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M&A insider

Q1 2016 Highlights:

- Middle Market M&A volume is down more than 20% compared to same period last year
- Valuation multiples are no longer increasing, but have stabilized at 2015 levels
- Political uncertainty and soft macroeconomic conditions have contributed to a pause in M&A

Pursant's Thoughts on Q2 2016

- Dealmakers are optimistic that M&A volume will pick up as the year progresses
- Fed is signaling that another rate increase may not take place until second half of 2016
- Increased clarity on potential political outcomes could reduce distraction from M&A

Q1 2016 Middle Market M&A Summary

What has happened to middle market deal flow? Q1 2016 middle market deal flow has slowed to levels not seen since the Lehman Brothers collapse in 2008. We are not on the verge of another collapse, but many dealmakers say we are dealing with two other potential causes for slowdown: the political climate and the tightening of credit.

In the short term, the uncertainty of an election year may be a factor in slowed middle market deal flow. Which presidential candidate will be better for dealmaking is heavily debated. Traditionally, Republicans are perceived as more business-friendly; however, the primary candidate selection process to date has been anything but traditional. Certainty is one of the prerequisites for a healthy M&A environment. Once U.S. leadership has been determined, there will be more certainty, and M&A volume should increase.

Another factor likely contributing to the M&A slowdown is the tightening of credit. Traditional banks continue to face regulatory scrutiny as to how much leverage should be applied to strategic transactions.

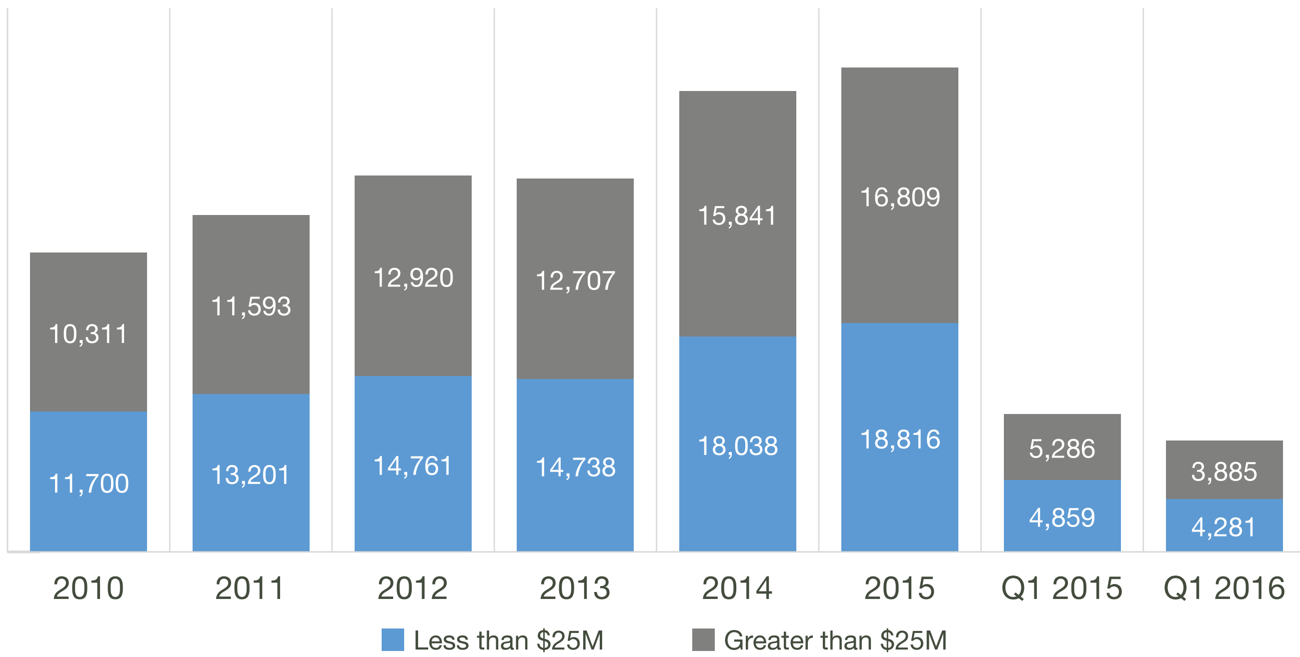
(Continued...)

Inside this edition of the M&A Insider:

The Pursant 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.

Chart #1

US & CANADA M&A TRANSACTION VOLUME BY TRANSACTION VALUE



Source: Cap IQ®

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Chart #1 shows that North American Q1 deal flow in the middle market fell compared to the same period last year.

Looking at the US macroeconomic picture for Q1:

GDP - The US economy expanded an annualized 0.5 percent in the first three months of 2016, lower than a 1.4 percent expansion in the previous period, and below market expectations of 0.7 percent growth. It is the weakest performance since the first quarter of 2014 when the economy contracted 0.9 percent as consumer spending slowed.

Consumer Sentiment - The GDP decline was matched by a decline in Consumer Sentiment, which declined every month in Q1, from 92.6 in December to 91 in March; however, early Q2 data shows an improvement in Consumer Sentiment.

Business Spending – According to the Federal Reserve Board, business spending generally expanded across most Districts. Districts reported that inventories generally were in line with sales. Capital spending increased on balance in most Districts.

Unemployment – Unemployment is largely unchanged at around 5% for Q1 2016, with wage growth virtually non-existent, especially for unskilled and semi-skilled positions.

Fed Lending Rate – The Federal Reserve Bank said that recent economic data warrants continued gradual interest-rate increases and that policymakers could risk fueling a bubble in the commercial real estate market if they delay action for too long. If the incoming economic data continues to be consistent with gradual improvement in labor markets and inflation keeps nearing target, the Fed should be ready to gradually normalize interest rates. Fed officials will next meet in June to share their assessments of the economy and decide whether to raise rates for the first time since December 2015. While several Federal Open Market Committee (FOMC) members have said that a June hike remains an option, investors think otherwise. Prices in Fed funds futures imply that investors do not expect a rate increase before December of 2016.

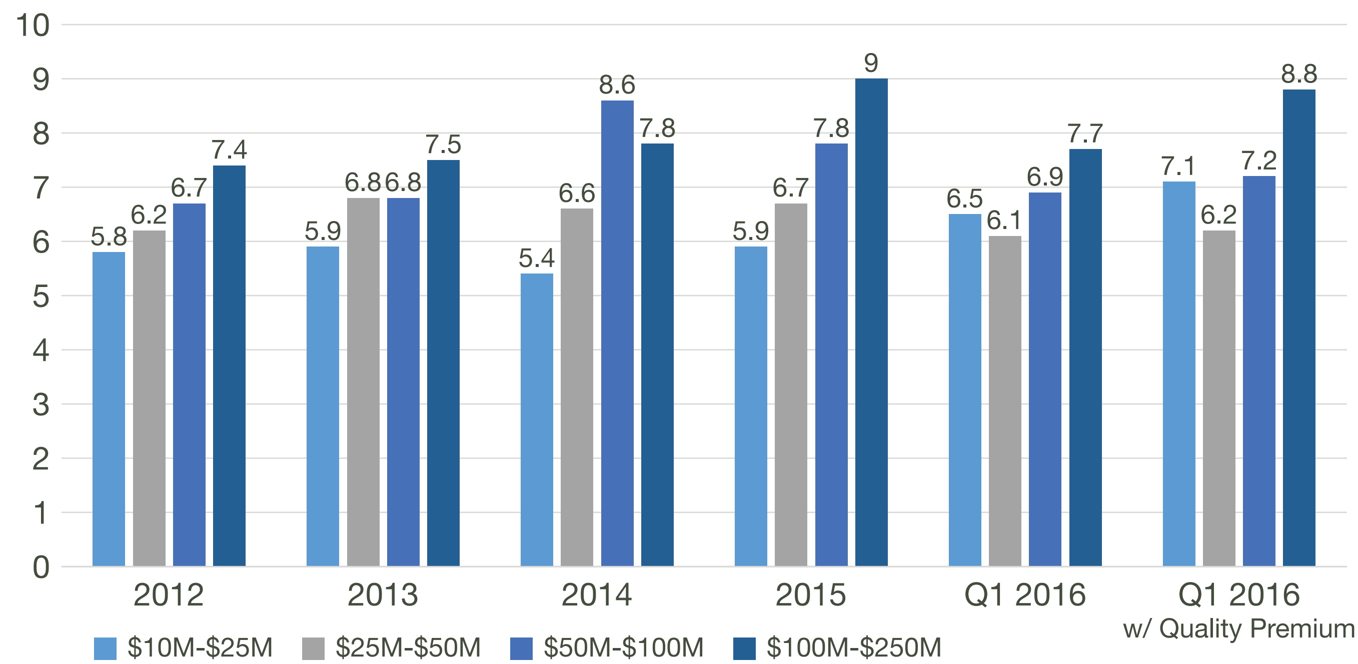
What does all of this mean for middle market M&A and strategic transactions? We know interest rates affect strategic transaction volume and valuations. When combining the economy's low unemployment rate, low wage growth, modestly growing business spending and soft GDP growth, despite a looming commercial real estate bubble, the Fed is in no hurry to raise rates. This means that as the election cycle works its way to a close, dealmakers are optimistic that M&A volume will increase, or in a worst case scenario remain at its current level. While not ideal, things could be worse.

Transaction Multiples – Not surprisingly, with slowed deal flow comes stabilizing and even softening valuation multiples, especially for businesses that do not have revenue or earnings growth that is markedly better than other companies in the same sector. Good times or bad, better companies will always value higher, but marginally performing companies will be the first to feel the impact of a slower M&A market.

Chart #2 shows that, as anticipated, valuation multiples in the lower middle market have peaked and may even be showing signs of softening; however, companies that have above average financial characteristics, defined as TTM EBITDA margins and revenue growth each exceeding 10 percent, trade at a premium (Quality Premium). Excluding companies with a Quality Premium, Q1 2016 multiples averaged 6.7x, consistent with 2015 and 2014.

Chart #2

Total Enterprise Value (TEV)/EBITDA



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.

The "quality premium" is reserved for companies that have above average financial characteristics, defined as TTM EBITDA margins and revenue growth each exceeding 10 percent.

Key Deal Terms: Indemnifications and Escrow/Holdbacks

When discussions take place about M&A and strategic transactions, most of the dialogue is around valuation and the percentage of cash at close; however, there are a host of other important deal terms that may have greater significance than transaction value. Two very common terms to be negotiated are terms around Indemnification and Escrow/Holdbacks.

Indemnification - In a strategic transaction, sellers indemnify the buyer against potential issues that may arise post-close as a result of the seller's actions prior to close. The buyer needs protection from these actions. The question then is what is an appropriate cap and period of time for these indemnifications. The answer is that it depends on the size of the deal and risk profile of the business. Generally speaking, the bigger the company, the lower the cap as a percentage of total purchase price. Chart #3 and #4 below illustrates how deal size plays a role in determining the cap and period. **For 2015, the average indemnification cap was 14.9% and period was 18.1 months.**

Chart #3

Indemnification Cap – Percent of Total Enterprise Value

TEV	2010	2011	2012	2013	2014	2015
$10M-$25M	23.0%	27.3%	23.0%	19.9%	23.0%	16.2%
$25M-$50M	15.3%	12.1%	14.1%	16.5%	14.6%	16.2%
$50M-$100M	13.4%	9.2%	10.4%	14.3%	10.7%	11.2%
$100M-$250M	16.0%	15.4%	10.1%	10.3%	12.8%	10.6%

Source: GF Data®

Chart #4

Indemnification Period – Months

TEV	2010	2011	2012	2013	2014	2015
$10M-$25M	19.8	18.7	18.5	21.3	18.1	17.8
$25M-$50M	18.0	17.9	17.8	19.3	16.6	19.4
$50M-$100M	21.1	17.5	18.0	16.8	18.3	18.9
$100M-$250M	21.2	16.6	20.6	14.6	22.3	14.4

Source: GF Data®

Indemnification Cap *refers to the general indemnification provided by the seller to the buyer against breaches of reps and warranties. This does not include carve-outs for specific issues or items. For example, parties often agree that the general cap will not apply in the event of fraud.*

Indemnification Period *refers to the period after closing during which a buyer may assert a breach of the reps and warranties against seller. Again, this does not include carve-outs. For example, exposure on tax, environmental, and ERISA issues often exceeds the general indemnification period.*

Escrow/Holdback - Even in the case of an "all cash" deal, there will almost certainly be some transaction funds placed in escrow or retained by the buyer, subject to events or conditions expected to occur post-closing. Whether the transaction is an asset or stock transaction, both buyers and sellers can benefit from holdbacks. A holdback can serve as a bridge between differing views on specifically targeted risks. For buyers, it can assure them access to indemnification payments for post-closing risks ranging from working capital adjustments, to tax issues, to financial statements representations and warranties. For sellers, it can serve as an exclusive fund to which buyers can look for breaches of representations and warranties, thereby creating a "cap" on indemnification liability. Chart #5 and #6 show market percentage and periods for escrow/holdbacks. **For 2015, the average lower middle market escrow/holdback percentage was 6.6% and period was 16.1 months.**

Chart #5

Escrow/Holdback – Percent Of Total Enterprise Value

TEV	2010	2011	2012	2013	2014	2015
$10M-$25M	8.1%	7.4%	7.4%	8.0%	8.6%	6.9%
$25M-$50M	7.9%	6.4%	7.3%	6.5%	6.9%	6.5%
$50M-$100M	5.5%	6.9%	5.5%	4.4%	4.2%	3.9%
$100M-$250M	5.1%	6.8%	6.0%	3.3%	6.0%	10.2%

Source: GF Data®

Chart #6

Escrow/Holdback Period – Months

TEV	2010	2011	2012	2013	2014	2015
$10M-$25M	17.1	16.6	17.8	15.7	17.0	16.0
$25M-$50M	16.2	15.5	16.6	17.1	19.0	16.6
$50M-$100M	17.5	19.1	14.4	18.4	15.4	16.3
$100M-$250M	16.6	19.4	17.1	11.3	16.3	14.3

Source: GF Data®

Escrow/Holdback *refers to transaction consideration either placed in escrow or retained by the buyer, subject to events or conditions expected to occur post-closing. For example, the parties may agree to a working capital adjustment based on financial statements that will not be available until after the end of the fiscal period. This does not include earn-outs or other payments payable to the seller post-closing contingent on the selling company's performance for a certain period post-closing.*

Escrow/Holdback Period *refers to the time when the last of the funds placed in escrow or held back are scheduled to be released to the seller.*

Private Equity - An Attractive Liquidity Solution

Things You Should Know When Evaluating an Opportunity with Private Equity

When executives and business owners assess exit, liquidity and capital solutions, they are faced with a variety of options. A popular option to consider is private equity.

The term "private equity" is commonly used terminology in today's business and investment world; however, this asset class remains mysterious and vague to many executives and business owners. In the ensuing discussion, we provide an overview of private equity and at the end of the article provide several key considerations business owners and executives should address when evaluating an opportunity to transact with a private equity investor.

Private Equity 101

Private equity is an asset class in which investors expect to achieve returns that exceed those possible through public markets.

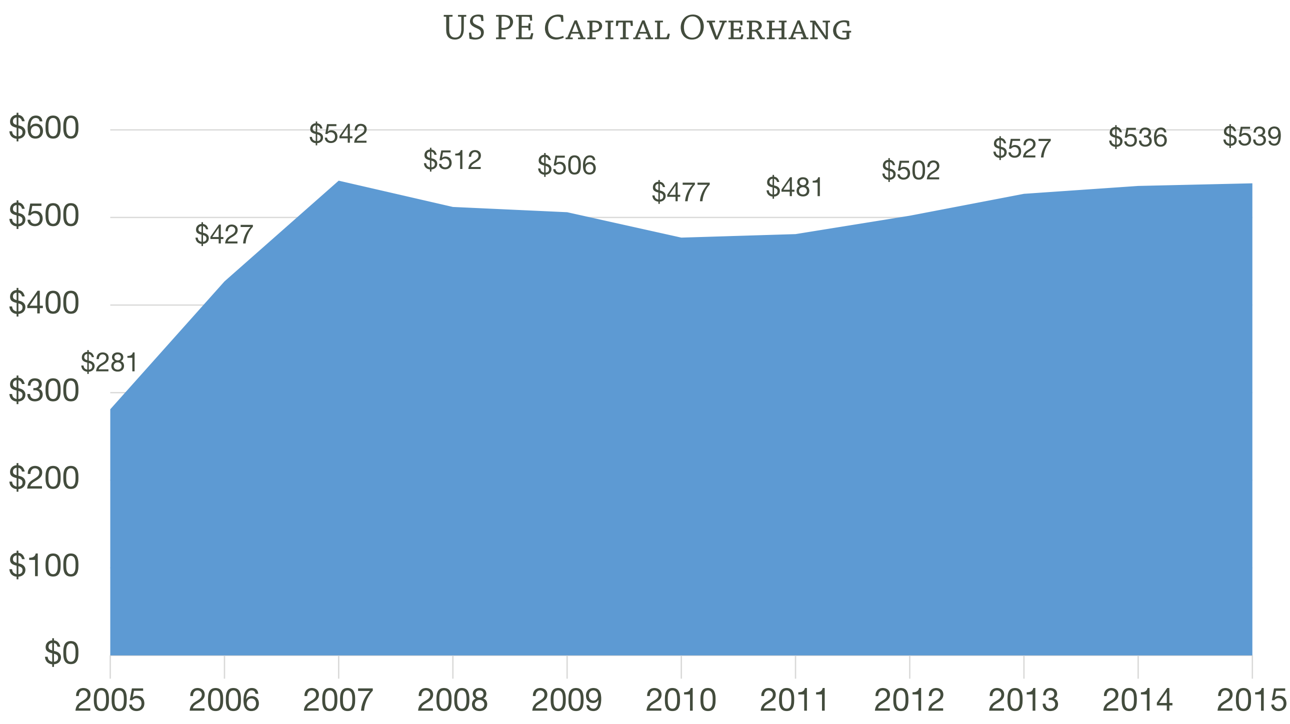
Private equity groups invest from dedicated, committed funds raised from institutions such as pension funds, endowments, sovereign wealth funds and high net worth families and individuals. Over the past decade, the fundless private equity group (also referred to as independent sponsors) has emerged and is continuing to gain popularity. These investors don't have committed funds but rather raise the capital on a deal-by-deal basis.

The amount of capital raised but un-invested by private equity is called the "capital overhang". Chart #7 below shows how this number has ballooned to nearly $540B, its highest level since 2007. This is not an optimal situation for private equity groups. If they don't invest this money, they have no return on the capital raised.

Every private equity group has specific goals, preferences and investment strategies. For example, certain funds focus on providing growth capital to existing businesses, whereas others focus on early stage concepts (e.g. venture) or distressed situations. Some are generalists while others target certain sectors, geographies or business sizes.

Private equity investors generally control and maintain significant influence over strategic decisions, governance and key personnel. Private equity groups focus on enhancing the enterprise value of the business

Chart #7



Source: Pitchbook®

in which they have invested. Some employ a passive approach to managing investments while others utilize an active, high touch approach. A key element of the private equity model is the goal of exiting an investment and realizing a return. Accordingly, private equity groups generally hold investments (portfolio companies) for three to seven years.

Private equity investors evaluate new opportunities as platforms which have a proven business model and sufficient scale with which to operate as a stand-alone business; or as an add-on which is a smaller operation that is "tucked in" to a platform business. Private equity investors target companies in which it is felt that value can be unlocked by addressing the business strategy, injecting new managerial talent or engineering the financial approach. Many private equity investors encourage and incent sellers to remain with the business for a period of time ranging from a shorter term transitional period to a more permanent, long term role.

A common and key metric used particularly in private equity is earnings before interest, taxes, depreciation and amortization ("EBITDA"). EBITDA is a proxy for cash flow the business generates. Generally, private equity firms value investments based on a multiple of the Company's EBITDA. The multiple is based on a variety of factors including company-specific items (size, financial profile, growth opportunities, etc.) as well as market conditions.

Key Considerations When Selecting a Private Equity Partner

Private equity investors will conduct thorough due diligence prior to making an investment. As the recipient of the investment, you should feel equally empowered to perform due diligence on the private equity suitor.

As part of a seller's due diligence on the potential private equity group, we strongly encourage our clients to perform reference checks which include a good cross section of companies the private equity group currently owns, exited and even ones they considered but with whom a transaction did not take place. We also highly recommend that a seller research and evaluate answers to the following key questions:

- What is the private equity group's track record with businesses of similar size and type?
- Aside from capital, what does the private equity partner offer to the business – relationships/network, strategic planning capabilities, operational enhancements, new business opportunities?
- Who at the private equity group will be assigned as dedicated team members that will work with the executives and managers of the business?
- Do the culture and values of the private equity group fit with those of the business and its key executives?
- What are the post-closing expectations related to communication/correspondence protocols, reporting requirements, frequency of BOD and other meetings?
- What are the expected returns on the private equity investment and how are those determined, monitored and tracked over the course of the investment?
- What is the expected exit transaction, including timeline to the exit?

In conclusion, private equity remains a viable option for businesses seeking a liquidity event. Current market conditions are favorable for sellers seeking to transact with private equity firms, as the amount of capital raised but un-invested by private equity firms is at the highest level since 2007. Private equity firms typically bring non-monetary value to the table. Each firm has its own strengths, strategies and objectives, so it is important that business owners pursuing such an opportunity conduct thorough due diligence to find the right fit.

Pursant's Expectations for Q2

Even though the 2015 M&A party is over, it doesn't mean we have swung to the other side of the spectrum where gloom and doom reside. Strategic and private equity dealmakers remain motivated to do deals due to low interest rates, good (not great) macroeconomic numbers and an abundance of cash. Additionally, the emerging clarity of potential presidential outcomes will help fuel the M&A engine.

The Fed expects second-quarter GDP growth to slightly exceed the estimate for the economy's long-term potential growth rate, which is pegged at 1.75 percent. That should be enough to continue pushing down unemployment, while edging wages and inflation upward. With this in mind, interest rates are not expected to increase until the second half of 2016, which should result in decent, if not improving, deal flow in Q2.

We expect the appetite for strategic buyers to remain intact.

According to a recent study by KPMG, the top 5 reasons buyers are motivated to buy this year are:

1. Expand customer base
2. Enter new lines of business
3. Expand geographic reach
4. Enhance IP
5. Opportunistic reasons – intriguing targets become available

We expect that valuations will continue to be equal to or slightly less than the levels experienced in the last 24 months. This excludes companies with the Quality Premium characteristics.

Despite our strong dollar, we also expect US M&A volume and valuations to continue exceeding those in other countries by wide margins, due to our across-the-board stronger economic performance and safe haven environment.

In summary, we expect the middle market strategic transaction climate to be favorable for both buyers and sellers. With sustained healthy economic recovery, many businesses are doing well and some are doing great, which means it continues to be a climate very favorable to sellers. For buyers, capital remains cheap, organic growth options are limited and the average age of business owners to continues to increase, so more and more businesses will come to market, giving buyers continued exposure to new deals—however, not likely as many as they would like to see to sustain good deal flow for all buyers.







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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