Q3 2016 EDITION

Pursant
INSPIRED PURSUIT

DEAL insider
M&A and Strategic Transaction Insights

THE INVESTMENT BANK THAT ALSO BUILDS THE VALUE OF YOUR BUSINESS

Q3 2016 Highlights:

- Political uncertainty constrained Middle Market M&A volume
- Cheap capital propelled financial buyers to chase deals
- Cheap capital kept valuation multiples frothy

Pursant's Thoughts on Q4 2016

- Middle Market M&A volume should grow with closure on the election
- The Fed's rate increase threats are getting more real, but should be nominal
- Baby Boomer Middle Market owners will continue exiting their businesses, no matter what happens

Q3 2016 Middle Market M&A Volume and Who is Buying

Middle Market M&A deal volume experienced a decline in Q3 2016, compared with Q2 2016 as well as the same period last year (-19.6%). This decline appears to be unrelated to M&A related indicators such as cost of capital and the strength of corporate balance sheets and more driven by macro-economic uncertainty of a tumultuous U.S. presidential election and polarizing candidates. Different candidate policies related to taxes, foreign policy, trade and the overall economy are likely causing some buyers to sit on the sidelines for now. Once the elections are behind us, expectations are that momentum will increase, so long as the macro-economic fundamentals remain favorable.

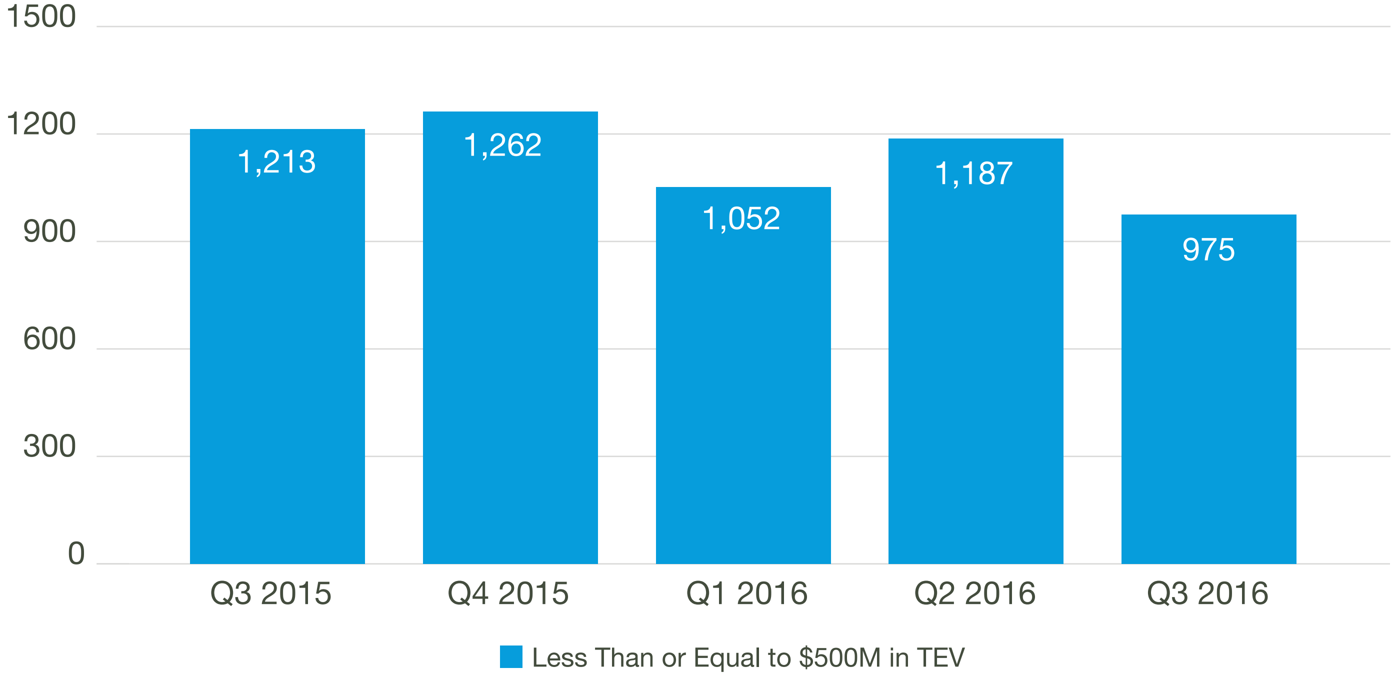
(Continued...)

Inside this edition of the DEAL insider:

The Pursant Deal 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.

Chart #1

US Middle Market M&A Transaction Volume



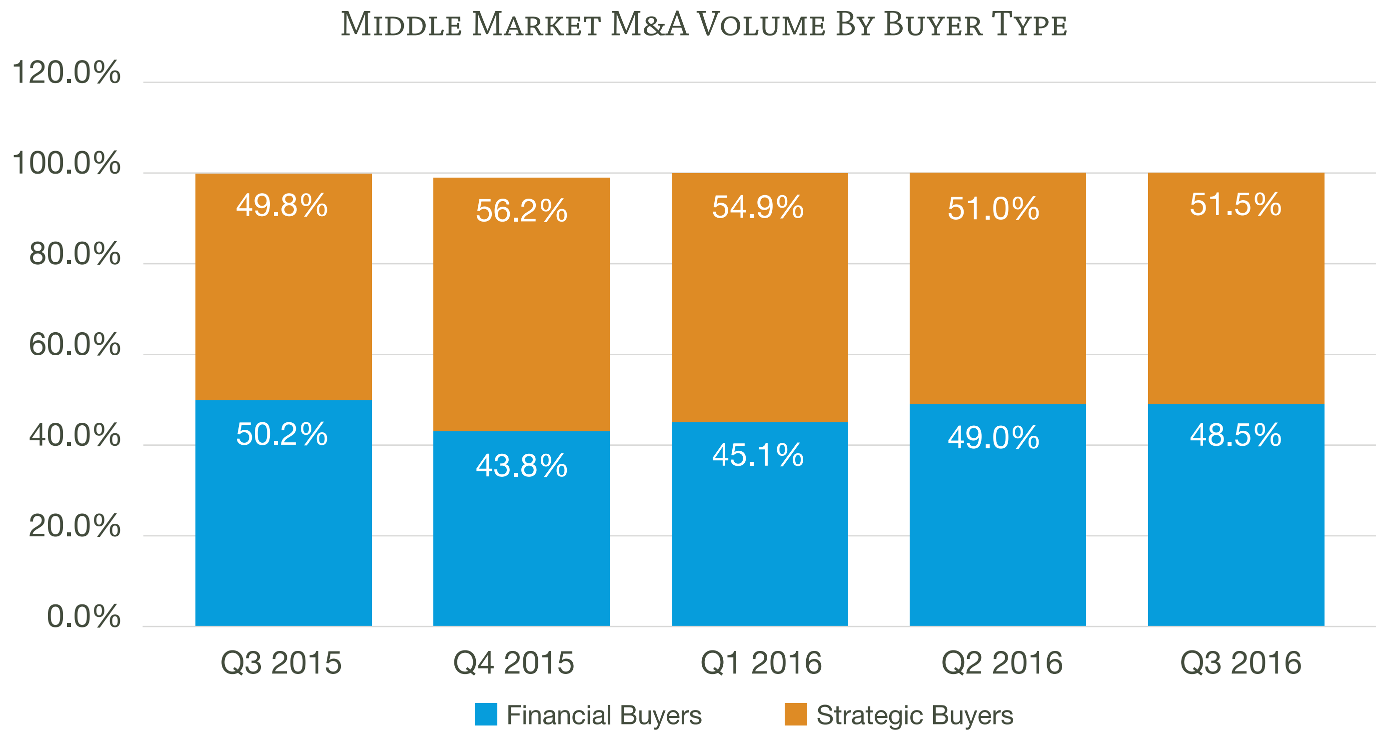
Source: Cap IQ®

Chart #1 shows that Q3 2016 US Middle Market deal flow has slowed after a slight increase in Q2.

Chart #2 shows the split between financial (private equity) and strategic buyers, with each representing approximately 50% of the Middle Market M&A deal volume. Private equity volume highlights the low cost of capital in U.S. capital markets. Prior to the recession, private equity typically comprised less than one quarter of Middle Market M&A activity. Restrictive banking regulations and the search for yield by many investors have resulted in significant change in the capital markets—particularly in the debt markets where an abundance of new non-traditional lending sources have emerged.

Restrictive banking regulations and the search for yield by many investors have resulted in significant change in the capital markets—particularly in the debt markets where an abundance of new non-traditional lending sources have emerged.

Chart #2



Source: Cap IQ®

The US Macroeconomic Picture for Q3

GDP - The US GDP was at a 2-year high for Q3 2016. The economy grew an annualized 2.9% in the 3rd quarter, more than double the 1.4% increase reported for Q2 2016. This also beat market expectations of a 2.5% increase. Nearly all indicators within the GDP showed improvement, including consumer spending, exports, inventory investment and non-residential fixed investment. Residential fixed investment was the biggest drag.

Consumer Sentiment - The University of Michigan's Consumer Sentiment Index for the United States focuses on three areas: how consumers view their own financial prospects, prospects for the general economy over the near term, and prospects for the economy over the long term. This Index ended Q3 at 91.2 in September, down from 93.5 in June and down from a 2016 high of 94.7 in May. Given the increasing presidential election uncertainty during this period, this decline is not surprising.

Business Confidence – The Institute for Supply Management's Manufacturing PMI rose to 51.5 in September 2016 from 49.4 in August—a solid increase. There was a rise in domestic and international sales, possibly triggered by purchases made in advance of anticipated inflation related price increases.

Unemployment – Q3 Labor market conditions remain largely unchanged, with unemployment hovering around 5% and wage growth at 3.83% for September.

Fed Lending Rate – Minutes of the September meeting of U.S. central bankers revealed a debate over the merits of raising interest rates; the decision was characterized as a close call, with several bankers saying a rate hike was needed "relatively soon." Several members judged that it would be appropriate to increase the target range for the federal funds rate relatively soon if economic developments unfolded as the committee expected. A reasonable argument could be made for either direction: make an increase at the next meeting or wait for additional information on the labor market and inflation.

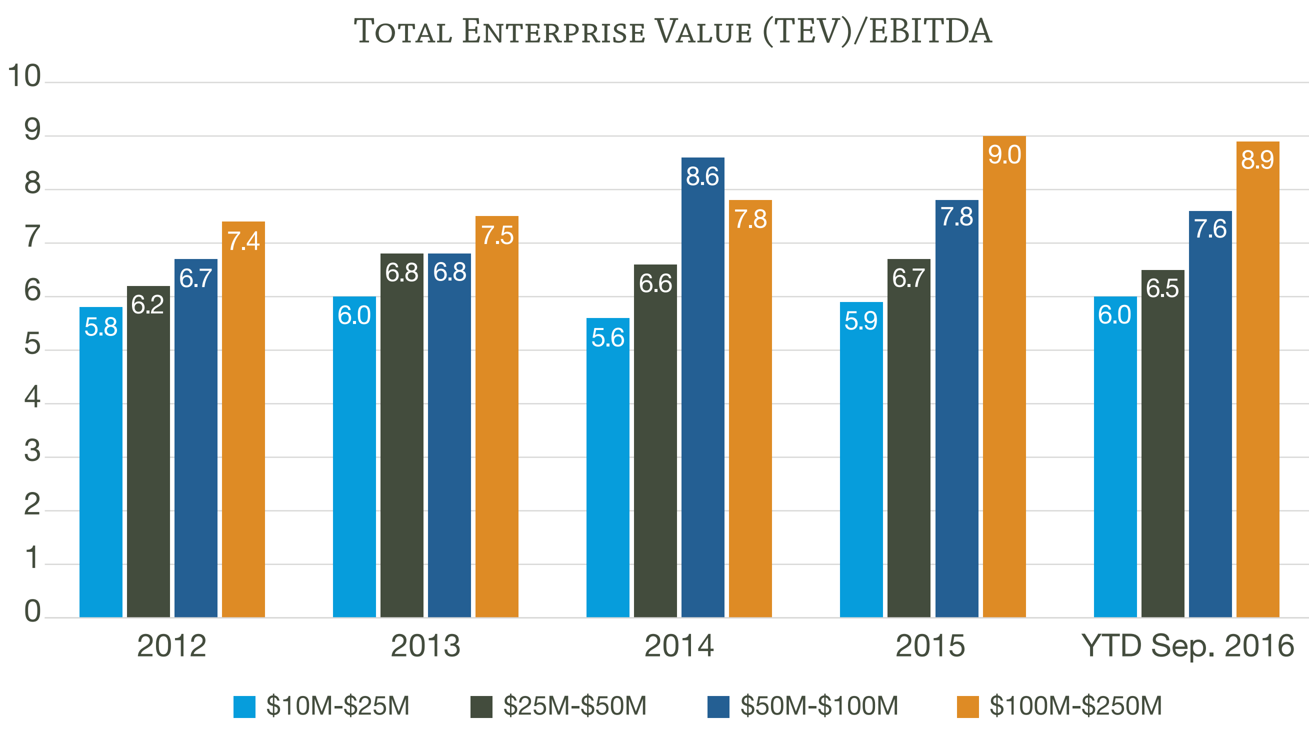
The Federal Open Market Committee left the benchmark lending rate unchanged in a range of 0.25 percent to 0.5 percent for the sixth straight meeting, with the majority of the 17 participants still forecasting at least one hike this year.

Pursant watches these macro-economic indicators because the direction and performance of the greater economy gives us an indication of where the Middle Market is heading as it relates to favorable or less favorable phases of the business transfer cycle. The business transfer cycle is continually moving 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*.

Transaction and Leverage (Debt) Multiples

Transaction Multiples – Chart #3 shows Lower Middle Market EBITDA multiples, as measured by Total Enterprise Value (TEV)/EBITDA, remained in line with 2015, with an average of 7x for transactions YTD through Q3 2016. The continued strength in multiples is driven by favorable financing rates and terms; equity capital trends; well-capitalized strategic buyers who find it challenging to propel organic growth; and a limited supply of good acquisition opportunities.

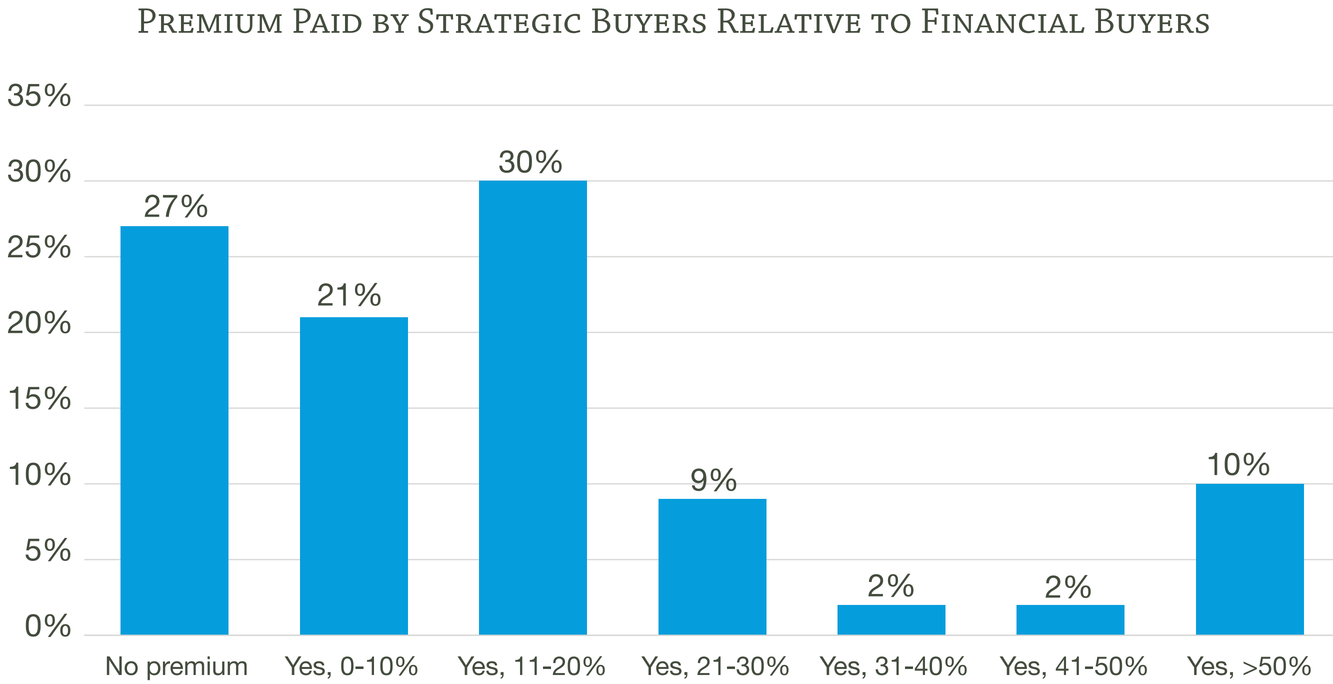
Chart #3



Source: GF Data®

When thinking about multiples, one question most often arises: who will pay more—a Strategic buyer or a Financial buyer. The answer to this question can vary from deal to deal, industry to industry. It also depends on whether or not the Financial buyer already has a platform investment in the underlying industry, thus making it a hybrid buyer—both Financial and Strategic. Regardless, all things being equal, Chart #4 shows that Strategic buyers will generally pay a premium when compared to Financial buyers.

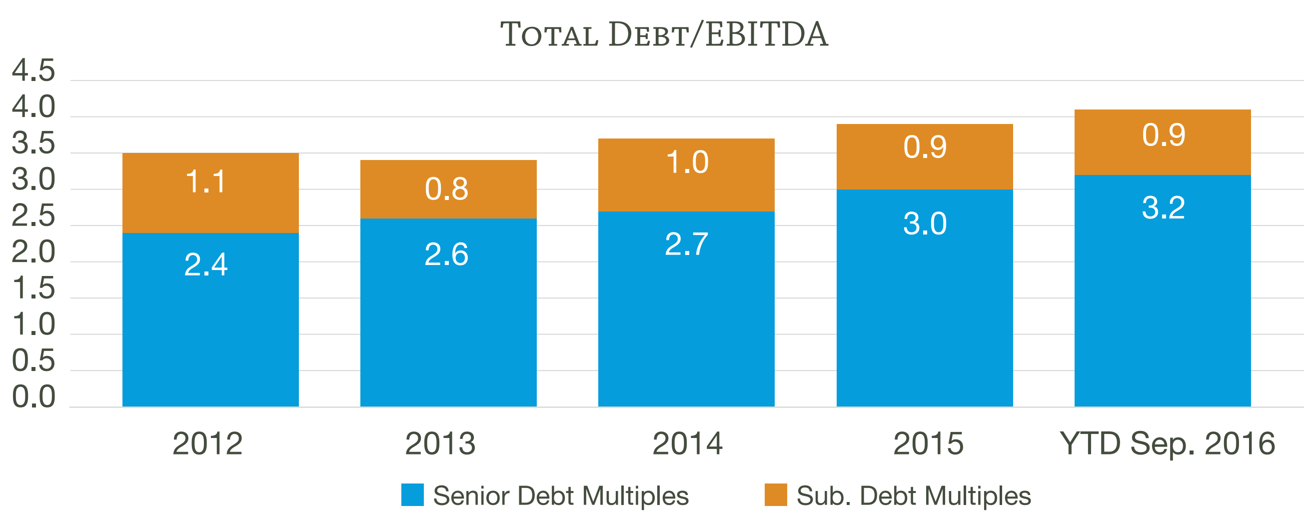
Chart #4



Source: Pepperdine Private Capital Markets Project®

Leverage Multiples – Chart #5 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 subordinated M&A related debt in YTD 2016 averaged just over 4x EBITDA, continuing the steady rise we have seen over the course of this decade.

Chart #5



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.*

Best Practices of Successful Buyers

Brian Steffens – Pursant Managing Director

The success rate for closed M&A transactions is dismal. For example, the recent Pepperdine Private Capital Markets report recently reported that 35% of sale engagements terminate without transacting. The odds of your deals actually closing improve if you follow these buyer best practices:

- **Document an Acquisition Strategy and Vision:** Successful buyers take the time to develop a corporate growth plan and layer in an acquisition strategy. They take an inside first, outside second approach: first fully understand where their business makes money, the growth rates of different products and services, skill needs/gaps, leadership/talent voids and more. Then they look beyond their business, analyzing the competition and the trends impacting their business today and in the future. With this insight, they answer questions like: What are we trying to accomplish with a deal? Is it better to acquire a tangible advantage than to create it internally? What impact will an acquisition have on our business model? This diligence will allow you to quickly filter out companies that are not a good fit and keep your focus on the best possible targets.

- **Ensure Culture Alignment:** Successful buyers are very aware of their culture, able to articulate it to others and ascertain as to whether or not other cultures are compatible. They seek transactions with businesses that will not only meet the desired deal expectations, but also those that fit culturally. Assessing culture fit early in the transaction process reduces the chances of a failed deal or significant integration issues post-acquisition. You can learn a lot about a company's culture by simply looking at how the target company makes decisions (centralized or decentralized) and how customers and suppliers are treated.

- **Take the Long View:** Smart, successful buyers recognize that buying companies is a marathon, not a sprint. They take a long view to methodically growing the business and understand that they should be saying "no" more than "yes" to acquisition opportunities. This view allows them to walk away when necessary (too expensive or not the right fit), allocate resources to achieve the greatest impact, and be ready to evaluate opportunities when they arrive. Sellers take buyers like these very seriously and want to work with them.

- **Communicate:** Accomplished buyers do a great job of communicating throughout the deal process to all stakeholders (internal, external, inclusive of the sellers). They clearly articulate key value drivers internally, allowing stakeholders to appropriately value and identify risks and opportunities. They consider and develop effective communication plans to ensure that they are in control of the message. They don't leave this critical factor to chance. Acutely aware that people process change differently, they personalize the message so that it best resonates with each party. They do not over promise, but they do follow through on what they say they will do, building credibility.

- **Make Decisions Swiftly and Collaboratively:** Successful buyers realize that transactions entail decisions big and small, critical and less critical, and leverage resources to make informed decisions quickly. Decisions often require cross-functional team expertise. For example, you'll want to involve people from sales, operations, finance/accounting, technical systems/infrastructure, and human resources. Also consult with outside advisors including deal attorney(s), intermediary/investment bankers, industry experts, and/or an accounting firm. Not all decisions can be planned for in advance. A well-developed project plan defines the decision process and assigns decision-making responsibility to keep the transaction moving along. Escalation protocol also should be defined to ensure that bigger and more critical decisions are prioritized and expedited. Not making a timely decision is often worse than making a wrong decision and then having to course correct later.

Emulating the best practices of these successful buyers will greatly enhance your likelihood of closing success.

“Working Capital” – A Hot Topic in Every Business Acquisition

Scott Glickson – Pursant Managing Director

Working capital is the backbone which supports a company’s day-to-day operations. It is generally best represented by the company’s current assets less its current liabilities. It is also a major source of confusion and frustration in business transactions.

In any business acquisition evaluation, it is critical to understand a business’ sources and uses of working capital because it directly impacts cash flow. For example, one company may collect from customers in 60 days of delivering products/services while having to satisfy vendor obligations within 30 days. Contrast that working capital environment with one in which collections are made within 30 days. From a P&L perspective these two companies can look identical, but their cash balances would be very different.

Addressing working capital early in the transaction process is critical. Too frequently, the topic of working capital is introduced too late and the confusion created can slow the process and potentially even kill a viable deal.

The overarching working capital question in any business acquisition is “How much, if any, working capital needs to remain with the business at Close.” In general, the answer is that Sellers should be prepared to leave the amount of working capital that it typically maintained to generate the earnings that the Buyer used to value the business.

The standard market approach is for Buyer and Seller to agree upon a pre-determined level of working capital to be delivered with the business at Close. There are different methodologies and approaches for determining the amount, but the most common is to use a historical average over the trailing 12 months (this assumes valuation is a multiple of the trailing twelve month EBITDA). This is a rational approach, as a Buyer is paying a multiple of the earnings power of the business. To generate that earnings power, there is an inherent level of working capital required by the business.

An analogy is a car purchase. When you evaluate a car (including the test drive), you expect gas, engine oil, windshield fluid, radiator fluids, etc. at normal operation levels. When it comes time to own and take possession of the vehicle, you expect those same items to come with the vehicle such that the car is delivered to you in the same fashion in which you evaluated and drove it. If the car was provided to you without the gas, oils and fluids, you would expect a price reduction to cover your cost to provide those. In this analogy, the gas, engine oil and fluids are the working capital in a business acquisition.

For an illustrated calculation of working capital using the standard market approach, refer to Table #1. This Table illustrates how after excluding cash and interest bearing liabilities, the sample company carries approximately $600k of working capital. Under the standard market approach, this would be viewed by both Buyer and Seller as a reasonable pre-determined level of working capital to be delivered at Close. Tactically, the closing balance sheet is estimated at the time of the Close and any difference between the estimated amount and the pre-determined amount is treated as an adjustment to the purchase price. Eventually, typically within 90 days of the Close, there is a look back to true up the closing working capital to reflect actuals.

Table #1

	BALANCE SHEET AVERAGES		
	Trailing		
	3 Months	6 Months	12 Months
ASSETS:			
Accounts receivable, net	$1,514	$1,512	$1,447
Prepayments	$114	$111	$105
Accrued revenue	-$126	-$131	-$128
Loans to Employees	$26	$32	$27
TOTAL CURRENT ASSETS	$1,528	$1,524	$1,451
LIABILITIES:			
Accounts payable	$738	$732	$695
Sales tax payable	$91	$86	$83
Payroll accrual	$58	$66	$71
Commissions payable	$40	$41	$40
TOTAL CURRENT LIABILITIES	$927	$925	$889
NET WORKING CAPITAL	$601	$599	$562

This approach is viewed as fair and protective to both the Buyer and the Seller. The Seller gets a multiple of the earnings and the Buyer gets a business with all the components in place. By setting the working capital amount, both parties are protected from large swings in working capital at Close. For example, if working capital at Close is greater than the pre-set amount, the Seller recovers the amount of the overage. This scenario could arise as collections of receivables gets neglected leading up to close. Buyers are protected from the Sellers collecting all receivables right before Close (as Sellers generally keep their cash as part of the transaction) or deferring payments leading up to Close. In either of those situations, working capital at Close would be lower than the pre-set amount and the Sellers would be required to remit cash to the Buyer at the settlement time.

Pursant's Expectations for Q4 2016

In the U.S., 2016 is on pace to deliver deal volume well below the record-breaking 2015 year, but still at a healthy level, all things considered. These levels are not unexpected given the tough-to-match blistering pace of 2015 and considering the uncertainly caused by the rollercoaster Presidential election process taking place during the bulk of this year. Post-election, we are expecting to see M&A activity increase.

Absent a significant geopolitical event that disrupts global capital markets, or an unlikely significant Fed lending rate increase and general tightening of credit, we're not seeing anything that will derail M&A and strategic transaction activity for the balance of this year and in early 2017. Both Strategic and Financial buyers still have record levels of capital to deploy. A sluggish economy is hampering organic growth initiatives. Middle Market baby-boomer business owners who aren't getting any younger need to exit. All of this means continued strong Middle Market deal activity for the foreseeable future.

The Fed will continue to debate when and how much to raise rates: tightening too soon could choke-off the sub-optimal economic growth; increasing rates too late could create an overleveraged environment. Meanwhile, favorable borrowing rates, closure on the political cycle, and a sluggish economy mean healthy valuation multiples for good businesses.

In summary, Pursant expects the Middle Market to finish 2016 with M&A and strategic transaction volume at slightly subdued but still healthy volume levels. The strategic transaction climate remains favorable for both Buyers and Sellers for the balance of 2016, with both benefiting from cheap capital.

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.

Pursant

INSPIRED PURSUIT