

Portfolio Valuation

Private Equity and Credit

Second Quarter 2022

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FEATURE ARTICLE

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Market Tenor

Cliff Asness, the co-founder of AQR Capital Management, raises a couple of interesting questions about investing in private equity in a recent Morningstar podcast that speak to his background as a “quant” who runs one of the largest and most successful quant-focused funds.

Asness questions whether private equity investors are “paying up” to invest in PE to avoid public market volatility whereby portfolios are marked-to-market each day. He thinks the answer is yes, and in doing so PE investors have (or may have) shifted to paying a premium for illiquidity. It seems like a preposterous notion because illiquidity is a universally accepted risk factor that is priced by investors by adding a premium to the discount rate.

Nobel Prize winner Daniel Kahneman, the father of modern behavioral economics, might argue Asness is not off base because individuals feel more pain from a loss compared to an equivalent gain. The dopamine released in a bull market is outweighed by the bile released in a bear market.

Marking private equity and credit investments in the second half of 2022 will be tricky compared to halcyon days of roughly 4Q20 through 1Q22 when monetary spigots were wide open and asset prices for everything boomed. Since then, a bear market has enveloped markets as central banks shift to fighting inflation. As of June 17, the S&P 500, NASDAQ and Russell 2000 indices are down 23%, 31% and 26% year-to-date. IPO and M&A activity has declined sharply, too.

Always Cash Flow and Earning Power

By Jeff K. Davis, CFA

So how does one value private equity and credit when financial conditions are tightening, IPO and M&A activity is moribund, and a recession may be developing?

The accountants provide perspective and guidance on valuation, but not precision beyond the preference hierarchy of Level 1 vs Level 2 vs Level 3 valuation inputs. ASC 820-10-20 defines fair value as, “*the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.*” Fair value from the accountant’s perspective represents the exit price of the subject asset for a market participant in the *principal or most advantageous* market.

Alternatively, years ago we once heard sage valuation advice given to an analyst who would one day become an executive: focus on getting earning power and all of the variables that drive it (e.g., revenue sustainability, margins, etc.) rather than the multiple.

Primacy of Cash Flow

Figure 1 (on the next page) provides a sample overview of the template we use at Mercer Capital. The process is not intended to create an alternate reality in which adjusted EBITDA is ridiculous due to a myriad of addbacks; rather, it is designed to shed light on core trends about where the company has been and where it may be headed. Adjustments are intended to strip-out non-recurring items and items that are not related to the operations of the business.

In addition, EBITDA is but one measure to be examined because EBITDA is a good base earnings measure, but it does measure cash flow, capex, working capital and debt service requirements.

The adjusted earnings history should create a bridge to next year’s budget, and the budget a bridge to multi-year projections. The basic question to be addressed: Does the historical trend in adjusted earnings lead one to conclude that the budget

and multi-year projections are reasonable with the underlying premise that the adjustments applied are reasonable?

The analysis also is to be used to derive “earning power,” which represents a base earning measure through the firm’s (or industry’s) business cycle. Therefore, the analysis requires examination of earnings over an entire business cycle. If the company has grown (or contracted) such that adjusted earnings several years ago are less relevant, then earning power can be derived from the product of a representative revenue measure such as the latest 12 months or even the budget and an average EBITDA margin over the business cycle.

Build-Up Multiples vs Transaction Multiples

Marking private equity (and credit) can be challenging during and after a period of extreme valuations that intuitively do not make sense. For instance, relying upon transaction data from 2021 when some valuations could be characterized as extreme relative to the pre-COVID years would not make sense if the subject company could not reasonably be expected to obtain the same multiple today. Stated differently, transaction data from a bubble is factual, but is it useful or just misleading?

Likewise, transaction data from a bear market such as the 4Q07-1Q09 is what it is, but the observations may not be relevant given the context of why a transaction occurred (e.g., distress).

One way to navigate the issue is to apply a fundamental discount to data to reflect a material change in market conditions. Another would be to put more weight on build-up methods where capitalization factors (multiples) are derived from the cost of capital, targeted capital structure and the expected long-term growth rates in a company’s debt-free earning power. Build-up multiples are used in the *Direct Capitalization of Earnings Method* and can be used in lieu of or in conjunction with transaction multiples to derive the terminal value in the *Discounted Cash Flow Method*.

Figure 1

Core Earnings Analysis	Budget	LTM	For the Fiscal Years Ended December 31				
	2023	06/30/22	2021	2020	2019	2018	2017
Units	1,525	1,488	1,390	1,190	1,223	1,267	1,221
x Average Price	\$9.85	\$9.55	\$9.50	\$8.95	\$9.20	\$9.25	\$9.00
Reported Net Sales	\$15,021	\$14,210	\$13,205	\$10,651	\$11,252	\$11,720	\$10,989
Adj (1) Acme Surcharge	0	(120)	(150)	(175)	0	0	0
Adjusted Net Sales	\$15,021	\$14,090	\$13,055	\$10,476	\$11,252	\$11,720	\$10,989
Reported Cost of Sales	9,175	9,109	8,438	7,775	7,145	7,395	6,868
Adj (2) None	0	0	0	0	0	0	0
Adjusted Cost of Sales	9,175	9,109	8,438	7,775	7,145	7,395	6,868
Adjusted Gross Profit	5,846	4,982	4,617	2,701	4,107	4,325	4,121
Reported Operating Expense	2,750	2,575	2,450	2,178	2,195	2,115	2,025
Adj (3) Facility Closure	0	0	(90)	(15)	0	0	0
Adj (4) Litigation Expense	0	0	0	0	(35)	0	0
Adj (5) Rebate Settlement	0	35	0	0	0	0	0
Adjusted Operating Expense	2,750	2,610	2,360	2,163	2,160	2,115	2,025
Adjusted Operating Income	3,096	2,372	2,257	538	1,947	2,210	2,096
Reported Other Inc/(Exp)	(530)	(450)	(410)	(370)	(360)	(350)	(345)
Adj (6) Loss/(Gain) on Asset Sale	0	(95)	(75)	50	120	(20)	65
Adjusted Other Inc/(Exp)	(530)	(545)	(485)	(320)	(240)	(370)	(280)
Adjusted Pre-Tax Income	\$2,566	\$1,827	\$1,772	\$218	\$1,707	\$1,840	\$1,816
EBIT, EBITDA, CapEx & WC							
Adjusted Pre-Tax Income	\$2,566	\$1,827	\$1,772	\$218	\$1,707	\$1,840	\$1,816
- Interest Income	(27)	(23)	(21)	(19)	(18)	(18)	(17)
+ Interest Expense	477	405	369	333	324	315	311
Adjusted EBIT	3,017	2,209	2,121	532	2,013	2,137	2,109
+ Depreciation & Amortization	750	710	660	530	560	590	550
Adjusted EBITDA	\$3,767	\$2,919	\$2,781	\$1,062	\$2,573	\$2,727	\$2,659
Reported Capital Expenditures	830	780	730	590	620	640	600
Adjusted EBITDA less CapEx	\$2,937	\$2,139	\$2,051	\$472	\$1,953	\$2,087	\$2,059
Incremental Working Capital	140	155	387	(116)	(70)	110	50
Adj EBITDA less CapEx & WC	\$2,797	\$1,984	\$1,664	\$588	\$2,023	\$1,977	\$2,009
Adjusted Margins							
Adjusted EBIT	20.1%	15.7%	16.2%	5.1%	17.9%	18.2%	19.2%
Adjusted EBITDA	25.1%	20.7%	21.3%	10.1%	22.9%	23.3%	24.2%
Adjusted EBITDA less CapEx	19.6%	15.2%	15.7%	4.5%	17.4%	17.8%	18.7%
Adj EBITDA less CapEx & WC	18.6%	14.1%	12.7%	5.6%	18.0%	16.9%	18.3%
Period-to-Period Growth							
Adjusted EBIT	36.6%	4.2%	298.6%	-73.6%	-5.8%	1.3%	
Adjusted EBITDA	29.0%	5.0%	161.8%	-58.7%	-5.7%	2.6%	
Adjusted EBITDA less CapEx	37.3%	4.3%	334.4%	-75.8%	-6.4%	1.4%	
Adj EBITDA less CapEx & WC	41.0%	19.2%	182.7%	-70.9%	2.3%	-1.6%	

Figure 2

Derivation of Capitalization Factor		June 2021		June 2022	
Risk-Free Rate		1.60%	1.60%	3.25%	3.25%
Equity Premium (Beta = 1.0)		5.50%	5.50%	5.50%	5.50%
Size Premium		3.50%	3.50%	3.50%	3.50%
Specific Company Risk Premium		2.00%	3.00%	2.00%	3.00%
Equity Discount Rate		12.60%	13.60%	14.25%	15.25%
Cost of Debt Financing		4.00%	4.00%	5.50%	5.50%
After-Tax Cost of Debt	25.0%	3.00%	3.00%	4.13%	4.13%
WACC with Equity Financing =	75%	10.20%	10.95%	11.72%	12.47%
- Earning Power Growth Rate		3.00%	5.00%	2.00%	4.00%
Capitalization Rate		7.20%	5.95%	9.72%	8.47%
Capitalization Factor (1/Cap Rate)		13.9x	16.8x	10.3x	11.8x
Determination of Value		June 2021		June 2022	
Revenues		\$150,000	\$150,000	\$135,000	\$135,000
EBITDA		30,000	30,000	25,000	25,000
<i>EBITDA Margin</i>		20.0%	20.0%	18.5%	18.5%
Depreciation Expense		10,000	10,000	10,000	10,000
EBIT		20,000	20,000	15,000	15,000
Taxes / (Benefit)	25.0%	5,000	5,000	3,750	3,750
After-Tax Income		15,000	15,000	11,250	11,250
Add: Depreciation		10,000	10,000	10,000	10,000
Less: Capex		(10,000)	(10,000)	(10,000)	(10,000)
Incremental Working Capital		(1,500)	(1,500)	(1,350)	(1,350)
Net Op Profit After-Tax NOPAT		\$13,500	\$13,500	\$9,900	\$9,900
Capitalization Factor (1/Cap Rate)		13.9x	16.8x	10.3x	11.8x
Capitalized Enterprise Value		\$188,000	\$227,000	\$102,000	\$117,000
Ent Value /2021 EBITDA	\$30,000	6.3x	7.6x		
Ent Value / 2022 EBITDA	\$25,000			4.1x	4.7x

An example of using a build-up to derive the capitalization factor (multiple) is presented in Figure 2. The method has subjectivity that unadjusted observed transaction data multiples do not have, but that is the beauty of the method as assumptions for risk and growth are varied depending upon the subject company's profile.

Build-up multiples are affected by market conditions, too. Changes in long-term interest rates are immediately reflected (the rising rate environment of 2022 translates into lower multiples on a stand-alone basis), while equity premia evolve over time as historical return data is updated.

The balance of 2022 is shaping up as a period when investors and plan sponsors may have more questions and disagreements about how assets are marked after 2022 when many asset values moved steadily higher from 2H20 through year-end 2021. Each investment will have its own facts and circumstances to consider, the primary one being the trend in earning power.

About Mercer Capital

Mercer Capital is a valuation and transaction advisory firm. Over the last four decades we have valued tens of thousands of equity and credit investments in virtually every industry and sub-industry grouping that exist in a variety of markets. We also have significant M&A experience. Please call if we can assist in the valuation of your portfolio companies.



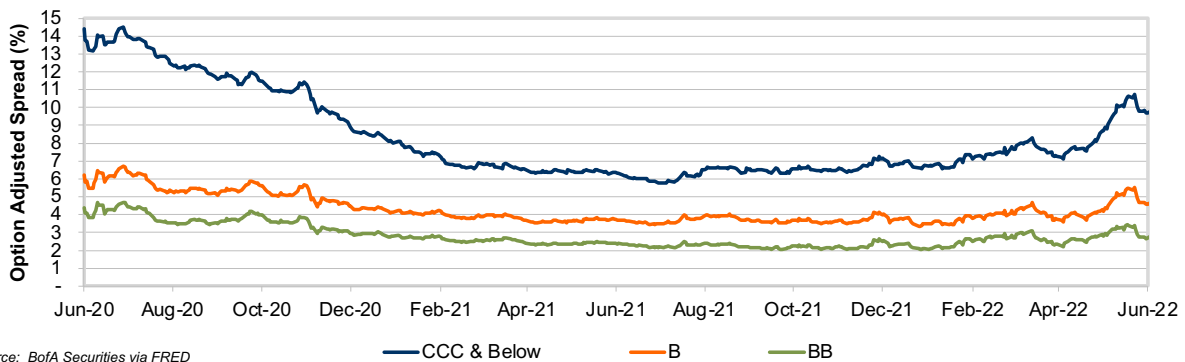
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Private Credit and Equity

CCC-rated high yield bonds (“triple-hook”) not surprisingly have seen the most widening in 2022 given growing investor concerns about a recession as the Fed has been forced to hike short-term policy rates more aggressively to contain inflation. CCC spreads were 1092bps as of June 16, 2022 compared to 678bps as of year-end 2021. B- and BB-rated high yield bonds have widened 209bps and 158bps, respectively. In percentage terms, widening is about the same for all three categories at 61%-CCC, 60%-B and 74%-BB.

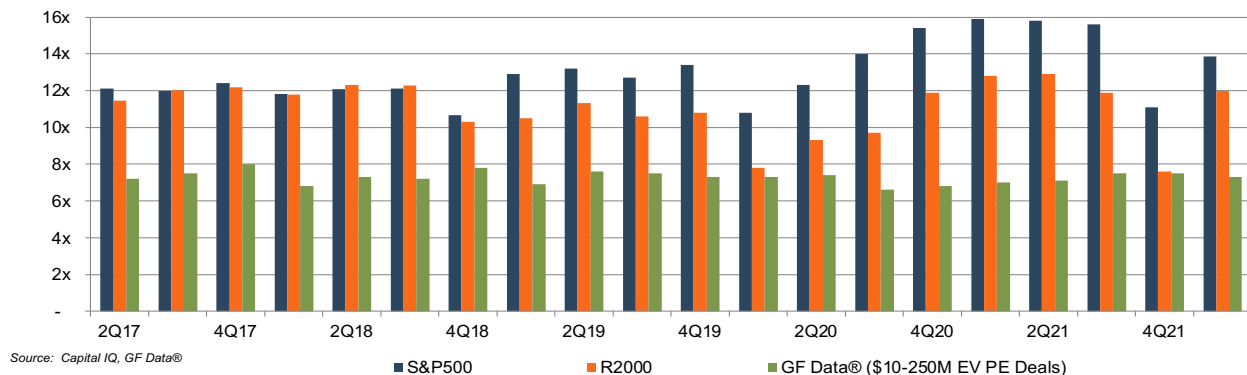
Debt Investments: High Yield Spreads by Credit Rating



The uptick in the LTM EBITDA multiple for both the S&P 500 and Russell 2000 (x-financials) from year-end 21 reflects strong corporate profitability and lower index values that fell further in the second quarter. While second quarter earnings are not available, the 2Q22 LTM multiples when available may not fall as much as the reduction in the indices would imply because corporate profits for some sectors x-energy may be pressured by cost inflation.

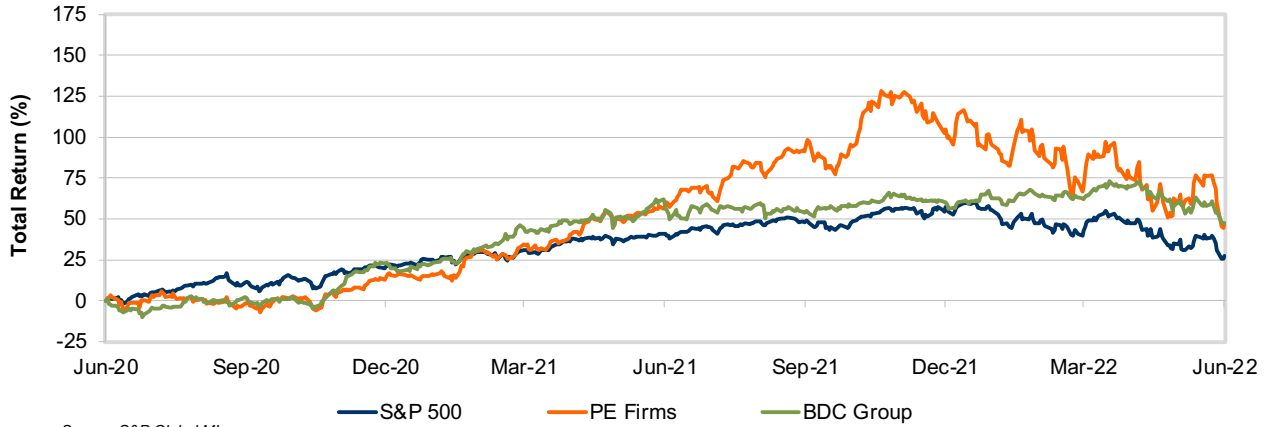
GF Data ® for multiples paid by private equity firms for companies with an enterprise value of \$10 million to \$250 million for 1Q22 eased to 7.3x from 7.5x in both 4Q21 and 3Q21 when deal activity was exceptionally heavy as more companies transacted after the 2020 disruption from COVID. Given growth in asset values generally, GF Data has expanded its dataset to capture deals in the \$250 to \$500 million. Preliminary data indicates the median multiple of adjusted (core) LTM EBITDA to be 12x. If so, this is consistent with years of data in which higher multiples are obtained generally for larger transactions and when the seller has superior financial characteristics as measured by growth and margin.

Equity Valuation: EBITDA Multiples Over Time



PE Firms (APO, ARES, BX, KKR and CG) posted stellar returns from June 30, 2020 through Thanksgiving 2021 with an average total return for the five companies of 125% compared to “only” ~60% for the S&P 500. Blackstone (BX) and KKR were notable standouts with peak gains in excess of 150%. Since then, the group has underperformed the market by giving up all of its 2H21 levitation as the prospect of a slowing economy, higher rates and lower equity values reduce unrealized gains and potential realized gains.

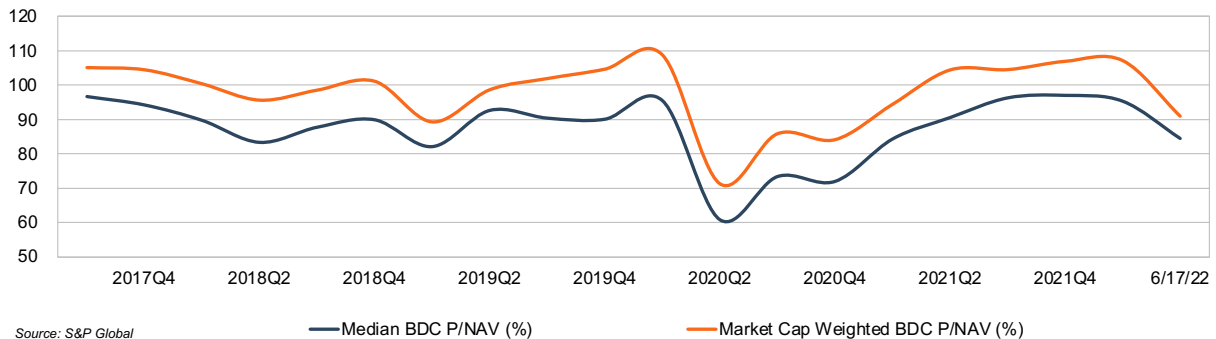
Stock Performance for Publicly Traded PE Sponsors: Total Returns (Trailing Twelve Months)



Publicly Traded Private Credit

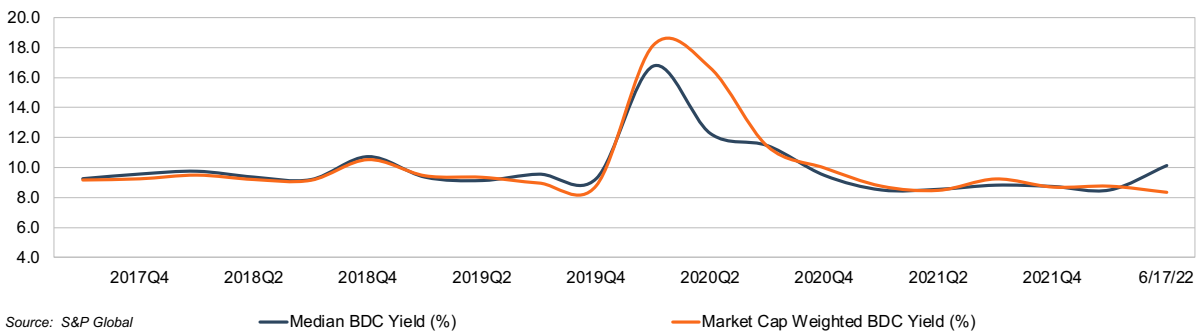
BDC prices softened in 2Q22 as equity markets fell and credit spreads began to widen. As of June 17, 2022, the median BDC P/NAV was 85% and the market cap weighted multiple was 91% down from 97% and 107% as of year-end 2021 and 95% and 107% as of March 31, 2022.

Price / NAV for Publicly Traded Business Development Companies



BDC yields fell by about 50% from the March 2020 panic highs to just above 8% as of year-end 2021. Since then the median yield has increased to 10% as credit spreads widened and equity prices declined; however, the yield weighted for market cap declined slightly to 8.1% as the market pays a premium for size and perceived quality.

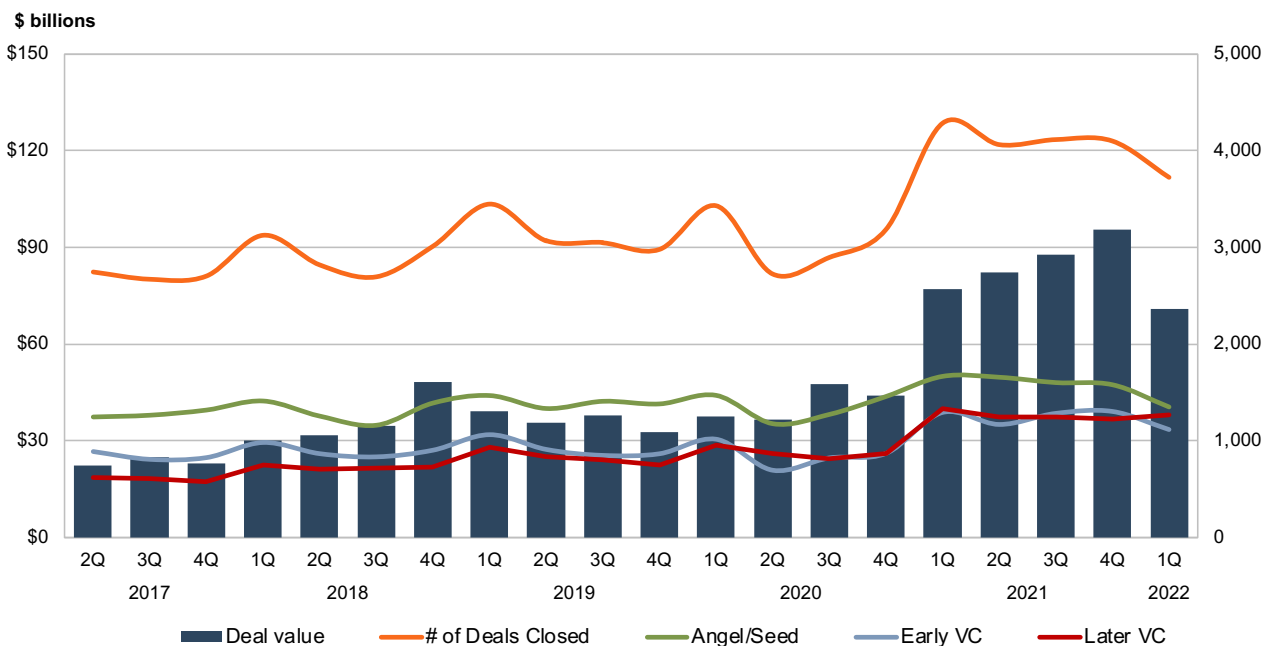
Long-Term Dividend Yield Trend



Venture Capital

1Q22 venture funding decreased to \$71 billion from prior quarterly records of ~\$95 billion in 1Q21 and 2Q21; both were significant records relative to the past several years when quarterly fundings ranged from \$20 billion to \$40 billion. The average funding per transaction decreased to \$19 million from \$23 million in 4Q21.

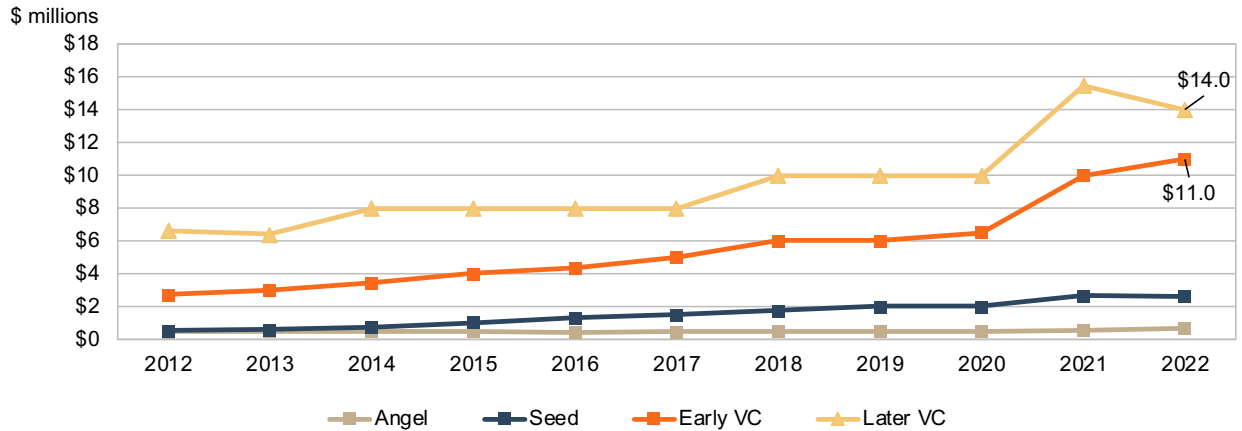
U.S. VC-Backed Funding Activity



Source: Pitchbook/NVCA Venture Monitor

Presumably the bear market that has developed in the public markets that is reflected in a ~31% reduction in the NASDAQ through June 17 will eventually impact venture funding if for no other reason exit multiples--for now--are less favorable than in 2021. Plus, M&A has slowed dramatically and few SPAC M&A deals are occurring. Nonetheless, the median early stage venture capital raise increased 10% in 2022 to \$11 million while late stage funding eased 10% to \$14 million.

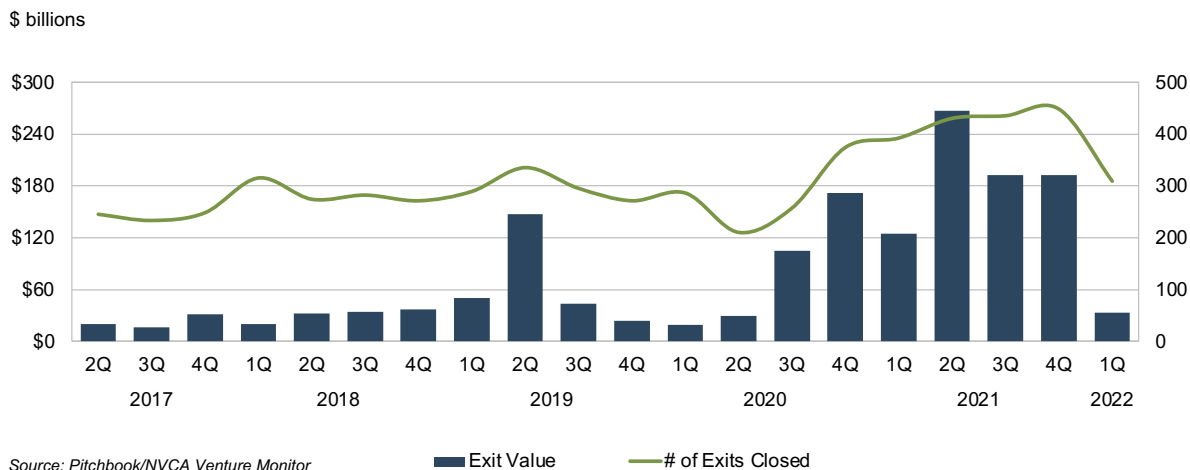
Median Funding by VC Stage (\$ millions)



Source: Pitchbook/NVCA Venture Monitor

1Q22 exits tumbled from ~\$180 billion in both 3Q21 and 4Q21 to ~\$30 billion. Exit data the next few quarters may decline given the sharp reduction in public market prices for many venture-backed companies the past few months.

U.S. VC-Backed Exit Activity



Source: Pitchbook/NVCA Venture Monitor

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.

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- Purchase Price Allocations
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Contact a Mercer Capital professional to discuss your needs in confidence.

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