Portfolio Valuation

Private Equity Marks & Trends

Third Quarter 2016

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Credit Costs Should Be Part of Banking Industry's Post-Nov. 8 Narrative, Too

__Jeff K. Davis, CFA__, Managing Director of Mercer Capital's Financial Institutions Group, is a content contributor to the SNL platform of S&P Global Market Intelligence (formerly SNL Financial). This article first appeared on November 14, 2016 and is reprinted here with permission.

The Nov. 8 election of Donald Trump as president has produced a rewrite of assorted narratives. One is that the banking industry is a winner. Investors agreed. The SNL U.S. Bank index rose 13.3% last week. Outside of the financial crisis era, it was the biggest weekly move in the index over the past 10 years. The largest was the trading week ended March 13, 2009, when it became clear the Obama administration was not going to nationalize the banks and, if my memory is correct, the week in which application of mark-to-market accounting was diluted.

Regardless of one's politics, I do not think it is controversial to state that a Republican administration, whether populist or not, will be beneficial for banks. Whether there is a broad rollback in Dodd-Frank (excluding higher capital requirements) or as I think more probable a trimming of the law's excesses remains to be seen. Last week's narrative included a widespread but unproven view that the new administration will be good for business with a rollback in the regulatory state, tax reform and more infrastructure spending.

What appeared to give additional legs to the bank rally were comments by Duquesne Capital founder Stan Druckenmiller that he is bullish on the economy and bearish on bonds. He described the Fed's rate policy as akin to holding a beach ball under water. Also, DoubleLine CEO Jeffery Gundlach has had a number of nonconsensus calls in recent years that proved to be correct, including when he strayed into the political arena in January when he predicted that Trump would be elected president. Gundlach's call last week was that the 10-year yield could rise to 6% in the next four or five years because Trump's policies are inherently bond unfriendly. Midyear, he proclaimed the secular low was in when the 10-year yield fell to near 1.3% in the aftermath of the Brexit vote. After the election, the yield pushed solidly above 2%. Prognostications aside, Gundlach and Druckenmiller are heavy hitters whose views are closely followed by global investors.

If one of them said it, I missed it, but rates also may be destined to rise if Trump engineers an intellectual change at the Fed in favor of a more honest monetary policy. This would occur at the same time deficit spending from higher infrastructure, entitlement and defense spending is poised to rise. Someone has to buy newly issued Treasurys to fund the government. Without buying in size from the Fed and other central banks, the market clearing price should be lower unless the economy rolls over.

Bank investors, rightly, cheered the prospect of higher rates. A slow-moving Fed means a steeper yield curve if Gundlach is right about inflation and where longer-dated yields are headed. Also, higher short-to-intermediate rates will "reflate" the value of core deposits — especially non-interest-bearing deposits — and thereby push NIMs higher. But there will be a debris field. One will be bond and fixed-rate mortgage portfolios, though core deposit funded banks have the capacity to wait on the assets to mature. Mortgage banking will finally see its comeuppance, too.

Another possible and more meaningful find in the debris field could be credit, or at least credit extended by poor underwriters and those who took outsized risk when ZIRP reduced asset yields to nominal amounts. The reduction in long-term rates that on a secular basis ran from the early 1980s through possibly July 2016 has been a powerful contributor to asset inflation. Lower rates equate to higher present values of future cash flows unless an offsetting increase in risk premium that investors require occurs. Those in the bubble camp may argue that not only have risk premiums not risen to offset lower rates, but the opposite has occurred with investors willing to accept lower risk premium in search of income and capital appreciation when safe assets yield virtually nothing. The result, if you buy the argument, has been alarming asset inflation in broad swaths of CRE, public and private equities, high-end housing, art, and other assets. Bubble or not, higher prices have reduced credit losses for banks even though commercial banks are theoretically cash flow lenders rather than asset-based lenders.

Rising rates will produce the opposite impact of lower asset prices if not offset by even lower risk premiums and/or higher cash flows produced by the assets. Proponents of the view that the Trump administration will prove to be good for the economy would argue this, I believe. That may prove to be true, but I think investor calculus should consider what higher rates could mean for today's ultra-low credit costs. In the event of default, losses may be higher than expected. We will not know for several years, however, assuming Gundlach, Druckenmiller and the new consensus are correct.

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

On the Call

The following is a brief compendium of quotes from 3Q16 earnings season conference calls. In general, executives are looking forward to greater market activity in 2017, although many are wary of the impact of rich valuations on future returns.

Kipp deVeer (ARCC) "The third quarter was actually a relatively modest period of activity for middle market loan issuance and with this more moderate supply of new transactions, terms on most new deals have become more competitive with tighter pricing and looser structural protections in terms of documentation and covenants."

Steve Schwarzman (BX) "Real estate remains an attractive asset class globally. Although there is less distress today, we expect fundamentals to remain solid for the foreseeable future. In most markets supply remains constrained. Demand for high-quality real estate is strong. Debt levels are not excessive and bank competition is diminished."

David Rubenstein (CG) "…while returns might come down, investor expectations of returns coming down are pretty significant. In other words, investors, because they have so few other options, are actually saying: Well, if rates of return are lower than they were a couple of years ago, we're fine with that because we have nothing else that we can get better returns [from]."

David Golub (GBDC) "The private debt direct lending industry faces a clear challenge in the coming period, and the challenge is the result of a lot of new investor capital that's been coming into the space. If you go back to when you took economics 101, we all learned that when there's too much money chasing too few goods, prices go up. It's just inflation."

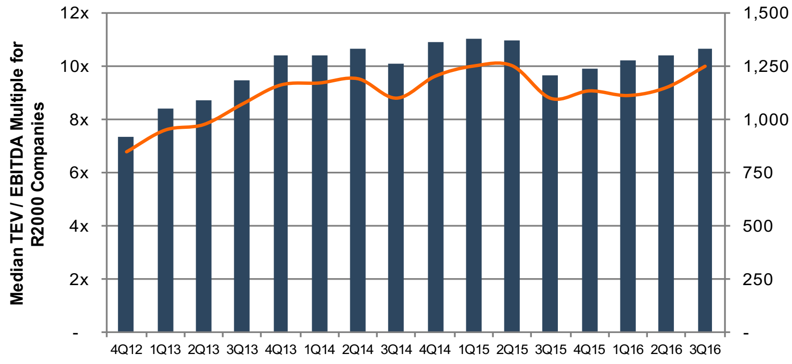
Ashton Poole (TCAP) "As many US-based middle-market companies begin to look past the somewhat all-consuming presidential election, we believe the capital markets are poised for meaningful activity during the first half of 2017. Many companies are sitting on significant amounts of available liquidity, but they've been reluctant to spend or invest that liquidity given the uncertainties that have persisted for the last several quarters."

Source: All transcripts obtained from SNL.

Equity Valuation

Russell 2000 Index Values and EBITDA Multiples

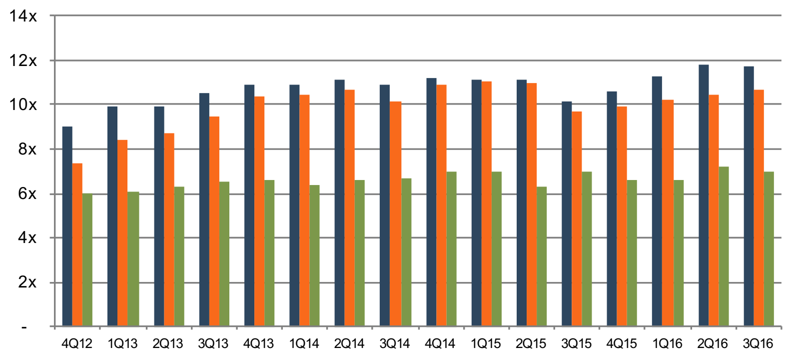
The median multiple for the Russell 2000 index reached 10.7x in 3Q16. Small cap stocks outperformed other segments amid stabilizing global growth prospects and improving oil prices, both of which bolstered investor confidence.



Source: Capital IQ
Median EBITDA Multiple (ex-financials)

EBITDA Multiples over Time

The gap between small cap and large cap multiples narrowed in the third quarter of 2016 as investor confidence improved with steady economic growth, rising consumer spending, and rebounding oil prices.

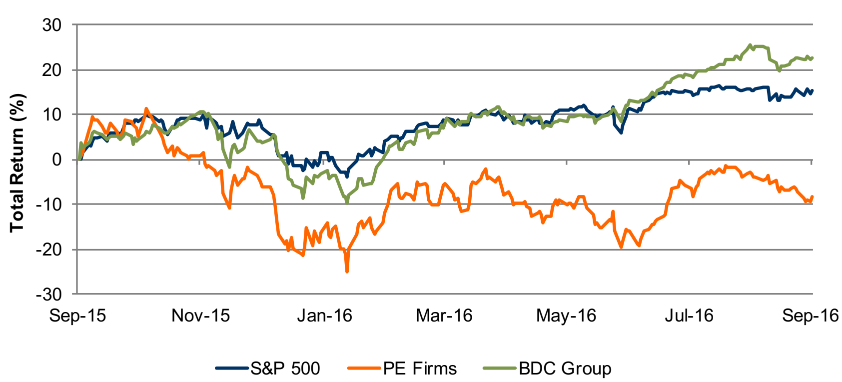


Source: Capital IQ, GF Data
Excludes financials

Stock Performance for Publicly Traded PE Sponsors

Total Returns (Trailing Twelve Months)

Total returns for business development companies outpaced the broader equity markets during 3Q16. Overall, equity markets reached all time highs as economic conditions remain favorable and corporate earnings prospects appear sound.

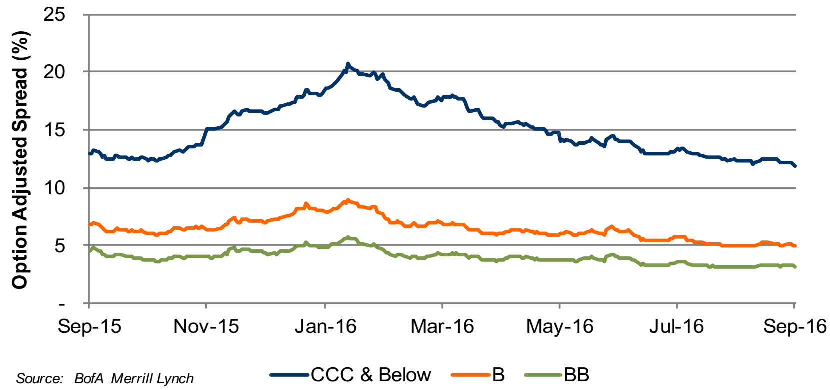


Source: S&P Global Market Intelligence

Debt Investments

High Yield Spreads by Credit Rating

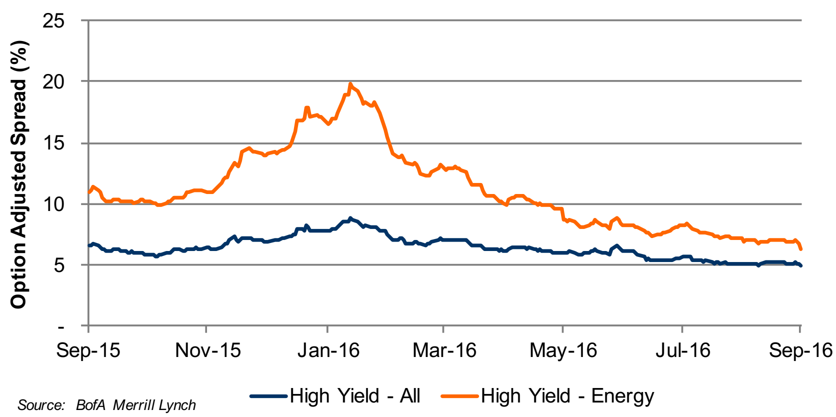
Spreads on credits rated CCC or below continued to tighten in 3Q16, with riskier credits proving more sensitive as yields narrowed 466 basis points from year-end 2015, compared to changes of 213 bps and 101 bps for B and BB credits, respectively.



Impact of Energy Sector on High Yield Spreads

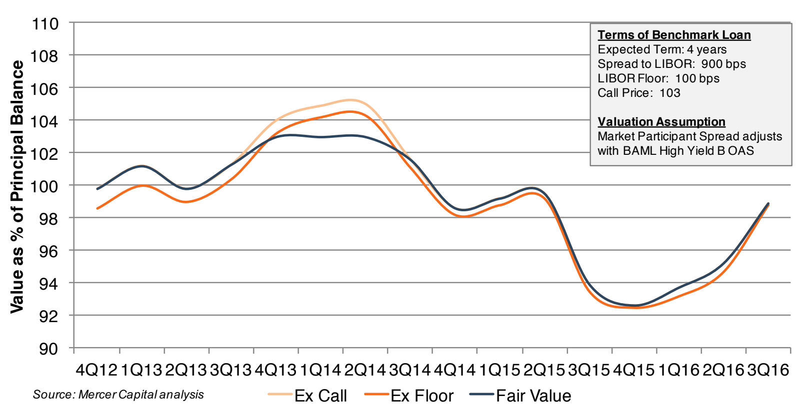
With rebounding commodity prices and the global hunt for yield remaining strong, credit spreads continued to tighten during 3Q16.

At the end of the quarter, the energy premium relative to the rest of the high yield market was at its lowest level in a year.



Fair Value of Benchmark Debt Instrument

Further spread tightening among B-rated credits provided continued lift for our benchmark loan, with fair value increasing to 98.9, compared to 92.6 at December 31, 2015 and 95.2 at June 30, 2016. With the current yield curve, spreads would need to contract another 35 basis points for fair value to approach 100.



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

Contact Us

Travis W. Harms, CFA, CPA/ABV
901.322.9760
harmst@mercercapital.com

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

Mary Grace McQuiston
901.322.9720
mcquistonm@mercercapital.com

MERCER CAPITAL

Memphis
5100 Poplar Avenue, Suite 2600
Memphis, Tennessee 38137
901.685.2120

Dallas
12201 Merit Drive, Suite 480
Dallas, Texas 75251
214.468.8400

Nashville
102 Woodmont Blvd., Suite 231
Nashville, Tennessee 37205
615.345.0350

www.mercercapital.com