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Venture Capital

Mid-Year 2016

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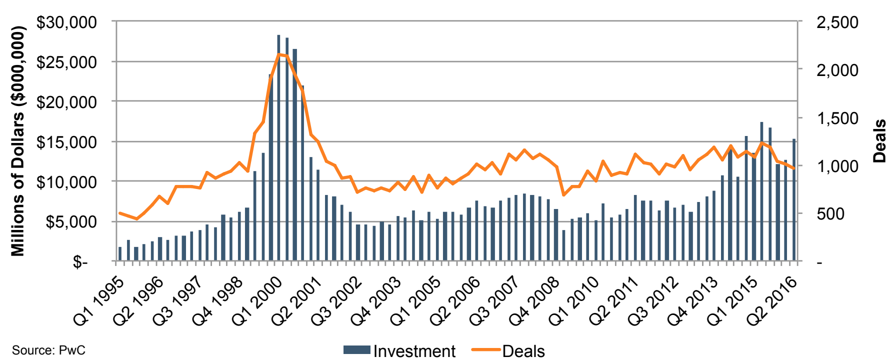
Mid-Year Market Perspective

Venture Capital Overview

The first half of 2016 has offered no respite from the sudden and drastic flight to safety that began in late-2015, and which led to a marked decrease in valuations, round counts, and public offerings in the venture capital industry. Spooked by market volatility and burned by the poor performance of several IPOs in 2015, many investors instead turned towards late-stage financings in companies with proven track records. The IPO market withered as an ever-increasing glut of capital in late-stage funding rounds led to an increasing preference for the relative safety of the private capital markets. The amount of capital invested in unicorns increased from 21% of total dollars invested in the first half of 2015, to 31% in the first half of 2016, while round counts fell 35% and exits declined from 500 in the first half of 2015 to only 329 in 2016.

Fundraising numbers were more promising, with a steady increase largely driven by a small number of large vehicles and a growing trend in LPs turning to venture capital and private equity as other asset classes have underperformed. Fundraising totals were up from $15.4 billion in the second half of 2015 to $22.6 billion in the first half of 2016. Much like the capital space, risk-aversion has led to a capital concentration in known managers, with only ten first-time VC funds closing in the first half of 2016. However, the level of fundraising has been a surprising sign of strength in an industry marked by a considerable decline in exits and deal counts that suggest a cooling of the investment cycle in the industry is eminent. The second half of the year will be a challenging landscape for investors and the industry alike to reconcile the growth in capital and pre-money valuations with the dearth of venture activity and IPO underperformance.

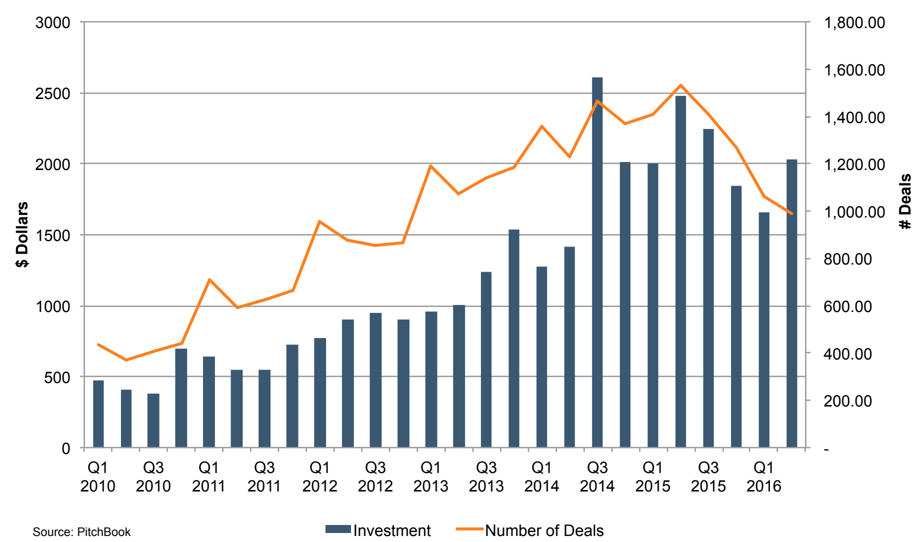
Venture Capital Overview



Venture Capital Activity by Stage & Quarter

Capital inflows have been largely concentrated in late-stage funding in the first half of 2016 due to a softening of investor confidence, creating newfound challenges for the overinflated seed and Series A rounds. Although capital remained abundant for those companies with strong performance metrics, year over year **dollars invested in seed/angel stage companies declined 18%** in the first half of 2016, while deal count numbers declined 30% over the same period. The decline in activity illustrates a shift in investor risk-tolerance towards mature companies and out-performers rather than a decline in investment altogether, as capital amounts have remained high and pre-money valuations across the industry are well above historical medians. Going forward, angel and seed activity is expected to plateau from the run-up experienced in 2014 and early 2015, with greater focus on reigning in over-exuberance.

Seed Activity



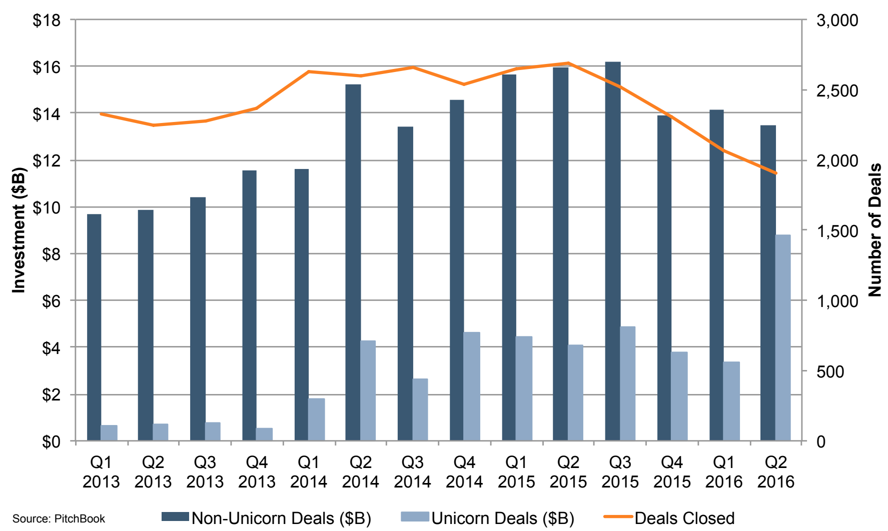
Source: PitchBook

Venture Capital Activity by Stage & Quarter

(continued)

In contrast, the first half of 2016 has seen an increase in unicorn financing from 21% of total financing in the first half of 2015 to 31% of total financing in the first half of 2016. In the second quarter of 2016 alone, $8.8 billion was sunk into unicorn deals, encompassing 39% of the $22.3 billion invested in the entire industry during the quarter. Even later stage financings have seen a perceptible shift towards proven performance and the rise of unicorn-financing, as expansion stage financings increased 8% year-over-year, while deal counts decreased 24% for the same period, and late stage financings decreased 2% year over year, while **deal counts fell 15%**.

Total Unicorn & Non-Unicorn Investments



Source: PitchBook

Exits Overview

Twilio and the Rise of Debt Financing

Despite the inhospitable IPO climate, one tech company managed to brave the market with just the right mix of novelty and disruption to garner attention and reap rewards. Twilio, a cloud communications platform designed to help developers add messaging, voice and video to web and mobile applications, went public on June 23. Priced at $15 per share, Twilio's share price closed at $28.79, the largest single-day increase of an IPO in over two years, which **increased the company's market cap by 95%** to nearly $2.4 billion. The next day, on June 24, the UK voted to leave the European Union. **Brexit effectively wiped out over $2 trillion in global equity**, ushering in weeks of market volatility and a freefall of the pound. Despite the global volatility, Twilio's share price as of June 30 was up to $36.50 per share. Optimistic investors lauded the IPO as an indication of a turnaround in the venture-backed IPO market, and for good reason. Over the 2010 to 2015 period, more than half of the 200 tech companies that went public were **trading below their initial IPO price** by mid-2016.

The number of venture capital exits completed in the second quarter of 2016 (153) was the **lowest total since the second quarter of 2010**, with only 19 venture-backed IPOs in the first half of 2016 (well below the 52 IPOs completed in the first half of 2015). As discussed previously, unfavorable IPO market conditions have led many companies to alternative exits such as M&A. A growing number of venture capital firms have also turned towards another source for cheap cash: debt.

Given the current interest rate environment, several unicorns, including Airbnb, Didi Chuxing and Uber, have capitalized on the cheap debt available in the market as an alternative to issuing more equity. The debt markets are proving unusually receptive to venture financing, for example giving Uber, a cash flow negative company with famously opaque financials, over $1.6 billion at 5.0%. Concerns over weaker credit standards in the banking industry have risen as competition for quality loans has driven down loan yields. Prolonged periods of low interest rates have compressed margins and **impeded any profitability gained from an increase in loan growth alone**. Since the Fed first announced progressive rate hikes in December, banks have positioned themselves as asset sensitive in order to benefit from an increase in rates that has yet to occur. In fact, thanks to Brexit and the wave of capital market uncertainty it created, the central bank has even **discussed *cutting* short-term rates**. In order to maintain profitability, banks need lending volume – which is where unicorns come in. Venture capital has taken advantage of the perfect storm that is the banking industry to acquire low-cost debt and build credit for future rate negotiations, should the need ever arise. In addition, private companies use **debt financing to avoid breaching the 2,000 accredited investor** threshold for remaining private. Crossing the 2,000 limit would require full disclosure of company financials, which could bring to light certain underperforming metrics these companies have been trying to overcome, as evidenced by their refusal to undergo an IPO. Whether more companies choose to go down the debt route is yet to be seen, but it is a financing vehicle that enables companies to avoid having to leave the sympathetic capital still available in private markets.

Exits Overview

Twilio and the Rise of Debt Financing

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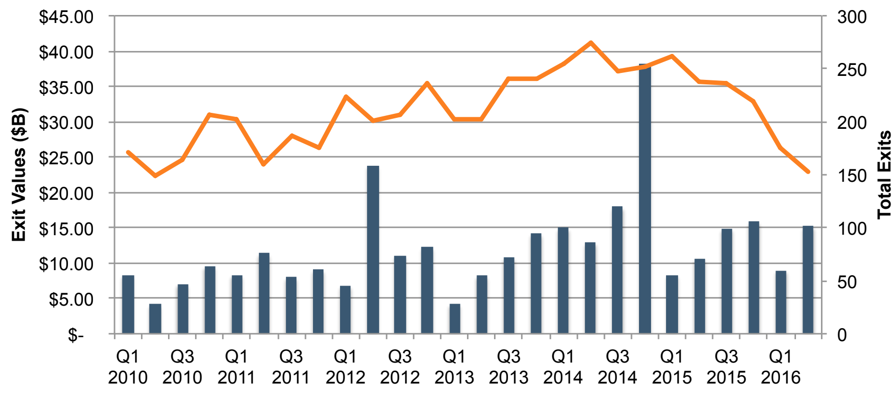
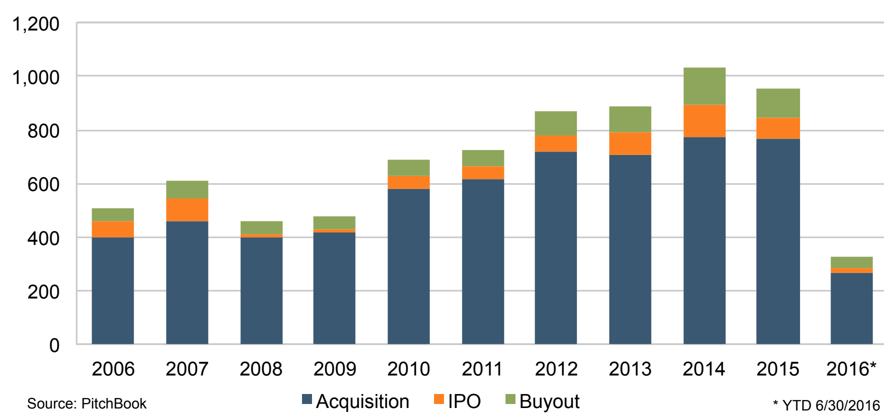
Exits by Quarter



Source: PitchBook

Exits by Type (#)



Source: PitchBook

* YTD 6/30/2016

Industry Focus: Regulation

This article, by **Madeleine Harrigan**, originally appeared on Mercer Capital's ***RIA Valuation Insights Blog.***

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It's no secret that ZIRP has pushed most portfolio managers farther out on the risk spectrum than anyone could have imagined just a decade ago – with many managers diving into the realms of venture capital and private equity, beyond the protective hand of government watchdogs. As a consequence, the SEC seems to be increasingly interested in implementing a series of new regulations designed to rein in the animal spirits of the previously untouched private market. Securities law has long operated under the assumption that sophisticated investors within the private market do not require the same amount of protections afforded the broader range of investors in the public market. However, an increasing number of retail investors – through pension plans, hedge funds, and mutual funds – are becoming involved in private placements through venture capital and private equity funds. The SEC has not shied away from growing its footprint in this area through Dodd-Frank and the JOBS act and has now turned its attention towards **establishing the frameworks and guidelines necessary to protect investors**.

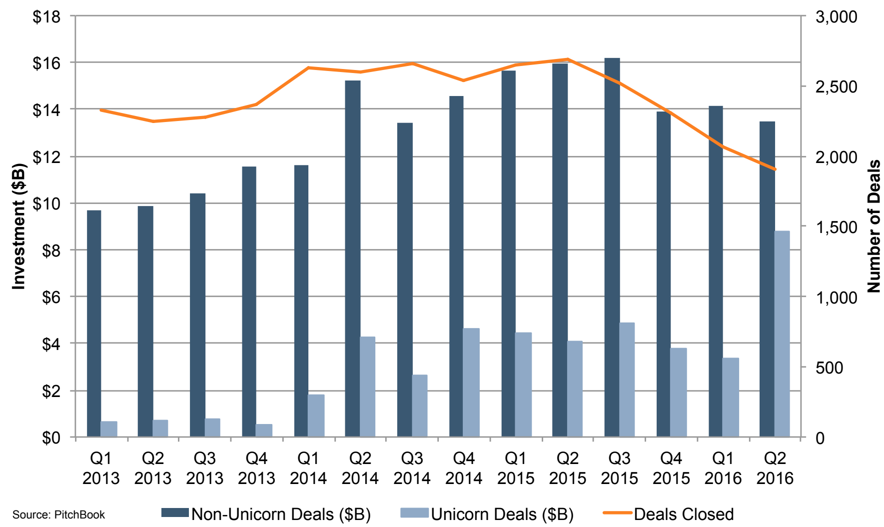
Recently, SEC Chair Mary Jo White gave a keynote speech to attendees of the **SEC's and Rock Center's Silicon Valley Initiative**, an event bringing together regulators, academics and entrepreneurs to discuss issues affecting venture capital and private equity within Silicon Valley. Although the audience may have been targeted, **White's speech provides insight into the SEC's concern** over the lack of transparency, governance and oversight in the PE and VC industries.

Both venture capital and private equity have witnessed an exponential growth in funding, due in part to a growing number of retail investors – guised as institutional platforms – accessing the private capital market. Combined with longer (i.e. indefinite) pre-IPO lifecycles **creating more and more inflated "unicorns"**, White has reason to worry. In the second quarter of 2016 alone, investors sank nearly $22.3 billion in venture capital, with unicorns receiving 39% of it. For venture capital firms, the amount of funding available in the private market as well as the poor track record and higher expenses associated with the public market leaves little incentive for an IPO. However, the risks associated with a high concentration of large amounts of capital within a relatively unregulated private market are a cause for concern.

Industry Focus: Regulation

(continued)

VC Activity by Financings of Unicorns



Source: PitchBook

In her speech, White focuses on a number of key concerns within venture capital and private equity:

1. Value Distortion

> *"In the unicorn context, there is a worry that the tail may wag the horn, so to speak, on valuation disclosures. The concern is whether the prestige associated with reaching a sky high valuation fast drives companies to try to appear more valuable than they actually are."*

Valuation can be subjective, especially within a speculative market such as venture capital in which reaching "unicorn" status brings publicity, prestige, and most importantly, funding. The SEC believes there is an endemic risk of distortion due to a lack of governance and internal controls, combined with a shift in investor sentiment that clearly favors bigger firms.

Industry Focus: Regulation

(continued)

2. Fiduciary Responsibility

> *"Whether the source of the obligation is the federal securities laws or the fiduciary duty that is owed to shareholders, the resulting candor and fair dealing should be fundamentally the same. And beyond any specific regulatory requirements, some of the principles that characterize public companies – transparency with investors, controls on financial reporting, strong corporate governance – have applicability and relevance to private companies, especially those pre-IPO companies that aspire to go public, and should not be overlooked or avoided, whether or not mandated by federal law or an SEC regulation."*

Even without explicit legislation, White makes it clear that venture firms have a fiduciary (a newly loaded term these days) duty to their investors. Within the private market, several state courts have also decided that shareholders in closely held corporations, such as a private company, owe an additional level of fiduciary duty to each other. In this respect, **shareholders are treated as partners**. White is therefore making the case that the SEC is not being egregious by demanding fair dealing, transparency and governance, when companies are (or should be) doing so already.

3. Widespread Market Effects

> *"So, if those participants [sophisticated investors] choose – with eyes wide open – to invest in private companies at valuations that may be ethereal or overinflated, who loses when the truth behind inflated valuations is revealed? I think we all do. […] To better understand what I mean, we need to look more closely at how these deals are done and structured, as well as the downstream effects on other market participants."*

Ensuring that investors are not defrauded by a misrepresentation of value is an issue that affects all market participants. The venture capital industry is currently defined by a sort of herd mentality, in which one bad IPO can spook an entire industry while one big winner can drive a deluge of capital. It is clear that the SEC has begun to further scrutinize deals in the interest of getting ahead of any potential dislocation of value for the sake of protecting the entirety of the market and the exorbitant amount of capital invested therein.

Industry Focus: Regulation

(continued)

4. Preventing Control Failures

> *"Rapidly growing enterprises present significant risks if the appropriate control structure is not in place. Time and again, we have seen companies go public and grow at a pace that exceeds their control structure."*

White is sure to make it clear that this is not the SEC's first rodeo, and she doesn't expect it to be the last. The question is no longer whether a failure of control will happen, but whether it will be great enough to both demand sweeping regulation of the venture capital and private equity industries.

Conclusion

Whether you are for or against increasing regulation in the private market, the SEC seems to be taking the stance that it's better to be safe than sorry. The potential for regulation has become more of a reality with the burgeoning involvement of non-traditional investors and excess of dry powder in both venture capital and private equity. Venture capital and private equity firms are encouraged to take a hard look at both their internal (portfolio management) and external (investor reporting) valuation practices. Imagine this environment if we have a meltdown of funding and valuations in private equity – the SEC may just be looking ahead.

Sector Focus

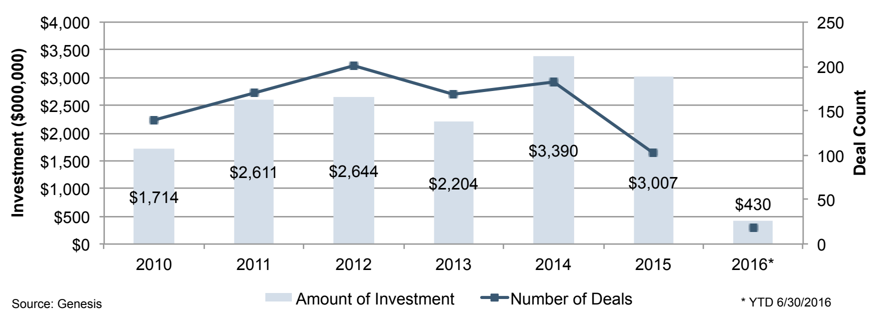
Biotech

The biotech industry has closely tracked the greater venture industry since 2014, with strong growth followed by unbridled excess in 2014 and early 2015, only to be dragged back to earth by a swift correction in the second half of 2015 and early 2016. By the second quarter of 2016, biotech investing hit a 15-year low as a share of venture capital at only 11%.

The biotech industry, however, has been anything but ordinary by venture capital standards. Even as biotech has declined as a percentage of venture capital activity, **biotech exit returns topped $79 billion** over the 2012 to 2015 period, more than doubling the $36 billion in capital deployed during the period. In addition, biotech has grown as a percentage of IPOs over the recent period, bolstered by funds from nontraditional investors such as hedge funds and public market "crossover" investors. Biotech accounted for nine of the twelve IPOs completed in the second quarter of 2016, **raising almost $900 million** in total. So, what gives?

For one, the biotech industry is somewhat esoteric. As anyone outside of the medical industry can attest to, understanding the burn rate and displacement of a tech app is much easier than understanding the clinical and regulatory environment behind the development of a biomedical device. As such, investing in technology has historically outpaced biotech investments, and may be indicative of **inefficiencies in the deployment of capital**. In addition, funding within the biotech industry is highly concentrated, with a **majority of funds going towards the largest 10%** of the financings. The same can be said for the public market, with a small minority of firms bolstering returns for entire funds, which has led to concerns over the sustainability of current share prices and the IPO environment for venture biotech companies. In this risk-off venture capital environment, the remainder of 2016 may be a tough sell for the biotech industry from both an investor and IPO standpoint.

Yearly Biotech Investments



Source: Genesis

* YTD 6/30/2016

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Venture Capital Services

Mercer Capital provides business valuation and financial advisory services to venture capital firms and other financial sponsors.

Our financial advisory services to the venture community include:

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- » Dispute Resolution
- » Buy-Sell Agreement Valuation
- » Carried Interest Valuation

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Fairness Considerations for Mergers of Equals

When asked about his view of a tie years before the NCAA instituted the playoff format in the 1990s, Coach Bear Bryant famously described the outcome as "kissing your sister." If he were a portfolio manager holding a position in a company that entered into a merger of equals (MOE), his response might be the same. Wall Street generally does not like MOEs unless the benefits are utterly obvious and/or one or both parties had no other path to create shareholder value. In some instances, MOEs may be an intermediate step to a larger transaction that unlocks value. National Commerce Financial Corporation CEO Tom Garrott once told me that part of his rationale for entering into a $1.6 billion MOE with CCB Financial Corp. in 2000 that resulted in CCB owning 47% of the company was because bankers told him he needed a bigger retail footprint to elicit top dollar in a sale. It worked. National Commerce agreed to be acquired by SunTrust Banks, Inc. in 2004 in a deal that was valued at $7 billion.

Kissing Your Sister?

MOEs, like acquisitions, typically look good in a PowerPoint presentation, but can be tough to execute. Busts from the past include Daimler-Benz/Chrysler Corporation and AOL/Time Warner. Among banks the 1994 combination of Cleveland-based Society Corporation and Albany-based KeyCorp was considered to be a struggle for several years, while the 1995 combination of North Carolina-based Southern National Corp. and BB&T Financial Corporation was deemed a success.

The arbiter between success and failure for MOEs typically is culture, unless the combination was just a triumph of investment banking and hubris, as was the case with AOL/Time Warner. The post-merger KeyCorp struggled because Society was a centralized, commercial-lending powerhouse compared to the decentralized, retail-focused KeyCorp. Elements of both executive management teams stuck around. Southern National, which took the BB&T name, paid the then legacy BB&T management to go away. At the time there was outrage expressed among investors at the amount, but CEO John Allison noted it was necessary to ensure success with one management team in charge. Likewise, National Commerce's Garrott as Executive Chairman retained the exclusive option to oust CCB's Ernie Roessler, who became CEO of the combined company, at the cost of $10 million if he chose to do so. Garrett exercised the option and cut the check in mid-2003 three years after the MOE was consummated.

Fairness Opinions for MOEs

MOEs represent a different proposition for the financial advisor in terms of rendering advice to the Board. An MOE is not the same transaction as advising a would-be seller about how a take-out price will compare to other transactions or the company's potential value based upon management's projections. The same applies to advising a buyer regarding the pricing of a target. In an MOE (or quasi-MOE) both parties give up 40-50% ownership for future benefits with typically little premium if one or both are publicly traded. Plus there are the social issues to navigate.

While much of an advisor's role will be focused on providing analysis and advice to the Board leading up to a meaningful corporate decision, the fairness opinion issued by the advisor (and/or second advisor) has a narrow scope. Among other things a fairness opinion does not opine:

- The course of action the Board should take;
- The contemplated transaction represents the highest obtainable value;
- Where a security will trade in the future; and
- How shareholders should vote.

What is opined is the fairness of the transaction from a financial point of view of the company's shareholders as of a specific date and subject to certain assumptions. If the opinion is a sell-side opinion, the advisor will opine as to the fairness of the consideration received. The buy-side opinion will opine as to the fairness of the consideration paid. A fairness opinion for each respective party to an MOE will opine as to the fairness of the exchange ratio because MOEs largely entail stock-for-stock structures.

Explaining the benefits of an MOE and why ultimately the transaction is deemed to be fair in the absence of a market premium can be challenging. The pending MOE among Talmer Bancorp Inc. (45%) and Chemical Financial Corp. (55%) is an example. When the merger was announced on January 26, the implied value for Talmer was $15.64 per share based upon the exchange ratio for Chemical shares (plus a small amount of cash). Talmer's shares closed on January 25, 2016 at $16.00 per share. During the call to discuss the transaction, one analyst described the deal as a "take under" while a large institutional investor said he was "incredibly disappointed" and accused the Board of not upholding its fiduciary duty. The shares dropped 5% on the day of the announcement to close at $15.19 per share.

Was the transaction unfair and did the Board breach its fiduciary duties (care, loyalty and good faith) as the institutional shareholder claimed? It appears not. The S-4 notes Talmer had exploratory discussions with other institutions, including one that was "substantially larger"; yet none were willing to move forward. As a result an MOE with Chemical was crafted, which includes projected EPS accretion of 19% for Talmer, 8% for Chemical, and a 100%+ increase in the cash dividend to Talmer shareholders. Although the fairness opinions did not opine where Chemical's shares will trade in the future, the bankers' analyses noted sizable upside if the company achieves various peer-level P/Es. (As of mid-July 2016, Talmer's shares were trading around $20 per share.)

Fairness is not defined legally. The Merriam-Webster dictionary defines "fair" as "just, equitable and agreeing with what is thought to be right or acceptable." Fairness when judging a corporate transaction is a range concept. Some transactions are not fair, some are in the range—reasonable, and others are very fair.

The concept of "fairness" is especially well-suited for MOEs. MOEs represent a combination of two companies in which both shareholders will benefit from expense savings, revenue synergies and sometimes qualitative attributes. Value is an element of the fairness analysis, but the relative analysis takes on more importance based upon a comparison of contributions of revenues, earnings, capital and the like compared to pro forma ownership.

Investment Merits to Consider

A key question to ask as part of the fairness analysis: are shareholders better off or at least no worse for exchanging their shares for shares in the new company and accepting the execution risks? In order to answer the question, the investment merits of the pro forma company have to be weighed relative to each partner's attributes.

- **Profitability and Revenue Trends.** The analysis should consider each party's historical and projected revenues, margins, operating earnings, dividends and other financial metrics. Issues to be vetted include customer concentrations, the source of growth, the source of any margin pressure and the like. The quality of earnings and a comparison of core vs. reported earnings over a multi-year period should be evaluated.
- **Expense Savings.** How much and when are the savings expected to be realized. Do the savings come disproportionately from one party? Are the execution risks high? How does the present value of the after-tax expense savings compare to the pre-merger value of the two companies on a combined basis?

- **Pro Forma Projected Performance.** How do the pro forma projections compare with each party's stand-alone projections? Does one party sacrifice growth or margins by partnering with a slower growing and/or lower margin company?
- **Per Share Accretion.** Both parties of an MOE face ownership dilution. What is obtained in return in terms of accretion (or dilution) in EBITDA per share (for non-banks), tangible BVPS, EPS, dividends and the like?
- **Distribution Capacity.** One of the benefits of a more profitable company should be (all else equal) the capacity to return a greater percentage of earnings (or cash flow) to shareholders in the form of dividends and buybacks.
- **Capital Structure.** Does the pro forma company operate with an appropriate capital structure given industry norms, cyclicality of the business and investment needs to sustain operations? Is there an issue if one party to an MOE is less levered and the other is highly levered?
- **Balance Sheet Flexibility.** Related to the capital structure should be a detailed review of the pro forma company's balance sheet that examines such areas as liquidity, funding sources, and the carrying value of assets such as deferred tax assets.
- **Consensus Analyst Estimates.** This can be a big consideration in terms of Street reaction to an MOE for public companies. If pro forma EPS estimates for both parties comfortably exceed Street estimates, then the chances for a favorable reaction to an MOE announcement improve. If accretion is deemed to be marginal for the risk assumed or the projections are not viewed as credible, then reaction may be negative.
- **Valuation.** The valuation of the combined company based upon pro forma per share metrics should be compared with each company's current and historical valuations and a relevant peer group. Also, while no opinion is expressed about where the pro forma company's shares will trade in the future, the historical valuation metrics provide a context to analyze a range of shareholder returns if earning targets are met under various valuation scenarios. This is particularly useful when comparing the analysis with each company on a stand-alone basis.
- **Share Performance.** Both parties should understand the source of their shares and the other party's share performance over multi-year holding periods. For example, if the shares have significantly outperformed an index over a given holding period, is it because earnings growth accelerated? Or, is it because the shares were depressed at the beginning of the measurement period? Likewise, underperformance may signal disappointing earnings, or it may reflect a starting point valuation that was unusually high.
- **Liquidity of the Shares.** How much is liquidity expected to improve because of the MOE? What is the capacity to sell shares issued in the merger? SEC registration and even NASADQ and NYSE listings do not guarantee that large blocks can be liquidated efficiently.
- **Strategic Position.** Does the pro forma company have greater strategic value as an acquisition candidate (or an acquirer) than the merger partners individually?

Conclusion

The list does not encompass every question that should be asked as part of the fairness analysis for an MOE, but it points to the importance of vetting the combined company's investment attributes as part of addressing what shareholders stand to gain relative to what is relinquished. We at Mercer Capital have over 30 years of experience helping companies and financial institutions assess significant transactions, including MOEs. Do not hesitate to contact us to discuss a transaction or valuation issue in confidence.

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