Pursant
INSPIRED PURSUIT

Q1 2019 EDITION

DEAL insider

M&A and Strategic Transaction Insights

THE INVESTMENT BANK THAT ALSO BUILDS THE VALUE OF YOUR BUSINESS

Q1 2019 Highlights:

- M&A activity started strong in Q1 2019, albeit dialed down a bit compared to Q1 2018
- Stable Fed rates fuel M&A related borrowing
- Favorable macroeconomic indicators bolster both M&A and business sentiment

Pursant's Thoughts on Q2 2019

- Middle market M&A remains largely unaffected by Asia supply chain issues and Brexit drama
- Buyers remain active, but still frustrated with limited deal flow
- Sellers remain beneficiaries of the current market conditions

Q1 2019 Middle Market M&A Activity Healthy; Lower Middle Market Strongest

We crossed the 2018 finish line with plenty of fuel for M&A in 2019. Deal flow is still solid, albeit a bit slower than during the first quarter of 2018. Inexpensive borrowing, a strong economy, a deal friendly government administration and Baby Boomer retirement continue to be major drivers of lower middle market M&A activity.

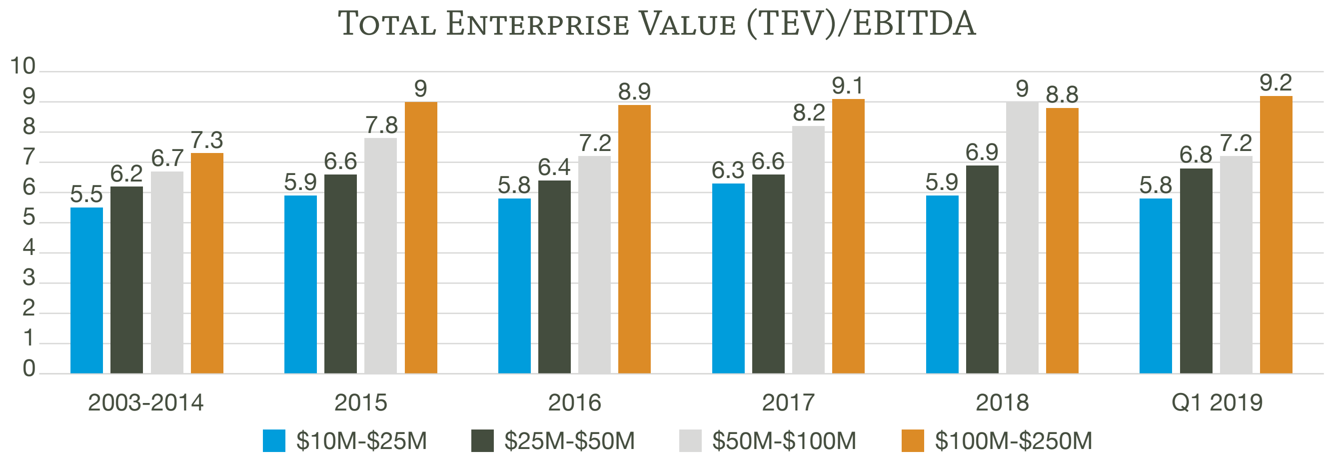
Valuation multiples continue to signal a peak, and in less than optimal transactions there is softening. The drop in multiples in Q1 2019 was very similar to that of the first quarter of 2018, which followed the strong fourth quarter of 2017; we have definitely seen this pattern before, which in the past has led into strong quarterly performance as the year unfolds.

Chart 1 shows a softening of lower middle market EBITDA multiples—measured as Total Enterprise Value (TEV)/EBITDA—with the exception of the upper end of that market. Transactions YTD through Q1 2019 averaged 6.9x compared 2018 overall at 7.3x. These Q1 2019 valuation multiples are similar to those of the same period in 2018. Last year this softening was followed by strong quarterly performance as the year unfolded.

(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.

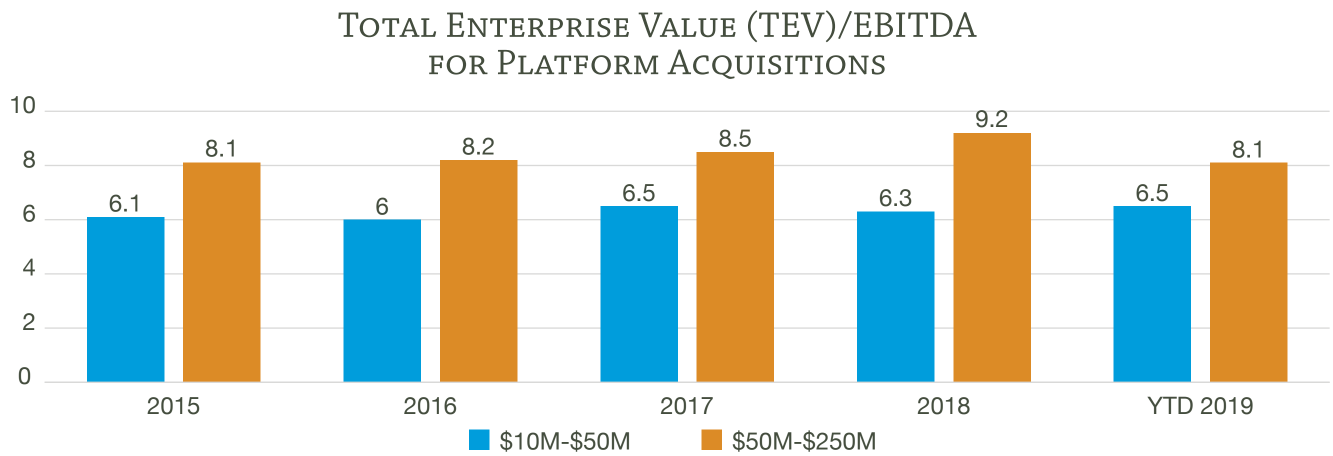
Chart #1



Source: GF Data®

The Size Premium – We often get asked about when a smaller middle market company might "jump" to a higher tier of valuation multiples. The answer is when the company is viewed as a "platform" size acquisition rather than an "add-on" or "tuck-in" acquisition. A platform acquisition is generally recognized as one in which enterprise value exceeds $50M in TEV. The reward in valuation extended to these larger companies can be seen in Chart 2. Platform companies in the lower middle market have historically commanded an additional two multiples. YTD 2019 shows that gap has narrowed to 1.6x. We will see how 2019 plays out to determine whether this is a Q1 anomaly or a trend.

Chart #2

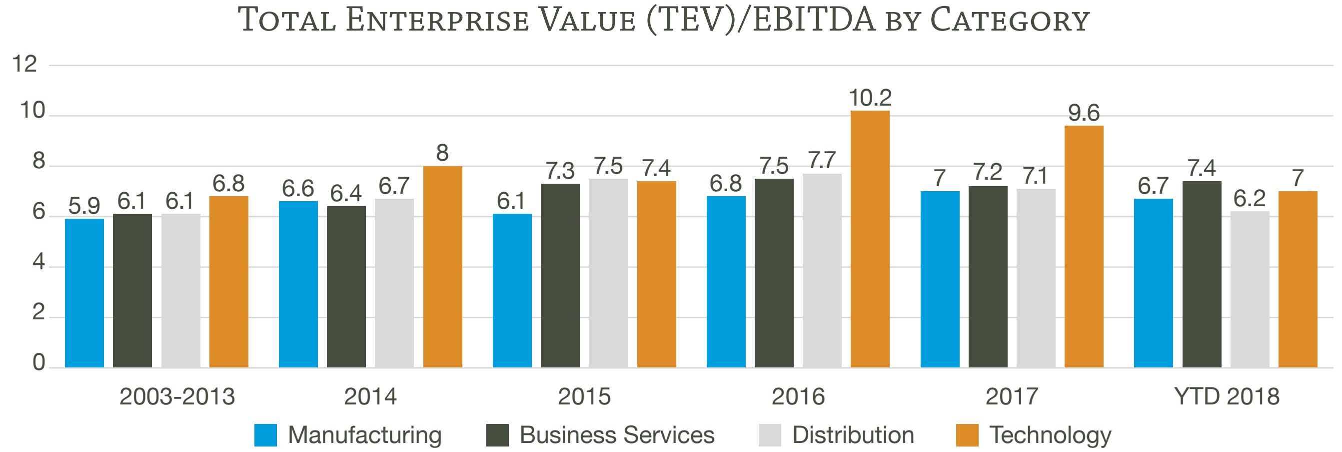


Source: GF Data®

The Middle Market by Business Category – When looking at select categories of the lower middle market, we can again see that valuation multiples have peaked, even in a growth sector like Technology. See Chart 3 for this comparison.

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.*

Chart #3



Source: GF Data®

The US Macroeconomic Picture for Q1 2019

GDP – The US economy grew by an annualized 3.2 percent in the first quarter of 2019, easily beating market expectations of 2 percent and following a 2.2 percent expansion in the previous three-month period. Growth was mainly supported by personal consumption expenditures (PCE), private inventory investment, exports, state and local government spending and nonresidential fixed investment. A strong GDP growth rate further fuels the active M&A climate.

Inflation – The US annual inflation rate finished Q1 2019 at 1.9 percent in March, up from a two-and-a-half-year low of 1.5 percent in the previous month, and slightly above market consensus of 1.8 percent. We watch this key indicator as it influences Fed behavior and its management of interest rates, which effect M&A.

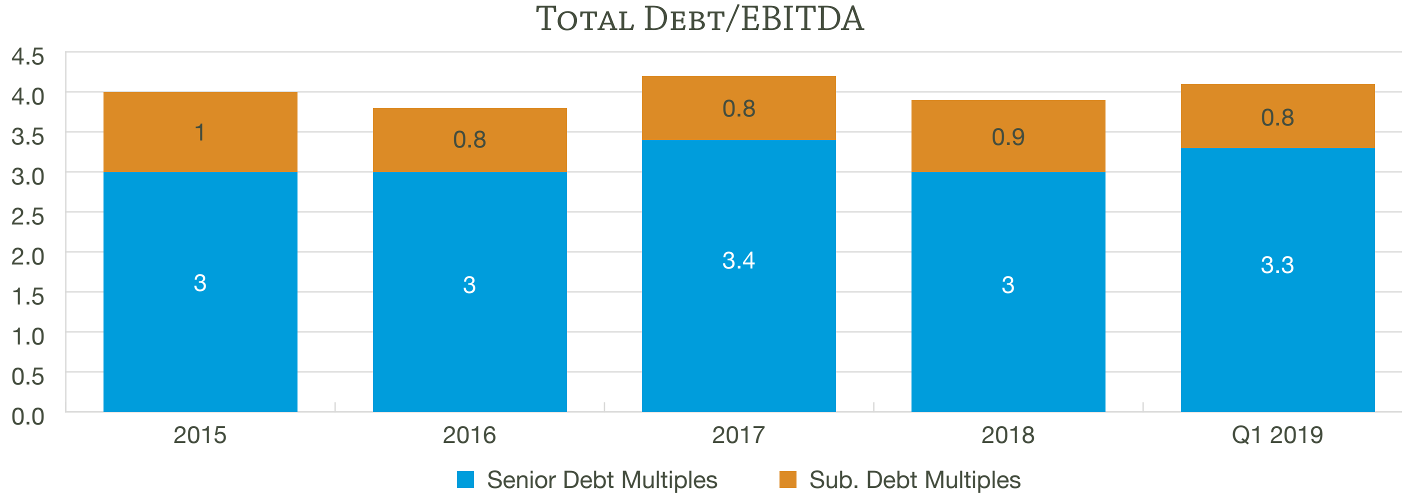
Business Confidence – The Institute for Supply Management's Manufacturing (ISM) Purchasing Managers Index (PMI) in the US finished Q1 2019 by rising to 55.3 in March, recovering from a 2 year low of 54.2 reported in February and compared to market expectations of 54.5. PMI is a number from 0-100. A PMI 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 further the number is from 50, the greater the level of change.

Fed Lending Rate – The FOMC left the Fed Funds rate unchanged in Q1 2019 from its 2.25-2.5 rate set in December 2018. Incoming data available in March was much less encouraging with three consecutive quarters of declining GDP in 2018, and preliminary data for Q1 2019 suggested a continuation of that trend.

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 for valuation purposes and Buyers for access to affordable capital to fund M&A activity.*

Leverage Multiples – Chart 4 shows that lenders are still optimistic about the M&A climate and that borrowers are still willing to lever-up for M&A as a result of cheap capital and a healthy economy. Buyers—especially financial Buyers—are willing to borrow heavily to get deals done. Combined senior and sub M&A related debt in Q1 2019 averaged more than 4x EBITDA, continuing the healthy borrowing appetite we have seen over the course of this decade.

Chart #4



Source: GF Data®

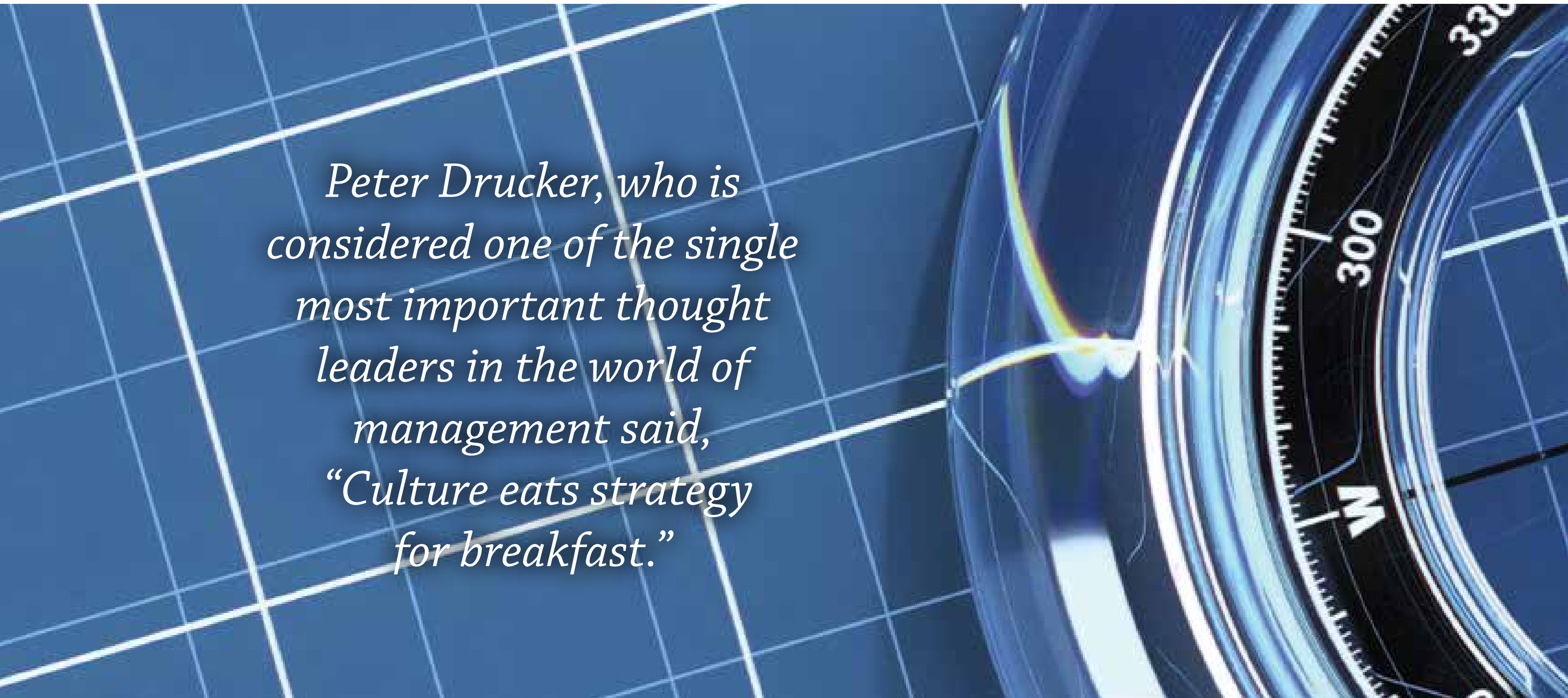
Culture Eats Strategy for Breakfast, and It Can Eat Your Deal Too

Scott Glickson & Richard Curry – Pursant Managing Directors

The success (or failure) of M&A transactions is influenced by many factors. Some recent studies have quantified culture and cultural alignment between the transacting parties to be the main driver in 30% of failed deals, while others have cited figures as high as 80%. While that is a broad range, it does highlight the relevance of this topic on the outcome of a deal. Even when cultural differences don't specifically cause a deal to fail, they are often cited as a root cause for other deal related post-close issues including poor integration, inability to retain and/or attract talent, declining productivity and underperforming financial results.

Given the importance, there is merit to asking: what is culture? Culture is shared values and beliefs that shape employees' behaviors and attitudes. Culture impacts every aspect of a business including decision making, pricing, client acceptance practices, customer experience, leadership styles, employee hiring and retention, appetite for change and the definition of success.

Companies can have similar values, but how a company conducts its business defines the culture. Different businesses can value making money, but one can use legal means to accomplish this goal, whereas another



organization can do so illegally. In this example, there is clearly a right and wrong; however, oftentimes one business approach isn't more right or wrong than another—just different. As a result, typically there isn't a good or bad culture. *The key is having a culture that is compatible with the business model and strategy.*

The following provides examples of different approaches to business activities. A company's approach provides insights into the culture of the organization:

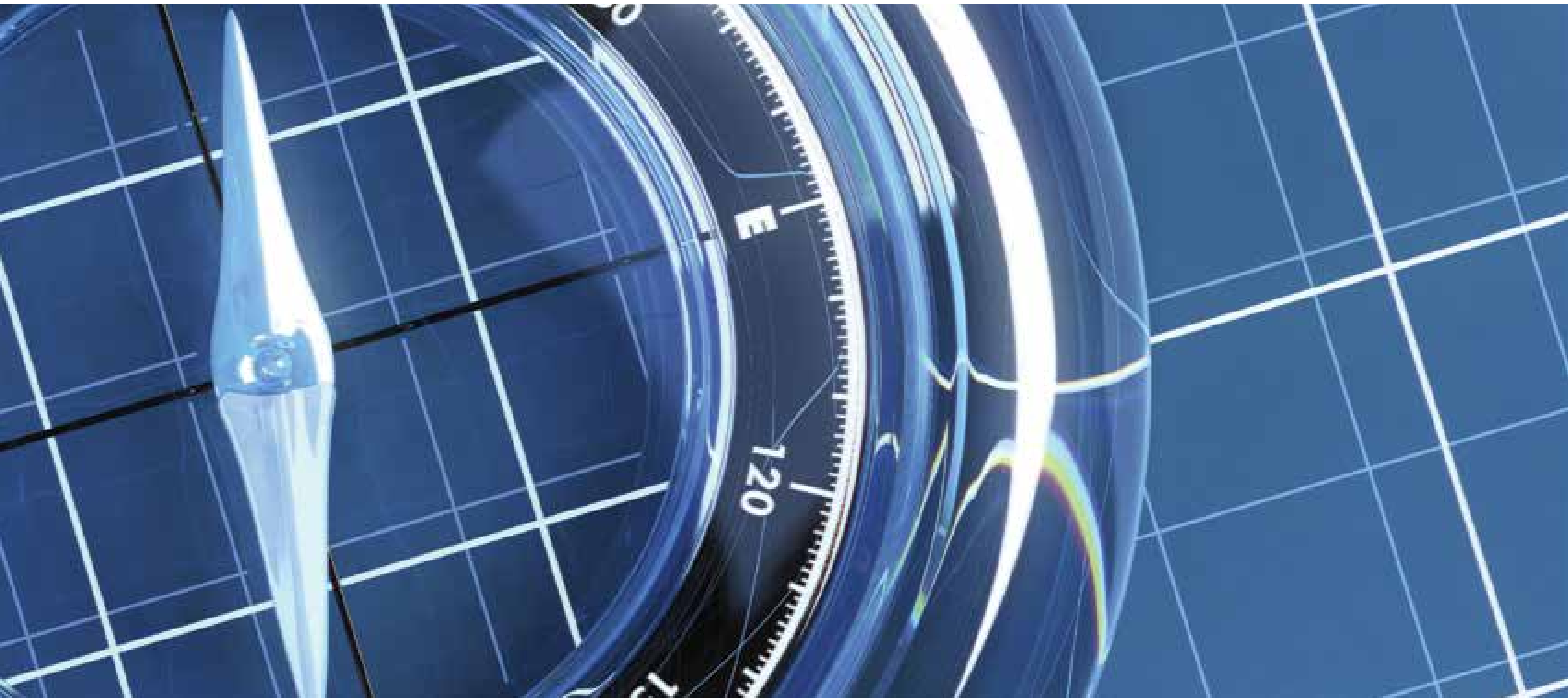
- **Decision making** – hierarchical, clear chain of command vs. egalitarian, collaborative.
- **Incentives/rewards** – team performance vs. individual successes
- **Employee development** – use of outside training and development resources vs. leveraging internal, on-the-job development and job rotations.

Evaluating Culture in the Context of a Deal

Often in M&A transactions, evaluating culture and cultural alignment is overlooked. It is not easily measured or checked off a checklist. It is more art than science. In many cases, a merger fails to have any degree of success due to cultural integration issues even though financial and other data would have indicated a wildly successful transaction. The Daimler/Chrysler and AOL/Time Warner mergers are prime examples of such failures due to cultural misalignment.

During the pre-transaction evaluation phase, Buyers and Sellers should examine the cultural fit of the organizations with the same rigor and thoughtfulness as other pre-transaction diligence activities. This requires having a well-managed approach to addressing culture. Too often in the due diligence process, culture is assessed based on the beliefs and values of the top leaders. However, frequently there are major cultural differences between the top leaders and the rest of the organization. As a result, evaluating culture requires deep dive discussions with employees across all levels of an organization, not just an evaluation of its leadership. This includes ascertaining input from customers, vendors, suppliers and others that intersect with the organization. Equally important, there should be a clear view of the culture that will emerge from the combination of the businesses. Imposing new cultural values on an acquired company is not the solution, as imposing cultural values will not replace underlying values and beliefs.

After the close of a transaction, managing cultural assimilation should be an ongoing process of its own for a successful integration. It requires ongoing attention, reinforcement and sponsorship. Culture needs to be focused on, defined, talked about and tied to value creation. When sidestepped or treated as an afterthought, culture will often undermine value creation in a deal.



Sharpen Your Knife: Carve-Outs & Strategic Divestitures

Brian Steffens – Pursant Managing Director

M&A market dynamics have favored the Seller in most cases for some time now. Capital remains cheap and abundant. Profits are up. Valuations are high and competition for deals is as intense as ever from Buyers of all different levels of sophistication. If you are a business owner not looking to exit in the next 12-24 months; you should prepare yourself, your business and your family to take advantage of the next cycle (7-10 years from now), as this Seller's market will eventually soften, and you will have missed this phenomenal exit opportunity.

A carve-out or strategic divestiture is a way to participate in and take advantage of the current market environment while also retaining the core business and improving operations. This type of transaction can convert underserved, undervalued or noncore business units into cash that can either be distributed as dividends or reinvested in the business.

It is natural that as your business has grown and matured, it has become a collection of customers, contracts, products and services across an ever-expanding geographic footprint that may no longer fit cleanly together. These elements compete internally for the company's valuable resources of talent, capital and time. The skills and acumen that made your business a success in the first place are also the ones preventing your team from turning its back on any piece of business, regardless of profitability or fit. Carve-outs and strategic divestitures help your business capitalize on such underserved, undervalued or noncore business units and opportunities.

Carve-out and strategic divestiture transactions come in all shapes, sizes and complexities. Those that are successful in executing these types of deals are able to separate emotion from business decisions and depersonalize the connection to business assets. Doing so will allow you to objectively see similarities and differences between business units, product lines, service offerings and other assets so that you can identify parts that might be divested.. What does each component need in order to deliver your standard of quality? How do those needs change? How fast are they changing? What does the competition look like? This process can be difficult for many owners, as these assets are often great ideas, pet projects, and legacy businesses that can carry an emotional attachment. No matter the attachment or story (and there will always be a story), most business have assets that have become less relevant to the core business. Why hold onto them only to watch their value wither away or allow them to become an increasingly costly distraction? Why not capitalize on the assets and empower someone else to realize the full potential?

Once you view your business as a portfolio of assets, you can move on to the exercise of understanding segmentation, contribution margin and overhead allocation. Many business owners we come in contact with do not know what the real cost or profit is for individual customers, contracts, products and services, and what their real contributions are to the company, net of the overhead needed to service them. Oftentimes, it's because the company simply is not capturing an accurate and complete financial picture. Owners often favor a "peanut butter" overhead allocation methodology: spread costs evenly. This approach may have made sense at a certain point in time, but it grows increasingly obsolete as a business scales.

Now that you have a good handle on your business at a micro-level, it's time to think macro. It can be challenging for business owners to see the potential value to others of certain assets due to biases. This can be is especially true if the business has underperformed versus a competitor, if specific services or products are not viewed as winners or if an asset is challenging to manage. These biases may exist because your business may not be set up to effectively service that customer or provide that product, whereas a potential transaction partner may be.

Once ready to move forward, you will find that identifying buyers in this market is not a problem—finding the right Buyer is. Who is the ideal Buyer for this asset? What is that ideal Buyer looking for? What aspects of the deal will create value for them? Each potential Buyer group—strategic Buyers, PE groups, independent sponsors, family offices or even individuals that are capable of securing SBA loans—will look at it differently. Be prepared to engage this broad spectrum of Buyers by thinking through how to package your asset or assets depending on how they would view the deal.

You may need to create several variations of the carve-out opportunity depending on the Buyer. When scoping the carve out, be clear and transparent as to what is in and what is out. For example:

- **Assets** – Specifically identify the assets associated that will transfer as part of the deal. Is IP involved?
- **Talent** – One's first inclination will be to retain all the top talent and saddle the carve-out with few or underperforming people. Be mindful that there will be a formal diligence period that includes a deep dive into the talent coming with the deal. This sleight of hand will be discovered. Spend time giving an accurate picture of the people critical to the carve-out. Also, consider positions or functions that will be left empty for your business and will require back filling after the transaction.
- **Services** – What back office or corporate services may still need to be provided by your core business, if any. There may be an ongoing opportunity to be compensated to perform these functions for the Buyer.

Assuming that a deal gets done, be mindful of the potential underutilized fixed overhead costs that are left behind as a result of a carve-out. Once the carve-out is complete, what is then required to run the remaining business? A post-carve-out proforma will give clarity as to what the new financial profile of the business looks like.

Any transaction—whether a complete sale or a carve-out—can be disruptive and cause angst among employees. As the owner, make sure you remain in control of the narrative to all stakeholders. While this is sensitive, especially when talking about the potential departure of key employees, make sure to communicate why the divestiture will leave everyone better off: Buyer, Seller, employees, customers, and suppliers.

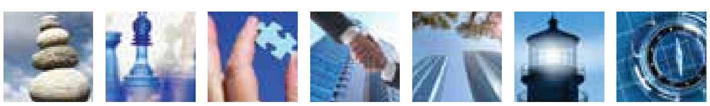
In summary, even if you are content with remaining in the driver seat of your business for the next 7-10 years, a carve-out or strategic divestiture can help you take advantage of the current market environment and recalibrate or refocus your business for a larger exit down the road.

Pursant's Expectations for Q2 2019

We expect middle market M&A to be strong in Q2 and the balance of 2019, especially in North America. A healthy U.S. economy, attractive and stable interest rates, big cash balances on strategic balance sheets and sponsors being flush with over $1 trillion of capital will fuel dealmaking. Global uncertainty around Brexit and Asian supply chains will bring pause for some, but not likely in the lower middle market.

For Buyers, there are many good companies out there. The challenge is motivating owners to sell when times are good. Increased competition for purchasing companies is creating high valuations.

For Sellers, the market remains in their favor. With many Buyers to choose from and cheap capital bolstering borrowing and related valuations, conditions could not be any better for an exit or simply taking some chips off the table. Premium valuations means Buyers must continue to be thorough in their diligence processes. So a Seller must have their house in order and have quality earnings to close with a valuation



Pursant helps companies grow and realize enterprise value by managing their M&A related initiatives.

Our Investment Banking, Strategic 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.

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