Q1 2015 EDITION

Pursant
INSPIRED PURSUIT

M&A insider

Q1 2015: Best Quarter in 8 Years

- Q1 2015 M&A volume up versus Q1 2014 and Q4 2014
- Overall valuations still strong and sub $50M TEV companies get a bounce
- Buyers' appetite for leverage growing, even with slight increase in cost of capital

Pursant's Thoughts on 2015

- Strong start to 2015 M&A activity expected to continue
- More sellers will continue to emerge
- Projected mid-year rate hike likely moving to late 2015 or 2016

Q1 2015 Middle Market M&A Summary

Middle market M&A momentum achieved in 2014 continued in Q1 2015 and actually grew. The first quarter represented the greatest quarterly M&A volume in eight years; the U.S. market did particularly well. In April of this year, the Wall Street Journal said that 2015 could be the biggest year in M&A history.

M&A confidence among dealmakers has continued to trickle down from the public markets to mid-cap companies and the lower middle market. Assuming no disruption in the capital markets or from other macro-economic indicators, 2015 should show better than 2014, keeping us in a stage of the business transfer cycle that favors the seller for the balance of the year.

Q1 2015 macro-economic indicators, which are a big driver of M&A activity, were more positive than negative.

Positives

- Unemployment (down to 5.4% in April 2015).
- Strong Consumer Sentiment (95.9 in April 2015 vs. 84.1 in April 2014).
- Business earnings growth—71% of S&P companies have Q1 2015 earnings above the mean estimate.
- Capital costs to likely remain low—in a statement released on April 29th, the Federal Reserve said the US recovery has lost momentum during the winter months of Q1 2015 and the pace of hiring has moderated, reinforcing expectations that rates would be kept near zero at next meeting in June or longer.

Negatives

- Q1 2015 GDP grew at an anemic annualized 0.2%. Excluding a large inventory buildup that occurred, GDP actually shrank an annualized 0.5%.
- Business fixed investment has softened in Q1 2015.

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Like cicadas emerging after years of prolonged development, sellers are finally appearing in greater numbers. Deal volume in the first quarter of any year is generally marked by a double-digit percentage decline in deal volume compared to the preceding fourth quarter. Q1 2015 has proven to be a significant exception. Chart #1 shows how Q1 2015 North American deal volume has not only beat out Q1 2014, but also Q4 2014, setting the stage for record M&A deal volume in 2015.

Chart #1

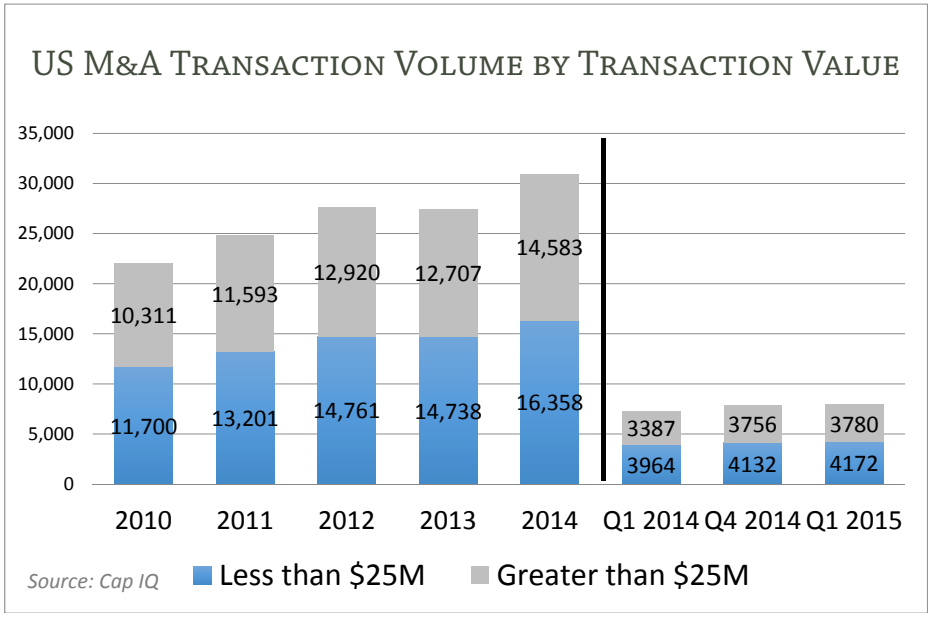
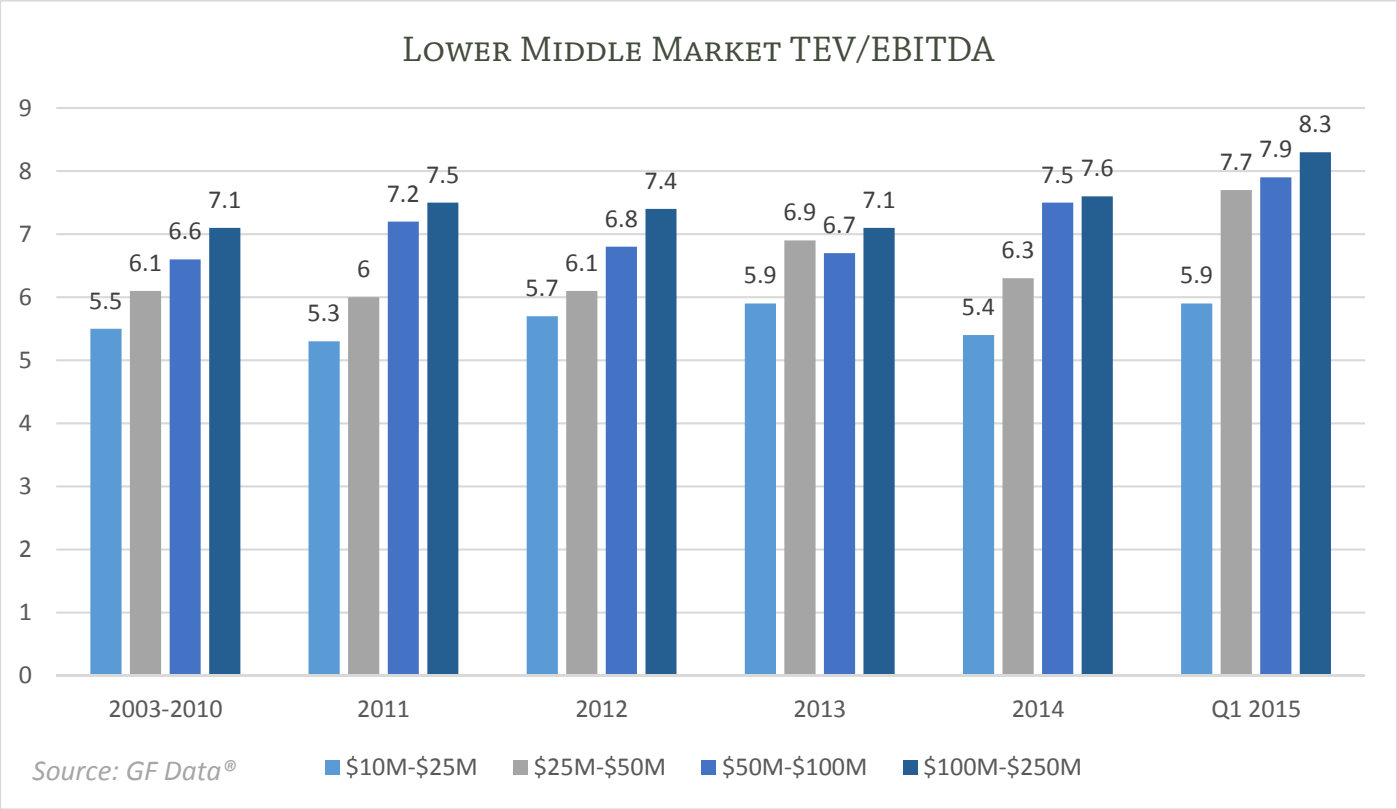


Chart #2 shows as much exuberance for overall lower middle market valuations as there is for deal flow. The data shows that companies throughout the lower middle market have managed to grow valuations YTD, especially those under $50M in TEV who managed a course correction from multiples that saw softening in 2014.

The leverage being applied to transactions can likely explain the robust increase in valuations, especially for transactions involving companies under $50M in TEV. Chart #3 shows that the leverage used for sub $50M transactions increased nearly a full

Chart #2



multiple. This heightened appetite for leverage manifested itself in the form of increased valuations for companies in this same TEV category. This is yet another example of the benefits of the low cost of capital in the M&A arena.

Chart #4 shows the quality premium that companies with above average financial characteristics are commanding. The market loves quality companies more than ever. These are companies that have above average financial characteristics, defined as TTM EBITDA margins and revenue growth each exceeding 10%.

Chart #3

Total Debt/EBITDA-Splits by Period

TEV	Q1 2014	Q2 2014	Q3 2014	Q4 2014	Q1 2015
$10M-$25M	3.1	3.7	3.3	2.9	3.8
$25M-$50M	3.3	3.7	3.4	3.4	4.3
$50M-$100M	4.6	3.7	3.1	4.2	3.9
$100M-$250M	5.2	4	4.5	4.2	4.3

Source: GF Data®

Chart #4

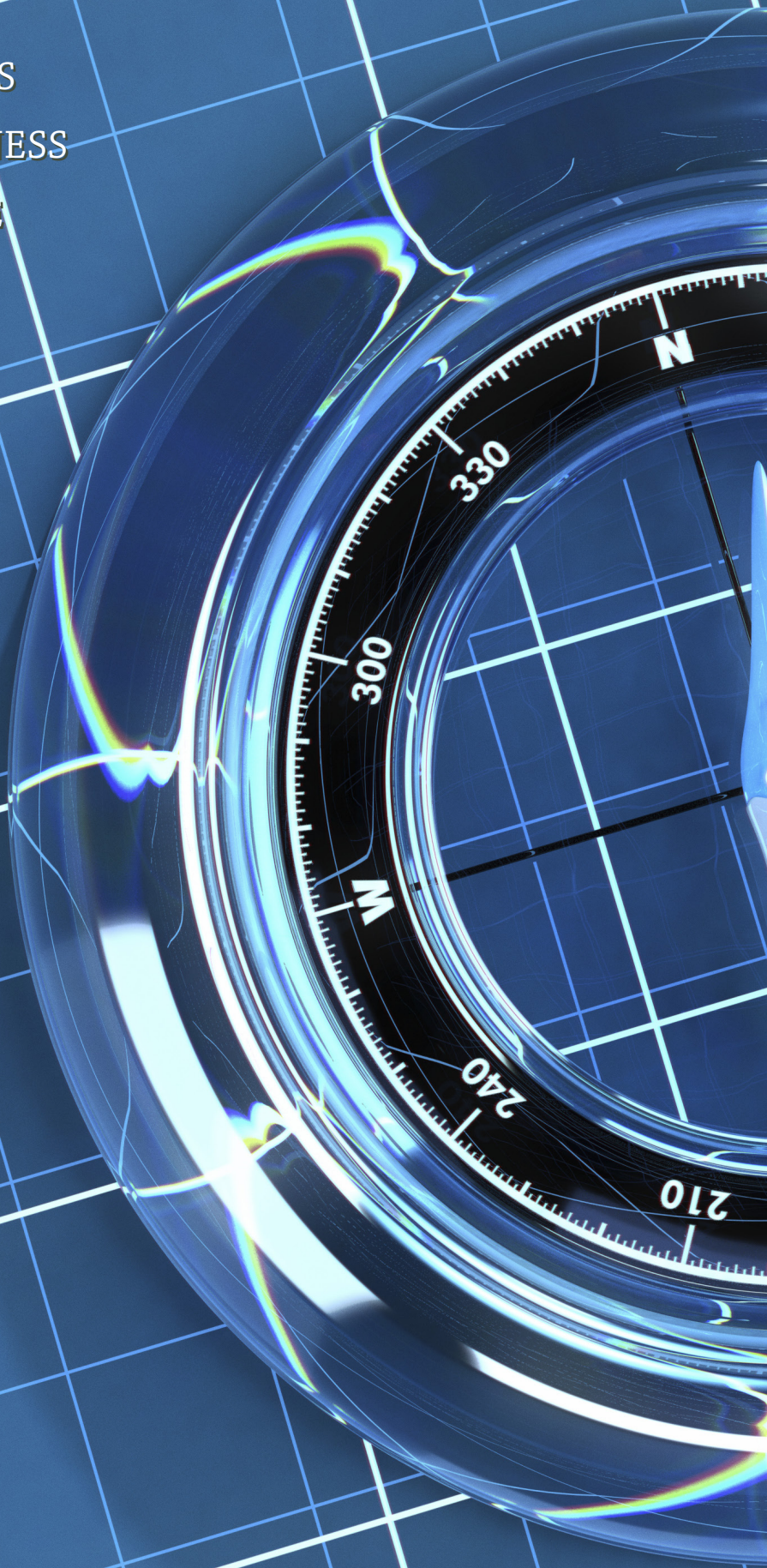
TEV/EBITDA -Buyouts With Above Average Financial Characteristics

TEV	2003-2010	2011	2012	2013	2014	Q1 2015
$10M-$25M	5.4	5.3	5.6	6	5.9	6.1
$25M-$50M	6.1	5.8	6.4	7.4	6.6	8.1
$50M-$100M	6.7	7.4	6.6	7.1	7.7	8.3
$100M-$250M	7.6	7.5	7.7	8.2	7.8	10.3

Source: GF Data®

For most 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.

"...EXIT PLANNING INCLUDES A WAY OF RUNNING A BUSINESS THAT MAXIMIZES ITS VALUE AND PROVIDES A MEANS TO ACHIEVE THE OWNER'S PERSONAL AND FINANCIAL GOALS."



Exit Planning for the 3rd Act of Your Life

10,000 people turn 65 years old each day. Many of them own businesses. Their companies usually are their largest asset—and not a liquid one. Many owners aren't prepared to retire, and their businesses aren't ready to be sold.

Many business owners have the view that exit planning is an event they need to execute at some point in the future when they have to "retire." Who wants to "retire" anymore in the way we have viewed retirement in the past? There is still a stigma to that word for business owners. "Retire" equals "old" in their minds. No one wants to view themselves that way—especially baby boomers. And they are right. Exiting a business is not the end; it's really the beginning of the "third act" in their lives.

The phases of life is a good analogy for the lifecycle of a business. In the first third, a person—or business—is growing up. We all know how challenging that can be. In the second third, one helps others grow up—i.e. their children. That, we know, is even tougher. The last third, if lucky, entails watching one's children helping their children grow up. Exiting a business in this phase could be the best time of a business owner's life. The pressure is off; the cost of living is down. If one plans properly, they should have considerable disposable income and more time than ever before, which is not a bad thing as long as they fill it with something fulfilling.

So, how does one accomplish that? First, exit planning includes a way of running a business that maximizes its value and provides a means to achieve the owner's personal and financial goals.

Note the emphasis on "maximizing enterprise value." This definition incorporates the thinking of people like Peter Christman and Rob Slee, the fathers of the Exit Planning Institute and Private Middle Market Finance Theory. Both tout the tremendous benefits of a focus on enterprise value. They believe that a successful exit strategy provides the following benefits:

1) Maximizes the value of the business.

2) Enables one to be personally and financially prepared.

3) Ensures planning for the third act of life.

The process of maximizing value is simply implementation of good business practices—nothing more. Exit planning cannot be separated from business planning. Looking at what drives value in a business and what a business strategy addresses, you won't see any difference.

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Deep Dive—Equity Recaps

In our Q4 2014 edition of the *Pursant M&A Insider*, we highlighted debt and equity recapitalizations as examples of liquidity options for owners of privately held businesses. In this edition, we take a deeper dive to expand the discussion on equity recapitalizations.

By definition, a recapitalization is a financing activity resulting in a change to a company's capital structure. The purpose is to shift the business and economic risk from the existing ownership to an outside party or parties.

In an equity recapitalization, ownership selects strategic partner(s) that will maximize long-term enterprise value. In exchange for capital, ownership relinquishes a portion of its equity interest to the recapitalization partner. Selection of strategic partners is based on criteria important to the owner/business and generally is related to one or more partners' ability to bring new,

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additional and innovative expertise, viewpoints, networks, channels, human capital and opportunities.

At the time of an equity recapitalization, ownership takes "chips off the table" and enters into a relationship with a qualified, proven partner. Ownership retains a level of economic ownership while continuing to manage business operations. Over time, the combination of ownership and the recapitalization partner results in accelerated results and exponential growth in enterprise value. Recapitalizations are very attractive options to business owners because the owner remains a stakeholder in the business and because frequently the second bite of the apple is bigger than the first.

A common misconception among business owners is that recapitalizations require sacrificing operating control. In fact, recapitalization is a great financing technique for owners that have a clear vision for the business but lack the network to open up new channels/opportunities or financial resources to make the appropriate investments (e.g., build out a sales force, open new offices, expand production capacity). Recapitalization partners focus on the process of growing a company and are not experts in operating a particular business. Accordingly, such partners generally require owners'/operators' participation in establishing a vision and executing the day-to-day operations.

There are situations in which a recapitalization transaction is not likely to be an optimal choice. For example, recapitalization may not make sense if the owner is evaluating a near-term shift away from the business, such as retirement or a

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career change. Generally, recapitalization partners like to ensure that their long-term interests are aligned with those of the other equity participants. Recapitalization also may not be an ideal direction when business owners intend to pass down the business to the next generation. This is because recapitalization partners seek to maximize business value in anticipation of realizing that value over a defined period.

An equity recapitalization is just one of several liquidity options and sources of capital for business owners. In future editions of *Pursant M&A Insider*, we will discuss other options, including debt recapitalizations and outright sale of a business. Stay tuned....

Pursant's Expectations for Q2 and Beyond in 2015

We expect sustained healthy deal flow and valuations in 2015 due to strong macroeconomic conditions; access to abundant affordable capital; and restocked piles of investment capital being held by PE groups after another year of aggressive fundraising and excess cash on corporate balance sheets.

The initial prediction of certain mid-year rate increases does not appear likely to come to pass until later this year now, if at all. The sluggish economy in Q1 2015 and slow wage growth will likely keep current fiscal policy in its current holding pattern.

Pursant's discussions with business owners reveals that business owners are realizing that these favorable market conditions are not indefinitely sustainable. They sense that it may be time to act on monetizing the value of their businesses given the fact less than 15% of companies are being passed to the next generation. This aligns well with buyers' continued desire for acquisitive growth and organic growth percentages that are generally low. We feel that acquisitions will continue to emphasize strategic fit, synergies and the need to acquire good people in the process. Creative deal structures will address these criteria accordingly. Buyers will continue to demand thorough and professionally prepared information, earlier in their review of each acquisition opportunity, including deep transactional and financial analysis.

We expect to continue to see more business owners planning for the 3rd act in their professional careers. Business owners want to understand the true value of their businesses and how to improve that value. The businesses that are better positioned in advance of the sale process will be rewarded with higher valuations, smoother and less intrusive pre-closing due diligence, and a quicker deal cycle to close the transaction.

Pursant's Investment Banking practice served as advisor on the following strategic transactions in Q1 2015

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, Financial Services and Strategic Advisory business units use a deep immersion process, our expansive networks and experience as owner/operators to successfully optimize operations and manage strategic transactions — vital, integrative initiatives for which our clients may not have the time, manpower or competencies.

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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