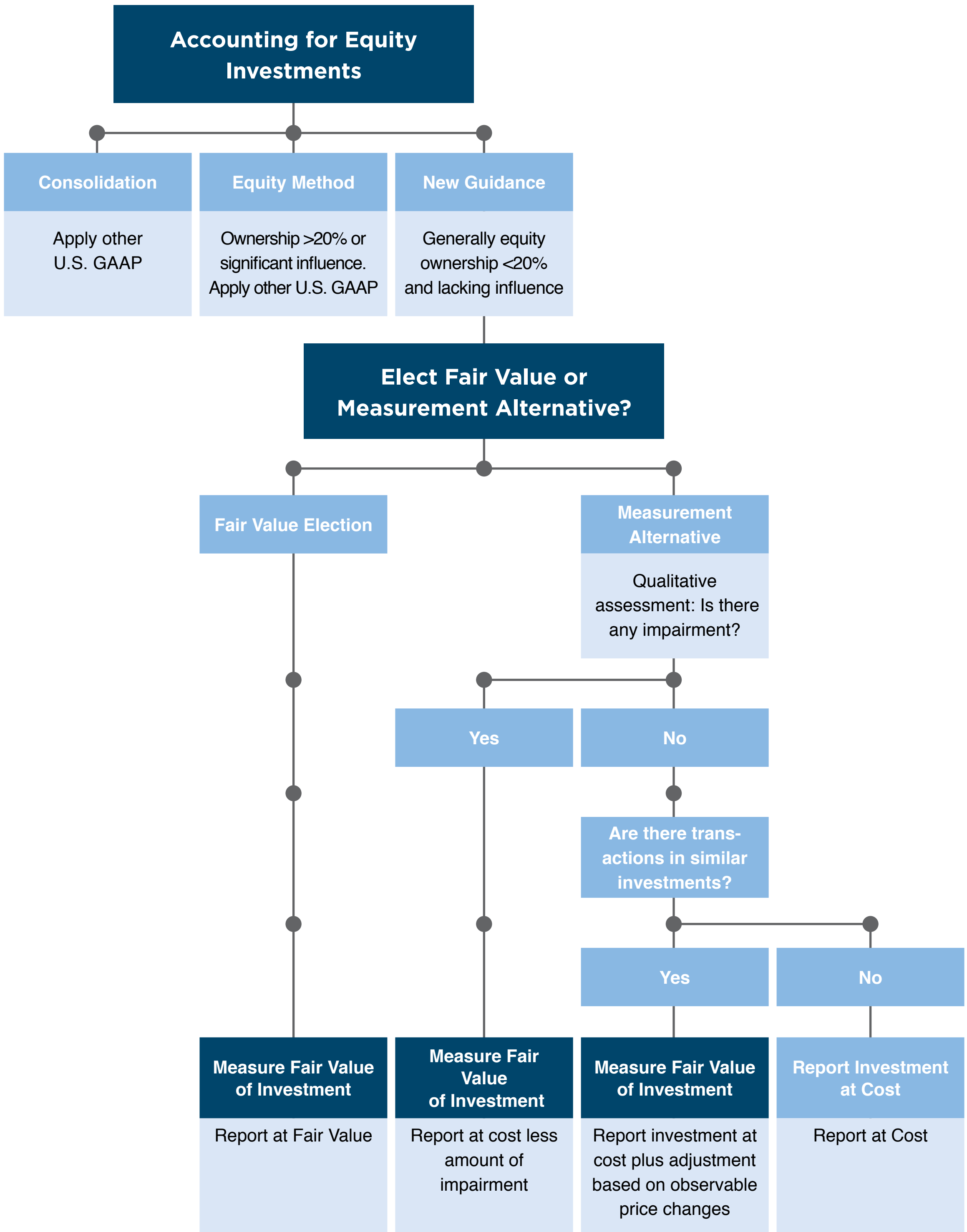
Kipp DeVeer (ARCC) – "So far into 2018, however, we've witnessed a bit of a change in course, with heightened volatility in the equity markets and a meaningful selloff in the U.S. Treasury markets. It seems investors are grappling with the prospects of higher rates, inflation and the potential unwind of an unprecedented amount of stimulus from central banks. Despite this volatility, the middle-market direct lending environment seems unchanged."

Kew Lee (CG) – "Private credit as an asset class continues to accelerate as the search for yield intensifies for many investors. Assets in the private credit industry today total more than $600 billion, up about sixfold since the year 2000. But even at this level, private credit is only about 1/4 of the more than $2.5 trillion in private equity AUM. The private credit market today appears strikingly similar to where private equity was approximately 20 years ago, and this market segment appears positioned to grow significantly over the next decade.

David Golub (GBDC) – "Documentation terms remain borrower-friendly and covenant light executions have become increasingly common for high-quality larger middle-market issuers. At the same time, capital continues to flow into our space. By most accounts, 2017 was a record year for fundraising. These factors all suggest us that borrower-friendly market conditions are likely to continue for the near term."

Source: All transcripts obtained from SNL.

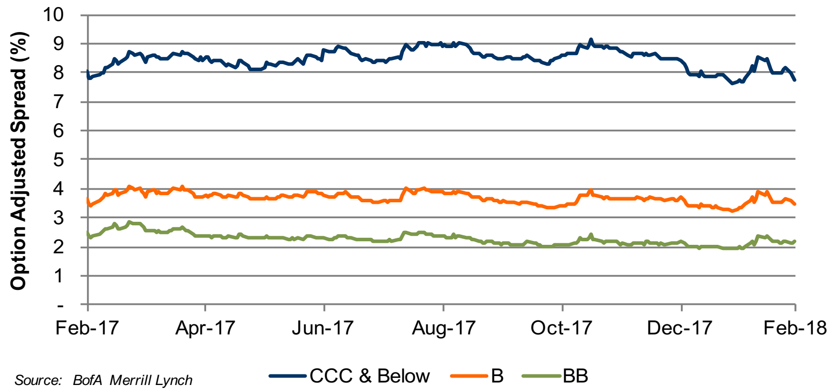
How to Report Corporate Venture Capital Investments Under ASU 2016-01



Private Equity

Debt Investments: High Yield Spreads by Credit Rating

Credit spreads remain essentially unchanged from a year ago as the economy remains strong, and credit performance continues to largely satisfy lender expectations.



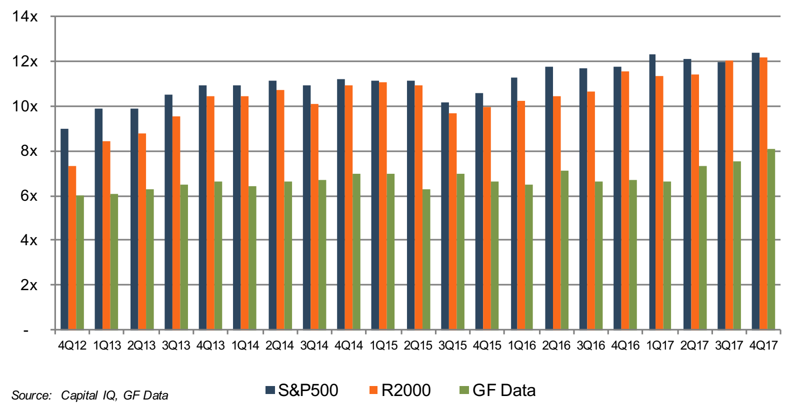
Source: BofA Merrill Lynch

Median EBITDA Multiple
Excludes financials

Equity Valuation: EBITDA Multiples over Time

Large cap and small cap multiples peaked at the end of 2017 as the stock market closed out a year of record high valuations.

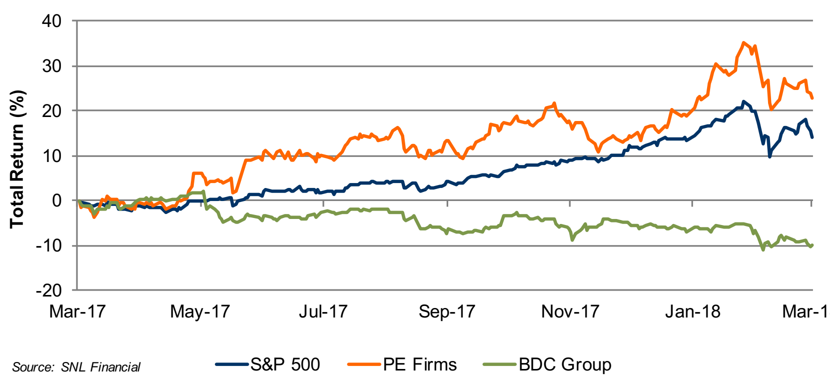
The median EBITDA multiple for PE-sponsored transactions in the lower middle-market as compiled by GF Data® was 8.1x, which is the highest multiple reported for any quarter from the fourth quarter of 2012 through the end of 2017.



Source: Capital IQ, GF Data
Excludes financials

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

In 2017, the stock market was characterized by record high valuations, steadily rising prices, and abnormally low volatility. In the first two months of 2018, fears about inflation and concern that the Fed will raise rates faster than anticipated have contributed to more volatile markets. BDCs continue to underperform the broader market as investors price in risk posed by a potential turn in the credit cycle, particularly for BDCs which have been pushed to accept lower rates and weaker terms due to competitive pressures.

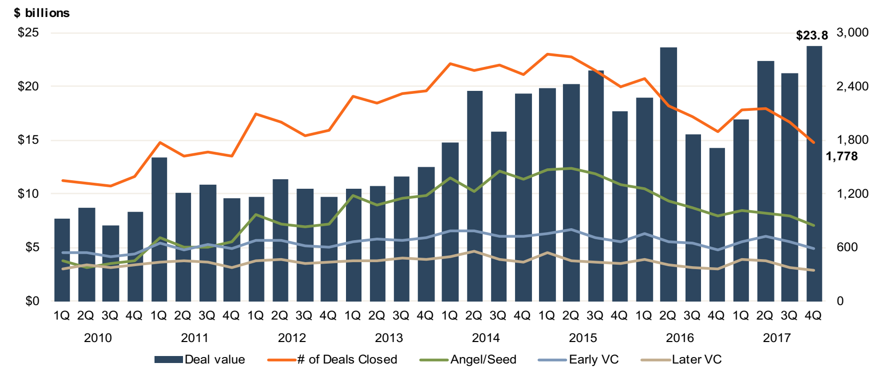


Source: SNL Financial

Venture Capital

U.S. VC-Backed Funding Activity

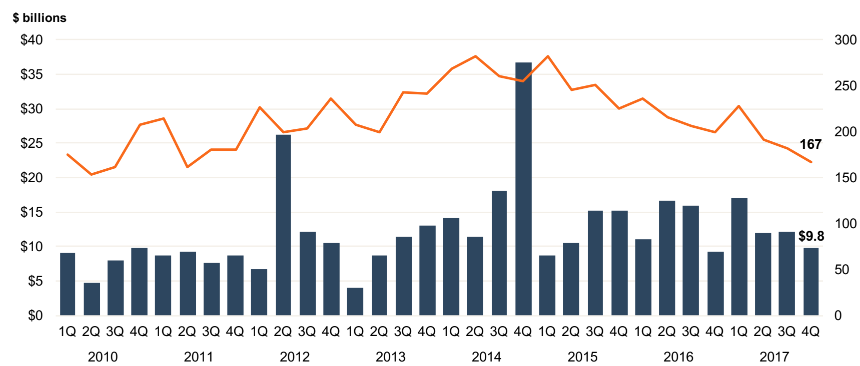
Total deal value in 4Q17 ($23.8 billion) reached the highest level in more than ten years, exceeding the $23.6 billion of funding deployed in second quarter 2016. However, total funding and total rounds funded continued to move in opposite directions. The overall number of deals in 2017 fell to pre-2012 levels, when total deal value was half of what it was in 2017.



Source: Pitchbook/NVCA Venture Monitor

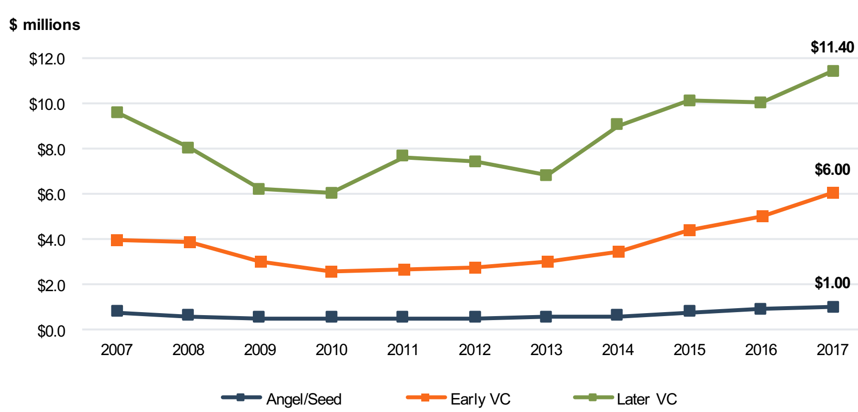
U.S. VC-Backed Exit Activity

Exit activity fell each quarter in 2017 to less than $10 billion in the fourth quarter. The year continued a trend of weak fourth quarter exits that started in 2016. This is a reversal from the prior three years, which posted their highest quarterly exit values at year-end. The number of quarterly exits continued to decline to the lowest volume in the past six years at just 167 in the fourth quarter.



Median Deal Size by Stage ($ millions)

The rise in deal sizes showed no signs of stopping in 4Q17. Seed stage deals hovered at a median deal size of $1.0 million, early stage grew to $6.0 million, and late stage rounds surged to $11.4 million for the year. As each stage continues to grow, industry participants have begun filling in the gap left at the smaller end of the spectrum, with the rise of "pre-seed" deals.



Source: Pitchbook/NVCA Venture Monitor

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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 provides financial and advisory services to help our clients minimize risk and maximize value. For financial sponsors providing debt and equity capital to the middle market, Mercer Capital provides a comprehensive suite of financial advisory services.

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

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