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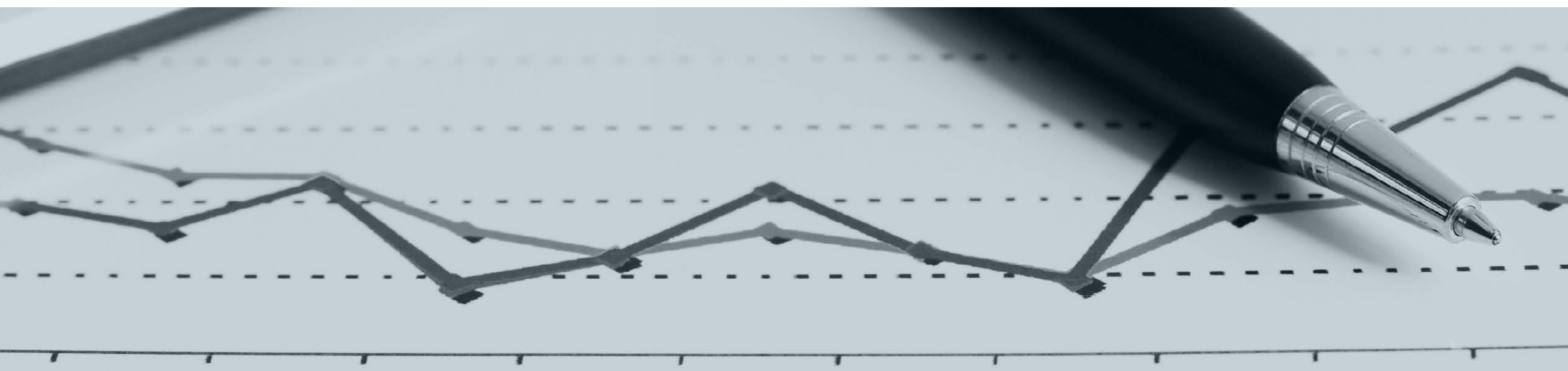
# Portfolio Valuation

## Private Equity & Venture Capital Marks & Trends

Second Quarter 2018



## Executive Summary

### Private Equity

According to PitchBook's breakdown of private equity in the U.S., PE fund-raising decelerated sharply in the 1Q18, totaling $36.6 billion across 55 vehicles, down from $55.8 billion in the 1Q17. Deal flow remained strong by volume relative to the 1Q17, declining only 4% to 1,101 transactions, while total deal value fell 32.8%. Reported figures are expected to improve in the coming months though, as 124 deals worth $94.3 billion have been announced but not yet closed in 2018.

### Leverage Lending

According to *Thomson Reuters*, leveraged loan issuance reached $362 billion in the first four months of 2018. While total volume is down 30% from last year, the institutional share of total volume remained stable at 70%. Refinancing continued to drive activity, with new money accounting for only 30% of volume in April.

### Venture Capital

Both the amount of funding and the size of various funding rounds reached new heights during the 1Q18. Companies continue to receive large funding rounds at all stages, putting little pressure on mature startups to seek avenues for exit. However, the announcement of a potential IPO by notable companies such as Uber in the coming years could create momentum for others to follow.

Whether Q1 is indicative of a trend that will continue throughout 2018 or the result of a spike in deal activity is yet to be seen. Deal volume of $28.2 billion represents a compound growth rate of 3.0% per quarter since 1Q10. IPO activity was also more favorable than recent quarters, with more than $2 billion exited through public offerings. However, exits overall remained low.


AICPA Publishes Guide for FV Marks 1

Private Equity 3

Venture Capital 4

About Mercer Capital 5

# AICPA Publishes Guide for FV Marks

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On May 15, the AICPA's Financial Reporting Executive Committee released a working draft of the AICPA Accounting and Valuation Guide *Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies*. The document provides guidance and illustrations for preparers of financial statements, independent auditors, and valuation specialists regarding the accounting for and valuation of portfolio company investments of venture capital and private equity funds and other investment companies. The comment period ends August 15, 2018.

Weighing in at nearly 650 pages, the guide defies quick summary. As noted in the preliminary "Guide to the Guide" section, different chapters in the working draft are likely to be of greater interest to some groups of intended users than others. In this introduction to the Guide, we provide a brief overview of the chapters and appendices with which PE and VC managers should develop familiarity.

- **Chapter 8, Valuation of Equity Interests in Complex Capital Structures**. For venture investments, valuation is often a two-step process. First, analysts must focus on the attributes, opportunities, and risks of the business as a whole. Second, analysts then need to assess how, amid the often staggeringly complex capital structures of venture-backed companies, to allocate the overall business value to the specific ownership interest held by the investor. Chapter 8 focuses on the challenges and potential pitfalls of the second step.

  The Guide distinguishes between the economic and non-economic rights typical of senior classes of preferred stock. Analysts generally value the economic rights attached to different share classes using one of four methods: scenario-based methods, the option pricing method, the current value method, or the hybrid method. The Guide provides a comprehensive overview of the relative strengths and weaknesses of these methods and describes which circumstances are most conducive to the use of each.

- **Chapter 10, Calibration**. Valuing portfolio company investments typically requires the use of significant unobservable inputs and considerable judgment in selecting appropriate company and market-level inputs and valuation techniques. Calibration is the process of using observed transactions in the portfolio company's own instruments, especially the transaction in which the fund entered a position, to ensure that the valuation techniques that will be employed to value the portfolio company investment on subsequent measurement dates begin with assumptions that are consistent with the original observed transaction as well as any more recent observed transactions in the instruments issued by the portfolio company.

  Chapter 10 of the Guide discusses the calibration framework and provides examples of how initial valuation assumptions used in valuing a debt or equity investment in a business can be calibrated with the original transaction price and subsequently adjusted to take into account changes in the subject investment and market conditions at the measurement date. When subsequent funding rounds take place, calibrating to the most recent transaction is typically most relevant, and the Guide outlines six different types of transactions and the process of potentially inferring value from these types of transactions.

- **Chapter 11, Backtesting**. The PE/VC task force believes it is best practice for investment companies to perform periodic backtesting. Backtesting refers to the process of using the observed value of the fund's interests as implied by the ultimate sale, liquidity event, or other significant change to assess the fair value estimated for an investment at an earlier date.

  The primary purpose of backtesting is to assess and improve the valuation process going forward. The Guide provides an overview of the backtesting process and advice on how to identify and evaluate factors that can

contribute to a difference in value for a particular investment between the measurement date and event date. The final section of Chapter 11 provides nine examples illustrating the backtesting process across different types of investments and under various scenarios.

- **Chapter 12, Factors to Consider at or near a Transaction Date**. In accordance with FASB ASC 946, funds initially measure the investment as the capitalized cost including transaction costs. At the first reporting date following the transaction, funds are required to measure the investment at fair value in accordance with FASB ASC 820. Chapter 11 addresses fair value considerations at initial recognition and fair value considerations at or near exit in the context of these two apparently diverging requirements.
- **Appendix A, Valuation Process and Documentation Considerations**. Appendix A discusses considerations related to internal control over financial reporting and identifies a set of principles that are important to the establishment and maintenance of an effective valuation process.
- **Appendix C, Case Studies**. Appendix C includes fifteen case studies that are designed to illustrate how information would be evaluated and incorporated when estimating value.

In short, the new Guide is a welcome addition to the resources available for fund managers in developing reliable fair value measurements for portfolio investments. We expect that having a common set of acknowledged best practices will promote efficiency in the preparation and auditing of fair value measurements. We will provide more detailed comments on specific elements of the draft Guide in the coming weeks. In the meantime, please do not hesitate to call us to discuss how any element of the new Guide may affect your portfolio valuation process.

## On the Call

The following is a brief compendium of quotes from 1Q18 earnings season conference calls.

**Kipp DeVeer (ARCC)** – "Market terms continue to be challenging, with many aggressive participants willing to provide high leverage to companies, along with looser documentation and structures."

"[…] the Small Business Credit Availability Act was signed into law in March. The law includes a provision that allows a BDC to achieve significant regulatory relief by increasing the asset coverage ratio required of BDCs from 200% to 150%. Or said another way, it increases the debt-to-equity limitation from 1:1 to 2:1."

"[…] we've seen yields expand largely because of the increase in LIBOR. We've seen just all-around weaker underwritings. So more covenant-light, lower-quality earnings being financed, i.e. lots of adjustments being financed to high multiples, structural loosening of all sorts of provisions and documentations, provisions for restricted payments that we haven't seen before, capital structures that allow for layering of debt, covenants that actually don't decline if they exist. [So] I'll give you a 9x leverage coverage covenant forever, which is a new invention in today's market. So just all sorts of things that we don't think represent particularly sound underwriting metrics."

**Jon Gray (BX)** – "On rates, yes, rates rising have – can have an adverse impact on pretty much all assets, certainly, fixed income, on real estate, on corporate. The question is in that kind of environment what do you want to own because not everything goes down in a rising rate environment. The things that do well, of course, floating rate assets on the fixed income side, […] And on the corporate and real estate side, it's assets that grow faster. And so to do that, you need to either buy assets or you're intervening in a big way as we've been doing on the private equity side with some of these corporate carve-outs or in sectors where we have real faith in the growth."

**Kew Lee (CG)** – " […] activity levels throughout the firm around the world are quite robust and you're quite correct in pointing out, it is a high priced environment. But if you think about our returns, and we've looked at this, 2/3 to 70% of returns in private equity are generated not by financial engineering or multiple expansion, but by fundamental revenue growth and EBITDA growth."

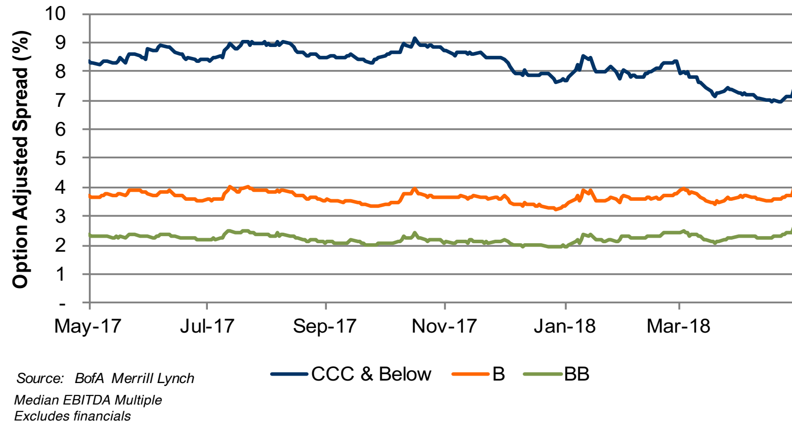
**David Golub (GBDC)** - "The increase in market volatility during the quarter was a healthy reminder that market conditions can change quickly. Frankly, we'll be happy to see a bit more volatility as it tends to move the market in a more lender friendly direction."

Source: All transcripts obtained from SNL.

# Private Equity

### Debt Investments: High Yield Spreads by Credit Rating

On a year-to-date basis, investor appetite for the most speculative credits increased as credit spreads on issues rated CCC & Below narrowed by 115 basis points while spreads on B and BB credits widened modestly.

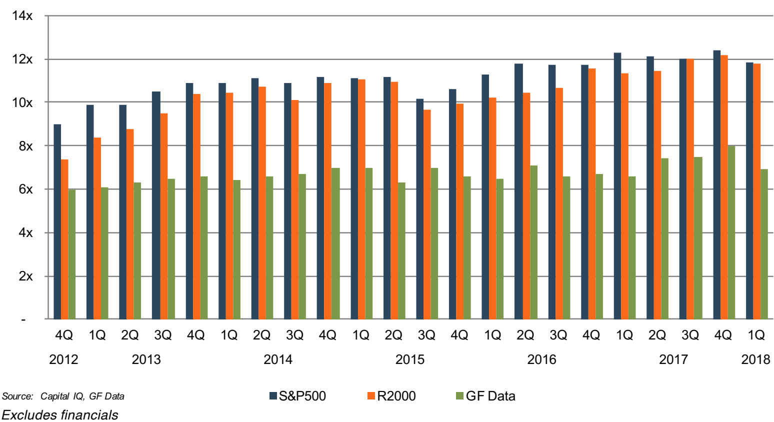



Median EBITDA Multiple
Excludes financials

### Equity Valuation: EBITDA Multiples over Time

Large cap and small cap multiples declined in the first quarter of 2018 after peaking at the end of 2017.

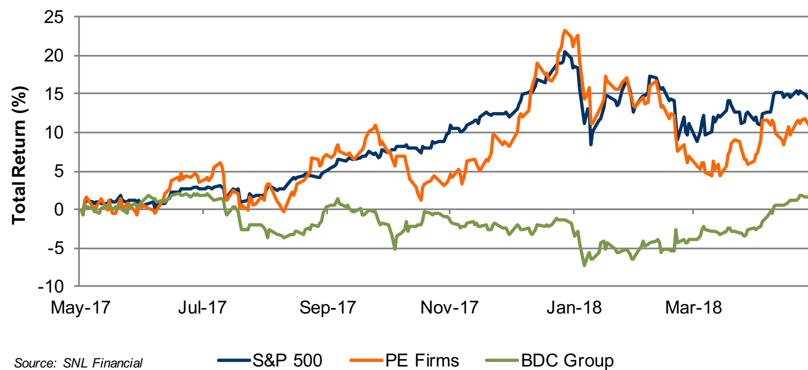
The median EBITDA multiple for PE-sponsored transactions in the lower middle-market as compiled by GF Data® was 6.9x, down from a record high of 8.0x in the fourth quarter of 2017.




Excludes financials

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

After a volatile start to 2018, markets cautiously trended upward in April and May as strong earnings and generally positive news associated with tax and regulatory reform was tempered by geopolitical uncertainty related to an off-again on-again summit between President Trump and Kim Jong Un, turmoil in Italy, and threats of a trade war. The BDC group's performance improved relative to the prior ten months.

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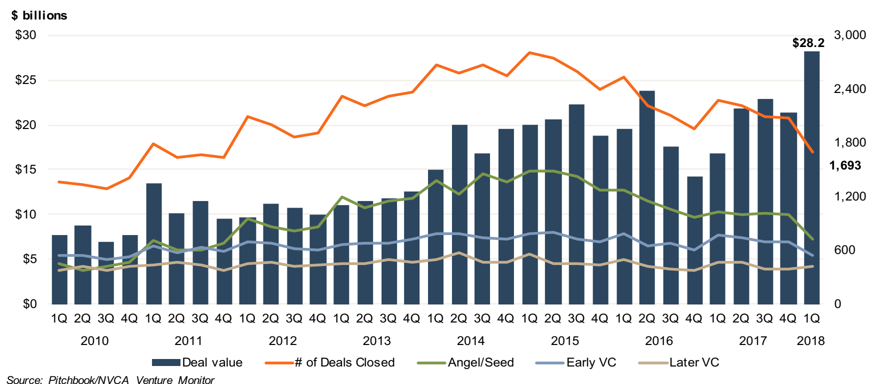
# Venture Capital

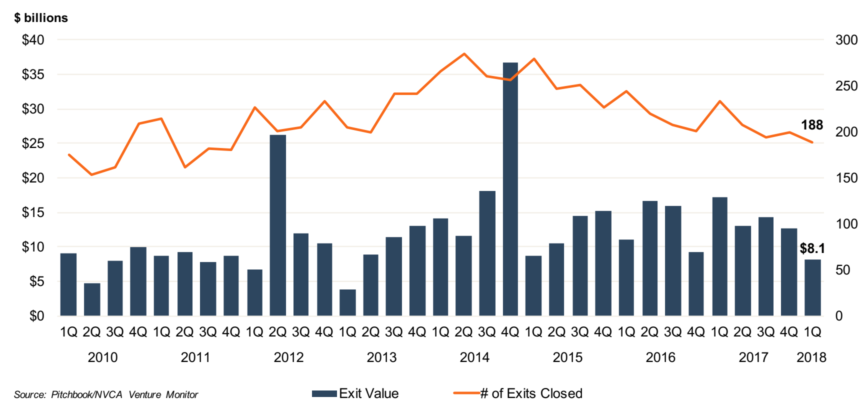
### U.S. VC-Backed Funding Activity

Total funding deployed continued to rise to new heights in first quarter 2018, reaching $28.2 billion. However, the number of closed deals continued a precipitous decline. Despite the large volume of capital that entered the market, fewer than 1,700 rounds occurred during the quarter. The trend is particularly magnified at the seed and angel stage, where the number of deals closed fell 27%.



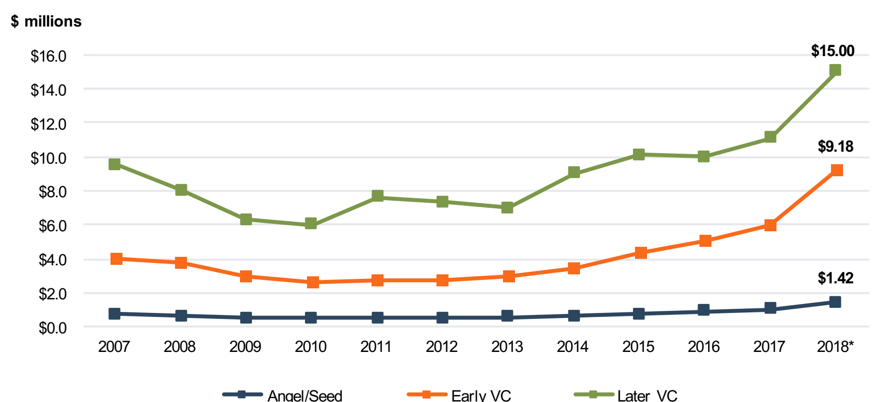

### U.S. VC-Backed Exit Activity

The number of overall exits fell again in first quarter 2018, due in part to the availability of larger, late stage funding. The total exit value was the lowest in any quarter since 2012. However, the IPO market picked up pace with long-awaited offerings including Dropbox, which raised $756 million. IPOs represented 26% of all exit value during the quarter, compared to just 17% during 2017.




### Median Deal Size by Stage ($ millions)

The angel and seed stage median deal size broke $1.0 million for the first time, reaching $1.42 million. Across all stages, five year cumulative annual growth rates reached double digits, ranging from 16% (late stage) to 25% (early stage).



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BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

# 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.

**Services Provided**

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

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

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