Q1 2017 EDITION

Pursant
INSPIRED PURSUIT

DEAL insider

M&A and Strategic Transaction Insights

THE INVESTMENT BANK THAT ALSO BUILDS THE VALUE OF YOUR BUSINESS

Q1 2017 Highlights:

- Deal friendly Trump policies sparked M&A optimism
- Cash-flush strategic buyers and record levels of PE capital overhang drove volume
- Nominal Fed rate increases kept valuation multiples frothy

Pursant's Thoughts on Q2 2017

- Continued easing of regulations stimulate more deal flow
- More businesses are positioned to sell and benefit from potential tax decreases
- Low interest rates keep cost of capital low and valuations up

Q1 2017 Middle Market M&A Volume Increases and the Lower Middle Market Leads the Way

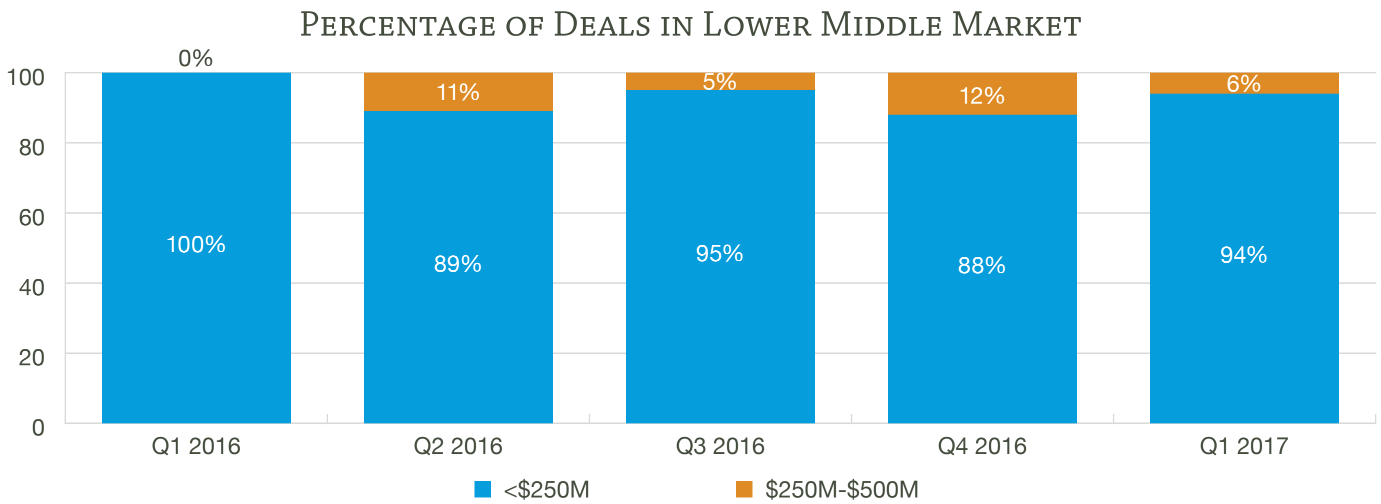
The first quarter of 2017 showed an increase in middle-market deal flow, with volumes up 2.2% over Q4 2016, according to Cap IQ. This M&A increase was helped by a number of factors, with the largest factor being improved business climate clarity with the presidential election uncertainty behind us. The data also shows that more than two thirds of the deals in the middle market involve strategic buyers, with a specific focus on deals below $250 million in transaction value. Chart #1 shows that 94% of transactions were valued at less than $250 million for Q1 2017, demonstrating that large strategic companies have a sustained appetite to make a greater number of investments in smaller companies rather than making large acquisitions.

Even though strategics lead the way in deals in the lower middle market, private equity is still highly interested, given its massive capital overhang (see chart #2). Private equity firms' desire for smaller add-on investments for their portfolio companies appears to remain strong.

M&A volume for both strategic and financial buyers is likely to continue to rise this year with the election having been completed, an improved regulatory environment and modest interest rate increases.

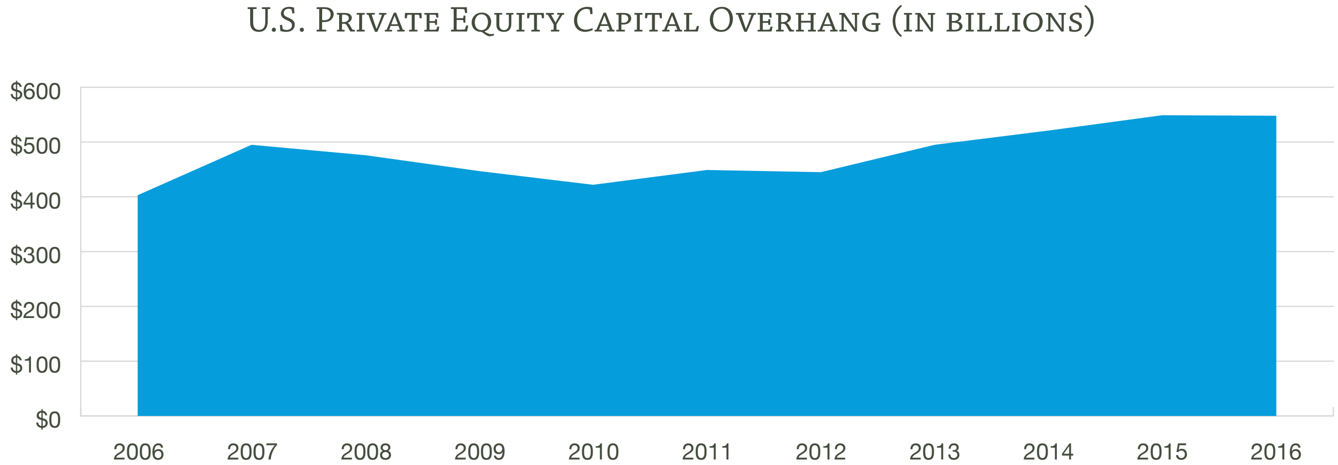
The Pursant Deal Insider is a quarterly publication offering analysis of the marketplace and climate for middle market mergers, acquisitions and strategic transactions. Our emphasis is on transactions with a total enterprise value of less than $250M. Our goal is to arm business owners and other parties with insight to help prepare for such transactions in order to maximize transaction outcomes.

Chart #1



Source: Cap IQ®

Chart #2



Source: Pitchbook®

Capital Overhang: *The current amount of raised but un-invested capital available to private equity investors.*

The US Macroeconomic Picture for Q1 2017

GDP - The US economy grew an annualized 1.2 percent in the first quarter of 2017, following a 2.1 percent expansion in Q4 2016; these results were in line with below expectations of 1.1 percent growth. The growth rate reflected a deceleration in personal consumer spending and downturns in private inventory investment and state and local government spending, partly offset by an upturn in exports and accelerations in nonresidential and residential fixed investment. This slower GDP growth rate will further temper the Fed's appetite for lending rate increases.

Consumer Sentiment – Consumer Sentiment remained generally positive for Q1 2017, finishing the quarter at 96.9; however, there is partisan noise related to these numbers. More Democrats than Republicans are expressing fears of a near-term recession, but this partisan gap does appear to be narrowing, with Democrats having fewer concerns about financial setbacks.

Business Confidence – The Institute for Supply Management's Manufacturing PMI soared to 57.2 in March 2017, wrapping up a first quarter that was significantly higher than any other period since 2014. This growth is attributed to rising new orders and production. Overall, the view of business conditions is very positive.

Unemployment – Q1 2017 unemployment finished at 4.5% its lowest rate since May 2007. The number of long-term unemployed (those jobless for 27 weeks or more) was essentially unchanged at 1.6 million in March and accounted for 22.6 percent of the unemployed.

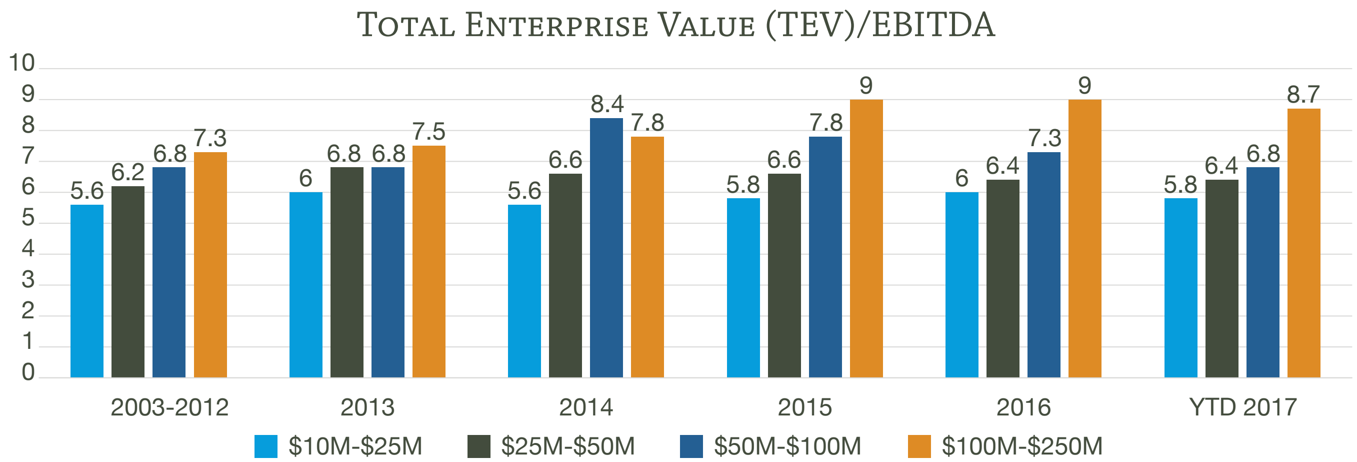
Fed Lending Rate – The Federal Open Market Committee (FOMC) raised the Fed funds rate to 1 percent in March. Members of the committee cited confidence that the economy will continue to strengthen and that inflation is close enough to the Fed's target of 2 percent. Additionally, the labor market has continued to strengthen and economic activity has continued to expand at a moderate pace. Job gains remained solid and the unemployment rate was little changed in recent months. Household spending has continued to rise moderately, while business fixed investment appears to have firmed somewhat. The Committee expects that economic conditions will evolve in a manner that will warrant gradual increases in the Federal Funds Rate; however, the actual path of the Federal Funds Rate will depend on the economic outlook as informed by incoming data.

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 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.*

Transaction and Leverage (Debt) Multiples

Transaction Multiples – Chart #3 shows that Lower Middle Market EBITDA multiples, as measured by Total Enterprise Value (TEV)/EBITDA, remained largely in line with 2016, with an average of 6.7x for transactions YTD through Q1 2017, versus 6.9x in Q4 2016. In spite of moderate Fed rate increases, there is continued strength in these multiples. This strength is driven by optimism about the current administration's policies, favorable to business; well-capitalized strategic buyers who find it challenging to propel organic growth; and a limited supply of good acquisition opportunities.

Chart #3

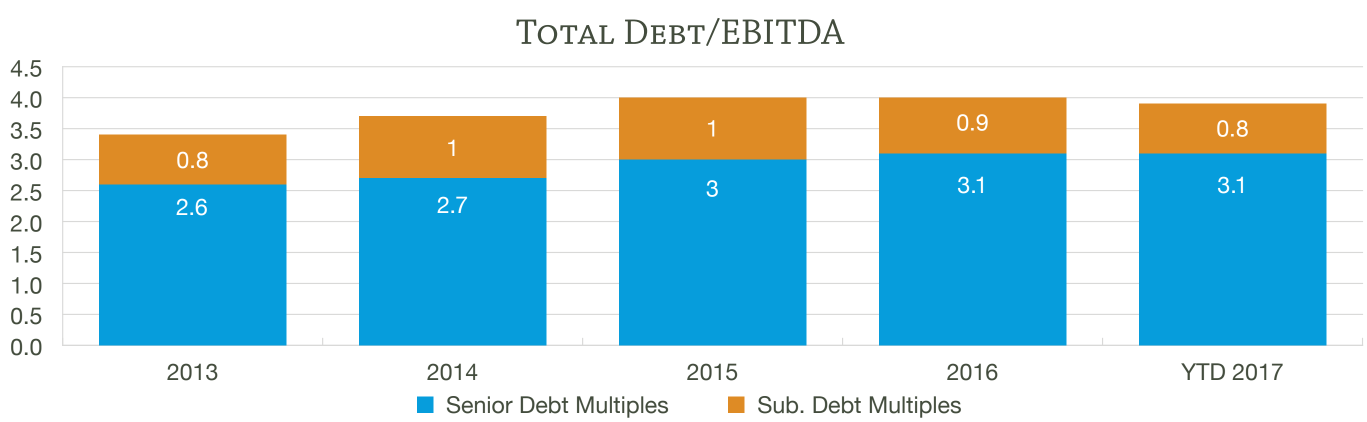


Source: GF Data®

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.*

Leverage Multiples – Chart #4 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 in YTD 2017 averaged 4x EBITDA, continuing the steady rise we have seen over the course of this decade.

Chart #4



Source: GF Data®

Purchase Agreement Pot Luck – What is "Knowledge" and Why is it Important?

Anthony Sobel – Pursant Transaction Specialist

The arrival of a Purchase Agreement is usually a good sign that your deal is on track, but such agreements are fraught with pitfalls that can derail even the best deals. One of those pitfalls is a simple word: "Knowledge."

In the Purchase Agreement, the seller represents and warrants that it knows certain things to be true. The challenge lies in what things the seller will be asked to represent and warrant that it does not know. In short, the seller wants the reps and warranties to be specific and limited and the buyer wants them to be broad and abundant. This often leads to different definitions of "Knowledge."

Knowledge generally falls into one of two categories: "Actual" or "Constructive." Actual Knowledge is literal awareness of the matter. Constructive Knowledge includes information that a person should have known after reasonably investigating and inquiring.

Assuming the parties can agree to what parts of the agreement are Actual versus Constructive Knowledge, agreement also must be reached as to whom within the seller's company this rep and warranty applies. Is it just the active shareholder, or all shareholders? Which members of the management team? A buyer's perspective is that in larger corporations, this group should include individuals with active control over the business; however, for smaller corporations with control centralized in a small group of shareholders, it may be appropriate to put all the shareholders in the knowledge group.

Parties generally get through these knowledge hurdles, but having a strategy prepared in advance of Purchase Agreement receipt will help minimize the drama and accelerate the documentation timeline.

Earnouts – Often Necessary, Rarely Liked: A Guide to Better Outcomes

Brian Steffens – Pursant Managing Director

Ask an experienced dealmaker about earnouts and s/he will have some very strong opinions and feelings. The word alone will invoke a knee-jerk response and often several anecdotal stories as to why they are the best or worst thing. One's viewpoint and perspective is often shaped based on what side of the table one normally sits during a deal (i.e. buyer, seller, dealmaker, advisor or lawyer).

In middle-market M&A, earnouts are often a necessary tool when structuring a deal to allow for the orderly transfer of value between parties. They are contingent payments (non-guaranteed) that bridge the valuation gap between sellers and buyers. Without them, far fewer deals would transact, or those that do would be at significantly reduced valuations.

So, is it possible to construct a win-win earnout scenario about which both parties are excited? Excitement, no. But here are some best practices to improve alignment for transacting parties when considering the use of earnouts.

Pick your partner wisely - When agreeing to an earnout, the buyer and seller are agreeing to be partners for the length of the earnout period. Picking a good transaction partner often involves more than just price. What is the overall structure of the deal, and does it meet both parties' needs while addressing the key shared risks? What is the vision of a post transaction entity and role of the former owner? Have the parties been respectful, honest, and considerate of each other's time and resources during the process to date? If the answer to most of these is "yes,", chances of a good partnership are strong. If you are a buyer, and the seller is not someone you want to do business with, do your best to make a solid offer (albeit at a discount) that does not include an earnout, hope for the best, and continue sourcing potential deals. If you are a seller and the buyer has done previous transactions, ask if you can speak to other sellers to understand how they were treated after the sale. If the deal is too good to turn away, but you still lack trust and respect, consider having an agreed upon third party (independent CPA or financial firm) assist in the earnout calculation and review.

There is no one size fits all solution - Each transaction needs to be evaluated on its own merits. Consider key attributes such as the industry, financial performance, seller's role post transaction; and weigh risk factors including customer concentration, retention of employees with unique skills, expiring contracts and new product launches. These are driving factors when structuring an earnout. Note, earnouts are often more effective and palatable when the former owner(s) remains involved in the business and has influence in ensuring the performance of the key metric on which they will be paid out. A proven effective structure allows a former owner to win new business on behalf of the company that first replaces any lost revenue/profit that was part of an earnout calculation and next serves as a potential upside incentive.

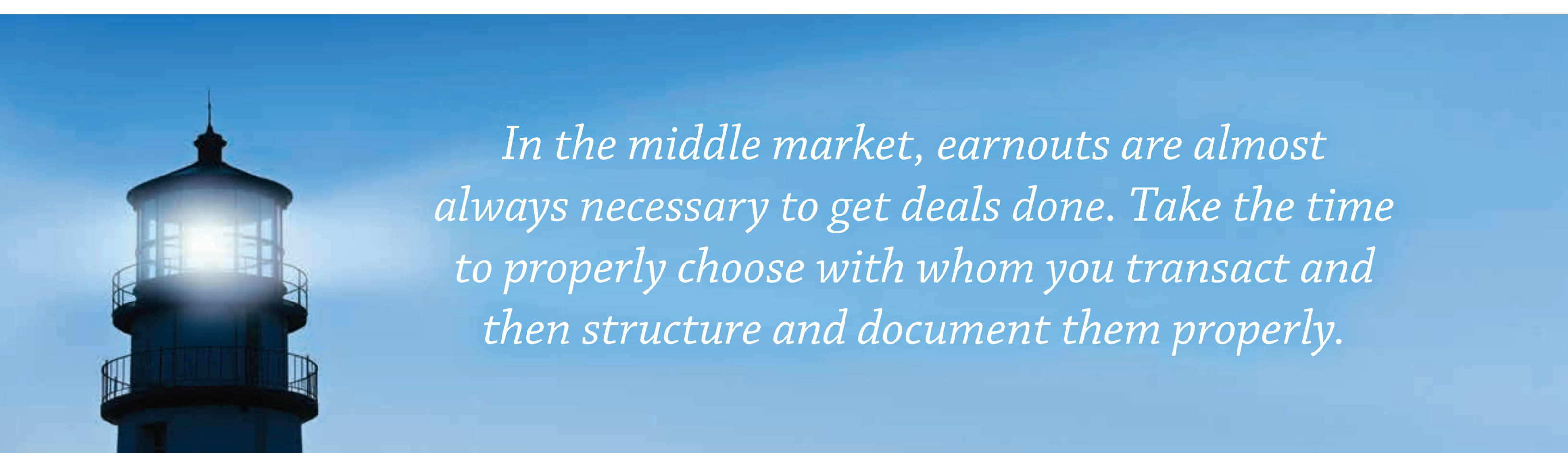
Simple is better - Select an easily identifiable performance metric that you can record, measure/calculate and report on. Some relatively clean performance metrics that should be less open to manipulation: revenue, customer retention, or the completion of specific projects or milestones. When selecting performance metrics for an earnout (i.e., EBITDA, Pre-tax Net Income, Gross Profit), as you work your way down the P&L, you invite more complexity and potential issues down the road.

Manage purchase agreement language - What is causing the value perception misalignment in the first place? Is it a customer concentration issue? Is it a disagreement over the forward-looking projections (i.e., a large contract that is up for renewal and is out to bid; the growth of a new product line)? Spell out the purchase price percentage amount, timing of payments and calculation of the earnout. Use examples to illustrate the calculation of the earn-out. An effective way to document a common understanding is to create an exhibit or supplement to the purchase agreement that contains multiple sample earn-out calculations under hypothetical scenarios. Failing to do so will most certainly lead to misinterpretation and, potentially, litigation. Also include language in the agreement that restricts the buyer from interfering with operations of the business during the earnout period.

Compromise – win/win approach - Think about who has the risk and who receives the benefit of post-close wins when you construct an earnout. Is the earnout one-sided or do the parties share the risk and reward? Consider which party will be investing resources (dollars, time, effort) to accomplish the underlying deliverables of the earnout. For example, if the buyer will be the one investing in new machinery or new human capital to execute an opportunity, it may be more difficult to argue that they should share the rewards of that opportunity with the seller. But, if the opportunity was "turn-key" or if there was pre-close investment by the seller, the discussion shifts to hitting agreed upon margin thresholds and balanced sharing of rewards.

Understand expectations & effectively communicate
Understand the expectations of the parties before, during and after the transaction. How will each react to full or partial payment of the earnout? One way to gauge is, as noted earlier, to provide example calculations early in the process, to begin the dialogue. If the post transaction operating plan (even if high level) will impact the earnout, make sure it is discussed.

In the middle market, earnouts are almost always necessary to get deals done. Take the time to properly choose with whom you transact and then structure and document them properly.



Considering a Liquidity Event or Raising Capital - Better Have a Budget

Scott Glickson – Pursant Managing Director

Preparing an annual operating budget is a well-known but often neglected best practice. It is a cornerstone for success in every business. Typically, an annual budget is designed to support a multi-year strategic business plan; however, even in the absence of a multi-year strategic plan, an annual budget is still a "must do."

Having a well thought out and constructed budget is particularly important for business owners and executives considering selling all or part of their businesses or raising capital. Without a budget, the likelihood of successfully executing a transaction that maximizes enterprise value is very low.

In the strategic transaction process, an annual operating budget is typically one of the first pieces of information requested. Prospective acquirers, investors and/or capital providers are eager to study budgets to gain an understanding of a business' strategy, goals, priorities, financial profile, cash characteristics and trajectory. It is a great conversation starter when engaging with an interested party.

Following are tips, suggestions and advice related to budgeting and the budget process:

- Think of a budget as a stake in the ground. The budget is developed based upon the best information available at the time. At future points, budgets can be updated to reflect more current information. Typically, this updating is done quarterly. Each quarter, future budgeted periods are reviewed and adjusted as necessary. The year-to-date actual performance is added together with the updated budgeted months, which is commonly referred to as the projections. This process repeats at the completion of each quarter. As such, the budget never changes from the initial version provided; however, the projections provide an updated and more current view for the full year expectations.
- A budget includes an income statement, balance sheet and cash flow statement. Most often the income statement is the starting point. The best income statement budgets are built "bottoms up" and account-by-account. Once the income statement is near completion, the balance sheet and cash flow statements can be efficiently addressed.
- Effective budget processes are those that are collaborative and leverage input, buy-in and sign-off from all key team members. Assumptions should be stress tested and challenged. The environment for creating the budget should cater to open, honest, respectful and transparent communication. From start to finish, a budget process can run several weeks.

While there are unlimited topics to address during the budgeting process, the following provides two examples of thought generating discussion that should be woven into the budget process:

- Human Capital – Is your budget representative of having the right team and staffing mix? Are compensation/incentive plans appropriate? Are there any key employees or positions that need top grading?
- Marketing and Sales Strategy – Have you budgeted for the right go-to-market messaging and what is the expected ROI on marketing efforts?

So how does all of this relate to maximizing transaction value? Simply stated, it shows you are in control of the future direction of the business and its earnings, as opposed to simply working hard and hoping it all works out. Having and using an operating budget shows a that business has a disciplined approach to managing its future and achieving its goals. This practice gives a buyer more confidence in the predictability of its investment returns, thus improving the risk profile, which generally increases valuation and improves deal structure.

Pursant's Expectations for Q2 2017

The Trump administration, now in charge, is working feverishly to enact a number of initiatives that will encourage M&A activity this year. There is no question that getting the required support for a number of these initiatives will be an uphill battle; nonetheless, many are likely to get done, even if in muted form. Two examples of these deal-favorable initiatives are:

Regulatory easing - A relaxed regulatory environment will knock down numerous deal barriers and, as a result, improve valuations as well. Certain sectors will benefit from this easing more than others.

Favorable tax law changes – There are plenty of signals that the current administration aims to lower personal and corporate tax rates. Those that were sitting on the sidelines waiting for this move are positioning their businesses to go to market and take advantage of the tax savings.

Interest rates on debt are still very attractive and even with the recent Fed rate increase, are still considered to be low. Figures from the second estimate showed that the US economy expanded an annualized 1.2 percent on quarter in the first three months of 2017—better than the advance estimate of 0.7 percent growth and beating expectations of 1.1 percent; regardless, growth is not strong enough to warrant any near-term aggressive rate moves from the Fed.

Strategic buyer balance sheets are flush with cash and, PE buyers are still seeking to deploy a record amount of capital overhang. With sluggish GDP growth, these same buyers are struggling to meet revenue growth objectives through purely organic strategies. They need to acquire good businesses to augment their lackluster organic growth.

This all sets the stage for a continued robust deal environment through the first half of 2017. The second half of the year will be shaped by closure on taxes, rates and the performance of other economic indicators, along with other global geopolitical events.

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.

Pursant

INSPIRED PURSUIT