Q3 2019 EDITION

Pursant
INSPIRED PURSUIT

DEAL insider

M&A and Strategic Transaction Insights

THE INVESTMENT BANK THAT ALSO BUILDS THE VALUE OF YOUR BUSINESS

Q3 2019 Highlights:

- Overall M&A activity in Q3 2019 remained on pace with previous quarters
- Fed rate cuts further fueled M&A borrowing activity
- More Sellers beginning to think about liquidity events in advance of 2020 uncertainty

Pursant's Thoughts on the Near Future

- Lower middle market M&A should continue to be largely unaffected by Asia supply chain issues
- Election year M&A jitters could appear soon
- More Sellers eyeing a 2020 exit with 2021 economic uncertainty

Nine months Into 2019, Middle Market M&A Valuations Remain Mostly Positive

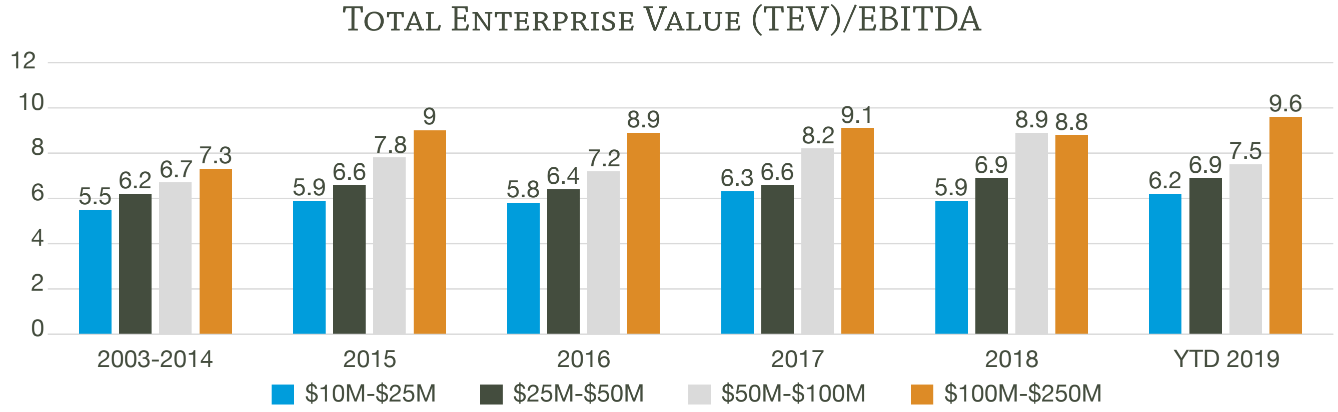
Generally favorable M&A middle market conditions for private business owners continued to prevail in the third quarter of this year. There have been few signs of a downturn; thus, the longevity of the seller-favorable cycle is very much in evidence. Favorable conditions are now extending to Sellers in the smallest deal size tier. In 2019 year to date, the average valuation for businesses that sold for $10-25 million is 6.2x. This is markedly higher than the same period in 2018 (an average of 5.9x)

It has been a different story for many companies two tiers up, in the $50-100 million range. The average multiple this year has been 7.5x—well short of the 8.9x average recorded in 2018. Every kind of market presents its own vexing anomalies. Our initial tendency was to regard this as a wrinkle that would be ironed out over time. However, the dampened valuations have persisted for long enough and are borne out by discussions with Buyers. In short, not every business is trading for 10x. A business must have a favorable risk profile to command double digit multiples, not just $5M+ in EBITDA. Chart 1 shows that overall, lower middle market EBITDA multiples—measured as Total Enterprise Value (TEV)/EBITDA—for transactions YTD through Q3 2019 averaged 7.2x, consistent with the same period last year.

(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.

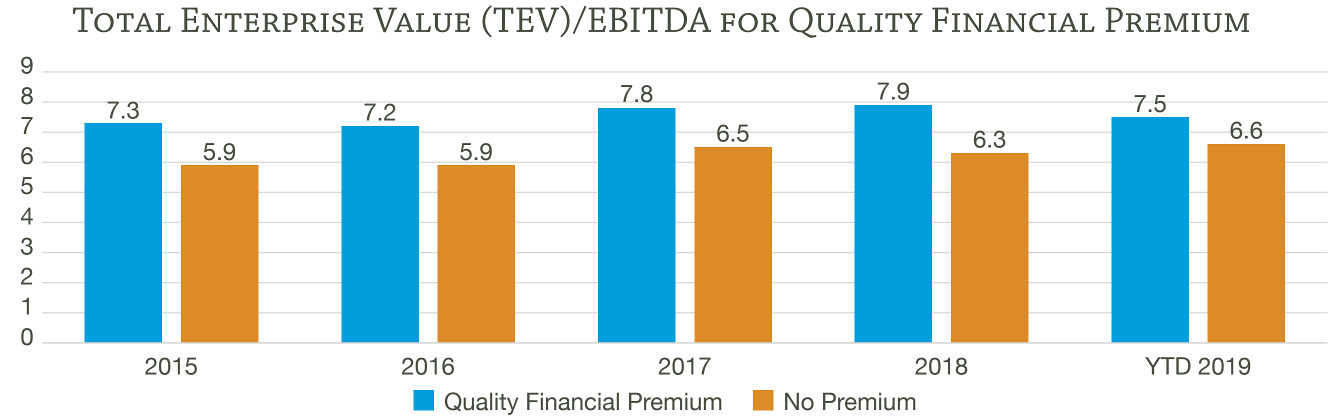
Chart #1



Source: GF Data®

The Quality Premium – As previously discussed, businesses with above average financial characteristics continue to outperform industry peers. A financial premium is paid for businesses with trailing twelve-month (TTM) EBITDA margins and revenue growth rates both above 10 percent, or one above 12 percent and the other at least 8 percent. Outliers on the high side are excluded from this calculation. Chart 2 shows that if there are two virtually identical companies being acquired, the company with more impressive revenue and margin growth rates will command nearly a full one multiple (1x) premium.

Chart #2



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 Q2 2019 and its Impact on M&A

GDP – The US economy grew by an annualized 2.1 percent in the third quarter of 2019, compared to an advance estimate of 1.9 percent and following a 2.0 percent expansion in the previous three-month period. Upward revisions to private inventory investment, nonresidential fixed investment and personal consumption expenditures (PCE) were partially offset by a downward revision to state and local government spending. As we stated before, even a moderate 2% GDP growth rate is good for M&A sentiment. A healthy economy keeps dealmakers confident about sustainable returns on their deals and motivates Buyers to augment revenue growth with acquisitive growth.

Inflation – The US annual inflation rate finished Q3 at 1.7 percent—up slightly from Q2 at 1.6 percent. Throughout 2019, the inflation rate has stayed within a fairly narrow range, peaking at 2.0% in April and bottoming at 1.5% in February. The index remains below its moving average, indicating that the trend is still down. However, highs and lows are getting closer together, so a small spike upward could easily cross above the moving average. We watch this key indicator, as it influences Fed behavior and the Fed's management of interest rates, which effect M&A.

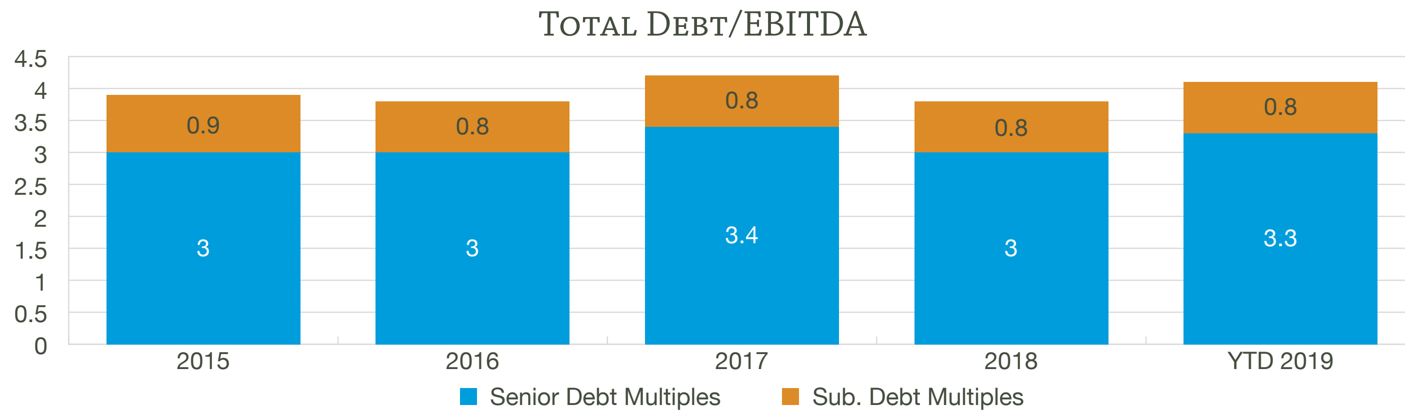
Business Confidence – The Institute for Supply Management's Manufacturing (ISM) Purchasing Managers Index (PMI) in the US finished Q3 2019 at 47.8 in September, markedly down from 51.2 in June, representing the lowest reading since June 2009. 50 is the threshold that separates expansion from contraction. 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.

Fed Lending Rate – We saw two Federal Funds Rate cuts in this quarter—one in July and a second in September—to finish Q3 at 2% amid global growth concerns and muted inflation pressures. This benchmark rate is an indicator of the economy's health. The Fed Funds Rate is critical in determining the U.S. economic outlook, and it controls interest rates including loans from M&A transactions. The lower the rate, the higher the rate of return. The higher the rate, the lower the rate of return, thus putting downward pressure on valuation multiples.

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

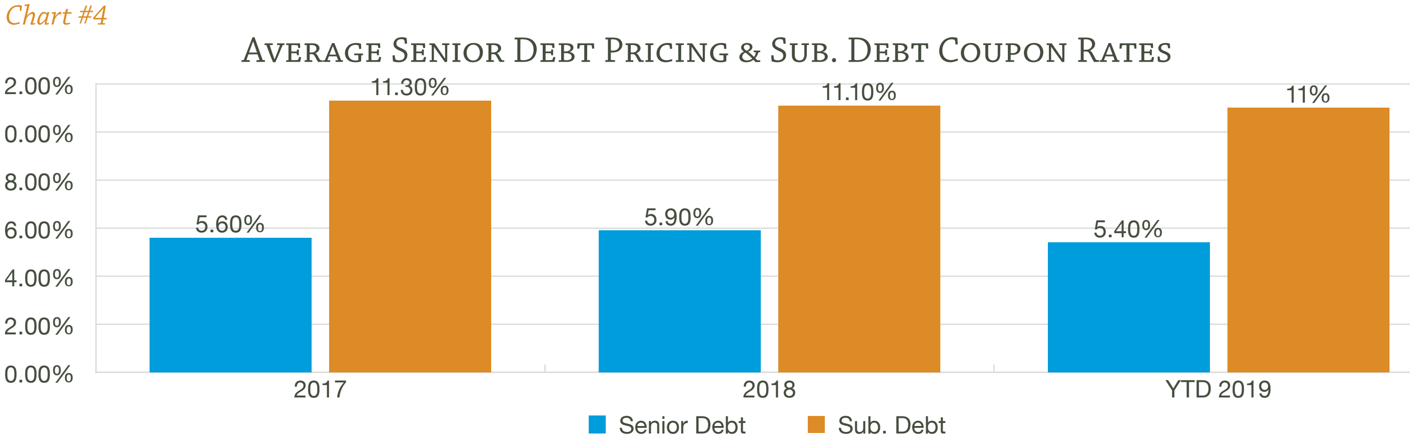
Leverage Multiples – Chart 3 shows how debt availability and usage remain unabated. Lenders remain ready, willing and able to support M&A transactions and Buyers are still willing to lever-up for M&A as a result of the affordable borrowing rates (Chart 4). Combined senior and sub debt multiples in the first half of 2019 averaged more than 4x EBITDA.

Chart #3



Source: GF Data®

Chart #4



Source: GF Data®

You Signed the LOI! – But Will You Close???

Scott Glickson – Pursant Managing Director

A key milestone in any M&A process for both Buyers and Sellers is signing the LOI. While signing the LOI represents a significant achievement, it is just the tip of the iceberg to actually getting a deal done. Oftentimes a deal doesn't get done even after the LOI is signed.

Signing up a deal is typically marked by both Buyer and Seller executing a Letter of Intent ("LOI"). The LOI lays out the general terms of the deal, including purchase price/valuation, deal structure, process, deal financing, key diligence considerations and timeline. While these terms are non-binding, the LOI almost always provides for a legally binding period of exclusivity defining a set amount of time during which the Sellers agree not to solicit other potential Buyers or entertain other offers.

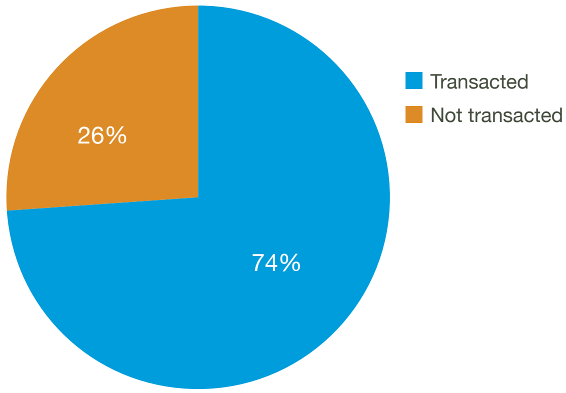
With an LOI in place, things get serious. The pace, velocity and sense of urgency all increase. The initial activities are driven by the Buyer's due diligence workplan. Both parties exert significant time, energy and resources to perform the diligence work. Buyers typically begin incurring real hard dollar costs as they engage third party diligence providers, most commonly including accounting/financial professionals for quality of earnings analysis, transaction tax specialists and legal counsel. While the Seller's real hard dollar costs during this stage are typically less than those of Buyers, Sellers are challenged by the complexity of managing the demands to satisfy the Buyer's diligence (and all the corresponding requests associated with it) while concurrently managing the day-to-day operations of the business.

Eventually, the heavy lifting from the diligence phase passes and the process shifts to deal documentation phase. At this point, lawyers drive the process. The key document is the definitive purchase and sale agreement but oftentimes includes an operating agreement, real estate leases and employment agreements. These documents are initially prepared by the Buyers and are heavily negotiated, resulting in investing more time, energy and resources.

As you can see, there are many hurdles to clear between signing the LOI and closing. Each hurdle not cleared represents a potential barrier to closing. Chart 5 below shows that according to a recent study by Pepperdine University's Private Capital Markets group, 26% of deals don't close.

Chart #5

LIKELIHOOD OF DEALS CLOSING



Source: Pepperdine Private Capital Markets Survey

For both Buyers and Sellers, the process to getting a deal done can be exhausting, and crossing the finish line is a great accomplishment. Our experience has been that the deals that didn't close most commonly derailed for one or more of the three following reasons:

- Seller's inability to produce required due diligence documentation or to produce it in a timely fashion
- Deal fatigue on the part of either the Buyer or Seller due to protracted due diligence
- Discovery during due diligence of material issues with the business being acquired

There are many other reasons a deal may not close post LOI, but these three most common reasons are largely preventable if a business owner "stress-tests" the business in advance of pursuing a sale transaction—essentially having a third-party diligence the business. This process will allow a Seller to enter post-LOI diligence with confidence and preparedness.

Diligence is physically and emotionally demanding. To increase your chance of closing, prepare your business and mind for the ultimate workout.

The Management Presentation – Put Yourself on the Buyer's Side of the Table

Richard Curry – Pursant Managing Director

Congratulations, you have made the decision to sell your company! Hopefully, you have engaged a professional transaction advisor to assist in the compilation of financial and marketing information to cast the very best light on all of the tremendous attributes of your business.

In previous articles, we have discussed ways to best position for the transaction, the types of Buyers and their attributes, and what to expect during the journey of selling. You are now at the point that with the assistance of a competent advisor, your numbers have been scrubbed to stand up against the rigors of diligence, the structure, strengths and opportunities that define your organization have been communicated in an engaging and truthful fashion, and information regarding your clients and employees has been presented in a compelling way. The teaser has been sent, NDAs have been signed with interested parties, the Confidential Information Memorandum has been dispatched and your first calls or visits with various potential Buyers have been scheduled.

How do you best prepare for these encounters with these interested parties? We believe it is most important to **think from the perspective of the Buyer**. Let's examine some key points in preparing to deal with a Buyer, without regard to whether Financial or Strategic in nature.

1. Buyers are human and busy just like you. It is critical that you attend all the scheduled meetings and put the necessary time aside in your busy schedule. The selling of your company is likely one of your life's biggest events. Therefore, make time on your calendar and avoid rescheduling or showing up late for scheduled discussions. First impressions are huge and lasting.

2. Buyers are intensely interested in your personality and history, as they believe that lower and middle market companies generally take on the attributes of the owners. The quality of the presentation of your personal background and company history is extremely important. The initial meeting in which you present yourself will have an important impact on how the chemistry between you and the Buyer develops. Organize your story with concise yet descriptive chronology. Infuse it with a certain amount of humility. Arrogant, abstract and forceful diatribe puts Buyers off guard and creates doubts about your company's culture. As it is likely you will be repeating this story many times, practice it until you can tell it consistently in an engaging way.

3. Promote your team. A successful Buyer will be spending a lot of time with you and your team post close. If you are exiting the business, it's all the more important to promote the team that will be carrying the flag for the new owner.

4. Project enthusiasm for your industry, the company's future, and the excellence of your clients and employees. This energy can be infectious for a Buyer, and should be kept fueled at high levels throughout the process.

5. Buyers are interested in charting a future course for the business. Although you may be exiting the enterprise entirely, be prepared to share with the Buyer your vision to ensure the successful continuation of the business. After all, if you were not selling your company, you would be doing what the Buyer now has to do: build plans to promote the profitable growth of the business.

6. Do your research on the Buyer. Every Buyer has a history and reason for their acquisitions. If you take the time to research the Buyer, you will be able to respond to questions in a way that will resonate. Use your formidable business acumen to explain how you believe your company may be able to fit into the Buyer's investment thesis. Even if you are off the mark, the Buyer will be impressed that you have taken the time to try to understand their needs and objectives.

7. Finally, and most importantly, realize that your Company is not perfect. Buyers are generally aware of industry drawbacks. However, they will become aware of what they perceive as company specific flaws. These perceived flaws should not be obscured or dismissed lightly. You probably already know what these flaws are and how they may be perceived. Therefore, with the assistance of your advisor, you should be prepared to address them in a straightforward and unapologetic manner. You should always remain enthusiastic about the strengths of your company, but don't be hesitant to address the tough questions with confidence. This approach builds trust between you and the Buyer.

In summary, take the time to put yourself in the shoes of a Buyer. One of the reasons for your success as an owner and entrepreneur has been your ability to read clients' and employees' needs. Why not use that skill in dealing with prospective Buyers? It is likely to work to your advantage.

Level Setting Expectations if You Are Going to Buy a Business

Brian Steffens – Pursant Managing Director

In our last issue of Deal Insider, we reviewed 5 of our 10 Buyer best practices for setting acquisition expectations in a market with an abundance of Buyers. To quickly review, they were:

1. **The perfect company does not exist, so stop looking for it.**
2. **The journey is not linear. You need to be flexible.**
3. **Be prepared to share sensitive information about your business as well.**
4. **Don't be surprised that you have to chase targets.**
5. **Marketplace relationships and connections are helpful, but they do not guarantee a pipeline of deals.**

This issue of the Deal Insider covers Buyer best practices 6 through 10:

6. **Don't undertake this effort on your own.** It will behoove you to use a broader team (internal & external) if you are to undertake an acquisition. It is natural that people synthesize information based on their own previous experiences. Having more people involved brings different perspectives and insights, thus reducing the probability of missed information or deal bias. Human beings are a wealth of information. What they say or not say, along with how it was said and the underlying body language, are all critical factors in understanding how you can get a deal done with the target. While you may feel that you can do everything, it is impossible for one person to capture and accurately analyze all of the information about an acquisition at once. Some of the best insights come from those participating in an active listening role. Because they are not facilitating and building a relationship, they can be more critical. Note, we try to have at least 2 people on every call or at every meeting to ensure representation of a broad set of skillsets and balanced analysis.

7. **Be transparent in how you approach valuing the business.** When you have gathered enough intel and information to have views on valuation and structure, don't keep it a secret. Being transparent will allow for open and objective dialogue about the risks and opportunities of the business. Maybe you missed something or misinterpreted a key piece of information. Through further discussions and review of additional supporting materials, you will gain comfort that you are placing the right weight on a particular finding and how it impacts the structure or valuation. Transparency increases the likelihood that you'll be able to find mutually agreeable ways to get a deal done, whether now or down the road.

8. **Allow time to uncover true motivations and emotional connections.** While it can save time to cut to "brass tacks" on what it is going to take to get the deal done, it's generally not wise to do so until you are ready. In fact, doing so on the first phone call or face to face meeting can be off-putting to the target. If it does not push the target away, it may create a confrontational tone out of the gate. You do not know enough about the business or the Seller yet to be having a serious discussion. You need to gather more intel to construct the right formula that will get the deal done. The numbers are the numbers. Ego, legacy, motivations and emotions are what that drive the discussions, and these take time to reveal themselves. Uncovering them will require an investment in listening to anecdotal stories and answers to your probing questions. Make notes and see if the financials, corroborating stories from others and details collected during preliminary diligence and formal diligence support these stories or if are they in conflict. What does that mean? Is it a critical or material fact or a happy opportunity that's been uncovered? Allow for the discussion and the relationship to evolve naturally.

9. **Don't fault an owner's weak financial acumen.** You will encounter attractive businesses with wildly successful owners that cannot articulate their profitability by product or service line, that do not know or understand GAAP (generally accepted accounting principles), and that are materially off on the size and scale of the business. In the many

years of doing M&A, we've seen a lot. You should be prepared to roll up your sleeves and dive into understanding how a targeted business makes money. It is not uncommon even for owners of good-sized middle market businesses to operate based on cash in bank and the size of their tax liability. Their financial acumen and the cleanliness of the books will become known pretty early in the relationship. Once you can rule out malice or deception, chalk it up to the owner having strengths in other critical aspects of the business. Encourage them to get their accountant or someone else with a stronger handle of the numbers involved as early as possible, as it will help you drive to the ultimate goal of getting a deal done.

10. **Expect the Seller's "number" to change as the process unfolds.** Negotiation can be stressful. If you have allowed the process to evolve, many of the key elements have already been discussed and pressure tested. That said, be prepared that true honesty as it relates to the deal a Seller will accept only comes when you tender your first offer. We've had Sellers that were fully onboard and aligned with our offer (developed over several calls and meetings and socialized with them along the way) resoundingly reject it once they receive it. How could this happen? It happens because this is often the first time they ask their outside advisors for advice (CPAs, Attorneys, Wealth Management Professionals, Intermediaries, Investment Bankers or spouse). Each of these parties wants to be perceived as smart and is likely to offer an opinion, even if a transaction such as this is outside their area of expertise. Given that the owner seeks their advice, their influence on the Seller cannot be ignored. In defense of these "influencers," they often are not privy to the evolving dialogue. They do not know you or your intentions, and most often they are not aware of the inherent or perceived risks and concerns that have been discussed with the owner as you've developed your valuation and deal structure. We find that many business owners gloss over those topics when sharing the indication of interest (IOI) or letter of intent (LOI) with their advisors and influencers. It's natural that this happens. So, be ready to explain and defend your position objectively. Also, be prepared for the resulting response or counteroffer to be significantly different than discussions leading up to that point. Listen to what the Seller says. It may just be the way they negotiate. If they have good points, take them into consideration. Have your walk away number and do just that if reached—you will find another opportunity.

In summary, remember that buying companies is a marathon and not a sprint. Recognizing this will allow opportunities to develop and evolve at their own natural pace. Make sure to treat everyone with respect and be open and honest in your feedback, as it is not a matter of if an owner will sell, it is simply a matter of when. You want to leave them with a lifeline to come back to you when the time is right. Remember that the more people you engage with along your journey, the higher the likelihood you will be successful in acquiring a business.

In summary, remember that buying companies is a marathon and not a sprint. Recognizing this will allow opportunities to develop and evolve at their own natural pace.

Pursant's Expectations for the Near Future

Evidence suggests that favorable M&A dealmaking will continue at its current pace through the balance of 2019 and into early 2020. The domestic economy performing at current levels or better will minimize chances for disrupting any of this. The Fed made multiple rate cuts this quarter and appears poised to hold firm for the balance of 2019. China trade tensions continue to dampen M&A in some sectors, but these trade issues appear to be resolvable in the near future and with the exception of certain sectors sensitive to the impact of foreign goods and trade, lower middle market M&A tends to be less affected by geopolitical and foreign market issues.

For Buyers, the cost of capital is going down and there are many good performing companies out there. The challenge has been motivating owners to sell when times are good, but even here, we are beginning to see a thawing of Sellers willing to transact. Buyers will continue to see robust competition to purchase companies, creating higher valuations in some situations. In spite of the heavy competition for acquisitions and limited supply, it is important for Buyers to ***stay in the game***. Dealmaker consensus appears to be that once the economic tide turns, which it must eventually, the market will shift to being more neutral and eventually Buyer favorable. If you are not already in the game at that time, you will miss out on the first mover advantage and the ability to reap the benefits of the relationships that have started to develop with potential Sellers.

For Sellers, the market will remain in their favor for the balance of 2019 and early 2020, but the balance of 2020 could prove to be a different story, as an election year and the beginning of related future economic policy uncertainty. Pursant's position remains that if selling is in your near future, from a market perspective, now is the optimal time to strike.

Upcoming Speaking Engagements

January 10, 2020
AM&AA Winter Conference – Scottsdale, AZ
Brian Steffens, Managing Director, Pursant

Session: "The Price is Right, but is Your Buyer? Selling Beyond the Purchase Offer for Privately Owned Businesses"

January 23-25, 2020
BSCAI CEO Seminar – Palm Beach, Aruba
Mark Herbick, Founder and CEO, Pursant

Session: "Middle Market M&A and Strategic Transaction Insights"

January 27-31, 2020
AM&AA Certification Course – Tampa, FL
Brian Steffens, Managing Director, Pursant

Session: "Deal Success: Strategic Buyer Process from Deal Thesis to Integration"

Pursant is an investment banking, financial and management consulting firm that supports and executes middle market M&A related initiatives and helps business owners grow enterprise value.

Our Financial Consulting practice delivers the strategy, skills and brainpower needed, in the form of advisory or interim financial professionals, to support and augment finance teams with needs often related to strategic transactions.

Our Management Consulting practice provides customized solutions designed to re-shape conventional thinking about leadership performance, profitability and growing enterprise value.

We use a deep immersion process, our expansive networks and experience as owner/operators, dealmakers and sector experts to effectively deliver on these critical initiatives 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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