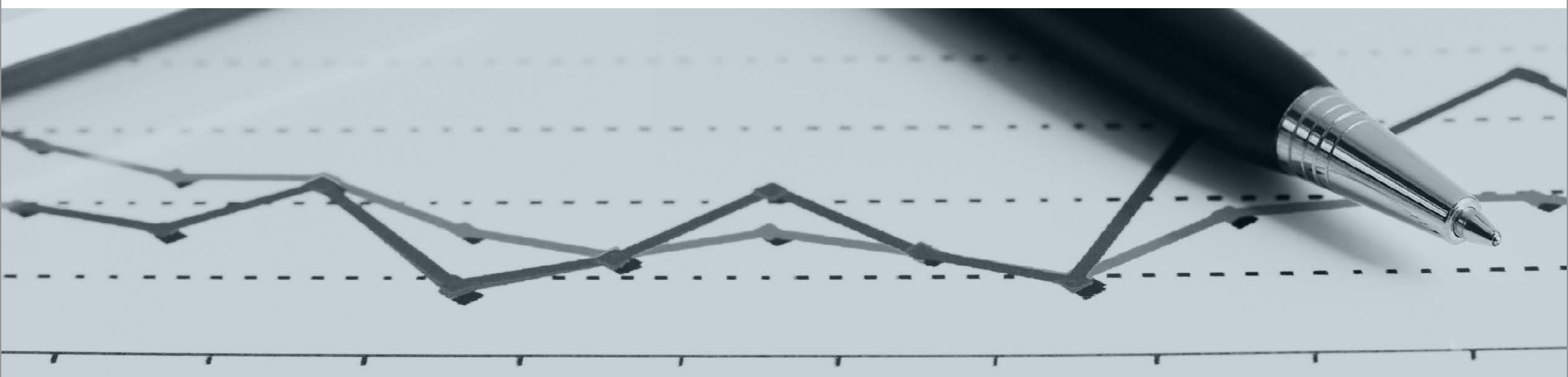
Portfolio Valuation

Private Equity & Venture Capital Marks & Trends

Second Quarter 2017



Executive Summary

In this issue of Portfolio Valuation, we expand our scope to include venture capital, which is the fastest growing part of our portfolio valuation practice.

Private Equity

A robust environment to monetize PE investments has added to the allure of PE investing as an asset class. With more capital allocated to alternative investments such as PE and private credit funds, pricing for new investments is being pressured upward while traditional PE investors look further afield for opportunities. Technology, which has long been a favorite industry sector for venture capital, is finding increasing popularity within PE as well. Technology deals accounted for 20% of all first quarter buyouts, compared to 10-15% historically.

Leverage Lending

The environment of low liquidity and wide spreads experienced in the leveraged loan market during 1H16 has been forgotten. During 1Q17 yields trended up with LIBOR; however, ample liquidity limited the move and helped tighten spreads a bit as refinancing accounted for 76% of the $345 billion of loan originations.

Venture Capital

After two consecutive quarters of lower VC-backed funding, VC investments ticked up in 1Q17 to $16.5 billion, perhaps in response to policies proposed by the Trump Administration that are perceived as being more friendly to business and capital; however, restrictions on visa programs and trade agreements with countries that supply labor and human capital to Silicon Valley startups could be problematic for VC-backed companies. Uncertainty remains an important theme when contemplating the future.

Realized returns are the handmaiden to attracting new capital. On that front, activity was encouraging during 1Q17 with $14.9 billion of VC-backed exits realized, helped in part by a pick-up in IPO activity. Some of the investments that were monetized will be reinvested in the sector. Among venture funds, 58 raised (or obtained commitments for) $7.9 billion of new capital in the first quarter.

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Portfolio Valuation and Regulatory Scrutiny

Over the past decade, we have been retained by several investment funds to assist them in responding to formal and informal SEC investigations regarding fair value measurement of portfolio investments. Reflecting back on those engagements yields a couple observations and reminders for funds and fund managers as they go through the quarterly valuation process.

First, fund managers should recognize that valuation matters, and it will really matter when something has gone awry. To that end, we recommend that funds:

- **Document valuation procedures to follow (and follow them).** Since valuation requires judgment, disagreements are inevitable. However, are you following the established valuation process? In hindsight, judgments are especially susceptible to second-guessing if established policies and procedures are not followed.
- **Designate a member of senior management to be responsible for oversight of the valuation process.** Placing valuation under the purview of a senior member of management demonstrates that valuation is an important function, not a compliance afterthought.
- **Create contemporaneous and consistent documentation of valuation conclusions and rationale.** No valuation judgment is "too obvious" to merit being documented. On the other side of the next crisis, what seems reasonable today may appear anything but. The middle of an investigation is not the best time to re-construct rationales for prior valuation judgments.

Second, it is important for fund managers to stay abreast of evolving best practices (or know people who do). Fair value measurement for illiquid portfolio investments is an evolving discipline. We recommend that funds:

- **Solicit relevant input from the professionals responsible for the investment, auditors, and third-party valuation experts.** Relying on appropriate professionals demonstrates that the fund managers take compliance seriously and are committed to preparing reliable fair value measurements.
- **Check your math.** In the glare of the regulatory spotlight, few things will prove more embarrassing than elementary computational errors. The proverbial ounce of prevention is certainly worth the pound of cure.
- **Disclose the valuation process and conclusions.** Just like potential investors do, regulators take comfort in transparency.

The best time to prepare for a regulatory investigation is before it starts. Call us today to discuss your portfolio valuation process in confidence.

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Corporate Venture Capital Trends

In an age of rapid technological change, the traditional corporate R&D **process just won't cut it**. Bureaucracy and slow decision making are impediments to a company's ability to innovate and execute. As younger companies like Tesla **potentially displace incumbents** in their industries, the established players need to change to keep up.

Rather than trying to make a corporate R&D department into something it's not, corporations are finding additional ways to bring **innovation** into their established business models – by making venture investments. For larger corporations, corporate venture capital (CVC) can be a way to **outsource** some research and development efforts in new and unproven technologies without assuming all of the costs and risks.

CVC is on the rise; the global number of active CVCs tripled between 2011 and 2016, according to ***Forbes***. Accordingly, activity has also been robust: the number of corporate VC-backed deals in the U.S. rose from 545 in 2010 to 1,268 in 2015, according to **Pitchbook**. CVC-backed deals have totaled over $30 billion in both 2015 and 2016. However, this high level of corporate venture investing in the past three years came as startup funding had already peaked. Now, as traditional venture capital firms are starting to slow their funding, CVCs appear to be dialing back as well.

From 2010 to 2013, CVC investing represented less than one-third of all investment activity on average. However, CVC-backed financing rose to 40% of all investment activity in 2Q14 and 58% in 2Q16. From 2010 to 2016, CVC investing was more volatile than VC financing overall. When non-CVC financing activity rose 17% on average in the first two quarters of 2014, CVC financing rose 52% on average for the quarters. When traditional VC financing began stagnating in 2016, CVC-backed financing fell 57% and then 32% in 3Q16 and 4Q16, respectively. Nevertheless, the trend the past several years has seen CVC grow as a percent of overall VC investments, though quarterly amounts can vary widely.

With the rapid **rise of corporate venture capital** and increasing pressure to jump on board with startups, it seems that many companies across the industry spectrum are making venture investments. As the rest of the year unfolds, we will be interested to see how corporate interest in venture investing persists. Will increased corporate participation increase the availability of funding and support for even more startups or will it simply drive prices higher for a select few?

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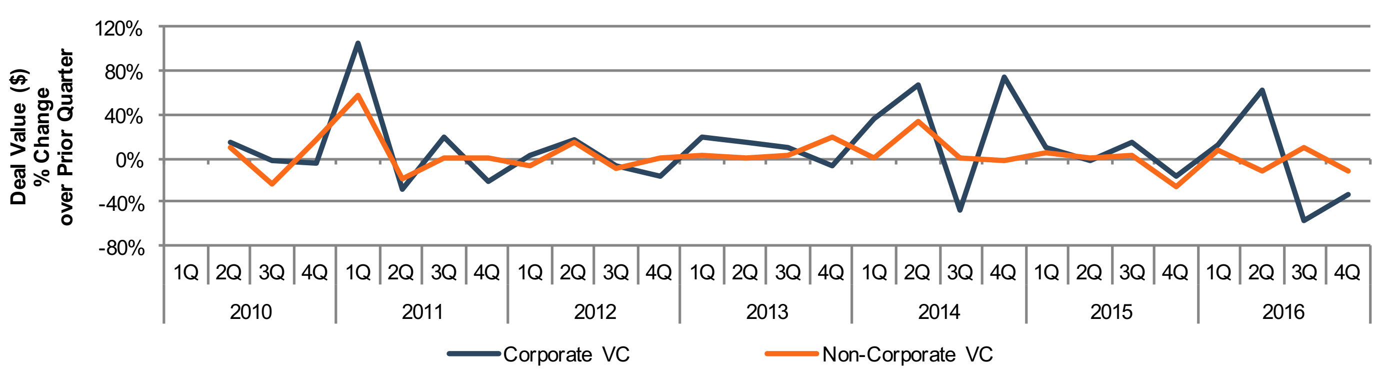
Venture Investment Deal Value (% change in $)



Source: 4Q 2016 Pitchbook - NVCA Venture Monitor, Mercer Capital Analysis

5 Things to Know about Fair Value and Equity Investments

The rules are changing for how companies report their investments in other businesses. As highlighted in a **recent article in the *New York Times***, new rules from the FASB regarding how entities will have to measure certain equity investments (for example, Google's equity holdings in Uber) may lead to increased earnings volatility and additional fair value complexities. Here are five things to know about the "new" rules and a few questions to consider as the implementation dates approach.

1. The rules are not new, but were part of the FASB's Accounting Standards Update No. 2016-01, issued in January 2016. That said, the guidance will be effective for public companies beginning in fiscal 2018 (for calendar year-end filers) and for all other entities beginning in fiscal 2019.

2. The new rules will require entities to measure equity investments at fair value (other than those accounted for under the equity method or those that result in consolidation), with changes in fair value recognized in net income. In other words, many minority-position equity investments that are currently carried at cost may now have to be carried at fair value at the end of each reporting period.

3. What about securities without a readily determinable fair value, like private company shares? The new rules allow for a "measurement alternative" whereby an entity may elect to measure an equity security that does not qualify for the ASC 820 NAV practical expedient at: a) cost, minus b) impairment (if any), plus or minus c) changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer.

4. The portion of the "measurement alternative" referencing orderly transactions for identical/similar investments raises a number of interesting valuation and accounting questions. Suppose Company A invests $10 million in a Series A financing round for Company B and initially carries its investment at $10 million cost. Six months later, Company B completes a Series B round at a higher "headline" valuation. How will this transaction be reflected in the fair value of Company A's equity investment at quarter-end? What about the potential for **different rights and preferences** between the Series A and B classes of stock? What about Company C – who might also have bought Series A shares – will the reported fair value of its equity holdings be different or similar to that reported by Company A? These are all questions that will undoubtedly challenge registrants, auditors, and valuation specialists.

5. Entities that use the new "measurement alternative" also will be required to make a qualitative assessment at each reporting period as to whether the investment is impaired. If an equity security without a readily determinable fair value is impaired, an entity shall include an impairment loss in net income equal to the difference between the fair value of the investment and its carrying amount.

Admittedly, this summary only scratches the surface of the potential implications and practical implementation of the new rules. The NYT article also suggests that the rules could have the potential to confuse investors about the value of these types of investments and may have the unintended consequence of muddling the presentation of financial statements rather than clarifying them. **With rising levels of corporate venture capital investment**, the number of companies with equity investments in early-stage or closely-held businesses on their balance sheets is increasing. We will continue to monitor the development and commentary on these changes and will explore some additional angles on the subject in future articles.

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Mercer Capital Supports New Valuation Credential

Mercer Capital supports the new credential for valuation professionals whose practices are dedicated to valuing businesses and intangible assets for U.S. public companies. The CEIV™—Certified in Entity and Intangible Valuations™—is now available to current or prospective members of the **American Society of Appraisers** (ASA), the **American Institute of CPAs** (AICPA), or the **Royal Institute of Chartered Surveyors** (RICS).

Travis W. Harms, CFA, CPA/ABV, leader of Mercer Capital's Financial Reporting Group, commented, "Over the past decade, valuation professionals have been given an increasing role in measuring the fair value of assets for public companies. The CEIV demonstrates the valuation profession's commitment to meeting this responsibility in the best interests of the investing public."

For more information on the CEIV, visit the American Society of Appraisers (ASA), the American Institute of CPAs (AICPA), or the Royal Institute of Chartered Surveyors (RICS).

On the Call

The following is a brief compendium of quotes from 1Q17 earnings season conference calls.

Josh Harris (APO) – "We are incredibly focused on monetizing the portfolio because to a large extent, we believe that we are heading into the ninth year of an economic recovery, financing markets are ebullient, equity markets are aggressively pricing things in most cases, and so we are doing everything we can."

Kipp DeVeer (ARCC) – "We feel confident that a slower pace of investing is warranted today. As it means positioning the company for less volatility long-term and the opportunity for stronger fundamental investment performance and higher earnings in future periods."

Bill Conway (CG) –"…government data captured the same recovery in business spending that we have observed in our portfolio and have reported to our LPs over the last several months. It is clear to us that CapEx has rebounded after a difficult 2 years. Overall, the US economy looks to us to be growing roughly a full percentage point faster than it was last year, at about 2.4% versus 1.5% last year. Despite this rosy economic environment, the investment environment remains challenging, characterized by high prices and significant competition."

David Golub (GBDC) – "Let's start with credit market inflation. I've used this term for a couple of quarters to describe what happens to credit markets when we see too much capital chasing too few deals. Spreads go down, leverage goes up and terms get looser. We started to see signs of credit market inflation in 2016, particularly in the second half. And the trend has continued into 2017."

Scott Nuttall (KKR) – "I think what we continue to see is the value creation being driven by improved operating fundamentals in the portfolio of companies themselves. So if you look at our private equity portfolio broadly, last 12 months, high single-digit revenue growth, high single-digit EBITDA growth, which translates given the capital structures into meaningful net income growth, well ahead of what you'd see in the Public Markets…. it's really driven by making the companies better post-investment and the growth in the portfolio themselves as opposed to multiple expansion or anything else."

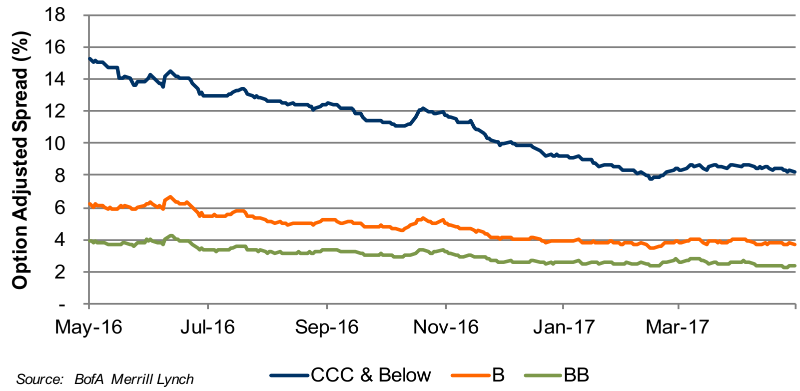
Vince Foster (MAIN) – "…I can see a business owner, as we get towards the end of the year that business owner is looking to transact and sell his or her company and it looks like tax reform might go effective at the beginning of '18, rather than in late '17. I can see them wanting to defer the sale, to be able to benefit from whatever favorable provisions are in there for them."

Source: All transcripts obtained from SNL.

Private Equity

Debt Investments: High Yield Spreads by Credit Rating

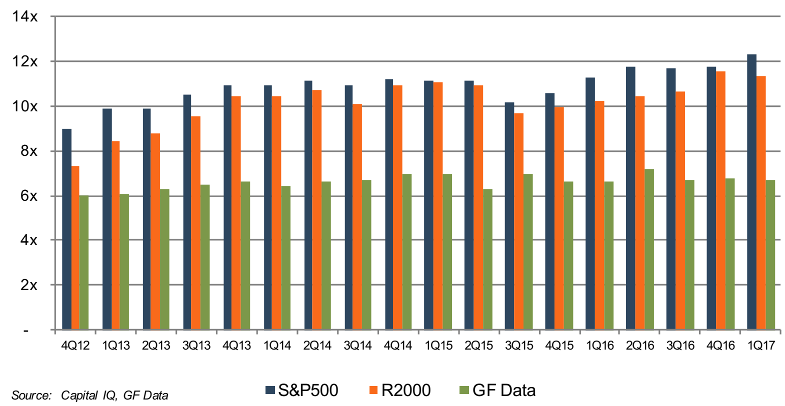
After a steady decline in 2016 from the peak in February when oil prices bottomed, credit spreads have generally leveled out in the first five months of 2017. Credit spreads have ticked up modestly from their lowest level reached at the beginning of March but remain tight as yield seeking liquidity remains abundant.



Source: BofA Merrill Lynch
Median EBITDA Multiple (ex-financials)

Equity Valuation: EBITDA Multiples over Time

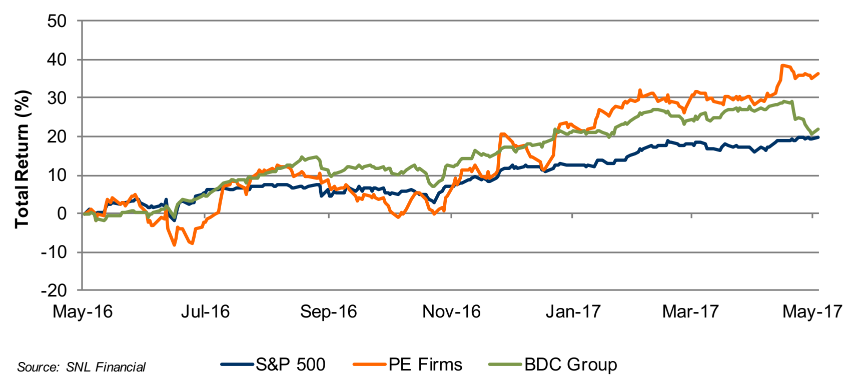
The gap between small cap and large cap stocks widened as the median EBITDA multiple for non-financial S&P 500 companies surpassed 12.0x for the first time over the period analyzed, compared to 11.4x for the Russell 2000 index. The median EBITDA multiple for PE-sponsored transactions in the lower middle-market as compiled by GF Data® was 6.7x.



Source: Capital IQ, GF Data
Excludes financials

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

Investor exuberance cooled in Trump's first 100 days in office as the reality of achieving policy reform sank in, but overall optimism remains high in anticipation of pro-growth policies including tax cuts, infrastructure spending, and deregulation. Returns for PE firms reached 36% year-over-year with the majority of the gain occurring post election. Total return for the BDC group was 22% while the S&P gained 20% in the trailing twelve months.



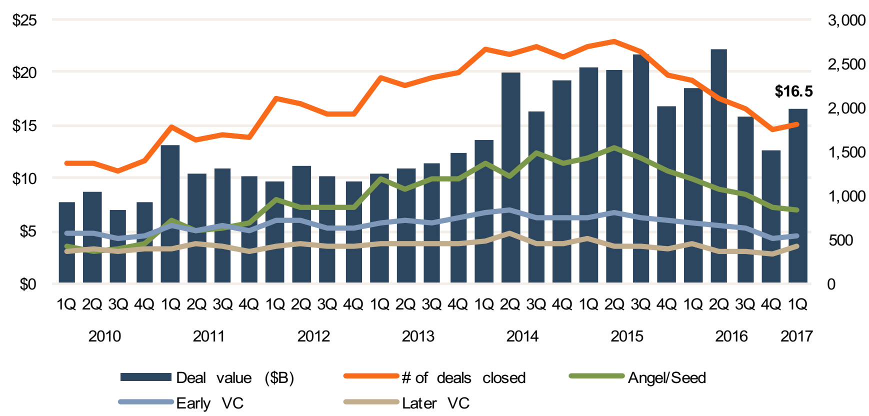
Source: SNL Financial

Venture Capital

U.S. VC-Backed Funding Activity

Venture capital-backed funding totaled $16.5 billion for 1,808 deals in the first quarter of 2017. Funding activity plunged quickly in the second half of 2016 from the high levels observed in the prior two years. As the dust settles, the funding environment appears to be returning to normal levels of investment, continuing the more steady growth trajectory of 2012 to 2013.

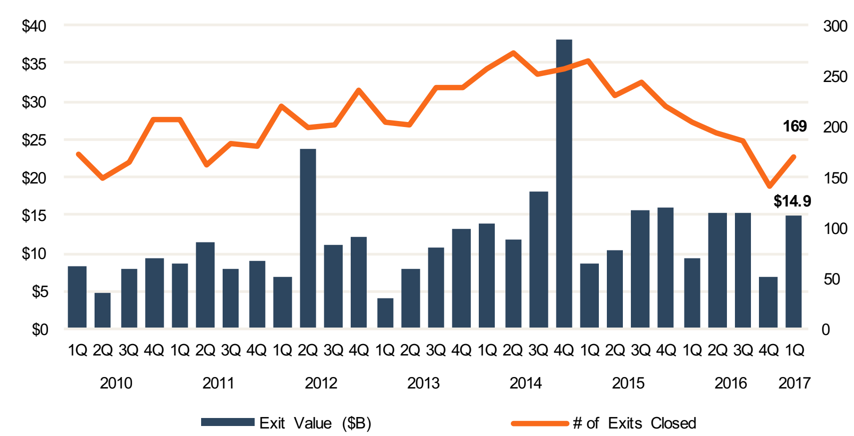
While late stage investments have remained relatively flat, the number of seed deals over the past eight quarters dropped. Investors may be waking up from their dreams of lofty unicorn valuations and approaching more proven and established companies, but they did not hold back entirely from making investments in Q1.



Source: Pitchbook/NVCA Venture Monitor

U.S. VC-Backed Exit Activity

After five quarters of steady decline, the number of venture capital-backed exits rose in 1Q17. At 169 exits, activity remained below the levels observed in recent years; however, several large exits boosted the totals. Exit activity has historically varied dramatically by quarter but 2017 posted an optimistic start to the year. Total exit value in 1Q17 was higher than first quarter exits in the prior eight years at $14.9 billion. IPO activity started to pick up again, though not with the fervor many investors hoped for, with just seven completed public offerings during the quarter. This included several high profile and highly anticipated exits, including Snap and Mulesoft's IPOs and Cisco's acquisition of AppDynamics.

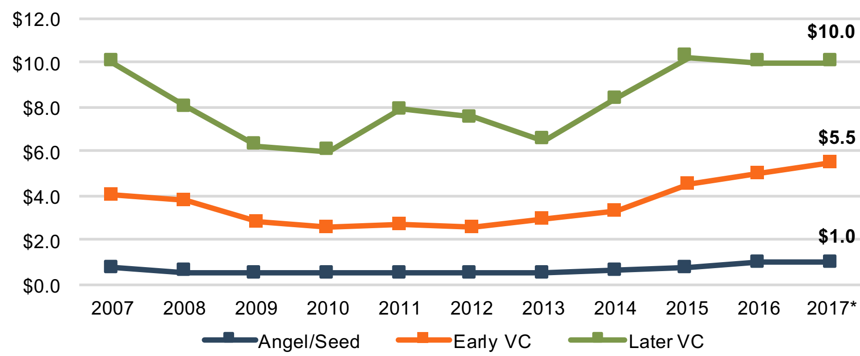


Source: Pitchbook/NVCA Venture Monitor

Venture Capital

Median Deal Size by Stage ($ millions)

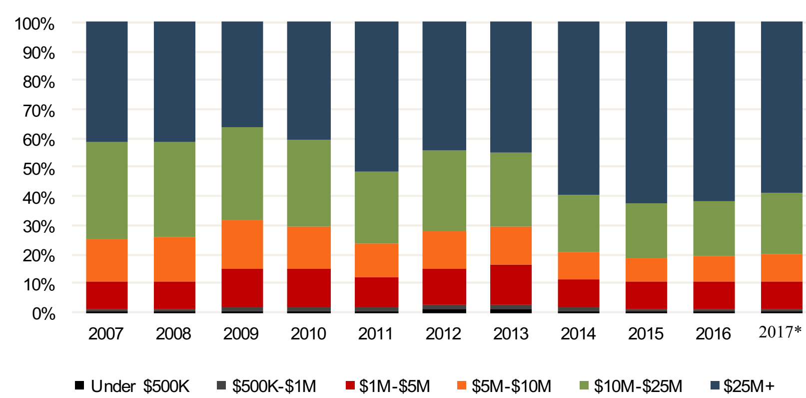
Median funding round sizes remained steady in 1Q17, at $10 million, $5.5 million, and $1.0 million for later VC rounds, early VC rounds, and angel/seed financings, respectively. Although the number of late stage investments has remained steady, the increase in median round size in recent years has contributed to the rise in total deal value attributed to late stage startups.



Source: Pitchbook/NVCA Venture Monitor *2017 data is through the first quarter

Funding By Round Size ($)

With the proliferation of unicorn valuations and massive raises, funding rounds of $25 million or more accounted for nearly 60% of all raises from 2014 to 2016. Through the first quarter, 2017 appears to be on the same track. Although deals under $5 million accounted for 64% of the 1,720 fundraising rounds in the first quarter, they represented less than 11% of the total deal value.



Source: Pitchbook/NVCA Venture Monitor *2017 data through the first quarter

Mercer Capital

Private Equity & Venture Capital Services

Mercer Capital provides business valuation and financial advisory services to venture capital 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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