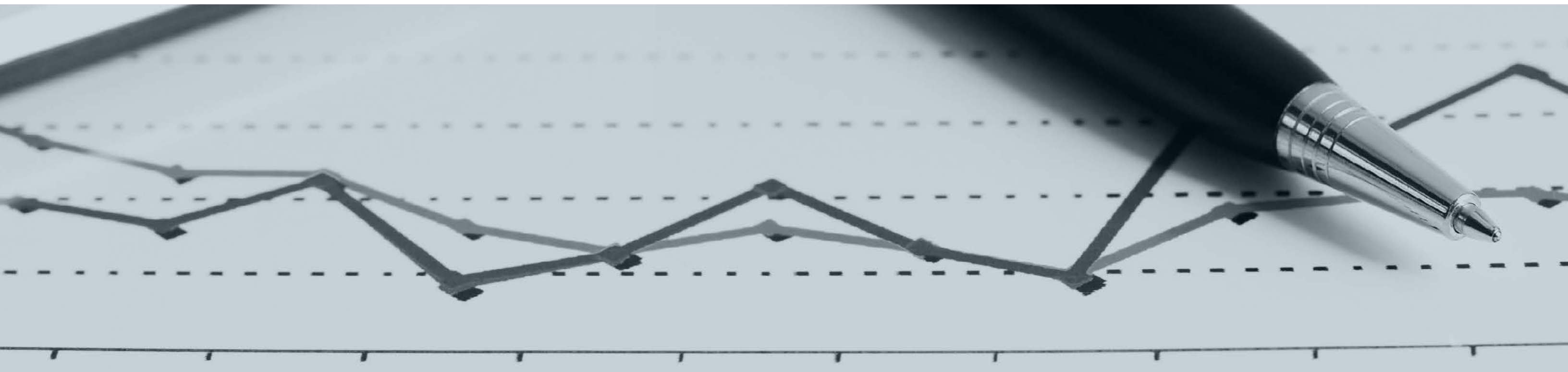
Portfolio Valuation

Private Equity & Venture Capital Marks & Trends

Third Quarter 2018



Market Snapshot

Private Equity

According to *PitchBook*, 2,247 private equity deals totaling $264 billion were completed in the U.S. during 1H18, a 2% increase in volume but a 6% decrease in value compared to 1H17. Exit activity was flattish, too, compared to recent quarters at $12.9 billion even though IPO activity has picked-up. About $4 billion of the IPO proceeds represented PE exits. FACTSET reports that M&A activity, while strong by historical standards, has not seen a dramatic uptick in 2018. Hence, the market reflects steady activity rather than a rush for the exits given elevated valuations and readily available financing.

Leverage Lending

Thomson Reuters reports that leverage lending volume eased 4% in 1H18 to $770 billion from $736 billion in 1H17 because there was less refinancing activity. Otherwise, the market remains strong as investors attracted to LIBOR-based loans in a rising rate environment have absorbed supply that would be retained on bank balance sheets. An emerging theme that may be bullish for LBO-sponsors is a looser regulatory interpretation of leverage lending guidelines in which 6.0x EBITDA may not be the Maginot-Line for bank participation. The 2013 guidance shifted most deals above 6x to non-bank firms.

Venture Capital

While venture funding has picked up this year, exit activity remained tepid during 1H18. The glut of invested capital continues to grow, but in fewer large, late-stage companies. Two of the larger pending exits are Lyft Inc. and Uber Technologies. Lyft is in the process of interviewing bankers, while Uber's CEO has reaffirmed an eventual IPO.

Venture Capitalists in the Family

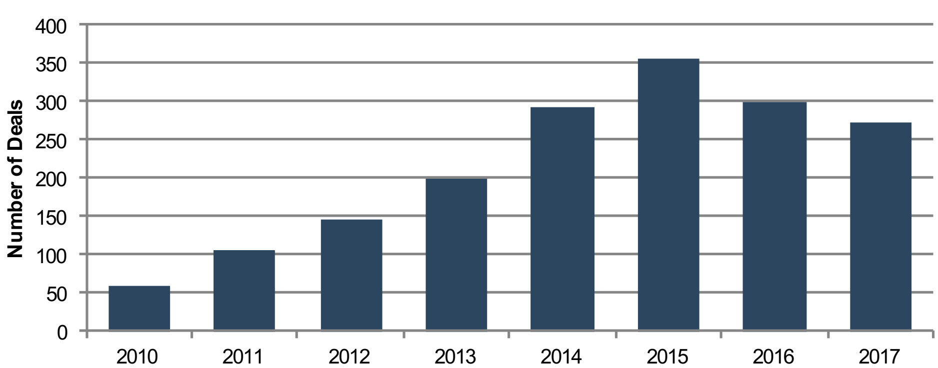
Megan E. Richards | richardsm@mercercapital.com

Many family offices are built from the success of once fledgling businesses that many would now know as household names. Successor generations seek to maintain and build that wealth through **prudent investments** in equities, fixed income, and private equity investments in mature companies. In recent years, however, family offices have started taking notes from their entrepreneurial beginnings and are investing more in early-stage ventures. Though more often seen as LPs in traditional venture capital funds, family offices are also increasingly taking on the role of direct—and sometimes lead—**venture investors**.

An analysis from *Crunchbase News* shows the progression of family office venture investment over the last few years. While this is a small sample, it helps demonstrate the growing trend. *Crunchbase* also notes **several prominent family venture-backed exits** including Twilio, Okta, Bitly, and Workday.

We have **previously analyzed the rise of corporate venture capital** and its effect on the funding landscape. So what does the increase in family office investors mean for venture capital? Here are a few of the characteristics that make venture investments from family offices unique.

Family Office Venture Investments



Source: Crunchbase News

Involvement

Despite an industry focus on the new wealth being built in the technology hubs of the U.S., abundant sources of potential investment lay in family offices all over the country. Family office investors are likely to source deals through their personal networks and professional ties with local business activity. Family offices typically take an active interest in each portfolio company and, therefore, may be likely to invest their capital in local ventures in order to better stay up-to-date with company developments. In order to maintain this involvement, a **board seat may also be one of the requirements** when a family office joins the cap table.

Motivation

Whether they hold a share of the original family company or a subsequent business investment, family offices often have a stake in mature industry players. Because of previous work within the space or an **inside vantage point** from an ownership position, family offices can often lend industry insight. They may also possess a unique perspective for identifying startups that could disrupt, or partner with, the incumbents in the industry. Family office investors typically enter with strategic motivations for investing, not just the lure of large returns.

Time Horizon

The primary focus of family offices is to preserve and grow capital for multiple generations. Family offices are, therefore, usually able to adopt a very **long-term view of their overall portfolio**. However, it should not be mistaken that family offices are willing to have their capital tied up forever. Like any other investment firm, family offices develop objectives and exit expectations for their various investments.

As family offices join the landscape of non-traditional investors in venture capital, startups may find that they have more options when it comes to funding. We expect to continue to see an increase in the diversity of funding sources, with cap tables boasting a combination of traditional, corporate, and family investors.

On the Call

The following is a brief compendium of quotes from 2Q18 earnings season conference calls.

Leon Black (APO, Chairman & CEO) – "In addition, we believe we are benefiting from several secular tailwinds in the asset management industry, including: one, the search for yield in a still low-rate environment; two, the consolidation of relationships amongst the most successful asset managers with broad product suites; and three, the migration away from traditional active equity and fixed-income strategies to a more barbell approach oriented towards its passive and alternative strategies."

Kipp DeVeer (ARCC, CEO) – "Despite these challenging conditions for investing, we did see evidence of increasing market volatility in the liquid credit markets beginning late June that has continued. Under the weight of strong new supply and deal activity, investors began to push back on both pricing and terms in the liquid loan markets. As supply and demand dynamics in the market become more balanced, the syndicated loan market is seeing spread widening of approximately 25 to 50 basis points, marginally improved credit protections, and tightening risk parameters from the syndication desks for liquid loan executions."

Steve Schwarzman (BX, Chairman & CEO) – "The economic backdrop is quite healthy, despite the recent turbulence in markets, due in part to growing fears around the impact of rising protectionism on global trade."

Tony James (BX, Vice Chairman) – "The global markets have been choppier. On the ground, we've not seen a lot of impact. What's been bigger impact of course is the strength of the U.S. economy, which has been surprising everyone, including us. I would say on the ground talking to our CEOs and other companies interact with, tax reform has increased in many cases their cash flows and has made them more confident. And so when companies' earnings are up, they tend to be more inclined to spend capex. They tend to be more inclined to travel. And we've seen that in the hotel business where there has been a re-acceleration of same-store sales in that sector as an example."

Kew Lee (CG, Co-CEO) – "I think you can't talk about the credit cycle without having some sense for what's happening in the real economy. From my perspective, it feels like we're in the later innings; not in the first few innings. But having said that the growth that we're seeing and the underlying health of the economy that we're seeing globally—not only in the United States, but in Europe and in China—continues to motor along. And right now, when we look at our portfolios, be it on the private equity side, but also all of the investments we have throughout our credit platform, performance continues to stay on track, and delinquencies and defaults are in line with what we want them to be. I would also point out that we have seen some pushback (among credit investors) with respect to terms and spreads."

David Golub (GBDC, CEO) – "From a macro perspective, our data suggests that the U.S. economy has a lot of positive momentum and this may interfere with the drive toward a more lender-friendly market."

David Golub (GBDC, CEO) – "I'll end with an update on our debt capital structure. On last quarter's call, we talked about 3 themes that underlie our thinking about the recent bill permitting higher BDC leverage. First, we believe in the Hippocratic Oath, "Do no harm." We think we have a great model today and we see no rush to change it. Second, we said we believe the environment today is challenging and that access to leverage isn't a constraint for us. The constraint is the availability of attractive investment opportunities. And consequently, we think this is the kind of environment in which it pays to be cautious. And third, we said that we believe incremental debt inevitably costs more and involves higher risk. We think that incremental cost and risk shouldn't be taken lightly."

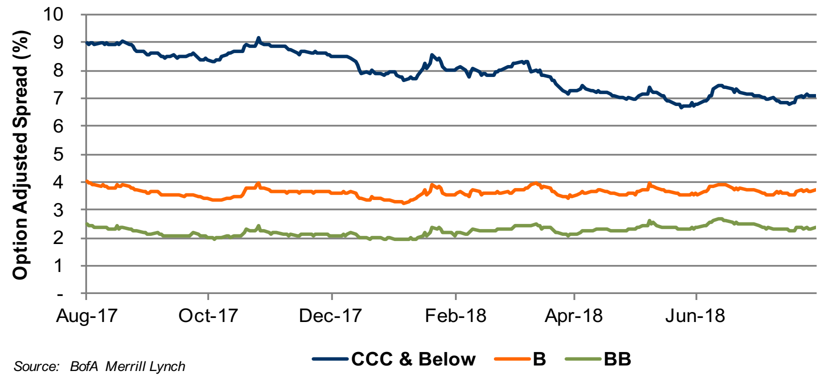
Art Penn (PNNT, Chairman & CEO) – "At this point in time, our underlying portfolio indicates a strong U.S. economy and no signs of recession."

Source: All transcripts obtained from SNL.

Private Equity

Debt Investments: High Yield Spreads by Credit Rating

Credit has performed well during 2018, especially in 3Q18, due to strong GDP growth and corporate earnings. Also, "high" yield credit remains well-bid as rates remain very low from a historical perspective. Interestingly, CCC-rated credits have performed the best in 2018 with spreads narrowing 131bp YTD and 23bp QTD while the upper end of the high yield market has seen spreads widen slightly since the beginning of the year.

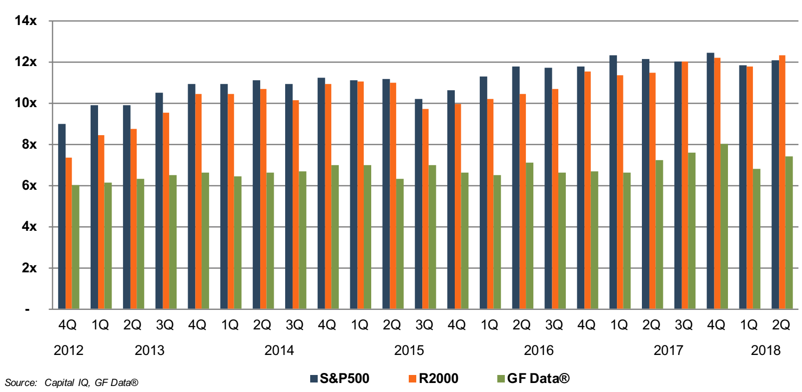


Source: BofA Merrill Lynch

Median EBITDA Multiple
Excludes financials

Equity Valuation: EBITDA Multiples over Time

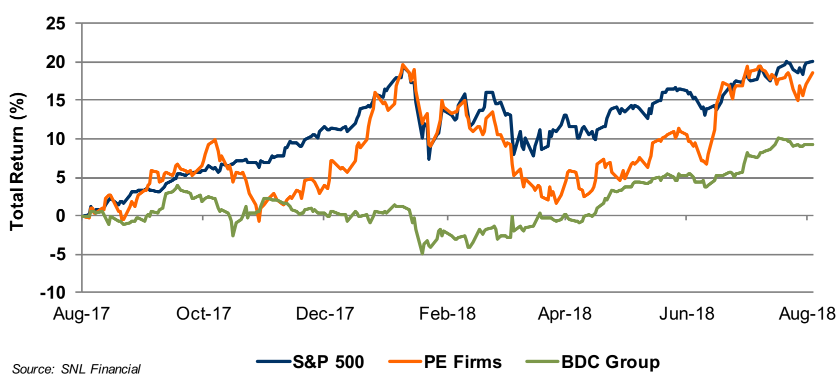
Since mid-2016 the gap between the valuation (EV/EBITDA) for non-financial companies in the S&P 500 and Russell 2000 has narrowed, in part because small cap companies tend to have higher effective tax rates and, therefore, benefit more from corporate tax reform. On the other hand, the spread between lower middle market acquisition multiples as compiled by GF Data® and the Russell 2000 has remained between 3.5x to 4.5x the past several years.



Source: Capital IQ, GF Data®
Excludes financials

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

Stocks posted a strong run in late 2017 through January 2018 as investors priced in lower corporate taxes and higher earnings as a result of tax reform. A sharp increase in volatility and profit taking pushed stocks lower over early 2018, but since then, equities have trended higher. BDC stocks did not participate in the late year rally (BDCs are pass-through entities that generally do not pay corporate taxes), but have performed strongly since February because the strong economy has created a benign, if not improving, outlook for BDC credit portfolios.

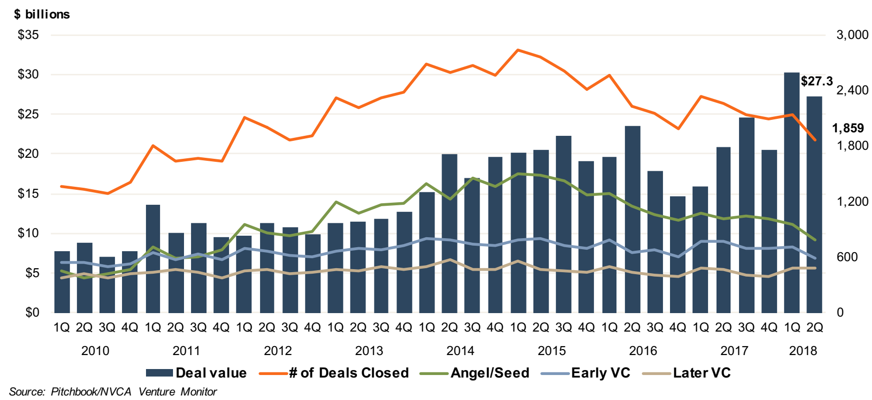


Source: SNL Financial

Venture Capital

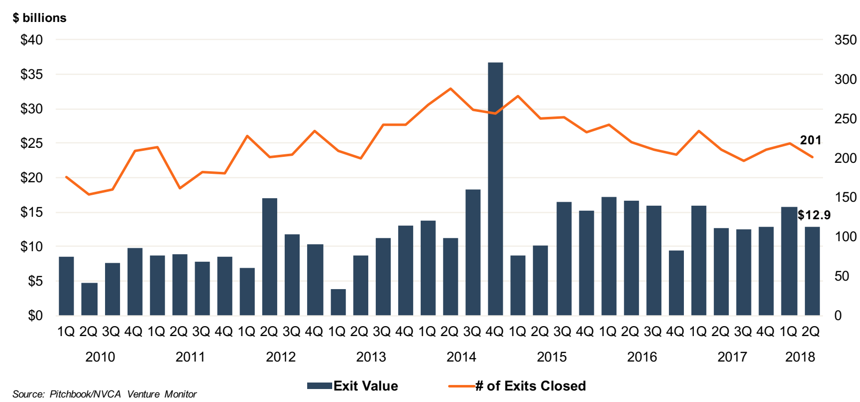
U.S. VC-Backed Funding Activity

Continuing the trend that emerged in venture funding in recent quarters, even larger amounts of funding were deployed to even fewer deals. Deal count fell to its lowest level since 2012, while deal value remained elevated at $27 billion. In general, investors appear willing to invest. The trailing twelve months have seen the most capital deployed of any period over the past two decades at over $102 billion.



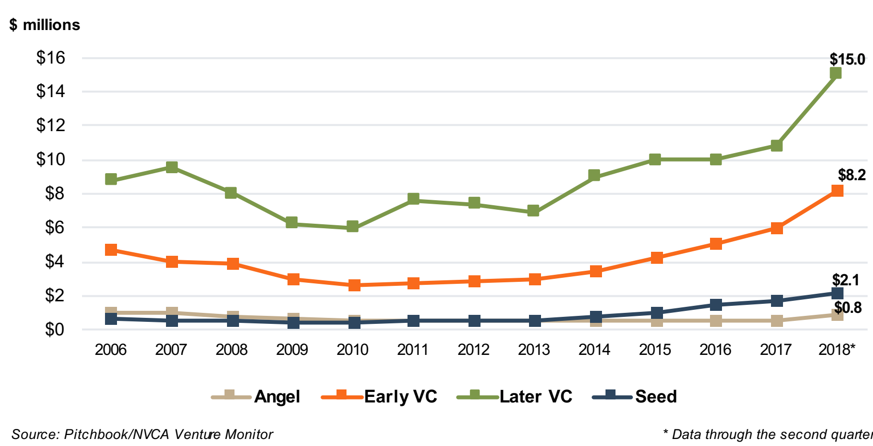
U.S. VC-Backed Exit Activity

IPO activity picked up again in 2Q18, though not as quickly as anticipated by many market participants due to slow exit activity overall. Total exit value was nearly flat with recent quarters at $12.9 billion. However, IPO exits accounted for one third of all dollars exited during the quarter at $4.1 billion.



Median Deal Size by Stage ($ millions)

The rapid growth in median deal size became even more pronounced in the first half of 2018, increasing by nearly 30% at each stage. The most dramatic increase can be seen at the later stage, where the median deal size increased 47% over 2017.



Mercer Capital

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

Contact Us

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

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

Mary Grace McQuiston
901.322.9720
mcquistonm@mercercapital.com

Megan E. 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