Q1 2018 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

Q1 2018 Highlights:

- M&A activity starts strong in 2018 partly due to TCJA taking effect
- Fed rate increase has not yet hurt valuation multiples
- Favorable macroeconomic indicators help M&A

Pursant's Thoughts on Q2 2018

- Steady as she goes: we are on a roll in the middle market
- More and more Buyers want to get into the game with economic momentum
- No end in sight to the 10,000 baby boomers retiring each day

Q1 2018 Middle Market M&A Activity Healthy; Lower Middle Market Strongest

Data and sentiment for the first quarter of 2018 show that middle market deal momentum continues to build following the upward trajectory of Q4 2017. According to Pitchbook, in Q1 2018 the lower end and mid-range of the middle market represented an increased portion of total middle market M&A deal value and according to Dealogic, Q1 was the fastest Q1 start ever, surpassing the previous two record years: 2007 and 2000. It was also significantly above the 23-year average Q1 volume. Some of the Q1 deal volume was associated with the planned deferral of Q4 closings until 2018, after the Tax Cut Jobs Act (TCJA) kicked in. Many Sellers were able to improve their post-tax positions with the passing of the TCJA and its 2018 effective date.

The fundamental drivers of activity—including low cost of capital, a favorable tax environment and challenging organic growth for businesses—remain in place, encouraging buyer and seller activity. Despite the struggle, business owners are enduring to grow topline revenue organically. They still feel optimistic about their business overall, which compels them to pursue M&A strategies to bolster growth. For these reasons, we do not expect deal volume to materially increase or decrease in the near term.

As stated before, one of the drivers of M&A activity that clearly separates the lower middle market (sub $250M in enterprise value) from the rest of the middle market ($250M-$1B in enterprise value) is the aging population of Baby Boomer owners looking to sell

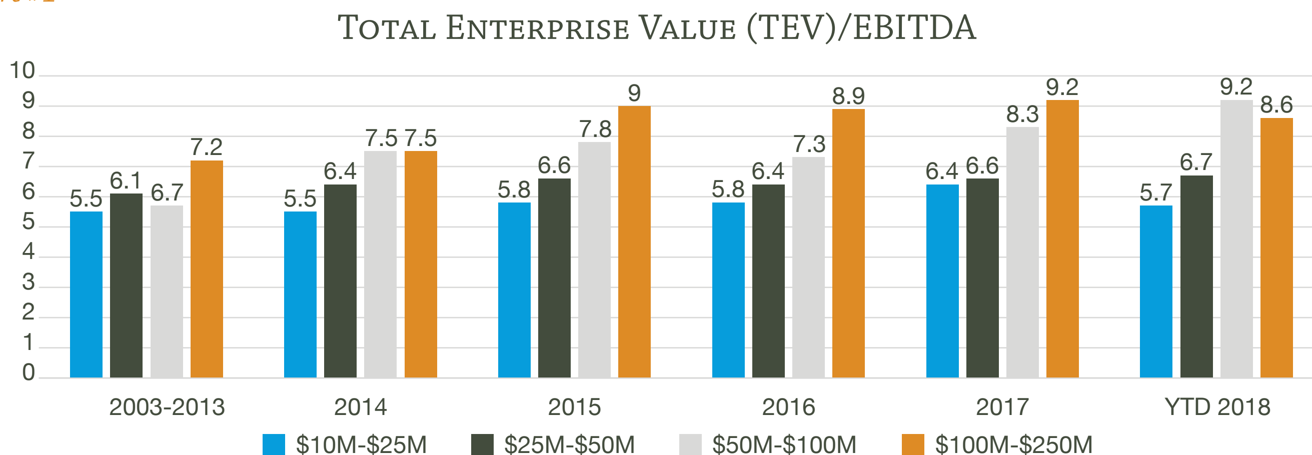
(Continued...)

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 optimize transaction outcomes.

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 as fairly insulated from the drivers of deal volume in the balance of the middle market.

Transaction Multiples – Chart 1 shows that Lower Middle Market EBITDA multiples, measured as Total Enterprise Value (TEV)/EBITDA, remain stable, with an average of 6.9x for transactions YTD through Q1 2018. The $50M-$100M transaction multiple showed a significant increase, but due to the low sampling size in this range, we feel this is a data anomaly and not a true trend. One of the biggest influencers of multiples is the cost of capital. There was a 25 basis point increase in March this year, pushing the Fed Funds rate to 1.50-1.75. This nominal increase still is not enough to derail lofty valuations. As 2018 plays out and further rate increases follow, multiple softening may begin.

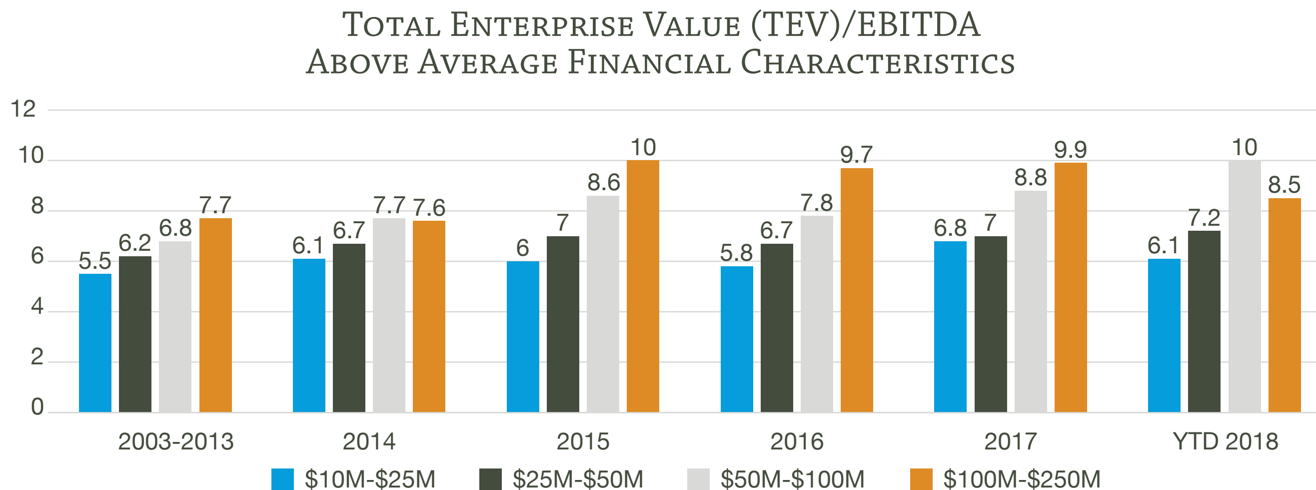
Chart #1



Source: GF Data®

The Quality Premium – The reward in valuation extended to above-average financial performers is at a healthy 21 percent (Chart 2). This premium is especially pronounced for the $50M-$100M transactions. Better financial performers (as defined on the next page) are valued at an average of 7.4x, compared to an average of 6.9x for the entire cohort at that size range. For the $10M-$25M deals, the above-par performers averaged 6.1x, compared to an overall mark of 5.7x.

Chart #2



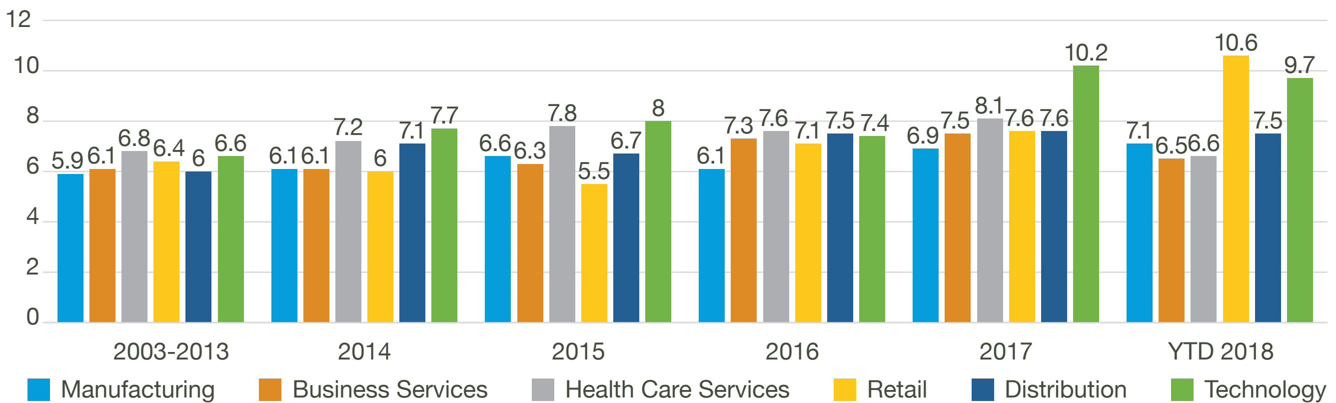
Source: GF Data®

We define better financial performers as businesses with TTM EBITDA margins and revenue growth rates both above 10 percent, or businesses with one of those metrics above 12 percent and the other metric at least 8 percent. Outliers on the high side are also excluded.

The Middle Market by Business Category – When looking at the lower middle market by category, we can clearly see some valuation differentiation when comparing growth sectors (i.e. Healthcare and Technology) to more mature sectors that don't benefit from the same rate of growth. Again, due to low sampling size, the Q1 2018 spike in Retail is likely a data anomaly. 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 Q1 2018

GDP – The US economy expanded by an annualized 2.2 percent in the first quarter of 2018, below the advance estimate of 2.3 percent and below market expectations of 2.3 percent. Downward revisions to private inventory investment, residential fixed investment and exports were partly offset by an upward revision to nonresidential fixed investment. This conservative GDP growth rate will likely keep the Fed conservative with rate increases, favoring the M&A climate.

Consumer Sentiment – Since Trump's election, the Sentiment Index has meandered in a tight eight-point range from 93.4 to 101.4, with the small month-to-month variations indicating no emerging trend. For example, we finished 2017 at 95.9 and Q1 2018 at 101.4. Consumers have remained focused on expected gains in jobs and incomes as well as anticipated increases in interest rates and inflation during the year ahead. As past expansions have shown, rising interest rates do not suppress spending gains as long as they are accompanied by more substantial increases in incomes.

Business Confidence – The Institute for Supply Management's Manufacturing PMI in the US fell to 59.3 in March 2018 from the previous month's near 14-year high of 60.8, missing market expectations of 60.1. The PMI number is a number from 0-100. A PMI above 50 represents an expansion when compared to the previous month. A PMI reading under 50 represents a contraction, and a reading at 50 indicates no change. The further the number is from 50, the greater the level of change.

Comments from the panel of 400 companies surveyed reflect continued expanding business strength. Demand remains robust, with the New Orders Index at 60 or above for the eleventh straight month and the Customers' Inventories Index at its lowest level since July 2011.

The Backlog of Orders Index continued a 14-month expansion with its highest reading since May 2004, when it registered 63 percent. Consumption, described as production and employment, continues to expand.

Unemployment – The US unemployment rate in March 2018 stood at a 17-year low of 4.1 percent for the sixth consecutive month, which was slightly above market expectations of 4 percent. The number of unemployed decreased by 121,000 to 6.59 million and employment fell 37,000 to 155.18 million.

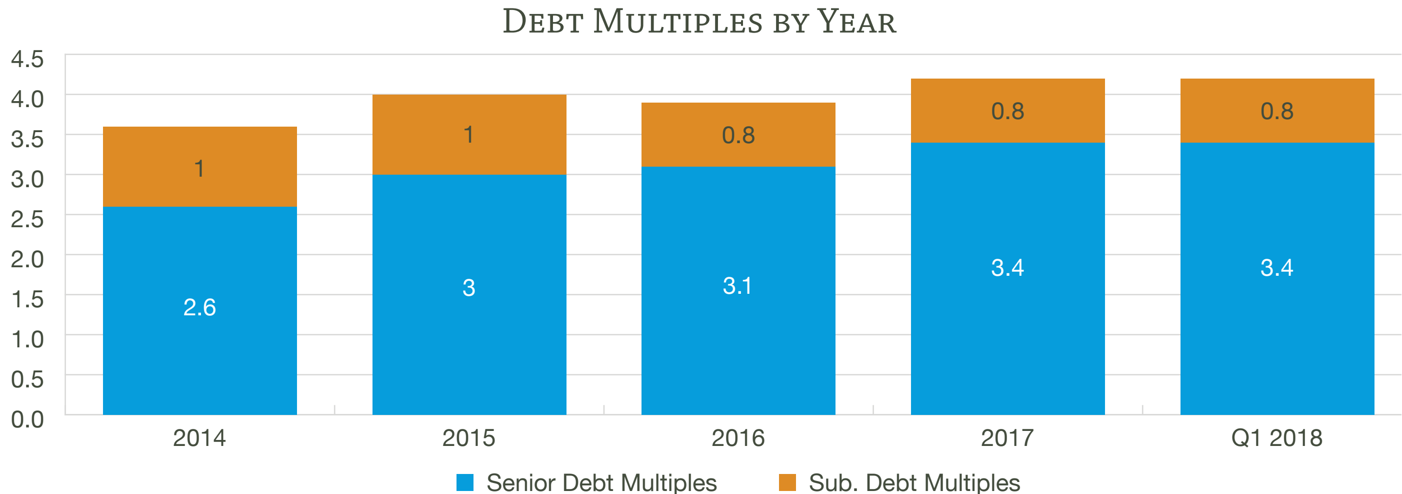
Fed Lending Rate – With continued improvement in economic and labor conditions, the Fed raised the Fed Funds rate 25 basis points to 1.50-1.75 in March. Further increases are expected this year, but are not thought to be significant enough to negatively affect the robust M&A climate.

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 for valuation purposes and Buyers for access to affordable 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 Q1 2018 averaged more than 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 our article "Leverage Buyout Model – Why Buyers Use It and What A Business Owner/ Executive Needs to Know About It" in our Q2 2017 issue of the *Pursant Deal Insider.*

Chart #4



Source: GF Data®

The Deal Closed!! Time to Celebrate But The Work Is Not Done

Scott Glickson, Pursant Managing Director

The closing of a transaction is typically a very exciting and exhilarating moment for Buyers and Sellers alike. However, as the dust settles, Buyers and Sellers frequently find themselves challenged, frustrated and caught off guard by the complexities of the post-closing work that needs to be completed in connection with the transaction. While there is no magic wand to eliminate the post-closing activities related to the transaction, having a knowledge and understanding of them should ease anxiety and mitigate the surprises.

A common question from both Buyers and Sellers is "Why are there so many post-closing activities related to the transaction?" The simple answer is: "Because

businesses are always 'in motion,' and grinding to a halt to facilitate a close isn't possible."

There are a variety of considerations and assumptions that are made in connection with closing a transaction. These range from estimating account balances to allowing for orderly transition of ownership. At an agreed upon future point in time, these matters are addressed (via true ups or through completing a task) and the parties settle any differences.

In addition to the "in motion" matters, oftentimes there are administrative exercises that are not deemed material enough to hold up closing a transaction but do need to be addressed later. The following provides an illustrative example of "in motion" and administrative post-close actions:

- *In Motion* – In a typical transaction, a Seller retains any cash at close and leaves an agreed upon amount of working capital. However, given that customer payments are continually being received, checks to vendors are being cut, and checks are being presented to the bank, it is impossible to know the amount of cash and working capital at the moment the transaction closes. Accordingly, the amount is estimated for the purposes of facilitating a close and then, post-closing, the final, fully reconciled balances as of the closing date can be determined in an orderly manner.
- *Administrative* – Buyers typically require key and material contracts to be assigned and consents to be received effective with the close. However, and given the effort and time required to obtain these, Buyers are less concerned about immaterial contract assignments and consents. For this reason, assignments and consents for immaterial contracts are frequently deferred until after the close.

Post-closing activities are laid out and clearly defined in the purchase and sale agreements. In addition to specifying the timing for completing any post-closing activities, it is common for a purchase and sale agreement to include purchase price holdbacks or some other way to allow the Buyer relief in the event that a post-closing condition requires a true up or is not satisfied.

Typically, the holdback amount is placed in escrow. As a broad-brush rule of thumb, holdback amounts (not to be confused with earnouts) for a middle market deal range from a low of 5% of the purchase price to a high of 20% of the purchase price, and the typical timeline for determining the adjustment and releasing any holdbacks is from as little as 90 days to as much as a year.

To summarize, the closing of a transaction is a great moment which typically should be celebrated and enjoyed by all parties involved; however, it is important for the transaction partners (and their advisors and representatives) to keep in mind that over the coming days/months following the transaction there is still meaningful work to be completed. While these tasks are anti-climactic and generally not appealing, they are critical to finalizing the transaction and ensuring that an effective transfer of funds and ownership is completed.

Types of Buyers—Choose Wisely

Brian Steffens – Pursant Managing Director

Today's M&A landscape is highly competitive if you are a Buyer. This should be good news if you are an owner looking to sell your business. As a Seller, you have specific needs and desires (value expectations, deal structure, post transaction involvement, legacy wishes) that are best met by a specific type of Buyer. Understanding the different categories of Buyers is the first step towards finding the best Buyer/Seller fit. The following highlights common types of Buyers.

Strategic Buyers: Companies looking to augment their organic growth via an acquisition are called "Strategics." They are seeking acquisition targets that provide some measure of the following: strong alignment with core strategy; ability to move into an adjacent space/market; or potential to expedite a growth path to stave off competition. Strategics will place a great deal of weight on a Seller's "fit" with their culture and business goals.

Strategic Buyers generally can (but may choose not to) pay a premium price for a business when compared to the other common types of Buyers. They can afford to do this because of synergies that allow them to recoup the costs of paying this premium. While this can be a great

circumstance if purchase price is a Seller's motivating factor, there is a downside, as synergies often come at the expense of removing identified redundancies between the two companies. The Strategic Buyer will often look to remove employees in departments that overlap (i.e., Accounting/Finance, HR, IT, Marketing) which may be a worrisome outcome.

A Strategic Buyer also can be a compelling buyer if the Seller wants a very limited role post transaction. Because the Strategics have teams and infrastructure in place to manage the day to day, it is possible for the Seller to do little after the sale beyond maintaining a few key relationships and being "on call" for a period of time.

One thing Sellers must consider when selling to a Strategic Buyer is how they will feel if the legacy and brand built over many years is erased. This concern is a real possibility in a transaction with a Strategic.

Private Equity: Private Equity firms invest the funds they raise from institutional investors and/or high net-worth individuals by acquiring companies. According to Private Equity Info, a subscription service that provides a comprehensive global directory of private equity firms, there are now more than 3,575 PE firms that deploy capital based on variety of investment theses depending on industry, size and other specific criteria.

Briefly, here is how PE firms work. The Limited Partners ("LPs") invest their money in a PE fund that the General Partners ("GPs") of the PE firm use to buy companies. A PE firm often will have several PE funds. The PE fund generally has an investment thesis rooted in a specific industry. Over a 5 to 7 year period, the PE executives seek to maximize the growth of the portfolio companies before ultimately selling the businesses and ideally returning the invested capital along with a healthy return for investors and themselves.

Since the value PE firms provide is professional oversight and additional financial resources, Sellers will likely need to be willing to maintain an active role in the business post-close. Most PE firms will need the owner(s) for operating expertise. For this reason, PE firms can provide a meaningful liquidity event (70-80%) while allowing owners the ability to retain a piece of equity when the PE firm sells the portfolio. A PE group also could be an excellent solution in the case of a strong management team that is interested in buying the business from the owner. In this scenario, the PE group will partner with the management team to help buy out the owner. Be prepared for an in depth due diligence process, as PE Buyers will be very thorough since they have a heightened level of accountability to outside investors.

Family Office: Family Offices share some attributes with Private Equity firms but they differ in several key ways. Rather than investing the money of high net-worth individuals or institutional investors, they invest the money of a single wealthy family, or in some cases several families that have come together as a multi-family office. The primary objective of the Family Office is to ensure that the family wealth will span multiple generations.

Family Offices tend to be long term, conservative investors versus having a defined hold period like PE groups. Their reporting requirements are often less onerous than that of a PE group given they do not have the same exposure to outside investors. But, like PE buyers, they tend to take a less active role in the day to day management of companies they acquire. As this group has matured in recent years, they are more likely to invest in sectors and industries that are not core to the way the family originally made money.

Finding Family Offices can be very difficult for Sellers. This may change, as this group has become more active and is now hiring deal and business development professionals. Overall, this group tends to move slowly. Since they often use a capital structure heavily weighted towards cash (and not debt), the purchase prices tend to be lower than those offered by PE firms or Strategic Buyers. They can make excellent partners for owners who are not in a rush to sell and are looking to join forces with another industry expert. The Seller's legacy, brand and workforce generally will stay intact when transacting with a Family Office, with the added benefit of the "secret sauce" that has made the family successful in business over the years.

Search Funds & Fundless Sponsors: This section discusses two emerging types of Buyers, as they are similar. Search Funds are specialized funds formed generally by one or two individuals for the specific purpose of acquiring one target company that the principals of the search fund then operate. Often,

that individual is a recent MBA graduate who aspires to operate a business. His/her team of investors is willing to buy the company for the individual to operate, confident that s/he will generate a return. The focus of Search Funds are often lower-middle market acquisition targets that fall below the radar of traditional private equity funds. The principals will assume day-to-day management positions within the acquired company. Search Fund principals receive a salary from the portfolio company and also earn a carried interest on the equity investment that financed the acquisition.

A Fundless Sponsor is a private equity professional or group that does not have committed capital. Fundless Sponsors search for acquisition targets first and then work with their network of known sources of capital (both equity and debt) to complete the transaction. Fundless Sponsors often have a role post transaction, but not generally in the day-to-day operations.

Sellers will need to be patient, as working with these Buyer types will take some time and the deal specifics may change and evolve. The reason for this is that the potential Buyer often needs to get up to speed on industry dynamics and the Seller's business model while also lining up capital providers that will fund the deal. Their offer and structure is directly dependent on capital providers believing in their ability to execute post transaction. When they are short on acquisition funds, they will often ask for the Seller to help finance the deal or roll equity back into the deal. Sellers that want to infuse some youth and energy into their companies while ensuring the long-term vitality of the business should view Search Funds as a great option.

Employees: Sellers looking for an exit opportunity that allows the Company to maintain its current course should look no further than employees as an option. An Employee Stock Ownership Plan (ESOP) transfers the company's equity into retirement packages for a Company's employees. This transfer can be done gradually over time or more immediately, in the case of a leveraged ESOP where the employees are provided debt to buy the Owner out of a portion of or all equity up front. ESOPs provide administrative hurdles that can slow future development, but it does provide employees with job security and input into the future.

When choosing an exit partner, make sure your transaction expectations from a pre- and post-close perspective match up with the key characteristics of the Buyer category, and your odds of a more successful M&A transaction will improve dramatically.

Buyer and Sellers—Keep your Eyes on the Assets

Richard Curry – Pursant Managing Director

During an M&A initiative or event, it is common to be consumed to the extent that existing business operations are negatively impacted. This discussion presumes that an acquirer is in possession of a fully functioning company and wishes to add girth and capability to their platform. The Seller wishes to monetize a fully functioning enterprise for any number of reasons and is usually very concerned that the transaction is a healthy and happy event for all impacted parties.

Two meaningful assets of any enterprise are its employees and customers. Without either, an enterprise is not extant. If both are mediocre, below quality or dispirited, the enterprise will eventually be marginalized, and existence will be threatened. If these assets are not cared for during the M&A process, serious issues will quickly emerge.

Buyers seek to develop increased service/production and expand the playing field with new capabilities brought on by acquired growth. The to-be-acquired employees and customers (the "Assets") are in play and must remain in play for the transaction to be successful and accretive. However, a common mistake Sellers make is to take eyes off these Assets and allow "drift" to occur while the deal is occurring. With all the excitement evaluating opportunities brings, it is very easy to assume that employees remain engaged and fulfilled and that customers remain happy and satisfied with service levels/products being delivered. This is a dangerous and, frequently, an incorrect assumption. The Buyer must step up to the plate and exert prodigious effort to ensure that their valuable Assets remain viable. Current employees and customers will be the biggest advocates of a smart buy and this fact will ensure that integration, always challenging, will be as smooth as it can possibly be. The excitement that a Buyer creates within an organization can only be amplified when current and eventually

acquired Assets are happily in play and constantly nurtured and developed.

From the Seller perspective, the act of selling the organization is often withheld from employees and customers until a strategic moment in time. This is by no means an easy task; because the Assets are key to the valuation and attractiveness of the enterprise to a potential Buyer, the continued attention and nurturing that must take place while information, meetings, phone calls and due diligence are taking place is a balancing act. Considerable thought must be given to how the transaction will be communicated to the Assets once a deal has been struck as well as equal consideration given to a worst-case scenario response when the transaction is discovered or telegraphed before the communication strategy is deployed. No amount of NDAs can assuage the fears of employees and customer concerns if a transaction is discovered before its appointed time; the damage can be substantial. Therefore, as with the Buyer, the Seller should continue to nurture and develop the Assets until the transaction is successfully executed.

Pursant's Expectations for Q2 2018

There is a lot of optimism about middle market deal activity remaining strong in Q2 and throughout 2018. With the TCJA firmly in place, Buyers and Sellers have more clarity on strategy and will be willing to pull the trigger on M&A deals. The question that follows is: how long will this last? Will the current administration remain in the next election cycle and if not, will the next administration unravel the TCJA? Time will tell. Meanwhile, both Buyers and Sellers are expected to strike while the iron is hot.

As we discussed, the Fed appears to be patient in its approach to rate increases. The resulting affordable capital will help keep valuations healthy and relatively stable, but not increasing. The economy's expansion of 2.2% in Q1 2018 is markedly better than Q1 2017's dismal 1.2% and unless things get overheated, we remain in a good place for affordable capital.

The overall economy is strong, keeping strategic businesses performing well and flush with cash for M&A. PE Buyers are still seeking to deploy a record amount of capital overhang (see the *Q1 2017 Deal Insider* for more on this) that has been sitting idle for years now and they continue their robust fund raising activity.

All of this sets the stage for us to remain in a very favorable (mostly **Seller** favorable) phase of the business transfer cycle in Q2 2018.

Pursant helps companies grow enterprise value by managing their M&A related initiatives and ultimately monetize that value in a sale transaction.

Our Investment Banking, Strategic Transaction Support and Business Value Enhancement practices use a deep immersion process, our expansive networks and experience as owner/operators and dealmakers to effectively execute strategic transactions—critical events for which most companies do 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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