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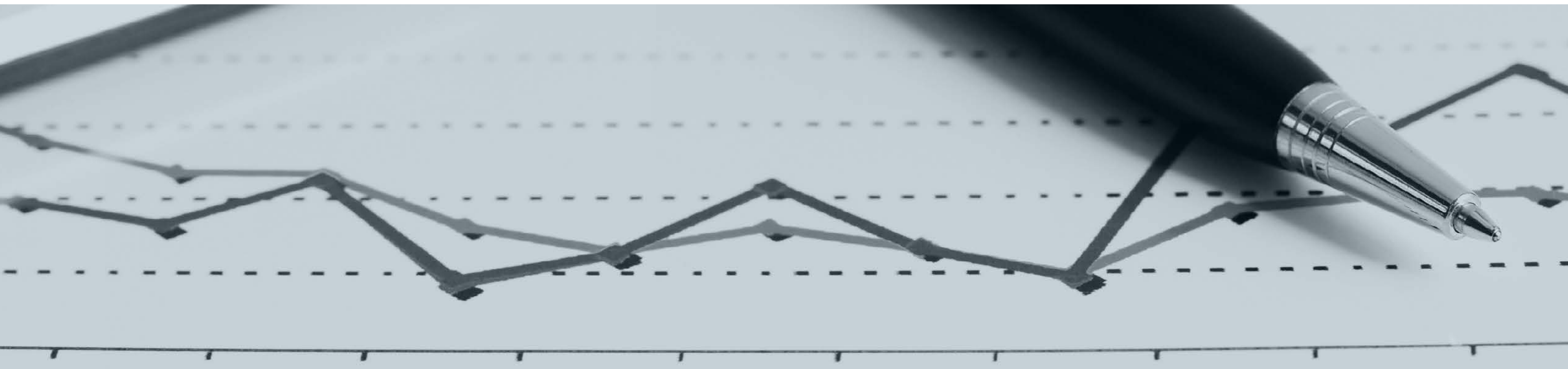
Portfolio Valuation

Private Equity & Venture Capital Marks & Trends

Fourth Quarter 2017



Executive Summary

Private Equity

Despite record fundraising levels by PE firms in the U.S., M&A deal volume is down 11% in the first three quarters of 2017 compared to the first three quarters of 2016 as pricing remains high and the number of targets dwindles. With pricing high, adds-on continue to comprise a larger portion of buyouts relative to 2013 to 2015. In addition, PE firms are holding on to portfolio companies longer, with the proportion of portfolio company inventory acquired more than five years ago increasing to 38% in 3Q17, which is the highest level recorded in Pitchbook's dataset.

Leverage Lending

Through October 2017, U.S. leverage loan issuance reached $1.07 trillion, which is 53% higher compared to the previous year, with the increase in volume largely attributable to a high level of refinance activity, which in turn has been supported by an increase in leverage loans distributed to institutional investors. Refinancing activity accounted for 67% of institutional volume compared to 49% in the prior year.

Venture Capital

Although 3Q17 looked underwhelming in comparison to a promising second quarter, year-to-date VC funding of $61.4 billion nearly matched the level of capital deployed in each of the first three quarters of 2015. However, the concentration of funding in fewer startups continued. The number of VC-backed deals in the first three quarters was nearly a third lower than in 2015.

The number of exits increased slightly in the third quarter but may not be enough to signal a reverse from the nearly three year decline. Later funding rounds continue as older, larger startups remain private and seek additional investment capital. As the market experiments with SPACs and ICOs, the rise of alternative exit vehicles could provide new routes to liquidity.

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Fairness When the Price May Not Feel "Right"

Viewed from the prism of "fairness" in which a transaction is judged to be fair to shareholders from a financial point of view, many transactions are reasonable; some are very fair; and some are marginally fair. Transactions that are so lopsided in favor of one party should not occur absent a breach of corporate duties by directors (i.e., loyalty, care and good faith), bad advice, or other extenuating circumstances. Obtaining competent financial advice is one way a board exercises its duty of care in order to make an informed decision about a significant corporate transaction.

The primary arbiter of fairness is the value of the consideration to be received or paid relative to indications of value derived from various valuation methodologies. However, the process followed by the board leading up to the transaction and other considerations, such as potential conflicts, are also important in the context of "entire" fairness.

A tough fairness call can occur when a transaction price appears to be low relative to expectations based upon precedent transactions, recent trading history, management prognostications about a bright future, and/or when the value of the consideration to be received is subject to debate. The pending acquisition of commercial finance lender NewStar Financial, Inc. ("NewStar"; Nasdaq-NEWS) is an example where the acquisition price outwardly seems to be low, at least until other factors are considered.

NewStar Example

On October 16, 2017, NewStar entered into a merger agreement with First Eagle Holdings, Inc. ("First Eagle") and an asset purchase agreement with GSO Diamond Portfolio Holdco LLC ("GSO"). Under the merger agreement, NewStar will be acquired by First Eagle for (a) $11.44 per share cash; and (b) non-transferable contingent value rights ("CVR") that are estimated to be worth about $1.00 per share if the transaction closes before year-end and $0.84 per share if the transaction closes in 2018. The CVR reflects the tax benefit associated with the sale of certain loans and investments at a discount to GSO for $2.37 billion.

Also of note, the investment management affiliate of First Eagle is majority owned by an entity that is, in turn, partially owned by Corsair Capital LLC, which is the largest shareholder in NewStar with a 10.3% interest.

Acquisition Price

As shown in Figure 1 on the next page, the acquisition price including all of the CVR equates to 83% of tangible book value ("TBV"), while the market premium is nominal. Although not relevant to the adequacy of the proposed pricing, NewStar went public in late 2006 at $17.00 per share then traded to around $20 per share in early 2007 before sliding to just about $1.00 per share in March 2009.

"Feel" is a very subjective term; nonetheless the P/TBV multiple that is well below 100%, when combined with the nominal market premium, feels light. NewStar is not a troubled lender. Non-performing assets the past few years have been in the vicinity of 3% of loans, while net charge-offs have approximated 1% other than 2015 when losses were negligible. Further, the implied haircut applied to the loans and investments that will be acquired by GSO is modest.

Transaction Multiples

While the P/TBV multiple for the transaction is modest, the P/E multiple is not at 26.5x (the latest twelve month ("LTM") earnings) and 18.4x (the consensus 2018 estimate). The P/E could be described as full if NewStar were an average performing commercial bank and very full if it was a typical commercial finance company in which low teen P/Es are not unreasonable.

What the P/TBV multiple versus the P/E multiple indirectly states is that NewStar has a low ROE, which has been less than 5% in recent years. The culprit is a highly competitive market for leveraged loans, a high cost of funds absent cheap bank deposit funding and perhaps excess capital. Nonetheless, management's projections incorporated into the recently filed proxy statement project net income and ROE will double from $20 million/3% in the LTM period ended September 30 to $41 million/6% in 2020.

In spite of a doubling of projected net income, the present value (assuming NewStar is worth 18.4x earnings in 2020 discounted to September 30 at a discount rate of 13%) is about $507 million, or about the same as the current transaction value to shareholders. Earnings forecasts are inherently uncertain, but one takeaway is that the P/TBV multiple does not appear so light in the context of the earnings forecast.

Additional perspective on the transaction multiples is provided in Figure 2 in which NewStar's P/TBV multiple based upon its public market price consistently has been below 100% the last several years while the P/E has been around 20x or higher due to weak earnings.

Performance and Timing

As for the lack of premium, there outwardly did not appear to be wide spread expectation that a transaction was imminent (as was thought possible in 2013 when *Bloomberg* reported the company was shopping itself). There were no recent media reports; however, the shares fell by 17% between May 2–May 19 following a weak first quarter earnings report. The shares subsequently rebounded 19% between June 6–June 14. Both the down and then up moves were not accompanied by heavy volume. Trading during most of this time frame fell below approximately 100 thousand daily average shares.

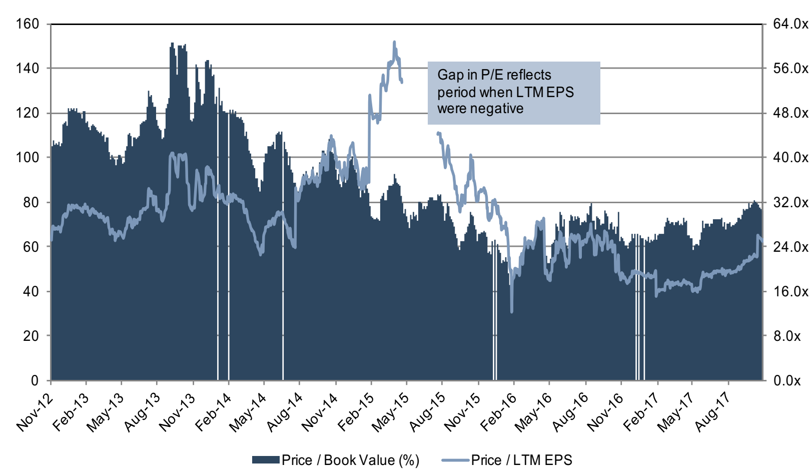
Figure 1: NewStar's Transaction Multiples

Price per NEWS Share		Base Cash $11.44	with CVR[1] $12.44
Transaction Value	41.6M Shares	$476M	$518M
Book Value / Share	$15.57	73%	80%
Tangible BV / Share	$15.01	76%	83%
Est Adj TBV / Share[2]	$14.01	82%	89%
LTM EPS	$0.47	24.3x	26.5x
FY18E EPS	$0.68	16.9x	18.4x
1-Day Premium	$12.13	-6%	3%
5-Day Premium	$11.96	-4%	4%
30-Day Premium	$10.94	5%	14%

1) Non-transferable contingent value rights up to $1.00 per share
2) Adj TBV assumes loss on sale of $2.4B of loans to GSO ~3%
3) Financial metrics as of 9/30/17
4) Transaction announced 10/16/17 after the market close

Source: S&P Capital IQ and Mercer Capital

Figure 2: NewStar's Historical Public Market Multiples



On the Call

The following is a brief compendium of quotes from 3Q17 earnings season conference calls.

Kipp DeVeer (ARCC) – "Our feeling is that pricing on new deals is generally stabilized, but underwriting terms are fairly aggressive driven by strong liquidity from a variety of sources, including new entrants who seem eager to put capital to work. […] With respect to our new investments, we are generally finding better relative value with upper middle market companies since there is often no meaningful pricing differentiation between small and larger mid-market companies. And given that we expect these larger companies to generally be more durable with better credit performance over time, we tend to favor these companies in the current markets unless of course, there is a meaningful difference in terms or in pricing."

David Rubenstein (CG) – "Today, the world of private equity has more than $2.5 trillion under management, doubling in size over the last decade, while the world of private credit has quadrupled over the past 10 years to more than $600 billion under management. As the world's liquidity grows and as the constant search for returns intensifies, most independent observers believe that the private investment world will continue to grow quite significantly, and we agree with that judgment. As a result, a great many investment firms in the U.S. and abroad, small firms and large firms, can be expected to grow and to attract both significant amounts of funds to invest and talented individuals to invest and oversee these funds."

Bill Conway (CG) – "And in the past, when you had companies public, it's easier to get liquidity out of a public company sometimes than it is out of private companies. This, frankly, is a part of a much bigger trend in terms of the, what I'll call, decline in the importance of the public markets. The total number of, for example, publicly traded stocks in United States has been cut in half in the last 20 years. The number of IPOs is down, probably 80% in the last decade or so. So the public markets are becoming much different than they used to be, and I think that's a factor perhaps even in the size of our publicly traded portfolio."

David Golub (GBDC) – "Don't be fooled by any elongated credit cycle. Yes, this recovery is unusually long and unusually slow, but that doesn't mean the credit cycle is dead. It doesn't mean this time is different. In our judgment, market conditions ultimately will get lender-friendly again."

Vince Foster (MAIN) – " […] we do a market approach and a DCF approach. And with respect to the DCF approach, you assume a C Corp buyer buys the company and then, in determining what they would pay, we've been assuming at 35% tax rate maybe plus [date], I don't remember. When you drop that to 20% that drives up the DCF component of your valuation as your companies are worth more to a C Corp buyer. On the other hand, your WACC would go up somewhat because your weighted average cost of capital has a 35% benefit on the interest expense component, which is no longer worth 35%, it is only worth 20%. So net-net, we were forecasting a low to mid-single digit increase in NAV attributable to the lower middle market valuation."

Art Penn (PNNT) – "I think one of the nice things in this market is sponsors are putting in records amount of equity as cushion. I mean, if you compare the environment we're in today versus the environment in 2007, for good or for ill, the equity cushions and the equity checks are larger. So that does provide more inherent comfort and cushion should something go wrong."

Source: All transcripts obtained from SNL.

Measured from June 14–October 17, the day after the announcement, NewStar's shares rose about 10% compared to 8% for the SNL Specialty Finance Index. Measured from May 19, when the shares bottomed following the weak first quarter results the shares rose 34% compared to 12% for the index through October 17. The market premium relative to recent trading was negligible, but it is conceivable some premium was built into the shares for the possibility of a transaction given the sharp rebound during mid-June when negotiations were occurring.

Other Support for the Transaction

Further support for the transaction can be found in the exhaustive process that led to the agreements as presented in the proxy statement. The proxy confirmed the *Bloomberg* story that the board moved to market the company in 2013. Although its investment bankers contacted 60 potential buyers, only two preliminary indications of value were received, in part because U.S. banking regulators tightened guidelines in 2013 related to leverage lending by commercial banks. The two indications were later withdrawn.

During 2016 discussions were held with GSO regarding a going-private transaction, in addition to meetings with over 20 other parties to solicit their interest in a transaction. By the spring of 2017, consideration of a going-private transaction was terminated. Discussions then developed with First Eagle/GSO, Party A and Party B that eventually led to the announced transaction. Given the experience of trying to sell NewStar in 2013 and go private in 2016, the board elected not to broaden the marketing, calculating the most likely bidders would be alternative asset managers (vs. banks with a low cost of funding).

Fairness considerations about the process were further strengthened through a "go-shop" provision in the merger agreement that provided for a 30-day "go-shop" period in which alternative offers could be solicited. If a superior offer emerged and the agreements with First Eagle and GSO were terminated a modest termination fee of $10 million (~2.5%) would be owed. Conversely, if NewStar terminates because GSO cannot close, then a $25 million termination fee will be owed to NewStar.

The go-shop provision was activated, but to no avail. More than 50 parties were contacted and seven other unsolicited inquiries were received. NewStar entered into confidentiality agreements with 22 of the parties, but no acquisition proposals were received.

Financial Advisors

Financing was not a condition to close on the part of the buyers because GSO secured $2.7 billion of debt and equity capital to finance the asset purchase. First Eagle will use excess funds from the asset purchase and existing available cash to fund the cash consideration to be paid at closing to NewStar shareholders. While two financial advisors cannot make an unfair deal fair, the use of two here perhaps gave the board additional insight that was needed given the four-year effort to sell, take the company private, or affect some other corporate action to increase value.

The Lesson from the NewStar Example

While the transaction price for NewStar seems low, there are other factors at play that bear consideration. When reviewing a transaction to determine if it is fair from a financial viewpoint, a financial advisor has to look at the entire transaction in context. Some shareholders will, of course, focus on one or two metrics to support a view that is counter to the board's decision.

Conclusion

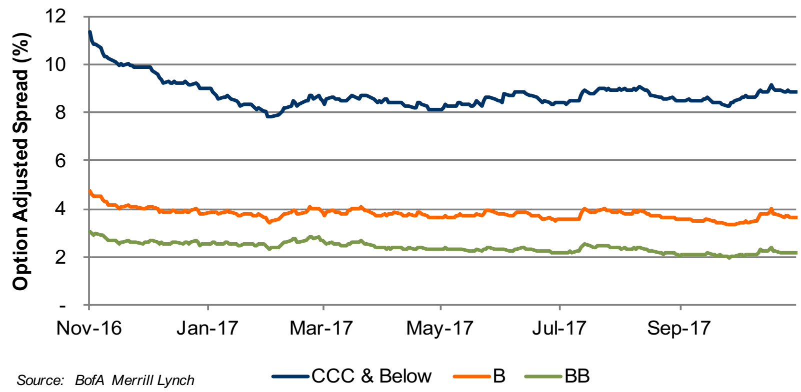
Every transaction has its own nuances and raison d'etre whether the price "feels right" or not. Mercer Capital has significant experience helping boards sort through valuation, process and other issues to determine what is fair (or not) to shareholders from a financial point of view. Please call if we can help your board make an informed decision.

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

Private Equity

Debt Investments: High Yield Spreads by Credit Rating

Credit spreads widened modestly between June 30 and the end of November 2017 but remain tight relative to historical averages.

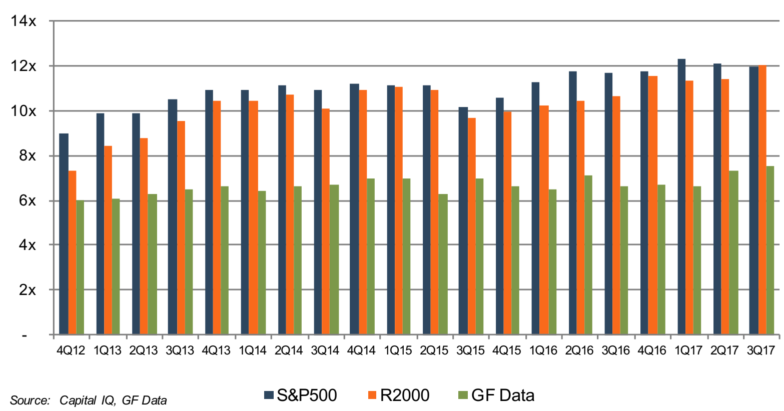


Source: BofA Merrill Lynch
Median EBITDA Multiple
Excludes financials

Equity Valuation: EBITDA Multiples over Time

The gap between small cap and large cap stocks narrowed to the smallest level observed since 2012 at the end of 3Q17.

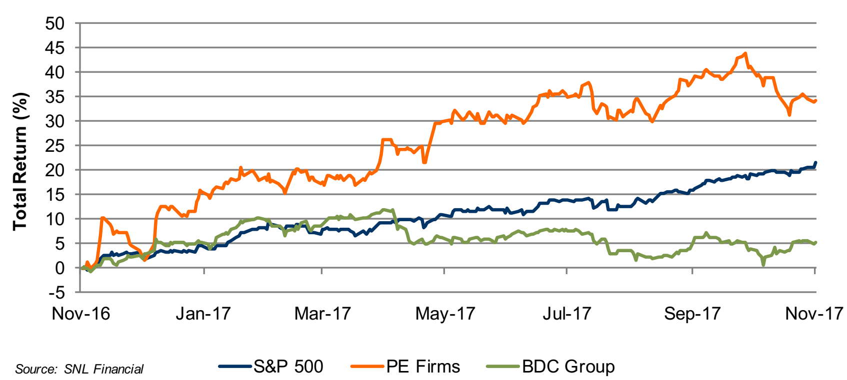
The median EBITDA multiple for PE-sponsored transactions in the lower middle-market as compiled by GF Data® was 7.5x.



Source: Capital IQ, GF Data
Excludes financials

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

The S&P climbed steadily upward in the third quarter of 2017 as consumer confidence remains at a 17-year high and investors continue to be undaunted by record-high stock valuations. The S&P returned 22% in the trailing twelve months, while PE firms continued to outperform the broader market.

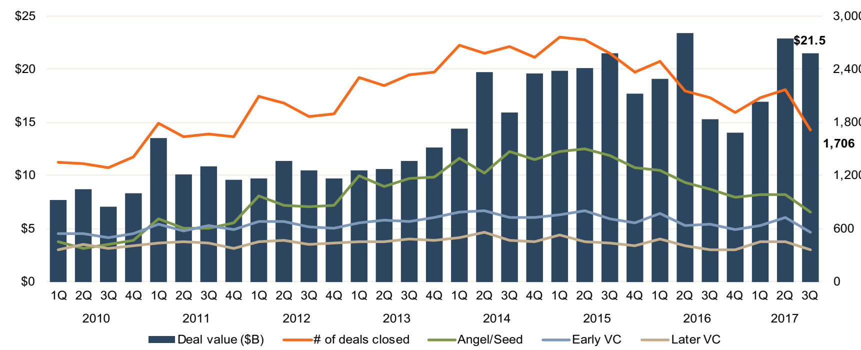


Source: SNL Financial

Venture Capital

U.S. VC-Backed Funding Activity

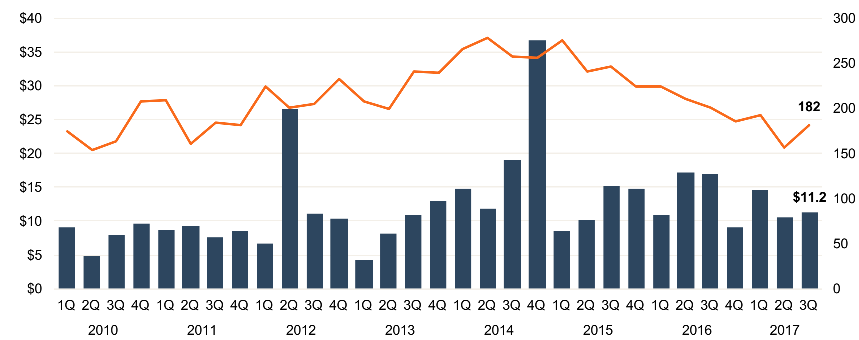
Although total deal value remained strong at $21.5 billion, funding volume dropped 21% from second quarter 2017 to just 1,706 deals. This is the first time deal count has dipped below 1,800 since fourth quarter 2011. Deal volume fell across all stages, with the largest decline in early stage (22%).



Source: Pitchbook/NVCA Venture Monitor

U.S. VC-Backed Exit Activity

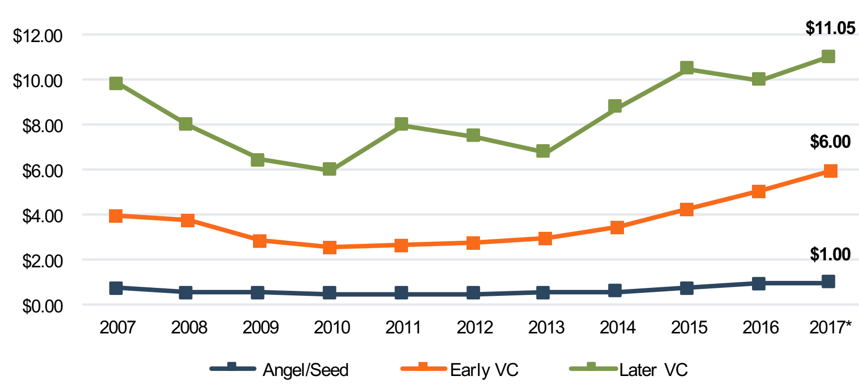
Venture-backed exit activity remained muted in 3Q17. The number of exits has hovered below 200 each quarter for the last twelve months, mirroring pre-2012 activity levels. As traditional exit prospects appear limited, investors are beginning to give more consideration to new routes to liquidity such as ICOs.



Source: Pitchbook/NVCA Venture Monitor

Median Deal Size by Stage ($ millions)

Early and late stage median deal sizes continued to climb in the third quarter, as deals became more concentrated at all stages. At $6 million and $11 million, the median deal sizes for early and late stage rounds, respectively, rose to their highest levels since 2007.



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

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 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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- Buy-Sell Agreement Valuations

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

Megan Richards
901.322.9767
richardsm@mercercapital.com

MERCER CAPITAL

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

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

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

www.mercercapital.com