Q3 2014 EDITION

Pursant
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M&A insider

No Apparent Missteps As We Near the 2014 Finish Line

- M&A Volume still up more than 20% versus 2013
- Valuations still good and consistent with 2013
- "Quality" Premiums of up to 16%
- "Size" Premiums of up to 30%
- Senior & Junior debt averaging 3.7x

We can predict the right time to do a deal; currently we are in the middle of the best selling phase.

Pursant's Thoughts on the 2014 Finish

- Q4 should surpass Q3 volume, making 2014 the best year since 2007
- 2014 will finish strong, continuing into 2015
- Despite increased volume in 2014, the shopping spree is not over

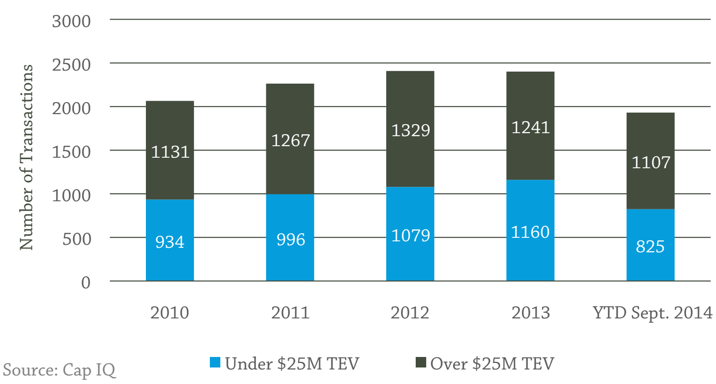
2014 Middle Market M&A Summary

Third quarter 2014 deal volume shown in chart #1 indicates that the middle market will perform just as well in the second half of the year as it did in the first half. Q3 2014 PE middle market deal activity continues, with YTD total deal volume beating that of 2013 and 2012. 2014 is still proving to be the best year since the financial crisis began in 2008. Business values remain strong; however, we have seen some firming up of the acquisition multiples for companies with valuations under $50M.

The market shows continued signs of strength going into the fourth quarter. We expect Q4 volume to exceed that of Q3 (as it typically does each year). We also expect sustained healthy deal flow going into 2015 due to the remaining stockpiles of investment capital being held by PE groups and cash on corporate balance sheets. With continued strong economic indicators, strategic buyers will continue with their shopping sprees.

Chart #1

LOWER MIDDLE MARKET M&A DEAL VOLUME



Source: Cap IQ

2014 Multiples Looking to Finish Strong

Companies valued at $25-$50M that were acquired by private equity firms have traded at 6.5x EBITDA through September of 2014, down .5x from 7x in 2013. The same .5x drop was seen for companies valued at $10-$25M; here multiples dropped from 5.9x EBITDA in 2013 to 5.4x EBITDA in 2014. Small businesses with less than $10M in transaction value are still exhibiting multiples in the 3x-5x range.

Transactions above $100M have been closing at 7.7x on average in 2014—significantly higher than the 7.1x multiple of 2013. Transactions in the $50M-$100M range are up slightly from 2013.

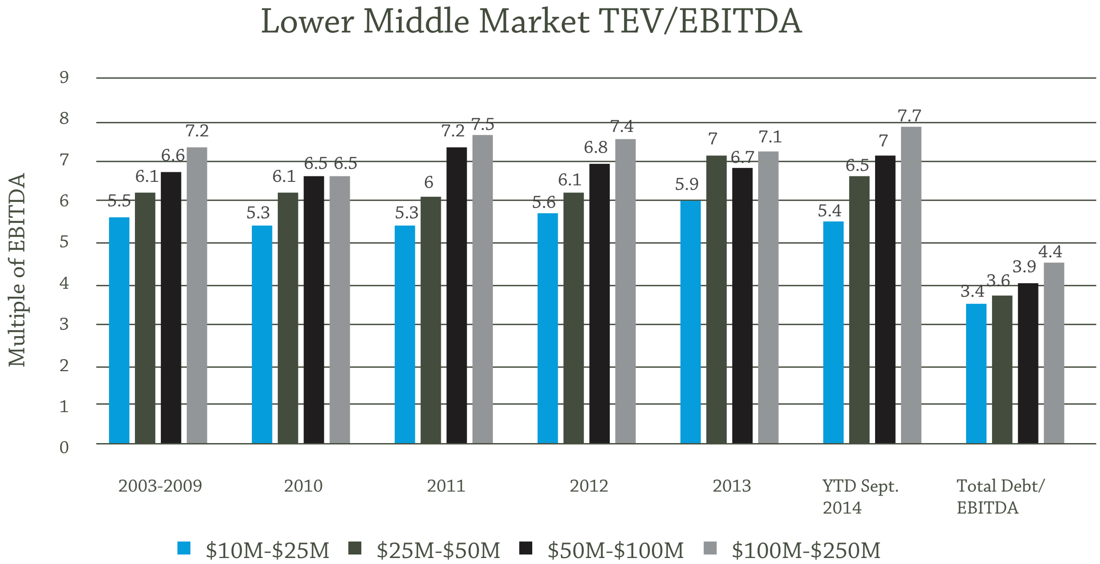
Pursant has completed numerous transactions year to date, primarily with strategic buyers. The multiples seen in these transactions closely resemble the PE multiples reflected in chart #2.

Capital Continues to Be Available As Leverage

Often buyers will use debt to fund acquisitions, regardless of their cash positions. Debt is currently an attractive way to fuel an acquisition campaign, as it is abundantly available and affordable right now. Depending on the buyer's capital structure and the deal economics, a buyer can generally count on being able to finance 25% to 75% of the acquisition cost in the form of Senior and/or Junior debt.

Chart #2 below includes a section showing how much leverage a buyer can count on accessing for a transaction, depending on its size. The senior portion generally will be 2.5x, with the balance coming in the form of Junior debt. Considering leverage in Senior and Junior forms and in all sectors of the lower middle market, the average multiple is 3.7x. Typically, the larger the business, the more a buyer can leverage.

Chart #2



Source: GF Data®

Quality Gets You a Premium

Regardless of size, if your business resides in the "quality" category, the data shows that you will be richly rewarded for this, especially in the $10-$25m TEV category. In the M&A world, a quality company is a company that has above average financial characteristics.

If your TTM EBITDA margins and revenue growth each exceed 10%, congratulations! You are part of what appears to be an exclusive club these days and the data shows that you will be rewarded with a significant valuation premium. For example, in the $10-$25M TEV category, the multiple jumps from 5.4x to 6.3x. On average, companies within the $10-$250M TEV range in the Quality Premium category can expect a 7% increase in valuation, with the smaller companies benefiting the most with a 16% increase.

TEV/EBITDA – BUYOUTS WITH ABOVE AVERAGE FINANCIAL CHARACTERISTICS

TEV	2003-09	2010	2011	2012	2013	YTD Sep. 2014
$10-$25M	5.4	5.3	5.3	5.6	6.1	6.3
$25-$50M	6.1	6.1	5.8	6.4	7.4	7.0
$50-$100M	6.7	6.8	7.4	6.6	7.1	7.6
$100-$250M	7.7	6.8	7.5	7.7	8.2	7.8

Source: GF Data

Size Gets You a Premium

The reward for a bigger company still remains very pronounced in 2014. Data shows that the "size premium" for a company valued at $50-$250M is significant. In 2014 it's worth an additional 1.7x. Debt availability appears to be driving the heightened interest in larger middle-market companies.

A talent premium also still applies when the incumbent management team is continuing on with the buyer, or if it is not needed.

TEV/EBITDA –SIZE PREMIUM FOR LARGER BUSINESSES

TEV	2010	2011	2012	2013	YTD Sep. 2014
$10-$50M	5.6	5.6	5.8	6.2	5.7
$50-$250M	6.4	7.3	6.9	6.9	7.4
SPREAD	0.9	1.7	1.1	0.7	1.7

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 they operate and the likelihood of continued returns.

Where Are We in the M&A Cycle?

We know that all good things must come to an end. The question is, when is that end coming? If you look at the graph below, you will see that to a certain extent, we can predict when M&A activity is more favorable and to whom. History shows that economic highs and lows run in cycles. In the case of M&A, those cycles run approximately 10 years. Rob Slee, author of "Private Capital Markets," has done extensive research in this area. For example, using Slee's framework, let's assume that real economic recovery started in late 2009 to early 2010. If history repeats itself, today's predominantly seller-favorable environment should end in 2016. However, 2016 is an election year, so we can expect a slight extension, and given the anemic rate of the recovery, some feel this cycle may last even a bit longer. History shows that ten years is the typical length of the M&A cycle.

Further research tells us that the United States economy experiences some sort of economic downturn during the first few years of every decade. When this happens, the capital supply becomes restricted, especially to the private markets. This is primarily due to restricted lending, which reduces the leverage a buyer can achieve and lowers valuations. This also limits access to working and investment capital.

After a few years, capital starts to again flow into the private market. When that happens, the market begins the cycle of over leveraging again. This is then followed by a period of deleveraging.

As human beings, we generally become overly optimistic in the good times and overly pessimistic in the bad times. We also take a predictable amount of time to adjust to changing conditions. The catalyst for each of these phases can vary (fiscal policy changes, bankruptcies, mortgage failures, etc.).

Obviously, businesses will continue to be bought and sold every day, but a savvy business owner will look to exploit this cycle to his/her advantage.

Lesson: When your M&A Advisor tells you that now is the time to do a deal, seriously consider acting on this insight.

U.S. TEN YEAR BUSINESS TRANSFER CYCLE

	Deal Recession (buyer's market)	Prime Selling Time (seller's market)	Uncertainty (neutral market)
1980	1983	1988	1990
1990	1993	1998	2000
2000	2003	2008	2010
2011	2013	2018	2020

Pursant's Perspective for the Balance of 2014

While it seems many other countries are still struggling with sustained economic recovery, the U.S. economy appears to be improving and on track to expand by nearly 3 percent for the current year--markedly better than the average 2.2 percent pace since the end of the recession in June 2009. In contrast, the EU area economy has stagnated and is suffering from the softest inflation in five years. Unemployment in the U.S. has dropped to a six-year low of 5.8 percent in October as nonfarm payrolls rose by a greater-than-forecast 214,000, according the Bureau of Labor Statistics.

To determine our outlook for upcoming periods, we look at indicators such as the economy, the job market, organic revenue growth of companies, inflation, interest rates, cash reserves and alternative opportunities for companies to get yield on their cash. All of these indicators point to continued strength in M&A activity in 2015. Strategic buyers need to continue augmenting top line growth with acquisitions, since organic growth is generally moderate. Financial buyers continue to have large amounts of investment capital available, and new funds are appearing weekly. The result: both types of buyers will be scrambling to identify the right candidates for acquisition.

Pursant's discussions with buyers continue to reveal a strong desire for acquisitive growth. 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 are demanding increasingly thorough and professionally prepared information, earlier in their review of each acquisition opportunity, including deep transactional and financial analysis.

Our firm has seen an increase in the number of "exit planning" engagements as business owners start the process to understand the true value of their businesses and how to improve it. 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 helps business owners grow the value of their companies and maximize that value when they exit.

Our Investment Banking, Strategic Advisory and Executive Search business units use a deep immersion process, vast industry network and experience as owner/operators to successfully manage M&A transactions, raise capital, pursue business optimization strategies and recruit talent — 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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