Q3 2018 EDITION

Pursant
INSPIRED PURSUIT

DEAL insider

M&A and Strategic Transaction Insights

THE INVESTMENT BANK THAT ALSO BUILDS THE VALUE OF YOUR BUSINESS

Q3 2018 Highlights:

- M&A activity holds steady in Q3 2018 and multiples remain at elevated levels
- September Fed rate increase didn't dampen heated deal pace
- Favorable macroeconomic indicators keep M&A attractive

Pursant's Thoughts on Q4 2018 and Early 2019

- No changes or surprises are expected for the balance of 2018 and start of 2019
- Affordable capital keeps valuations healthy, but softening will begin
- Rates are rising, slowing borrowing appetite ever so slightly

Q3 2018 Middle Market M&A Activity Continues at a Heated Pace

Favorable Middle Market M&A activity continues to be propelled by a healthy macroeconomic environment and affordable interest rates. Clearly there are deals and sectors that continue to command premium multiples, but it appears that there is caution about the sustainability of the current phase of the economic cycle, interest rates and government policy, all gradually throttling back valuation premiums.

Even though year over year M&A activity has declined modestly, high levels of consumer sentiment and business confidence are still propelling demand for quality companies that are positioned to capture the benefits of this favorable economic environment.

Financial Buyers remain awash in "dry powder" looking to be put to work in transactions; however, the percentage of deals utilizing less than the maximum available debt rose from 49% in Q2 2018 to 54% in Q3. On average, buyers are choosing to capitalize deals more conservatively.

Lower middle market valuations are still frothy at an average of 7.1x EBITDA through Q3 2018, according to GF Data. Higher quality companies (defined later in this issue) are getting acquired at an average of 7.7x EBITDA—a premium when compared to the rest of the lower middle market.

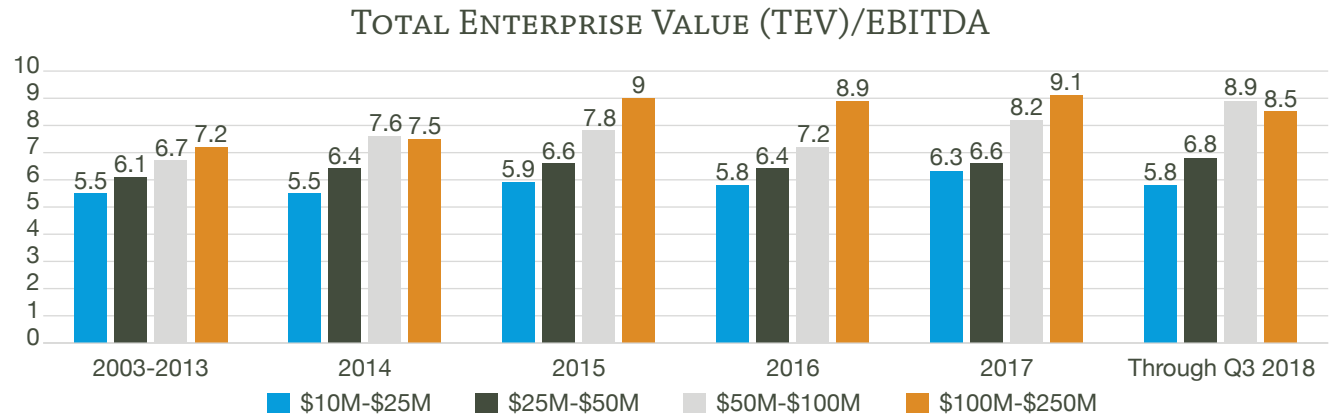
(Continued...)

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 optimize transaction outcomes.

Market valuations have topped out, but strong activity and valuation tailwinds are expected to continue at least through the balance of 2018 and early 2019.

Transaction Multiples – Chart 1 shows that Lower Middle Market EBITDA multiples, measured as Total Enterprise Value (TEV)/EBITDA, remain stable, averaging 7.1x for transactions through Q3 2018. One of the biggest influencers of multiples is the cost of capital. As of October of 2018, there has been a 75 basis point increase in the Fed Funds rate, pushing it to 2.00-2.25; however, it does not appear that this has meaningfully impacted valuation multiples.

Chart #1



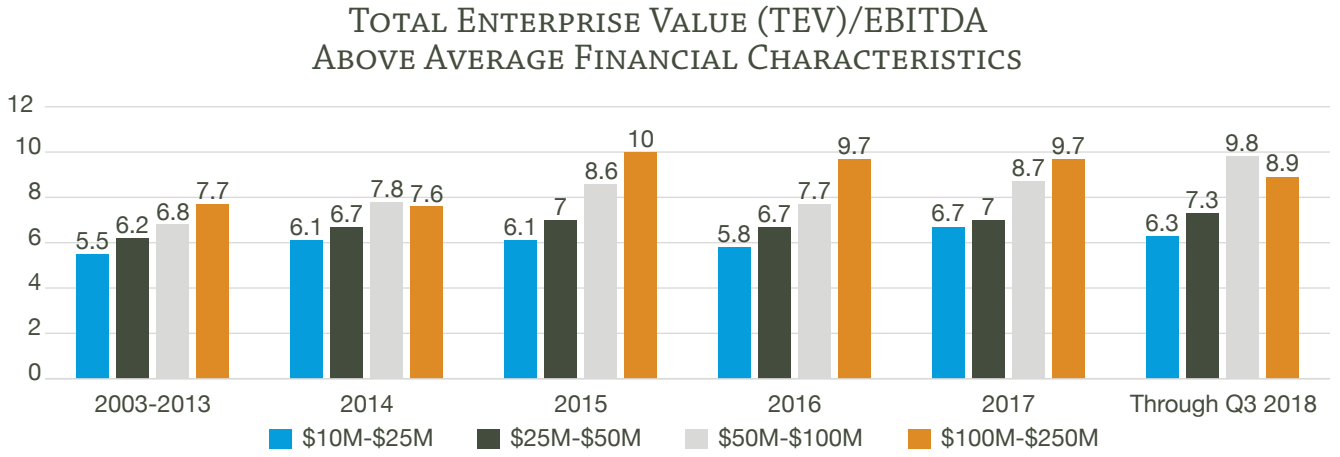
Source: GF Data®

Better financial performers were valued at 7.7x, on average, through October 2018, compared to an average of 6.3x for the balance of the lower middle market.

The Quality Premium – The valuation premium extended to above-average financial performers has stayed attractive at 24 percent through the first nine months of 2018 (Chart 2).

Better financial performers (as defined below) were valued at 7.7x, on average, through October 2018, compared to an average of 6.3x for the balance of the lower middle market.

Chart #2

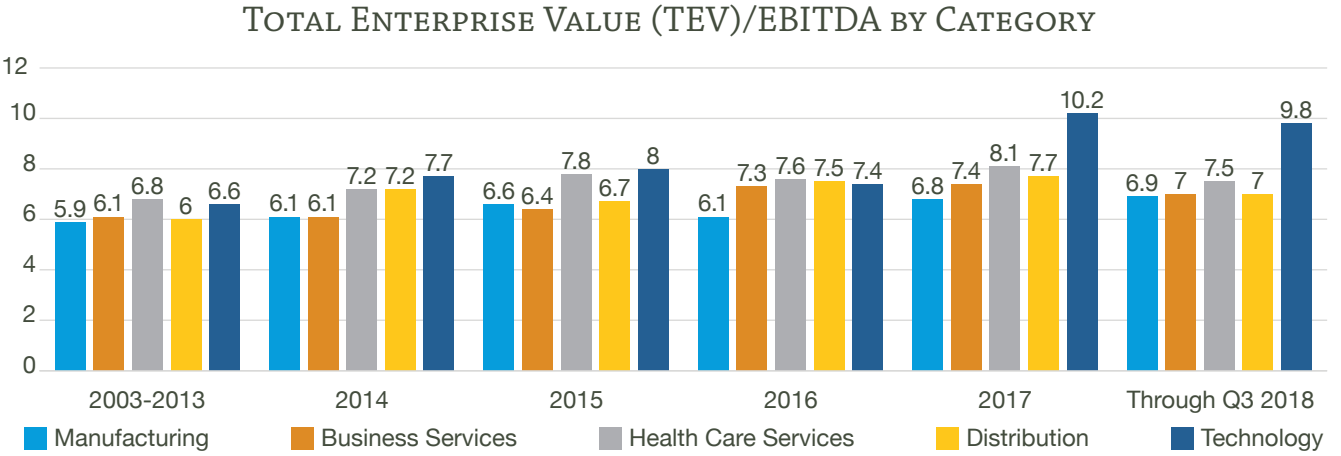


Source: GF Data®

We define better financial performers as businesses with TTM EBITDA margins and revenue growth rates both above 10 percent, or businesses with one of those metrics above 12 percent and the other metric at least 8 percent. Outliers on the high side are excluded.

The Middle Market by Business Category – When looking at the lower middle market by category, we can clearly see some valuation differentiation when comparing growth sectors (i.e. Healthcare and Technology) to more mature sectors that don't benefit from the same rate of growth. See Chart 3 for this comparison.

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.*

The US Macroeconomic Picture for Q3 2018

GDP – The US economy advanced an annualized 3.5 percent in the third quarter of 2018. It follows a 4.2 percent growth in the previous period, which was the highest since the third quarter of 2014. We have seen U.S. GDP expand for 18 consecutive quarters. The healthy economy has led to high levels of consumer confidence and strong demand for good companies to capture the benefits of the strong economy.

Consumer Sentiment – The University of Michigan's consumer sentiment for the US was 100.1 at the end of Q3 2018. The reading topped 100.0 for only the third time since January 2004. Tariffs were the single issue cited as having a potential negative impact on the economy. Concerns about the negative impact of tariffs were cited by nearly one-third of all consumers in September.

Business Confidence – The Institute for Supply Management's Manufacturing PMI in the US fell to 59.8 in September 2018 from 61.3 in August, which was the highest reading since May of 2004. The 59.8 measure was slightly below market expectations of 60.1, as new orders and inventories rose less than anticipated. Manufacturers remain concerned about tariff-related activity, including how reciprocal tariffs will impact company revenue and current manufacturing locations.

The PMI is a number from 0-100. A PMI above 50 represents an expansion when compared to the previous month. A PMI reading under 50 represents a contraction, and a reading at 50 indicates no change. The farther the number is from 50, the greater the level of change.

Unemployment – The unemployment rate in the US declined to 3.7 percent in September 2018 from 3.9 percent in each of the previous two months; the indicator was slightly below market expectations of 3.8 percent. It is the lowest jobless rate since December 1969. The number of unemployed persons decreased by 270,000 to 6.0 million. Over the year, the unemployment rate and the number of unemployed persons declined by 0.5 percent and 795,000, respectively. More people working is a great thing! But this low level of unemployment has created a tremendous employee shortage for employers.

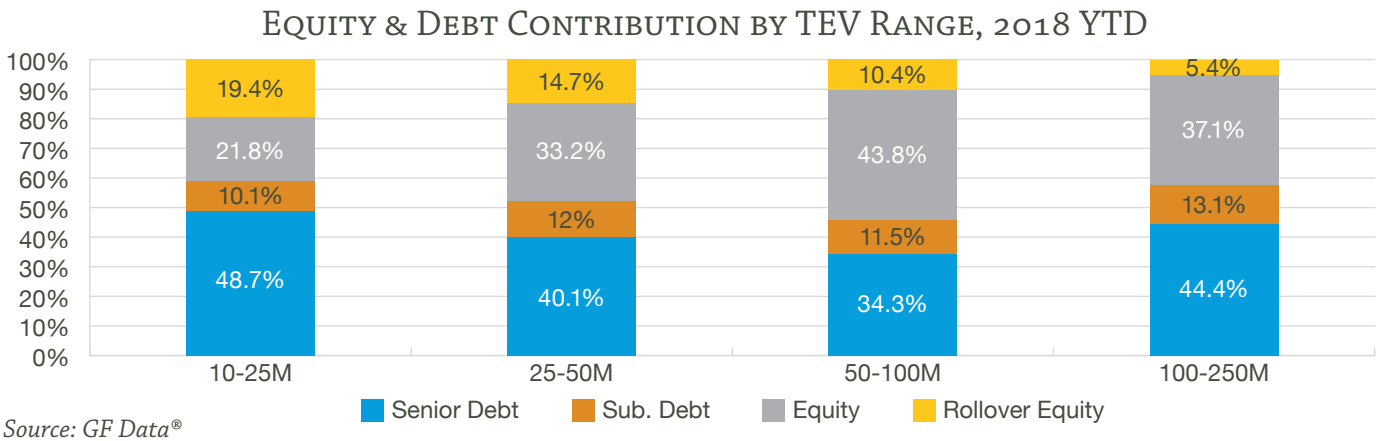
Fed Lending Rate – With continued improvement in economic and labor conditions, the Fed raised the Federal Funds rate 25 basis points for the third consecutive quarter this year, to 2.00-2.25 in September. This move is consistent with its forecast. The Federal Open Market Committee (FOMC) expects that further gradual increases in the target range for the Federal Funds Rate will be consistent with sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective over the medium term.

Pursant watches these macro-economic indicators because the direction and performance of the greater economy gives us an indication of where the Middle Market is heading as it relates to more favorable or less favorable phases of the business transfer cycle. The business transfer cycle is continually moving through periods that do or do not favor Sellers. *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 affordable capital to fund M&A activity.*

How Buyers Are Funding Transactions – Chart 4 shows that Buyers are able to deploy a variety of different options for funding transactions. Senior lenders are still ready, willing and able to finance one-third to nearly one-half of the purchase price and sub debt lenders will lend approximately 10-13% of the purchase price. Most interesting to note is the percentage of equity "rolled over" by Sellers and how the percentage decreases as the deal size gets larger. This is due to a number of factors related to smaller transactions, including a business' dependency on the owner and the depth of the management team.

To learn more about Rollover Equity in a strategic transaction, see Brian Steffens' article further in this *Pursant Deal Insider* issue.

Chart #4



Source: GF Data®

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 affordable capital to fund M&A activity.

Key Provisions in the Purchase Agreement

Scott Glickson – Pursant Managing Director

M&A transactions are governed by an agreement, commonly referred to as the Purchase and Sale Agreement ("PSA"). The PSA is a legally binding agreement entered into between the acquiring and selling parties.

The PSA stipulates the purchase price along with the mechanisms governing payment of the purchase price. The PSA also addresses a variety of other aspects of the M&A transaction, many of which are complex and often unfamiliar to transacting parties. Oftentimes, these non-purchase price elements are at least as important as the purchase price and need to be considered in the context of the entire transaction. The following discusses some of the more frequently included concepts and related terminology in the PSA.

- ***Working Capital*** – Buyers typically require Sellers to leave a "normalized" level of working capital with the business (refer to our 2016 Q3 newsletter for a detailed discussion on this topic). As a result, the PSA describes the net working capital mechanism including: (i) defining the components of net working capital; (ii) the target amount of net working capital to be left with the business; (iii) the settlement for any differences between the targeted amount and the actual amount left at the time of the transaction close; and (iv) the dispute resolution process should there be a disagreement related to the closing working capital calculation.
- ***Representations and Warranties ("R&W")*** – R&W refers to statements and assurances that transacting parties make within the PSA. The representations are statements about the business and the warranties are the assurances that those statements are true and accurate. Typically, Sellers represent the following: (i) they have the authority to actually sell the business; (ii) they obtained all the necessary consents required to sell the business; (iii) the financial statements provided are accurate; (iv) contracts are in good standing; (v) applicable permits are in place; (vi) the company is in compliance with regulatory requirements; and (vii) there are no undisclosed liabilities. It is common for Sellers to limit certain R&W to "knowledgeable parties," meaning the truth and accuracy of a statement are based on knowledge specific to certain individuals—typically, the shareholders of the business. A common challenge in developing this section of the PSA involves the definition of "knowledge"—what is known or should have been known. Buyers also make R&W, but those are more standard and often less contentious.
- ***Survival Periods*** – Post closing of a transaction, Buyers are entitled to make a claim for losses incurred by a breach of a Seller R&W. The timeframe during which a claim can be made is referred to as the Survival Period. Certain representations survive indefinitely. These are referred to as "fundamental" R&W as they are considered to be critical to the very basis of the transaction—for example, the representation that the Seller has authority to enter into the transaction. Other representations have a defined term and typically relate to the condition of

M&A transactions are governed by an agreement, commonly referred to as the Purchase and Sale Agreement ("PSA"). The PSA is a legally binding agreement entered into between the acquiring and selling parties.

the assets, enforceability of contracts and existence of permits. The term of the survival period varies but typically is between six and 24 months. R&W involving certain governmental concerns, such as taxes and environmental matters, have Survival Periods tied to the underlying statute of limitations.

- ***Indemnification Baskets and Caps*** – Indemnifications are provided by Sellers to protect Buyers against breaches of R&W. Indemnification typically involves a payment from the Seller to the Buyer to compensate the Buyer for losses incurred due to R&W breaches. The PSA will stipulate that the Seller agrees to provide relief if there is a breach of the R&W which causes the Buyer harm. The indemnification provisions in the PSA will serve as the Buyer's primary recourse to recover from the Seller any losses or damages suffered as a result of the breach.

  When negotiating the amount of the relief, typically other parameters are defined. The "Minimum" is the size of any individual claim; the "Basket" is the minimum threshold which must be reached before a Buyer is entitled to receive renumeration for losses caused by a Seller representation breach; and the "Cap" is the upper dollar limit on the Seller's indemnification obligations to the Buyer (or, said differently, the total amount of damages the Buyer is entitled to recover from the Seller).

  The Basket usually takes one of two forms. The first is similar to an insurance deductible where the Buyer is only entitled to receive the amount of loss in excess of the deductible. An alternative structure is referred to as a "Tipping Basket," whereby once the minimum threshold is reached, the entire liability is recoverable by the Buyer. As a simple example, assume a Basket of $100,000 and a claim of $150,000. If the Basket is defined like an insurance deductible, the Buyer would be entitled to $50,000. In the Tipping Basket scenario, the Buyer would be entitled to the full $150,000 claim. As a general rule, Basket amounts are typically calculated as approximately 1% of the transaction value.

  A Cap is generally stated as a percentage of the transaction value, ranging from a few percentage points to as high as 20%. Typically, the percent and the transaction value are inversely related—the larger the transaction value, the lower the cap percentage is set; the smaller the transaction value, the higher the cap percentage is set.

- ***Escrows*** – To provide the Buyer assurances that the Seller has readily available resources to satisfy any potential indemnification claims, a portion of the purchase price is placed into Escrow. Typical escrow amounts range from a few percentage points to as much as 10% of the transaction value. As with Caps, the percent and transaction value for Escrow are inversely related. Escrow Periods are typically aligned with Survival Periods.

The non-purchase price components of a Purchase and Sale Agreement are usually very heavily negotiated provisions. Buyers and Sellers need to ensure that they have a comprehensive understanding of these facets of the deal, as it is likely they will have real implications after the transaction.

Doing a Deal with A Financial Buyer? Get Comfortable with Rolling Equity into the Deal

Brian Steffens – Pursant Managing Director

Earlier this year, we discussed how a Seller has choices when deciding the right type of Buyer for a business (see Pursant Deal Insider Q1-2018). This article dives deeper into the Financial Buyer group—Private Equity (PE) Firms being the most common—and a popular deal component of many of their transaction structures called retained interest or rollover equity.

Rollover equity transactions can be structured in many ways: (i) the Seller's company equity is exchanged for the Buyer's equity; (ii) as a partial sale of the Seller's equity; (iii) the Seller's company assets are exchanged for the Buyer's equity; (iv) the Seller's company assets are contributed to a "Newco" that is formed by the PE Firm; (v) as an equity investment in the acquiring company; or (vi) as a merger. Each structure comes with its own set of tax and legal implications and precedent. It is important to be aware of the common concerns / issues: common v. preferred shares, subordination to the Buyer's debt and equity, preference of carried interest when distributing funds, management fees charged, first refusal rights, drag-along clauses that favor the PE Firm, tag-along clauses, BOD representation (governance / voting rights), operating profit distribution along the way or only when business is sold, the need for additional capital contributions by the Seller, loan guarantees by the Seller, and dilution concerns caused by the issuance of new equity. If you choose to go down the rolled equity path, make sure your tax and legal professionals are looped into discussions as early as possible so that all of these facets are evaluated in depth.

Deal structures involving rolled equity are popular; there are a number of reasons why. For the PE Buyer, keeping the Seller involved and incented to grow the business helps preserve the value and increases the likelihood of a successful ownership transition. For the Seller, their rolled interest provides another "bite at the apple," assuming the business achieves success and continues to grow. It can also help close a valuation gap between the Buyer and Seller or create balance if the deal is priced aggressively by the Buyer. Think of rolled equity as similar to an earn out: one's ability to cash in on the benefit depends on the future success of the business.

As a Seller, should you entertain this option and what percentage should you roll? This is heavily dependent on your unique situation. Consider: (i) your need for significant cash consideration at closing; (ii) your involvement in and importance to the business today and in the future; (iii) your belief in and commitment to the PE firm's investment thesis and strategy to execute the plan; (iv) whether your business is a platform company investment or an add-on investment to another portfolio company; (v) your fit with the team; (vi) the gap you are trying to close in the pricing; and/or (vii) where in the lifecycle the PE firm's investment fund is. All of these factors will color the PE Firm's offer as well as your leverage in negotiations. See Graph 4 in this issue of the Pursant Deal Insider for data related to common rollover percentages based on deal size.

Deals involving rolled equity require a look at the transaction and balance interests from the perspectives of both Seller and Investor. A Seller will need to do financial, legal and cultural due diligence on the Buyer, their business, their strategy, their capital and entity structure. This due diligence takes place in parallel

If you want to invite Financial Buyers into your sale process, spend time preparing and educating yourself on the potential issues and opportunities to ensure that you are not blindly giving away value.

with the Buyer's own process of due diligence process on the Seller's business. As a Seller, you will want to understand (i) the Buyer's business valuation in relation to the exchange; (ii) the equity and debt structure of the Buyer; (iii) governance matters, such as will the Seller have a position in the Buyer's governance structure; (iv) a meaningful review of the Buyer's business, if it will be combined with the target business. The percentage of the overall deal consideration that is rolled and the Seller's post transaction role will dictate the depth to which a Seller should perform due diligence on the Buyer.

If transacting with a seasoned PE Firm, a Seller considering the rollover equity option should ask to speak with owners of the Firm's other portfolio companies. The intent of these discussions is to gain comfort that the PE Firm is the right fit (not to inquire about their deal). You'll want to understand what role the PE Firm plays in the portfolio businesses (financial, strategic, tactical). Are they helpful in sharing their network, resources, expertise? How have they dealt with adversity? What is the reaction when budget targets are missed? What is the frequency of their communication? Be leery of a Firm that will not allow you to speak to a former owner that is still in their ranks.

In summary, if you want to invite Financial Buyers into your sale process, spend time preparing and educating yourself on the potential issues and opportunities to ensure that you are not blindly giving away value. Your team of experts can work to optimize the tax impact and ensure you have a seat at the table so you can realize value above what you could have generated on your own.

Why Mergers and Acquisitions Fail to Perform as Planned

Richard Curry – Pursant Managing Director

Through discussions with various professionals over time, I have heard and array of statements that address the frequency at which mergers and acquisitions failed to deliver the planned value and outcome:

- *"The range for failure is between 50% and 80%."*
- *"The stark truth is that 70% to 90% of acquisitions fail to deliver the value the Buyer anticipated."*
- *"Some 83% of mergers fail in one form or another."*

And my favorite citation:

- "*One-third of mergers create shareholder value, whereas one-third destroy value, and another third don't meet expectations.*"

No matter which statistic you favor, the message is staggering. It would seem that one may have more luck flipping a coin to predict if a Merger/Acquisition will be successful.

What is the definition of "failure" in this context? I would propose that an acquisition has failed if the Buyer's strategic, financial, cultural and commercial objectives were not met. Although there may be some degree of success if one or more of these objectives has been achieved, if any of strategic, financial, cultural or commercial objectives is not met, it can dilute the impact and importance of the others.

Why does this high rate of failure take place in Mergers and Acquisitions? Let's examine some of the most common reasons related to the Pre-Transaction phase of a deal:

1. The Deal Was Done for the Wrong Reasons

Experienced and inexperienced Buyers alike frequently get "deal fever"—seduced by the data presented (no matter that it is too good to be true) and the thought of what could be, allowing caution to go out the window. Companies often seek to acquire without a clear sense of purpose or realistic outcome. Many factors are involved in deciding whether to launch an acquisitive strategy. An acquiring company needs to be knowledgeable about what it can bring to a merged entity instead of just what a target company can bring; it must have clear and empirically based information; and it must invest the time and research into the market and ecosystem it wishes to enter. Plunging into the acquisitive/merging process without a clear plan and realistic expectations is not a recommended strategy. Ego, fear of being commercially "left behind" and idealistic financial expectations of the merged entities should be restrained.

2. The Wrong Deal Team

Owners or decision makers of an acquiring company may put together the wrong deal team to tackle a merger or acquisition initiative. Skills and capabilities may be misevaluated. The time and effort required of team members, whose daily responsibilities have not changed, are also frequently underestimated. It is recommended that competent outside advisors versed in the art of acquisitive search, negotiation and transaction be brought into the process as early as possible. What may appear to be an expensive pursuit may actually turn out to be a bargain in comparison to the results of a disastrous purchase. Deals tend to be complicated and unique; engaging the services of M&A professionals is a good investment.

3. Poorly Conducted Analysis of the Target's Attributes and Information

Pre-transaction diligence can be faulty and too much emphasis may be placed on the Seller's representations. The excitement of a potential deal, coupled by the wrong deal team in play, could lead to potentially adverse information never coming to light. The services of M&A professionals can reduce or eliminate surprises and manage the process of gathering information in a neutral and efficient fashion. A healthy dialogue based on trust and confidence between Buyer and Seller can also create balance in this data driven process.

4. Lack of Post-Transaction and Integration Planning

The time to prepare for a successful integration is before the deal is done. There are so many time sensitive action items to successfully integrate the entities that it can boggle the mind. Even simple actions can become complicated if they are executed poorly, out of sequence or in an inappropriate timeframe. If you are pursuing an acquisition strategy, then expect to acquire. If you acquire, expect to integrate. A successful integration plan will be built long before the deal is done and ideally before an acquisition strategy is ever launched.

Now let's look at common Post-Transaction reasons for the failure of a merger or acquisition:

1. Poor Communication

The whole M&A process is all about effective communication—particularly in the Integration phase. In order for communication to be effective it needs to be frequent, transparent and positive. Clearly communicating expectations, tasks, timelines and execution points across the merged entities is critical to the success of a smooth transition. Being secretive and uncommunicative in this critical phase is counterproductive and will most assuredly have negative consequences. In addition, provide for 2-way channels of discourse—top down and bottom up.

2. Poor Leadership

Leaders should be clear and demonstrative about the results they want to see from the combination of companies. The leadership team must be prepared to lead by example and communicate expected changes in order to achieve these results. There can be no effective substitute for an open and transparent leadership style. Leadership that is felt to be disengaged or disingenuous is extremely damaging to the image of the merged entity.

3. The Acquiring Company Paid Too Much

Many companies find that in post transaction analysis, they simply have paid too much. This could be as a result of being caught up in an auction atmosphere or conducting faulty diligence. As a result, hasty recasting action may be taken to mitigate the situation. This can easily lead to economic and cultural dislocation. Buyers need to set a walk away point in the negotiation process to reasonably insulate themselves from the risk of overpayment.

4. Synergies Were Overestimated

Related to earlier points, it is often found that planned synergies are overestimated and are difficult, if not impossible, to achieve. This can be a key issue in transactions merging same sector strategic entities that rely on synergies as a key component of success. To prevent this common issue, ensure that the Buyer clearly understands the target's business model and has adequately socialized the synergistic expectations with internal and external resources as well as with the target's resources.

We have briefly discussed common reasons that Mergers and Acquisitions fail to perform as planned. In our next issue of the Pursant Deal Insider, we will examine the #1 reason and discuss ways a Buyer can mitigate the chances of it happening to them.

The time to prepare for a successful integration is before the deal is done. There are so many time sensitive action items to successfully integrate the entities that it can boggle the mind. Even simple actions can become complicated if they are executed poorly, out of sequence or in an inappropriate timeframe.

Pursant's Expectations for the Balance of 2018

Deal volume for lower middle market transactions are expected to keep pace for the balance of 2018 and well into 2019. Unless there are meaningful increases in lending rates or negative macroeconomic changes (neither of which is expected), we expect valuations will stay at their current healthy levels.

The overall economy is strong, keeping strategic businesses performing well and flush with cash for M&A. PE Buyers are still seeking to deploy a record amount of uninvested capital, but showing signs of less willingness to over leverage.

Buyers and Sellers have good visibility into the sustainability of this favorable market and should remain willing to pull the trigger on M&A deals.

Upcoming Speaking Engagements for Pursant

January 23, 2019 – Shreveport, Louisiana
Warrior Leadership Conference
Topic: *Roadmap to Success: Best Practices for Growing Past Your Limits*

January 26, 2019 – Grand Cayman
BSCAI 2019 CEO Seminar
Topic: *Middle Market M&A and Strategic Transaction Insights*

January 29, 2019 – Malibu, CA
Pepperdine University, Certified M&A Advisors Credentialing Course
Topic: *Buy-Side M&A Deal Success*

February 27, 2019 – Nashville, TN
National Pavement EXPO 2019
Topic: *M&A in the Pavement Maintenance Sector*

Interested in having Pursant speak at your next conference, seminar, or special event? Contact our Marketing Director, Dawn at dzavalishin@pursant.com.

Pursant helps companies grow enterprise value by managing their M&A related initiatives and ultimately monetize that value in a sale transaction.

Our Investment Banking, Transaction Support and Business Value Enhancement practices use a deep immersion process, our expansive networks and experience as owner/operators and dealmakers to effectively execute strategic transactions—critical events for which most companies do 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.

Pursant
INSPIRED PURSUIT