Q3 2017 EDITION

Pursant
INSPIRED PURSUIT

DEAL insider

M&A and Strategic Transaction Insights

THE INVESTMENT BANK THAT ALSO BUILDS THE VALUE OF YOUR BUSINESS

Q3 2017 Highlights:

- Deal volume down from 2016, but still robust
- Valuation multiples remain high; borrowing costs remain low
- Favorable GDP growth and other macro indicators continue to fuel M&A optimism

Pursant's Thoughts on Q4 2017 and Early 2018

- 2017 total deal volume will be solid; down slightly compared with 2016
- Potential near-term closure on tax reform will favorably impact M&A
- Strategics and Private Equity are already signaling a rise in M&A activity in 2018

Q3 2017 Middle Market M&A Activity Remains Robust

Middle market deal activity remains robust and this segment continues to be predominantly a "seller's market," especially for businesses with healthy earnings and favorable risk profiles. Strategic parties continue to have excess cash on hand and limited organic growth options. Financial buyers still have a lot of dry powder to deploy, ample fund raising opportunities and access to favorable interest rates on borrowed funds. In short, the winds are blowing favorably for both buyers and sellers, but sellers still have the advantage.

Speaking specifically to middle market deal volume, Chart 1 shows that the lower end of the middle market has trended slightly lower (down 1.6%) in 2017 than in 2016.

Chart #1

Deal Size	9/30/17	9/30/16	Change
$1B+	313	285	9.8%
$500M - $999.9M	263	204	28.9%
$250M - $499.9M	301	314	-4.1%
$100M - $249.9M	527	537	-1.9%
$50M - $99.9M	411	419	-1.9%
$25M - $49.9M	412	393	4.8%
$10M - $12.9M	468	499	-6.2%

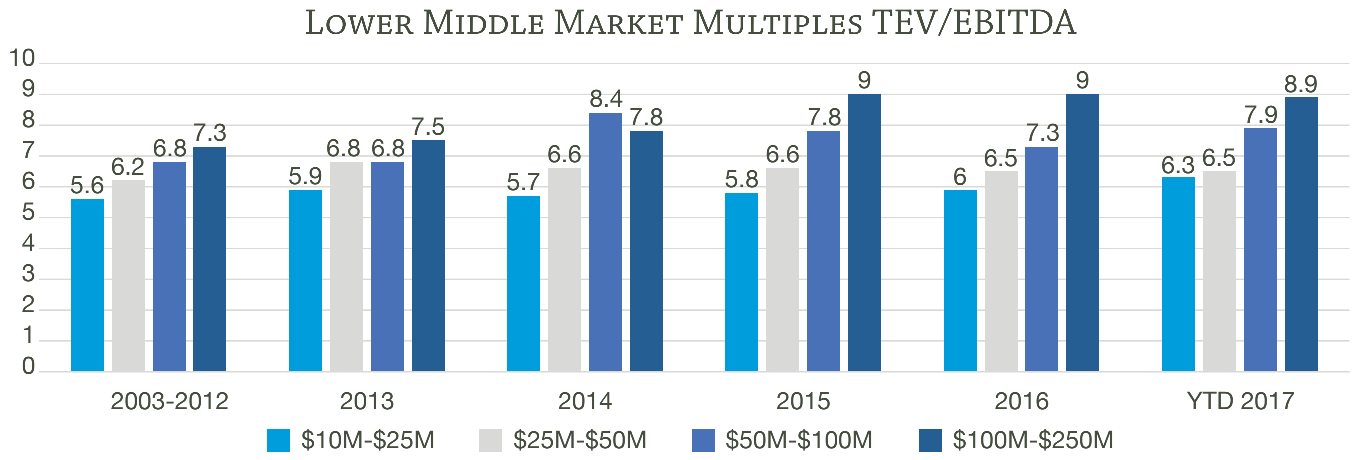
Source: Factset®

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 maximize transaction outcomes.

For the balance of 2017 and into early 2018, we expect this strong market for deals to persist as long as the seemingly endless supply of companies entering the deal market continues, and debt is cheap. Pending tax and regulatory reform remains a distraction in deal making discussions, but has not caused truly motivated parties to delay pursuing a deal. If you are a buyer or seller, now is an excellent time to be looking at strategic transaction options. And, if you are one of the 10,000 Baby Boomers retiring each day, the market is waiting for you with open arms.

Transaction Multiples – Chart 2 shows that Lower Middle Market EBITDA multiples, measured by Total Enterprise Value (TEV)/EBITDA, remain stable, with an average of 7.1x for transactions YTD through Q3 2017—slightly up from 6.8x in 2016. In the third quarter, we saw strength in valuation on smaller transactions (the $10M-25M tier clocked in at an unusually high 6.9x) and on deals not featuring above average financial characteristics (essentially no quality premium for the quarter). We caution against reading too much into numbers for any one quarter, but these could be signs that favorable market conditions are extending to more pedestrian businesses—typically a harbinger of a crest.

Chart #2



Source: GF Data®

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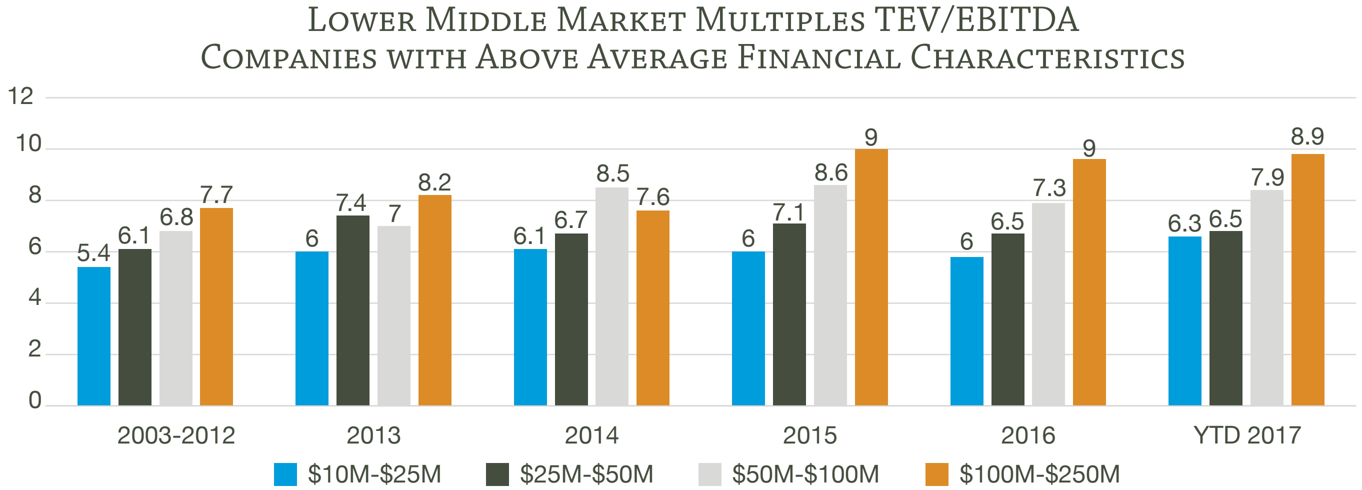
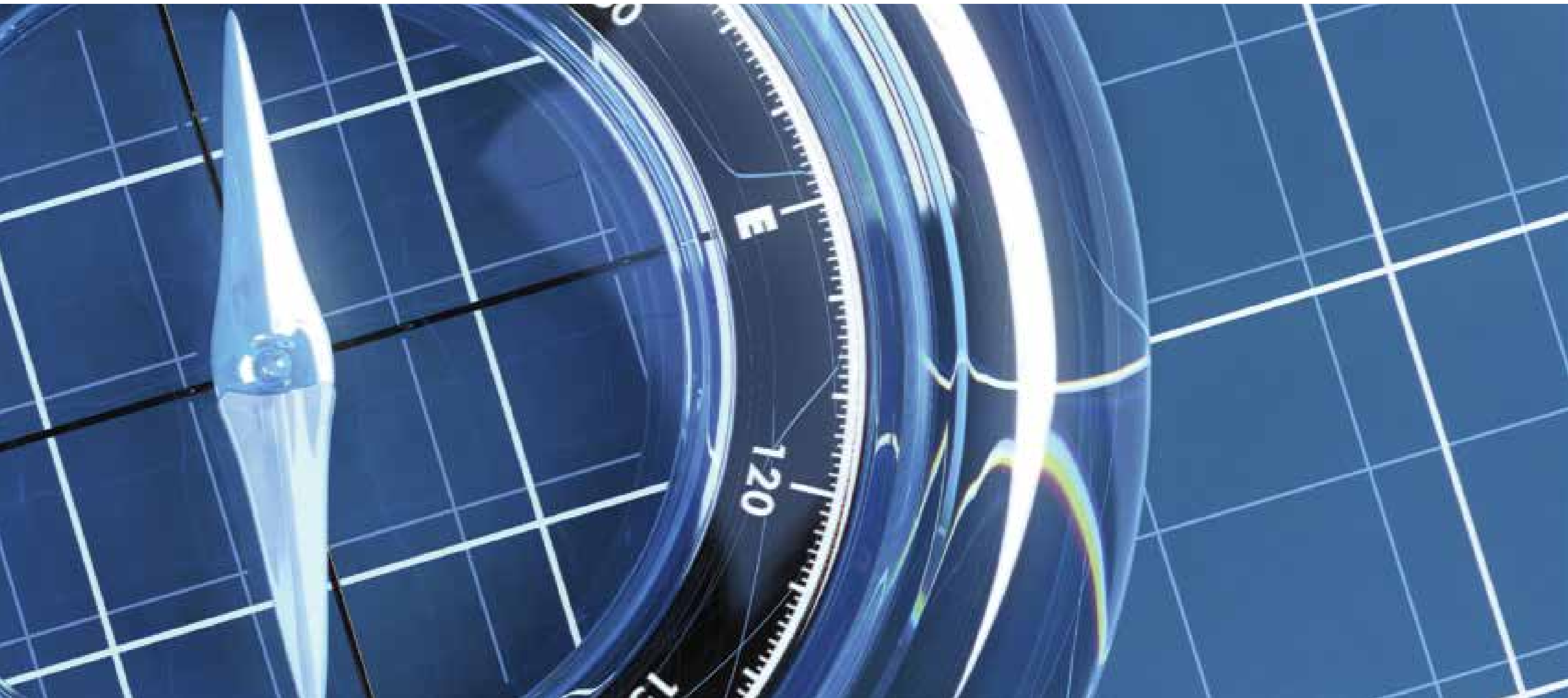
The Quality Premium – Chart 3 shows how the reward in valuation extended to "better" financial performers is especially pronounced on larger lower middle market transactions. The Quality Premium applies to businesses with TTM EBITDA margins and revenue growth rates both above 10 percent, or one measure above 12 percent with the other at least 8 percent. These better performers received an average multiple of 7.5x versus 7.1x for businesses without the better performance metrics.

Chart #3



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.*



Indemnification Caps and Periods – There is more to getting a deal done than simply agreeing to multiples and percentage of cash at close. Other factors that are often key to negotiations include Indemnification Caps and Periods. Charts 4 and 5 show how Cap percentages and periods have factored into deals over the past 5+ years. Most notable: in Chart 4 we see the precipitous drop in Indemnification Cap as a percentage of TEV as of late in the $50M TEV and up categories. This decline is directly attributable to the introduction and increased usage of Rep & Warranty insurance in larger lower middle market deals. The coverage is difficult to procure and is seldom used in deals with TEV less than $50M.

Chart #4

Indemnification Cap – Percent of Total Enterprise Value

TEV	2012	2013	2014	2015	2016	YTD 2017
$10M-$25M	23.0%	18.6%	22.4%	17.9%	19.6%	16.2%
$25M-$50M	14.5%	16.2%	15.2%	15.4%	13.5%	10.3%
$50M-$100M	10.4%	13.8%	10.6%	13.4%	21.7%	4.8%
$100M-$250M	10.1%	13.3%	12.8%	10.1%	4.2%	5.6%

Source: GF Data®

Chart #5

Indemnification Survival Period – Months

TEV	2012	2013	2014	2015	2016	YTD 2017
$10M-$25M	18.4	20.8	18.1	18.4	17.9	18.1
$25M-$50M	17.8	19.0	16.7	19.2	22.0	16.9
$50M-$100M	18.0	17.0	18.5	18.5	18.5	21.2
$100M-$250M	20.6	14.7	22.3	14.4	13.9	19.1

Source: GF Data®

To learn more about Rep. & Warranty insurance, see Pursant's Q2 2017 Deal Insider newsletter, which can be downloaded from www.pursant.com.

There is more to getting a deal done than simply agreeing to multiples and percentage of cash at close. Other factors that are often key to negotiations include Indemnification Caps and Periods.

The US Macroeconomic Picture for Q3 2017

GDP – The US economy grew 3.3% in the third quarter of 2017. This comes on the heels of an upwardly revised Q2 GDP of 3.1%. This is the fastest pace of growth since Q1 2015. The 3.3% GDP growth beat expectations of 2.5% despite the disruptions caused by Hurricanes Harvey and Irma. Inventories rose sharply and trade made the biggest contribution to growth in nearly four years amid a fall in imports. It helped to offset a slowdown in consumer spending and fixed investment and a drop in construction.

Consumer Sentiment – U.S. consumer sentiment finished Q3 2017 at 95.1, unchanged when measured against the end of Q2 2017. Consumers have voiced greater certainty about their expectations for income, employment, and inflation, which contradicts media buzz about approaching cyclical peaks and an aging expansion. The implication: greater uncertainty about future economic trends.

Business Confidence – The Institute for Supply Management's Manufacturing PMI finished Q3 2017 at 60.8, beating market expectations of 58. It is the highest reading since May of 2004, boosted by a rise in new orders, production and employment.

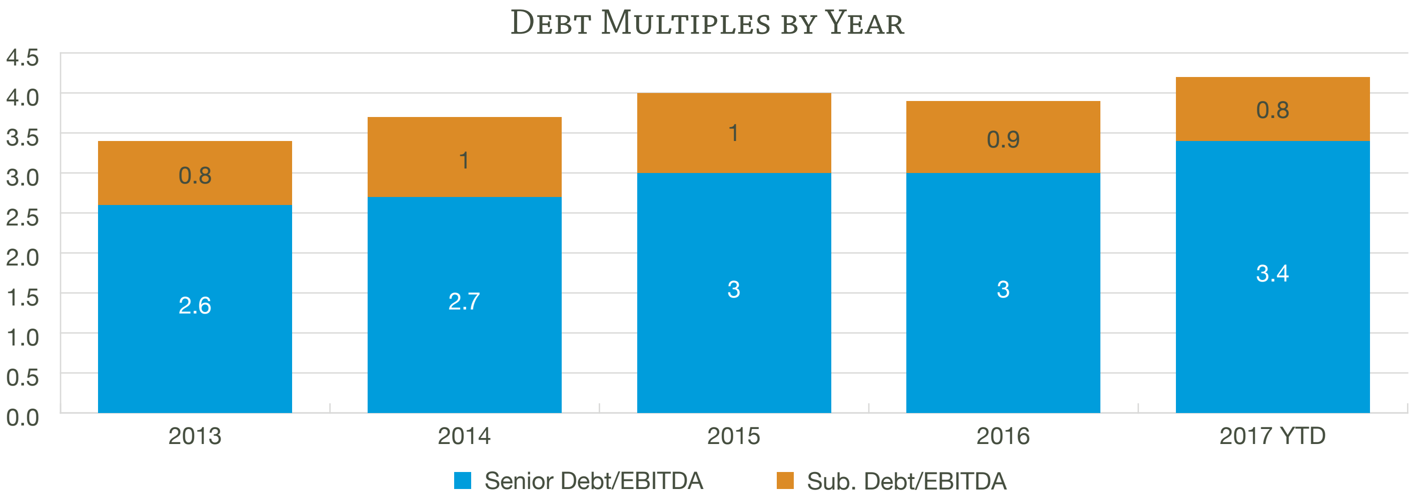
Unemployment – The U.S. unemployment rate continues to fall, finishing Q3 2017 at 4.2%. Since January of this year, the unemployment rate is down by 0.6 percentage points.

Fed Lending Rate – The Federal Funds Rate continues at 1% to 1-1/4% at the end of Q3 2017. Overall, Federal Reserve Bank directors remained positive about the prospects for economic growth, although their reports on recent activity varied across sectors and districts. Some directors noted the economic hardships and disruptions occurring in areas affected by recent hurricanes but generally did not expect a longer-term impact. The directors of one Reserve Bank favored increasing the Fed Funds Rate as an appropriate reflection of a growing economy, tight labor markets and an expected rise in inflation

Pursant watches these macroeconomic indicators because the direction and performance of the greater economy provide hints as to whether the Middle Market is heading into favorable or less favorable phases of the business transfer cycle. These favorable macro indicators continue to fuel a protracted favorable M&A climate. *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 capital to fund M&A activity.*

Leverage Multiples – Chart 6 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 YTD 2017 averaged 4.2x EBITDA. Most notable is the steady rise in appetite from senior lenders.

Chart #6



Source: GF Data®

The single most important Best Practice that owners should engage in—whether they are in acquisitive, continual operating, or sell mode—is to be consistent and forward looking in gathering, reporting and interpreting financial and operational results and to subject these findings to a documented business review.

Best Practices for Running Your Business for Maximum Performance and Enterprise Value

Richard Curry, Pursant Managing Director

Best Practices are defined as **"commercial or professional procedures that are accepted or prescribed as being correct or most effective."** In business, the various desired end results of a Best Practice implementation can be an individual or collective optimization of business operational efficiency, improved governance, financial improvement and production of transparent data.

The single most important Best Practice that owners should engage in—whether they are in acquisitive, continual operating, or sell mode—is to be consistent and forward looking in gathering, reporting and interpreting financial and operational results and to subject these findings to a documented business review. These business reviews, conducted with and by various stakeholders, operational and administrative personnel, typically consist of the following topics:

Financials – Uses predictable reporting cycles and consistent reporting formats to establish the ongoing earnings power of an enterprise; provides a consistent basis for forecasting future financial performance.

Operations – Gauges efficiency/productivity, supervisory efficacy, operational spend, safety metrics and other operational resource utilization.

Human Resources – Reviews adherence to policies/procedures relating to hiring, training, compensation, conduct, legal concerns, employee reviews and other human capital initiatives.

Client Information – Provides consistent and standardized modes of analyzing client mix, individual profitability and efficiency, historical commentary on the company-client relationship and periodic contract review.

Growth and Marketing Strategy – Reviews head and tail winds impacting the company's growth and marketing strategy and competitive intelligence.

In the context of a sale, an acquisition or ongoing business-as-usual operations, the discipline of maintaining predictable and documented enterprise commentary and results has value to:

The Acquirer – These processes make it much easier to determine if the acquisition target and deal structure will be accretive, dilutive or neutral to the company. The Acquirer starts with basis data, and if this data is in an internally consistent format (business review related), it is much easier to bring target data in, fold it to the internal analysis and produce predictive result modeling.

The Seller – A disciplined and documented business review process makes the selling and diligence process much more efficient and sends a powerful positive message to the prospective buyer. In effect, it will help tell the story of the company using consistent data and process as the underpinning. Valuable time will be saved if the dialogue is focused on explaining the process and results and not on "digging out" endless obscure data that is poorly presented.

The Ongoing Enterprise – The documented business review process will lead to the use of analytics to enhance the ownership experience as well as prepare the ongoing enterprise to engage in a successful acquisition or disposition strategy.

Regardless of industry, size and business strategy, a robust and direct business review process will always bring business benefits, enhance communication and improve enterprise value.

In M&A, It's Always the Season to Avoid Impulse Shopping—The Value of Properly Screening Target Companies

Brian Steffens, Pursant Managing Director

When executing an acquisition growth initiative, it is critical to develop a target company screening process that allows the acquiring company to objectively assess the strategic fit of the target(s). This screening process should take place after the deal thesis/strategy development and before Indication of Interest (IOI) or Letter of Intent (LOI) phases of a M&A deal timeline. When screening is done successfully, an acquisitive company will have built a database that includes robust potential acquisition target summaries—critical information that will foster informed discussions the company can leverage throughout the M&A deal process.

By performing proper screening, the acquiring company seeks to either include or exclude a potential target from a long list of potential acquisition targets. The deal team prioritizes targets by applying a framework to narrow the scope of potential targets as much as possible.

Companies that do not take the time to screen properly at the outset of an M&A initiative struggle to get good deals done. An ineffective process often begins opportunistically with a call or a meeting with another company executive or an investment banker/intermediary. In the absence of thorough screening, this approach to M&A will result in an inconsistent, informal, and mostly undefined assessment of the target company's "fit" with the acquirer's products, services, markets, and cultures. Needless due diligence, executive time and legal dollars, can be lost to sub-par opportunities. Do not fall prey to the shiny object syndrome.

Designing and implementing a well-organized vetting approach positively impacts every subsequent stage of the M&A process by providing:

- **Prioritization on Strategic Fits:** Corporate development activities consistently target opportunities that help fulfill the strategy of the business. If an ad hoc opportunity arises, management can quickly and efficiently assess it and move forward or discard.
- **Reduction of Bias & Influence:** When left unstructured, personal and professional relationships and individual preferences and experiences can strongly influence how opportunities are viewed and championed. This bias will complicate the process and can undermine strategic objectives. Having a common framework that ties back to your deal strategy keeps the discussion focused and objective.
- **More Efficient Use of Resources:** Time spent by key executives on companies with poor "fit" prevents them from focusing on more valuable opportunities. With a consistent screening process, a company is more likely to properly deploy resources by targeting companies that are more attractive based on the defined deal strategy.
- **Ongoing Growth Initiative Framework:** Maintaining focus on multiple opportunities is both critical and challenging when running an acquisition process. The formal screening process will preserve the integrity of the decision-making process and provide structure. Business leaders are able to keep tabs on why companies have been included or excluded over time and analyze opportunities as they develop.

Now that we have discussed some of the benefits of proper screening, let's review some of the key steps in the assessment process:

- **Establish & Define Target Assessment Criteria:** A well-designed target assessment distills the company's M&A strategy into the key attributes they seek in the target. It clearly articulates the organization's goals and highlights the factors that make an opportunity attractive. A few common initial assessment factors are geography (e.g., we are looking to grow our presence in the Northeastern USA), size (e.g., we are looking for companies with revenues greater than $20M), capabilities (e.g., we want companies that manufacture their own products), and customers or markets served (e.g., we do not want anyone that serves the retail sector). Over time, more criteria can be added to clarify and refine the criteria necessary to fulfill the M&A strategy.

- **Build a Target Acquisition Pool List:** Once you have documented the target assessment criteria, you will need to build a comprehensive list of companies from which to begin the screening process. The size and scope of this list is heavily dependent on the company's industry, strategic intent and how rigid the acquisition criteria are. The initial list should be assembled from multiple sources, such as SIC or NAICS codes databases, industry databases, trade associations, proprietary lists, industry journals, etc. Pulling information from diverse sources reduces the probability that a favorable candidate will be overlooked. Casting a wide net initially also can assist in consensus building: when multiple opinions exist it can force the deal team to further clarify the company's wants/needs.

  Once a comprehensive list has been created, a system can be built in which to store key data on an ongoing basis, including which companies have been included or excluded for consideration and why.

- **Vetting the List:** Now that the list has been built, the real work begins. Each company or potential opportunity should be assessed as either a "fit" that moves on in the process or "not a fit." This is done through a combination of primary research—such as contacting the company and talking to the owner or key executive, interviewing key industry players or industry insiders—or secondary research like articles, corporate websites or market research reports. Key here is to quickly and efficiently eliminate those opportunities that do not meet the basic threshold for inclusion and identify those that should be considered for further assessment.

  The acquiring company will need to balance attributes, some positive and some negative, that it discovers about a target company, and make sense of them. A best practice on how to handle this challenge is to use a numerical raking system. For example, a company at the ideal size of $20M in revenue might be given 10 points, whereas a company with a slightly less attractive size of $10M in revenues might be given 5 points. Adding up the points across all the criteria allows for prioritization of the opportunities. Weighting each criterion also can help with prioritization of target companies. For example, the target's management team might be rated a 10 (very critical), but revenue might be rated a 5 (important, but less important to the overall strategy). One should multiply the ranking in each category by the weighting and then total for each candidate. These aggregate rankings allow the company to review multiple opportunities and objectively compare them.

- **Documentation of Prospective Acquisition Targets:** It is critical to document information about the target in one place in a "target summary." Key information to include: owner, size, location(s), organizational structure, motivation of sale, background, contact information on target company's decision makers, management team background, ownership structure, company or product history, product or service information, customer concentration, market segment data, business alliances, and competitive overview. With these target summaries in hand, decision makers have enough information to make an initial decision whether or not to have a "chemistry call" with the owner and dedicate internal resources to the opportunity. While profiles should not be considered sufficient due diligence to move forward with a transaction, they do provide a good tool with which to begin the process.

In summary, implementing a proactive screening system will contribute significantly to the success of a company's M&A strategy, saving considerable time, effort and resources and translating to positive bottom-line results.

Stock versus Asset Deal—What Both Buyers and Sellers Need to Know

Scott Glickson,
Pursant Managing Director

Buyers and Sellers generically use the term “company” when discussing the acquisition or sale of business. No one actually buys or sells a “company.” More specifically, they buy or sell the company’s stock/interests or its assets. This early stage negotiation point can get complicated, especially when Buyers have limited information about the underlying risks in the target company.

In the middle market, Sellers generally prefer stock/interest sales, as the after-tax take home funds are generally higher and the transfer of all matters related to the business (customers, vendors, employees, licenses, IP, etc.) is much easier. Buyers often prefer asset purchases, as they avoid inheriting many known and unknown risks that come with the acquiring the stock/interests and they are generally more tax favorable for them.

So what is an asset or stock/interest transaction and how do they differ? An asset deal is the purchase and sale of the agreed upon assets of a business to generally include fixed assets and customer contracts. A stock deal is the purchase and sale of a company’s shares (or “interests,” in the case of a sole proprietorship, partnership or LLC). The following table compares and contrasts an asset sale to a stock/interest sale. We will generically use the term “stock”.

Chart #7

Topic/Question	Asset Deal	Stock Deal
What Happens To The Seller's Legal Entity	Seller retains possession of the legal entity.	Buyer takes ownership of the legal entity as the acquisition results in an ownership transfer of the business entity.
What Exactly Is Being Sold/Acquired And How Does The Ownership Transfer Happen	Buyer purchases individual assets such as inventory, equipment, licenses, contracts, leases, intellectual property, phone numbers and domain names, and specifies any liabilities it is willing to assume. Identifying the specific assets can be challenging in situations where assets are not exclusive to the business being sold or in a "shared environment" such as in the case of a subsidiary or business unit/division. All assets have to be assigned, transferred and/or re-titled in the name of the Buyer and that transfer may require third party consents, which can be difficult and/or time consuming to procure.	Buyer acquires all assets via tendering the stock. There is continuity of the corporate entity as it was pre-close. Some contract assignments may still be needed in cases where contracts have "change in control" provisions that require assignment. There are no separate conveyances of individual assets because the title of each asset resides within the legal entity; however, shares need to be tendered.
How Are Past, Present And Future Known And Unknown Liabilities Handled	Buyer avoids inheriting past or current known or unknown liabilities such as product liability, warranty issues, legal matters, environmental claims, employment issues and contract disputes. Sellers retain all liability for all matters up until close.	Buyer accepts the risk that it will be responsible for all liabilities (related to past, present and future events) of the legal entity. Very often, preclose known and unknown liabilities can be mitigated in the purchase agreement through mechanisms referred to as representations, warranties and indemnifications.
How Is The Transaction Taxed At Close	There are limitations as to how quickly the Buyer can write off the purchase price paid. May result in higher Seller tax expense as certain assets may be subject to ordinary income tax rates.	Proceeds to the Seller are generally taxed capital gains rates.
What Are Key Tax Planning Considerations	Buyer benefits from a "step-up" resulting from recording the purchased assets at fair market value. This typically results in a step-up in the tax basis of the assets, yielding higher depreciation and amortization tax deductions.	Buyer loses the ability to gain a stepped-up basis in the assets and instead carries the assets at the book value of the Seller. However, tax attributes such as NOLs and tax credits transfer to the Buyer.

In the lower middle market, especially sub $50M transactions, asset based transactions are by far the most common deal structure. Smaller companies generally lack the resources for the level of professional management needed to mitigate and manage risks, and there is simply too little earning power in smaller businesses to adequately protect the buyer from those inherited risks. That being said, in this Seller's market, well-run middle market companies that adhere to risk management best practices and employ professional management can successfully execute stock sales and capture the financial benefits associated with that structure.

Pursant's Expectations for the Balance of 2017 and Early 2018

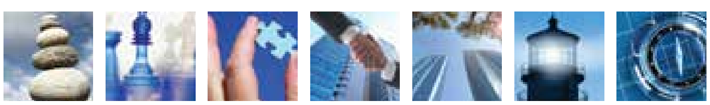
Corporate and private equity executives foresee an acceleration of merger and acquisition (M&A) activity in 2018, both in the number of deals and the size of the transactions.

A recent Deloitte study revealed that 68 percent of executives at US-headquartered corporations and 76 percent of leaders at domestic-based private equity firms say deal flow will increase in the next 12 months. Further, most respondents believe deal size will either increase (63 percent) or stay the same (34 percent), compared with deals brokered in 2017.

Many feel that 2017 M&A volume softened due to concerns associated with uncertainty about tax reform, the regulatory environment and the economy in general. With tax reform closure on the horizon, the economy clocking two consecutive 3%+ GDP growth quarters and generally favorable macro indicators, 2018 is positioned for M&A activity that could match or beat 2017. If the Fed makes meaningful increases in the cost of funds, it will likely slow M&A activity and soften multiples.

Strategic buyer balance sheets remain flush with cash and many plan to use that cash for M&A in 2018. PE buyers are still seeking to deploy a record amount of capital overhang and their fund raising activity continues unabated.

Regardless, as we have discussed in earlier issues of the Deal Insider, the lower middle market has its own unique driver that sets it apart from the rest of the middle market: the high average age of business owners. 10,000 baby boomers retiring each day will continue to push businesses to market, providing a healthy supply of M&A opportunities over the long term.



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, Strategic Transaction Support and Business Value Enhancement business units use a deep immersion process, our expansive networks and experience as owner/operators and dealmakers 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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