Q2 2017 EDITION

Pursant
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DEAL insider
M&A and Strategic Transaction Insights

THE INVESTMENT BANK THAT ALSO BUILDS THE VALUE OF YOUR BUSINESS

Q2 2017 Highlights:

- Deal activity remains healthy despite stalled deal friendly Trump policies
- The Fed continues to be restrained in rate increases, keeping cash for deals cheap
- Transaction multiples remain frothy, especially for better businesses

Pursant's Thoughts on H2 2017

- More of the same as H1 unless real tax and regulatory reform gets passed
- No Fed rate increases likely until Q4 at the soonest
- No end in sight to the 10,000 baby boomers retiring each day

Q2 2017 Middle Market M&A Activity Healthy, with Lower Middle Market the Strongest

Data and sentiment for the second quarter of 2017 indicates a healthy middle market deal environment. Deal activity is not as robust as many had hoped, but 5,260 middle market deals still were completed in the first half of 2017, according to data from Thomson Reuters. That represents a 12 percent increase over the 4,694 deals that closed in the first half of 2016. Until the timetable on tax reform and other expected Trump administration policies is known, we don't expect deal activity to surge.

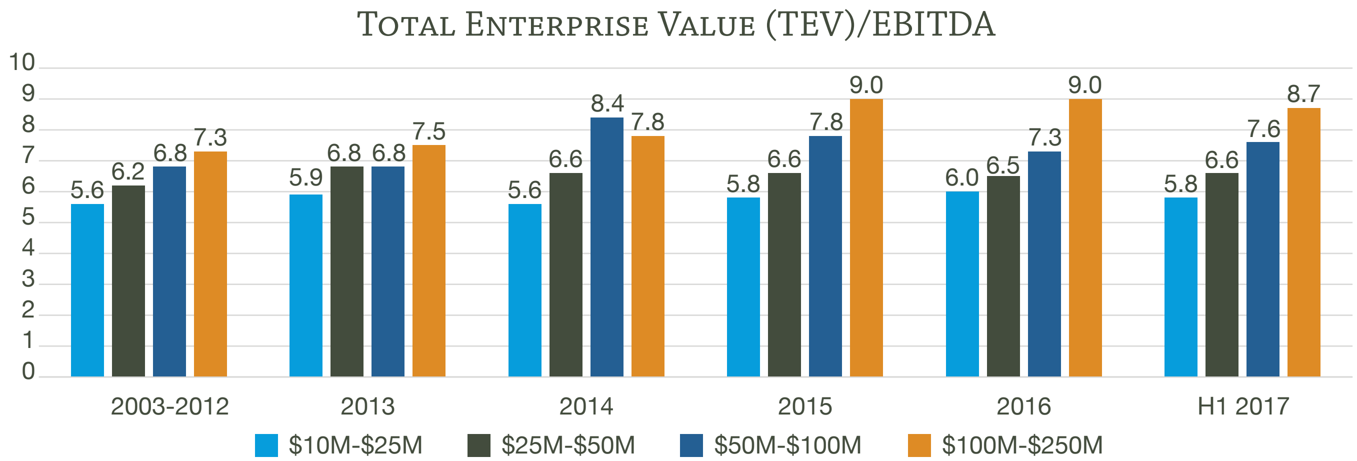
Other fundamental drivers of buyer and seller activity remain in place; these include a low cost of capital, a favorable tax environment and challenging organic growth for strategics. Pending tax and regulatory reform continues to be a distraction in deal making discussions, but has not caused truly motivated parties to delay pursuing a deal. Despite the struggle to grow the top line organically, business owners still feel optimistic overall, which compels them to pursue an M&A strategy to bolster growth. For these reasons, we do not expect deal volume to materially increase or decrease during the second half of 2017.

One of the drivers of M&A activity in the lower middle market (sub $250M in enterprise value) that separates it from the rest of the middle market ($250M-$1B in enterprise value) is the aging population of baby-boomer owners looking to sell their companies, regardless of market conditions. 10,000 baby boomers retire each day. Many of these retirees own businesses and have no succession plan; therefore, they must sell. For this reason, we see the lower middle market activity fairly insulated from typical drivers of deal volume.

The M&A Insider is a quarterly publication offering analysis of the marketplace and climate for middle market mergers, acquisitions and strategic transactions. Our emphasis is on transactions with a total enterprise value of less than $250M. Our goal is to arm business owners and other parties with insight to help prepare for such transactions in order to maximize transaction outcomes.

Transaction Multiples—Chart #1 shows that Lower Middle Market EBITDA multiples, measured by Total Enterprise Value (TEV)/EBITDA, remain stable, with an average of 6.9x for transactions YTD through Q2 2017—consistent with the 6.9x in 2016. In spite of moderate Fed rate increases, there is continued strength in these multiples. Because the Fed has not signaled material rate increases in the near term, we expect to see this level of multiples maintained.

Chart #1



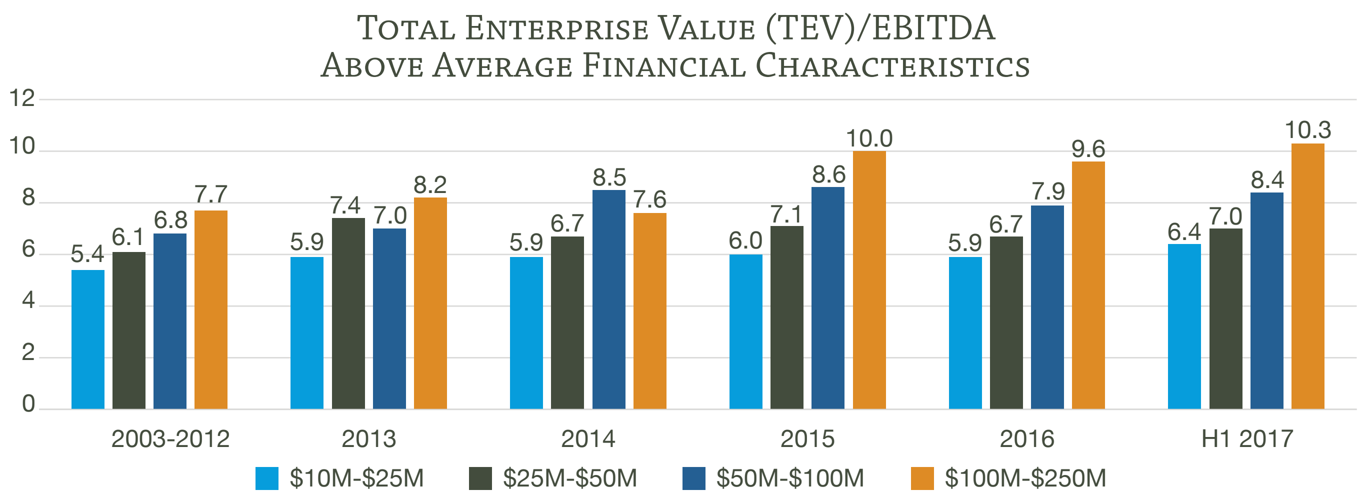
Source: GF Data®

The Quality Premium—The reward in valuation extended to "better" financial performers is at a record high of 33 percent (Chart #2). This premium is especially pronounced on larger transactions.

We define better financial performers as businesses with Trailing Twelve Months (TTM) EBITDA margins and revenue growth rates both above 10 percent, or one measure above 12 percent with the other at least 8 percent. Outliers on the high side are also excluded.

At $100M-$250M TEV, better financial performers are valued at an average of 7.8x, compared to an average of 6.9x for the entire cohort. At $10M-$25M, the above-par performers averaged 6.4x, compared to an overall measure of 5.8x.

Chart #2

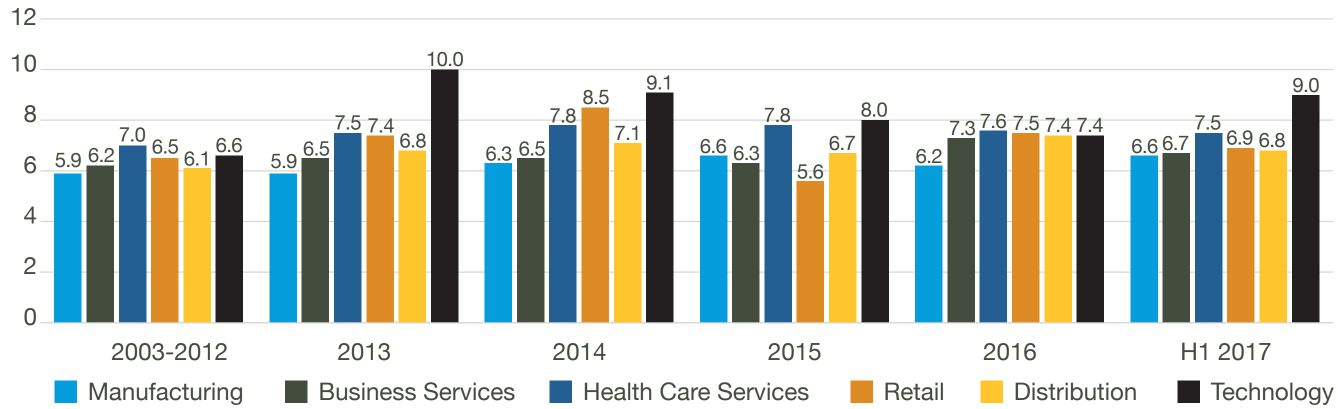


Source: GF Data®

The Middle Market by Business Category—Valuation differentiation also can be seen when comparing fast growth sectors (i.e. Healthcare and Technology) to more mature sectors that don't benefit from the same rate of growth. See Chart #3 for this comparison.

Chart #3

Total Enterprise Value (TEV)/EBITDA by Category



Source: GF Data®

EBITDA Defined—*For most middle-market businesses, valuation is typically expressed in the form of a multiple of EBITDA (earnings before interest, taxes, depreciation and amortization)—a measurement of a company's ability to generate cash flow. EBITDA figures also serve as a barometer of the company's health and performance. Multiples of EBITDA vary greatly depending on a company's risk profile, the markets in which it operates and the likelihood of continued returns.*

The US Macroeconomic Picture for Q2 2017

GDP—The US economy grew an annualized 2.6% in Q2, following a downwardly revised 1.2% growth in Q1, which matched market expectations. The growth got a boost from a rise in business equipment investment, consumption, and federal government spending. In contrast, residential fixed investment declined and exports and nonresidential fixed investment slowed. This conservative GDP growth rate will contribute to the Fed's unwillingness to increase lending rates.

Consumer Sentiment—U.S. consumer sentiment finished Q2 at 95.1, sinking 2.1 percent from May and hitting the lowest level since November 2016. Still, the first six months of the year yielded the highest average for the index since the second half of 2000.

While uncertainty in the overall economy remains high, the financial strength of consumers is increasing.

Business Confidence—The U.S. Manufacturing PMI finished Q2 2017 at 52.1 in June, down from 52.7 in May and well below market expectations of 53. It was the lowest reading since September 2016. In Q2 2017, output and new business growth slowed, offsetting contributions from job creation and inventory building. The relatively subdued PMI reading suggests that many are suspect of how much GDP will improve and how soon.

Unemployment—The U.S. unemployment rate surprisingly rose to 4.4 percent in June 2017 from the previous month's 16-year low of 4.3 percent, missing market expectations of 4.3 percent. The number of unemployed persons was little changed at 7.0 million, while the labor force participation rate edged up to 62.8 percent. Since January of this year, the unemployment rate and the number of unemployed persons are down by 0.4 percentage points and 658,000, respectively.

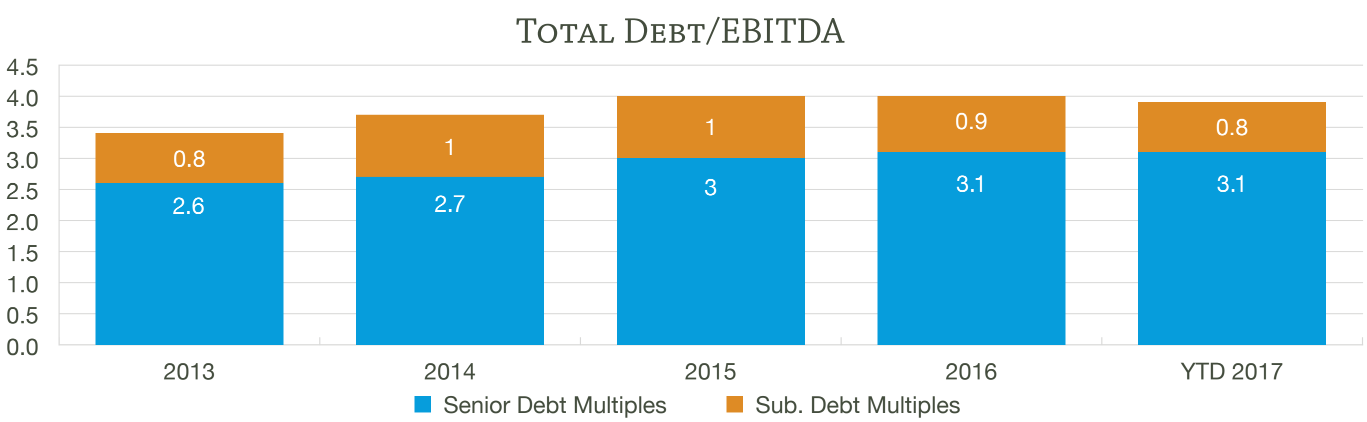
Fed Lending Rate—In view of realized and expected labor market conditions and inflation, the Fed decided to maintain the target range for the Federal Funds Rate at 1 to 1-1/4 percent. The stance of monetary policy continues to support further strengthening in labor market conditions and a sustained return to 2 percent inflation.

Pursant watches these macro-economic indicators because the direction and performance of the greater economy provides hints as to whether the Middle Market is heading into favorable or less favorable phases of the business transfer cycle. The business transfer cycle continually moves through periods that do or do not favor sellers. *Given low interest rates and good macroeconomic conditions, we are still solidly placed in a phase of the business transfer cycle that favors the seller for valuation purposes and buyers for access to capital to fund M&A activity.*

Leverage Multiples—Chart #4 shows that lenders are still ready, willing and able to finance acquisitions, and that buyers—especially financial buyers—are willing to borrow heavily to get deals done. Combined senior and sub M&A related debt in H1 2017 averaged 4x EBITDA, continuing the steady rise we have seen over the course of this decade.

To learn more about using leverage in a strategic transaction, see this month's article: ***Leverage Buyout Model—Why Buyers Use It and What a Business Owner/Executive Needs to Know About It.***

Chart #4



Source: GF Data®

Purchase Agreement Pot Luck—What is Rep and Warranty Insurance and is it right for your deal?

Eric Wasowicz, Pursant Sector Specialist

Rep and Warranty insurance was just introduced to the M&A market within the last two decades and it is becoming an increasingly popular tool for helping get deals done. However, it's not an option in every deal.

It is not uncommon for a breakdown to occur in the purchase agreement negotiation stage when the parties cannot agree on how to handle reps and warranties and how to protect the buyer against exposure to the seller's potential business issues (or the seller too, for that matter). Buyers and sellers must be able to agree on the allocation of exposure with respect to unknown risks and liabilities of the business. Representation and warranty insurance (RWI) protects the insured against ***unintentional and unknown*** breaches of a seller's representations and warranties made in the acquisition or merger agreement. It can add an extra layer of protection for the buyer if needed or serve as the buyer's sole source of recovery. Some questions you will have to answer in order to pursue this policy include:

- Is it a buy side or sell side policy?
- Who is requesting the coverage and why?
- Is it a stock or asset purchase?
- Who will be responsible for paying the premium?

Materials you will have to present to an underwriter:

- Financials of the company being purchased
- Quality of Earnings Report
- Final Purchase Agreement
- Confidential Information Memo and/or management's presentation on target company
- Signed Letter of Intent (if available)
- Anticipated closing date (typically the carrier needs between 30-60 days to finalize things)
- Written legal due diligence (if available)
- If available, specifics on the coverage requirements, i.e. limits, wording, etc.

Premiums for RWI policies generally range from 2% to 4% of the policy's coverage limit, which is typically equal to the escrow amount or a portion thereof. For example, a $10 million policy (which is generally the minimum policy size available) will generally cost between $200,000 and $400,000.

When employed early, RWI may increase deal value and may make the difference between whether or not a deal gets done.

Ensuring Acquisition Success—Don't Fall Victim to These Common Mistakes When Making Your Next Acquisition

Brian Steffens, Pursant Managing Director

When purchasing a privately held middle market business, there are risks that can reduce the likelihood of a successful outcome. Here are the common high-impact risk areas you should be aware of to increase your probability of success.

Overpaying: Buyers can get emotionally attached to specific acquisition opportunities. They will find a host of reasons to justify paying a certain price in the heat of battle. They ignore their professional skepticism when explanations of future growth do not reconcile with the current or past performance; or they exhibit hubris, thinking their team can fix the fatal flaws in a business and "that won't happen to us." They will use tools like "what if" financial models to justify their conclusions versus having that analysis contribute to an objective conclusion. To avoid these issues, commit to a formal proactive, non-emotional acquisition criteria and process. Have a well-defined deal thesis that integrates into your overall business growth plan. Establish a consistent and robust process for evaluating each opportunity to keep you grounded and focused. Lastly, make sure you are constantly sourcing opportunities. This will allow you some comfort in walking away if the deal structure or price moves unfavorably relative to your established acquisition goals.

Decision Making / Leadership: M&A success requires decisions to be made in a timely manner and with conviction, often with less than perfect information. Failure to have a well-defined decision-making process will delay decisions and stall the deal cycle. This lack of decision making can cause lost opportunities or strained goodwill with the counterparty. If the decision to be made is not easy, make sure to foster an environment in which management can safely challenge an owner, CEO or President. Healthy debate is good if it results in uncovering and identifying opportunities, risks and mitigation plans that inform a decision. Before embarking on an acquisition program, analyze how decisions are made in the organization. Document what information and what analysis you will need to complete in order to make a decision. Lastly, designate who will be part of the decision-making process.

Communication: A comprehensive communication plan is needed, and should cover the employees (target and buyer), customers (emphasis on the top 10 of both the target and buyer), regulators (if applicable), investors, communities and associations. An ineffective communication plan will cause the buyer to relinquish control of the narrative to external forces (i.e., competitors) or internal forces (i.e., disgruntled or fearful employees.) Failure to stay in clear control of the message also will cause speculation that results in inefficiencies and reduced productivity. Spend time before you complete the acquisition to consider what key stakeholders need to know and when. Review and revise that plan as the specifics of the deal come into focus. Identify key influencers within the organization that can cross over functional area silos to impact and drive the message.

Risk Identification: Companies tend to gravitate towards the legal and financials during due diligence because they are more tangible and easier to understand. But hasty or incomplete due diligence that places a heavy focus on financial and legal diligence at the expense of the Commercial, Operational, Cultural and IT systems will miss risks associated with key deal value drivers. Missed risks may cause a company to ineffectively structure the deal as it pertains to the amount of cash at close versus the amount held in the form of contingent payments tied to future performance. For example, failure to conduct thorough due diligence regarding the core values of the target business can lead to clunky attempts to integrate its work force and a loss of talent and tribal knowledge that could slow or derail integration of business operations and execution of business strategy. Companies tend to gravitate towards the legal and financials because they are easier and more well developed as an important part of the due diligence process. Don't neglect the other areas and be sure to involve experts where necessary to ensure thorough risk identification.

Value Capture: The integration phase of a deal is where savings and value are realized. An integration that is poorly scoped and executed can make a good deal go bad. Less seasoned acquirers often naïvely believe that integration execution will be easy. But those opportunities do not come naturally, easily, or without focused effort. Integration execution requires attention to the critical tasks tied to the key value drivers of the transaction, which requires multi-functional expertise and project management skills. Prioritize the top 20% of the tasks that drive 80% of the value. Ensure that these tasks are assigned ownership and oversight. Fully understand all cost and revenue synergy levers and translate them into executable plans. Take into account finance, payroll, compliance and people, which are typically Day 1 issues, but don't neglect brand protection, customer retention, service disruption, channel conflicts and product value.

Evolution: Failing to do a post-mortem review of each deal will doom a company to repeat the same mistakes with each transaction. Take the time to share with the team openly what worked, what did not, what was more challenging than anticipated and thoughts on how to improve the process in the future.

While there are many things that can go wrong during a transaction, focusing on these high-impact areas can increase your success rate, regardless of your experience.

Leverage Buyout Model – Why Buyers Use It and What a Business Owner/Executive Needs to Know About It

Scott Glickson, Pursant Managing Director

The leveraged buyout ("LBO") model has been in use since the 1950s; however, it was during the 1980s that it gained widespread use and became a "household" name to those within the M&A community. One of the most well-known LBOs still considered the largest (inflation adjusted), was the 1989 $30 billion acquisition of RJR Nabisco. A book and later a movie entitled "Barbarians at the Gate: The Fall of RJR Nabisco" chronicled the event.

Today, the LBO is one of the more frequent business practices used to execute a business acquisition. While it is used by all different types of buyers, it is commonly associated with financial buyers such as private equity investors.

So what is an LBO and why is it so appealing to acquirers? An LBO is an acquisition of a company in which the purchaser invests a small amount of equity and relies on a larger amount of borrowed funds to finance the remainder of the purchase price. This is very appealing to buyers as (i) it enables acquisitions without having to commit a lot of capital and (ii) debt capital is less expensive (relative to other forms of capital), which serves to reduce the overall cost of financing the acquisition and results in higher returns on investment. For these two reasons, leveraged transactions typically have higher valuations when compared to unleveraged acquisitions.

Debt financing for transactions with middle and lower middle market companies ranges from 40% to 60% of the purchase price. The level of debt financing available for a transaction is based on the characteristics of the industry, business model and a specific company's risk and financial profile. In addition to favorable macro-economic conditions, factors that result in more favorable debt financing include businesses with (i) a history of stable cash flows—this is critical as the buyer needs comfort that the acquisition debt can be serviced and paid down; (ii) strong growth prospects; (iii) experienced management team; (iv) low fixed costs; and (v) moderate capital spending and R&D. Also, the relationship between the investor and the lending institution plays a significant role in determining the total debt available for the transaction—the better the relationship, the more financing available (typically).

For an extreme example, assume a buyer purchases a business using all debt capital. Over time, the debt is repaid using the operating cash flows of the business. This is a critical assumption at the time of acquisition that must hold true for the LBO model to work. When the business is sold, outstanding debt, if any, is paid off with the proceeds from the sale. The remaining proceeds are pocketed by the buyer. In this example, the buyer invested zero capital at the time of the acquisition but received the proceeds (after paying off the remain debt) at the sale.

In the "real world," buyers rarely can use all debt capital to purchase a business. Lenders require buyers to contribute some level of equity capital. They like to see buyers have some "skin in the game."

Financial buyers, such as private equity groups, are aggressively seeking acquisition opportunities. For this reason, business owners considering a sale transaction should have an understanding of how and why this model works. Equally important, business owners should regularly assess whether there are operational and/or organizational changes that can increase the likelihood of a buyer using debt capital to acquire their business, thus increasing the size of a potential buyer pool.

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Pursant's Expectations for H2 2017

There is a lot optimism about the strength of middle market deal activity in the second half of 2017. July and August showed brisk activity and if the Trump administration can get tax reform into play and other policies favorable to deals passed, the anticipated surge will finally happen. Given all of the dissension within the Republican party and the related difficulties in getting reform passed, the surge will not come easy. But even some reform will help add fuel to the M&A fire. In the words of Ronald Reagan, "a half a loaf of bread is better than none."

As we discussed, the Fed appears to be sitting tight until later in the year as it relates to rates. The resulting affordable capital will help keep valuations healthy. The fact that the economy is expanding at 2.6% in Q2 is markedly better than Q1's dismal 1.2%, but until the economy is consistently hitting its growth mark, rates will remain low.

Strategic buyer balance sheets remain flush with cash and PE buyers are still seeking to deploy a record amount of capital overhang (see the Q1 2017 M&A Insider for more on this). With sluggish GDP growth, all types of buyers are struggling to meet revenue growth objectives through purely organic strategies. They need to acquire good businesses to augment their lackluster organic growth.

Lastly, as discussed earlier, the lower middle market has its own unique driver that sets it apart from the rest of the middle market: the high average age of business owners. The growing number of owners retiring will continue to push businesses to market, providing a healthy supply of M&A opportunities over the long term.

Pursant helps business owners grow the value of their companies and maximize that value in a liquidity event, partial sale or complete exit.

Our Investment Banking, Strategic Transaction Support and Business Value Enhancement business units use a deep immersion process, our expansive networks and experience as owner/operators and dealmakers to optimize businesses, manage strategic transactions and orchestrate liquidity events — vital, integrative initiatives for which our clients may not have the time, manpower or expertise.

To learn more about how Pursant can help you, contact Mark Herbick at mherbick@pursant.com, call 847.229.7000 or visit www.Pursant.com.

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