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M&A insider

Q2 2016 Highlights:

- Middle Market M&A volume held steady with Q1 2016
- Valuation multiples remain attractive and stable
- Political uncertainty and soft macroeconomic conditions have failed to derail M&A activity

Pursant's Thoughts on Q3 2016

- Current volume and other metrics will remain intact
- The Fed's rate increase threats are likely to be inconsequential
- Dealmakers will continue stewing over political outcomes but do deals anyway

Q2 2016 Middle Market M&A Summary

Middle market M&A transaction volume seems to have settled at a more "normal" level for the first half of 2016. The blistering pace of 2015 was not sustainable and there was certainty that 2016 would be down some, but the question was, how much, especially given the chaos of Brexit, acts of terrorism and the almost circus-like craziness of the political season. These events have failed to curb the middle market's appetite for strategic transactions. Q2 2016 transaction volume seems to be relatively consistent with the very healthy pace of Q1 2016.

Credit has failed to tighten any further since the Fed's rate increase at year-end 2015. Consensus is that the Fed has no real desire to increase rates again soon, despite almost weekly threats that rates may increase at any time. Dealmakers have mostly tuned out this chatter, feeling that a near-term rate increase is either not likely or will be immaterial to middle market deal activity.

Net out a stable interest rate environment and favorable economic conditions (especially compared to the rest of the world), and you

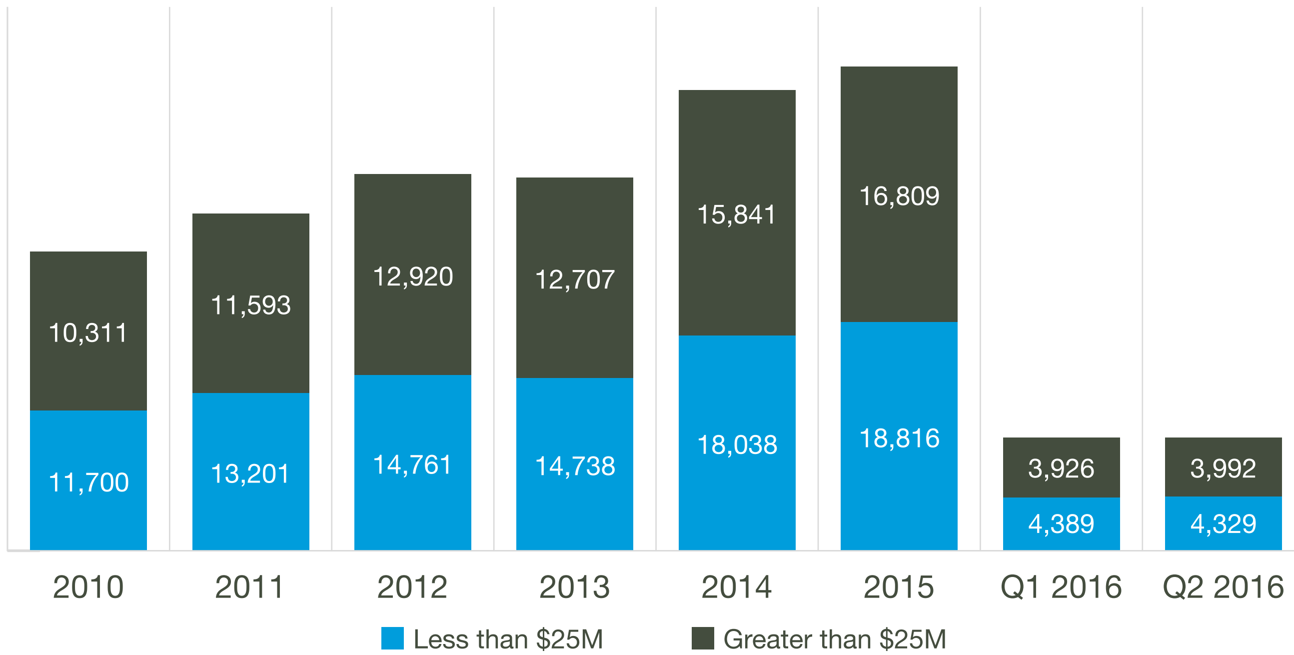
(Continued...)

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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create a middle market transaction environment that is still very healthy for deal activity and valuations. Chart #1 above shows that North American Q2 2016 deal flow in the middle market is paced with Q1, albeit down from the first half of 2015.

Looking at the US macroeconomic picture for Q2:

GDP - The US economy grew an annualized 1.2 percent quarter on quarter for the three months ending June 2016 (after Q1 was downwardly revised to 1.1 percent growth), well below market expectations of a 2.6 percent expansion. Consumer spending was the main driver of growth while investment slumped and business inventories fell for the first time since 2011.

Consumer Sentiment - The University of Michigan's Consumer Sentiment Index for the United States ended Q2 at 93.5 in June, down from 94.7 in May. The Index 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.

Business Spending – The business spending outlook was generally positive across broad segments of the economy including retail sales, manufacturing and real estate. Overall growth in business spending is expected to remain modest.

Unemployment – Q2 Labor market conditions improved modestly since Q1. Unemployment is largely unchanged, ending Q2 at around 4.9%. Wage pressure has picked up, leaving firms that have not increased their wages with the least-skilled employees.

Fed Lending Rate – The Federal Reserve Bank has held firm on not raising rates, stating that its assessment takes into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations (currently below 2%), and readings on financial and international developments. The Federal Open Market Committee (FOMC) will carefully monitor actual and expected progress toward its inflation goal. The FOMC continues to expect that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate. The federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run. However, the actual path of the federal funds rate will depend on the economic outlook as informed by incoming data.

What does all of this mean to M&A and strategic transactions in the middle market? The direction and performance of the greater economy gives us an indication of where we are at and heading as it relates to favorable or less favorable phases of the business transfer cycle. The business transfer cycle is continually moving through periods of more and less seller-favorable transaction periods. *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.*

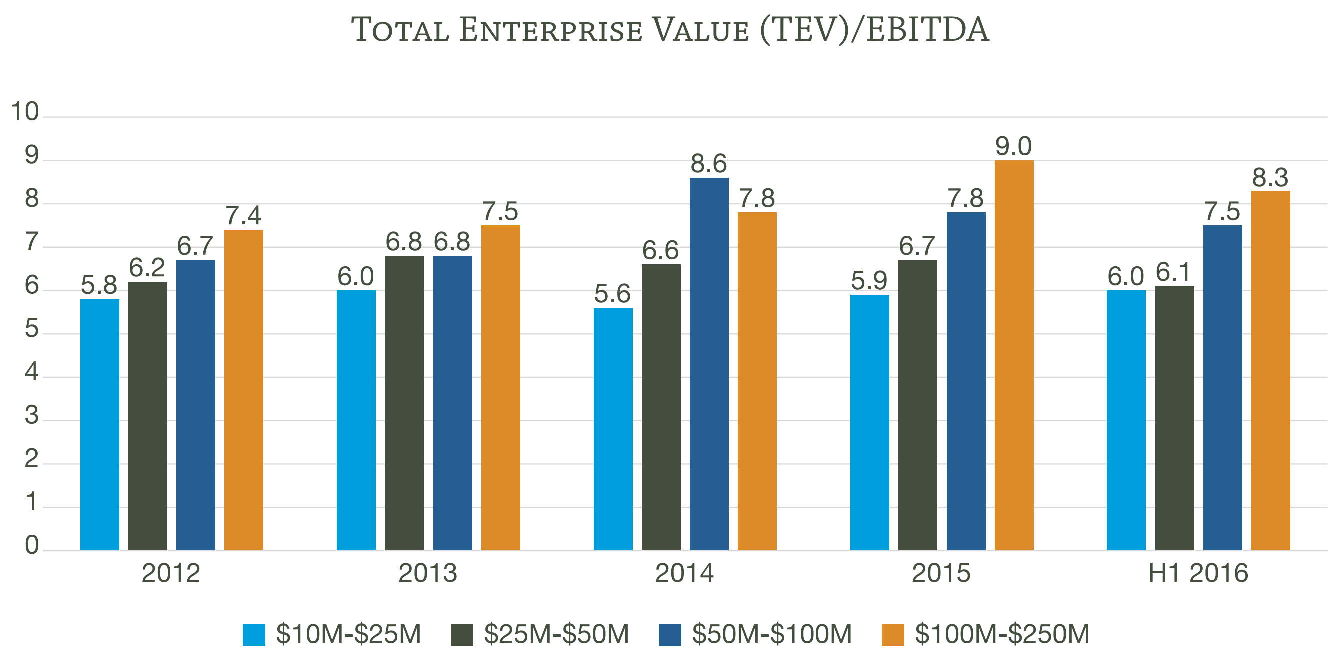
Transaction Multiples – Data shows that valuations generally have remained stable with an average of 6.8x TTM Adjusted EBITDA, which is up slightly from the prior two quarters but is essentially in line with market averages since 2014.

What's worth more, Platforms or Tuck-ins? - Pursant gets asked quite often whether a buyer will pay more for a platform acquisition or an add-on (tuck-in) acquisition. A drill-down of the data shows there is currently a slight premium (maybe up to .5x) for platforms over add-ons.

Lower Middle Market vs. Small Business - We are also asked about transactions with enterprise value below $10M. There is a gray area between $5M and $10M in TEV that is debatable as to whether it is in the zone of small business or middle market. But once below $5m in TEV, a deal is solidly placed in the small business category where there is a much wider range of valuation multiples.

Chart #2 shows that lower middle market valuation multiples for the first half of 2016 have remained relatively consistent with 2015. There may be some slight softening but levels are still very frothy.

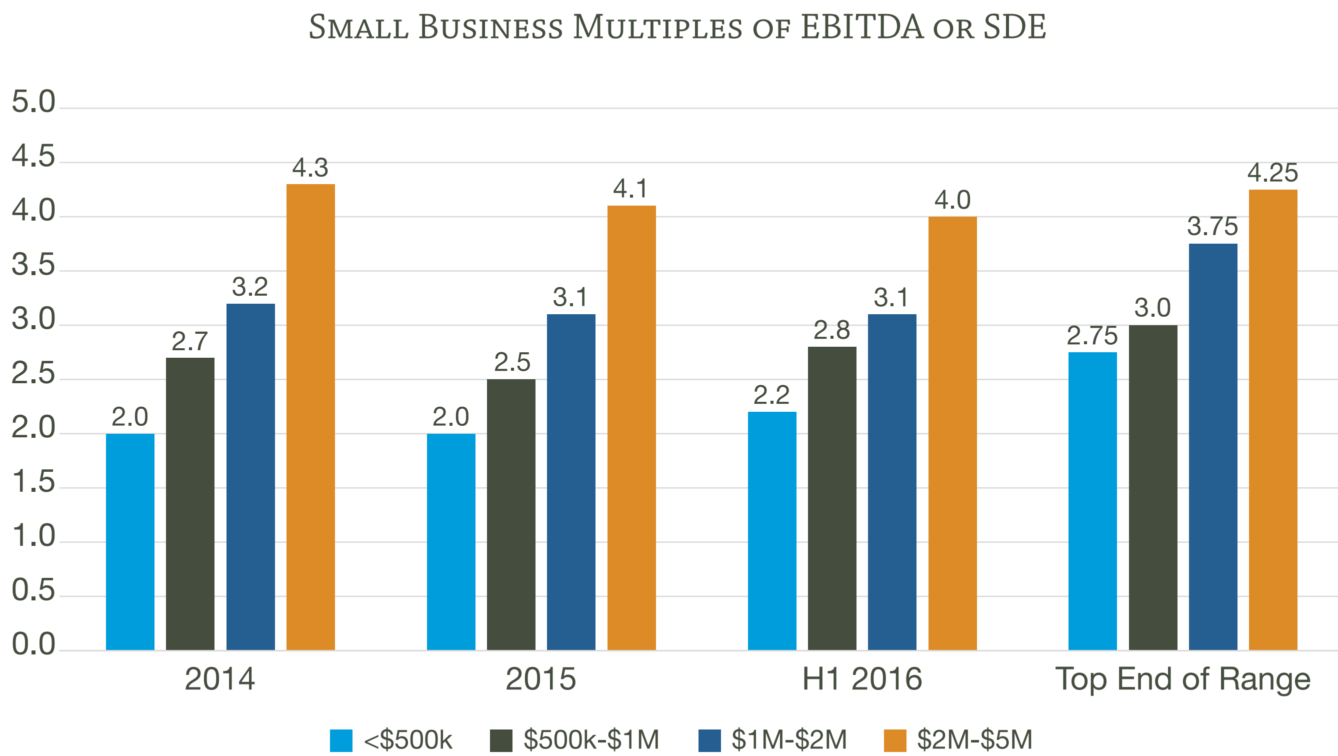
Chart #2



Source: GF Data®

Chart #3 shows that small businesses trade in the multiple range of 2-4 times EBITDA or SDE (defined below), with the top of the ranges being 2.75 – 4.25. These ranges have remained virtually unchanged historically and will likely continue to remain this way. This is largely due to the fact that there is limited ability to apply multiples of leverage to small business transactions. They are predominantly cash transactions, with some aspect of a seller note or SBA or senior secured loan.

Chart #3



Source: Pepperdine Private Capital Markets Project®

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.*

SDE Defined — *For many small businesses, valuation is expressed in the form of a multiple of SDE (seller discretionary earnings)—the pretax and pre-interest profits before depreciation, owner's benefits, one-time investments, and any non-business related income or expenses. SDE will generally ultimately get a "negative adjustment" to add expense for someone to perform the role of the owner post-transaction. Multiples of SDE vary greatly depending on a company's risk profile, the markets in which it operates and the likelihood of continued cash flow.*

How Long Does It Take To Complete A Deal?

The first two questions typically asked in advance of a sale are "what is my business worth?" and "how long will it take to get a deal done?" The first question is often easier to answer than the second. All strategic transactions, including M&A transactions, take many months to get done. Even the "easy" deals usually take longer than expected.

Chart #4 shows how for middle market companies with EBITDA in excess of $1M, the average time to close, from the time a business starts dialogue with interested parties, is nine months. The average time from LOI to close is four months. With smaller transactions, these durations are somewhat shorter, but all deals are taking longer to close than reported in the past.

Chart #4

TIME TO CLOSE

EBITDA	Months to Close	Months from LOI to Close
<$500k	6	2
$500K-$1M	6	3
$1M-$50M	9	4

Source: Pepperdine Private Capital Markets Project®

The increased time to close is likely a result of two factors:

1. It is a seller's market. Businesses are commanding valuation premiums, which buyers are okay with paying as long as the business is sound and sustainable. Buyers are applying increased due diligence scrutiny to support the more lofty valuations. This more extensive due diligence period has extended the time to get deals closed.

2. Due to the cheap cost of capital, there is more debt (leverage) being applied to transactions. With this increased debt load, buyers and lenders alike are being more thorough in reviewing the company's ability to consistently service the debt loads.

The extended deal timeline can be both physically and emotionally challenging for parties working the deal process and running the business. A seller's market can be a wonderful thing for a business owner, but it does not come without the price of deal fatigue.

Making the Case to Buy Your Growth Versus Building It

Brian Steffens – Pursant Managing Director

While acquiring a business is not without risk, it is typically a faster and more efficient way to grow your business and build value if you have a proper executable plan, a solid team, and a well-run core business. The following covers some of the reasons why this is the case.

Immediate results in new markets - Does your growth plan call for opening up a new territory? Will you need a sales force, a distribution point and inventory? Have you ever done this before? Embarking on this initiative organically will take time and money with an uncertain future. Contrast that with buying a business with an established presence in that market. Assuming you do your diligence and the target company is a solid fit with your organization, acquiring a business means you start on day one with an established customer base, recurring revenue, inventory, a distribution point and local know-how.

Greater predictability of expansion expenses - How long does it take and how much does it cost to ramp up from launch to profitability? One of the biggest challenges with green-fielding or forming an alliance to achieve growth is that the costs, timing and likelihood of success are difficult to predict and rely on assumptions and hunches. Conversely, there is a track record for the target company that can be modeled with some degree of surety and incorporated into your go-forward business plan.

Purchasing power - Your newly acquired entity will allow you to leverage bigger volumes and additional market share into cost savings with your supply base. It is likely that your firm and the target company can consolidate purchases with one supplier in order to leverage economies of scale and cut down on transaction costs (e.g. packaging, shipping). Does your combined volume move you up on a supplier's priority list? If so, you may reduce lead times and possibly reduce the amount of safety stock required as well. All of these factors can have a positive impact on margins and cash flow. Establish a task force to identify as many of these types of opportunities as early as you can in the acquisition process and ensure that the opportunities are addressed in the initial phases of the integration.

Abundant access to acquisition capital - It is often said that those that really need money cannot get it and those that don't need it have ample access. Acquisitions are a unique case where need and desire meet to form a robust ecosystem. If you have a well-run company with a good plan and story, the world of capital providers (debt and equity) opens up. There are many options available through traditional institutions, private equity and alternative lenders.

Build enterprise value faster - The capital markets reward larger, more established companies. Consider two identical companies with similar market positions, both with good futures and strong management teams, one with $5M in revenue and $750k in EBITDA, the other with $15M in revenue and $2.25M in EBITDA. The capital markets will value the larger company (all else being comparable) more favorably on a multiple of EBITDA perspective (see chart #2). That 1x to 2x difference as a multiple of EBITDA will translate to big dollars when you become the target acquisition.

These are just a few of the benefits of having an acquisitive growth plan to complement your organic growth strategy. Many middle market companies do not realize that acquisitions are within reach. Assuming you have solid business practices, strong management teams, access to capital and either the internal or outsourced resources to develop and drive the acquisition, acquisitions can significantly impact the growth trajectory and enterprise value of your business.

Want a Premium Valuation - Don't Forget to Focus on the Subjective Variables

Scott Glickson – Pursant Managing Director

Valuation is a process of determining a business' worth by looking at objective and subjective elements of the business. Analyzing objective measures is relatively straightforward. For example, financial performance is largely an objective measurement.

An equally important part of the process is understanding the role that subjective variables play in the valuation process. Subjective variables can drive the company's ability to command premium valuations at the higher end of the valuation range (see transaction multiple in Chart #2 & #3). This is due to the impact that subjective variables have on the sustainability and growth of the business. Accordingly, business owners and executives risk leaving value on the table if subjective variables aren't properly managed in advance of a liquidity transaction.

The following discusses five major subjective variables that are commonly evaluated in M&A transactions:

- **Management Team** – Companies not dependent on their owner but rather on experienced, layered and strategic management teams allow investors to reach higher on valuation. Generally, surrounding the owner with one or more qualified sales executives, operations leaders and financial teams, is an impactful human capital strategy.
- **Benchmarking** – Companies that demonstrate that they outperform industry and market benchmarks command premium valuations. As a starting point, businesses should be acutely aware of their industry and market key performance indicators ("KPIs"). KPIs should measure financial attributes (e.g., revenue per unit) as well as operational items (e.g., miles per route, square feet per hour, revenue per employee). Companies should regularly track and report their KPIs and analyze them against known industry and market KPIs.
- **Concentration** – Companies with less concentration concerns are viewed far more favorably than those that have an extreme dependency on a few customers or people. Concentration also extends beyond customers and suppliers to include manufacturing and the entire supply chain.
- **Future Untapped Value** – This subjective variable deals with the potential to take the business from good to great. Companies that can articulate and demonstrate that there is "plenty remaining to be harvested" generate higher valuations. For example, can your business platform and established customer relationships be leveraged by adding service or product offerings? Are there untapped geographic expansion opportunities?
- **Back of the House** – Companies that have sound practices, policies, procedures and platforms are highly valued. This includes having current licenses, appropriate IT/software solutions, financial controls, risk management strategies, accurate/timely financial reporting, up-to-date employee documentation and sound employment practices.

To achieve a specific transaction price at or above the higher end of a range, it is imperative that the subjective variables paint a favorable picture. Properly addressing subjective variables is a long term process. The key is to begin thinking about, planning and executing on these subjective variables well in advance of embarking on your liquidity event journey so that the results of these initiatives have time to "bake in" to the business.

Pursant's Expectations for Q3 2016

After crossing the 2016 midpoint, we now have more visibility into how early 2016 predictions have panned out and how the middle market strategic transaction arena is likely to close out this year. So far, as expected, 2016 volume fell off from 2015 but has remained surprisingly stable in spite of some chaotic world events (Brexit, terrorism, politics, etc.). This shows that it will take a lot more in H2 2016 to stop this North American strategic transaction train and that the year will still likely be the second-best year for deals since the 2008-2010 recession. The lower end of the middle market is especially resistant to macro-economic conditions since the baby boomer generation dynamics are forcing deal flow to increase, which is likely to continue for another decade.

With the flow of cheap capital expected to continue and the economy in fair but not great condition, growth hungry strategic buyers have been forced to seek acquisitions as the path for growth.

As a result, we expect that valuations will continue to hold steady for Q3 and the balance of 2016. In short, the formula for a strong valuation environment is:

Cheap capital
+ Limited organic growth options

= Frothy multiples

The Fed does not expect the economy to be markedly better through the balance of 2016 than it has been during the first half of the year, making a rate increase unlikely—especially as the rest of the world continues dropping rates, furthering the debt rate delta between the US and the rest of the world. This means cheap capital will remain plentiful. We are seeing interest rates for senior secured debt for deals remain in the 3-4% range with non-recourse senior debt in the 6-7% range, both credit facilities with favorable terms.

The impact resulting from the outcome of the election remains a wild card for the deal world. There is uncertainty swirling around both Presidential candidates as it relates to the effects of their policies on business. If recent poll results hold, resulting in a Clinton victory, it may hurt near term deal flow; however, if Clinton loads up on a pro business Cabinet, that may bring back deal favorable tailwinds.

In summary, Pursant expects the middle market, especially the lower middle market, to remain resilient to the current levels and types of domestic and global events. The result: a strategic transaction climate that remains favorable for both buyers and sellers for Q3 and likely the balance of 2016. Businesses overall are doing well and in some sectors doing great, which means it continues to be a climate very favorable to sellers. Buyers don't care for the frothy multiples, but if the targeted company is a good business and capital remains cheap, buyers remain ready, willing and able to get deals done.

Pursant is the Investment Bank that also builds the value of your business.

We use a deep immersion process, our expansive networks and experience as owner/operators and deal makers 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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