Q4 2016 EDITION

Pursant
INSPIRED PURSUIT

# DEAL insider

## M&A and Strategic Transaction Insights

THE INVESTMENT BANK THAT ALSO BUILDS THE VALUE OF YOUR BUSINESS

**Inside this edition of the DEAL insider:**

- ***Macroeconomic Indicators***
- ***Reflecting on Strategic Transactions in 2016***
- ***What to Expect in 2017***

## 2016 Overview

**This year-end 2016 Pursant Deal Insider reviews macro-economic indicators that effected 2016 strategic transactions, middle market metrics and other deal related facts. We finish with thoughts about what business owners and investors need to know to successfully execute M&A and strategic transactions in 2017.**

Middle market M&A activity during the latter half of Q4 2016 was robust, indicating that the market was shaking off the drama and slowdown caused largely by the election. Given that President Trump's regulatory and finance policies are generally business-friendly, deal making should accelerate in 2017.

Overall, 2016 middle market deal making volume was down when compared to 2015, which was one the strongest years on record. Valuations held stable at frothy levels, with the healthiest companies continuing to command a premium.

The main drivers of the market's appetite for M&A and strategic transactions last year include the low cost of capital, limited organic growth options due to a slow economy, exiting baby boomers and increasing foreign demand for U.S. businesses. The stage is set for 2017 to be an even better year.

*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.*

## Macroeconomic Indicators

**Pursant looks at a number of macroeconomic indicators that may impact deals in order to gain insight into M&A and strategic transaction trends.** Interesting indicators include GDP and Unemployment and Borrowing Rates. What happens at the global and macro-economic levels eventually impact the Middle Market and Main Street as well.

*Chart #1 - Slow economic growth makes it challenging for companies to hit organic growth objectives, thus fueling the desire and/or need to pursue acquisitions.*

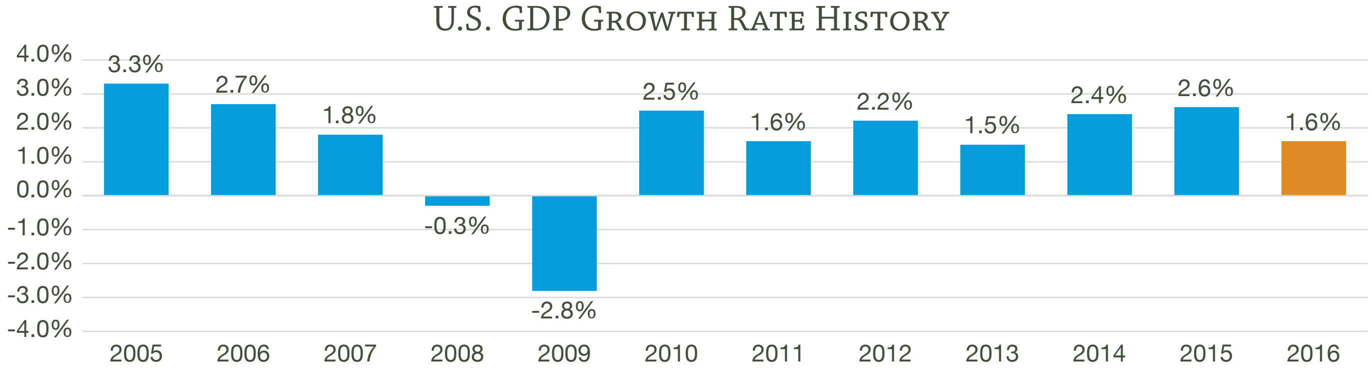



*Chart #2 - Declining unemployment rates generally result in increasing wages and downward pressure on earnings and, potentially, business valuations in a number of sectors, especially labor intensive ones.*

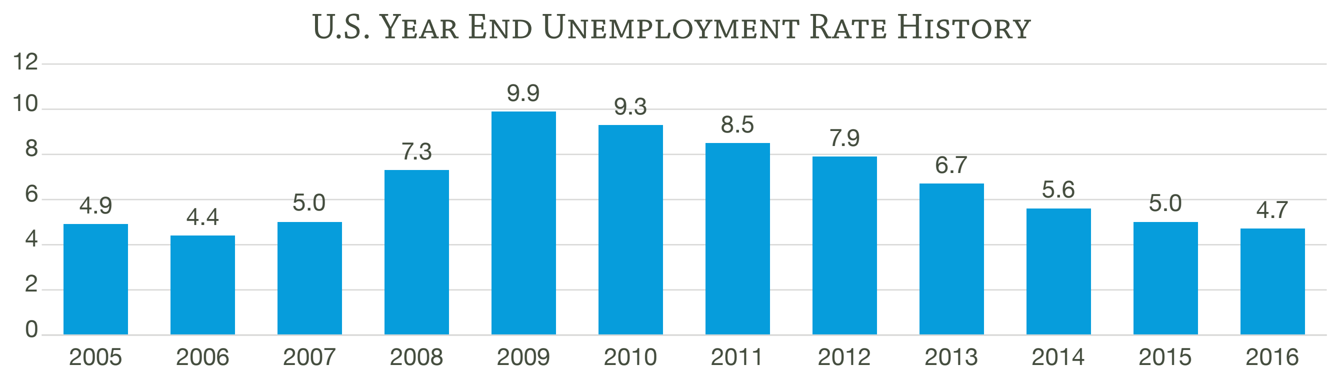
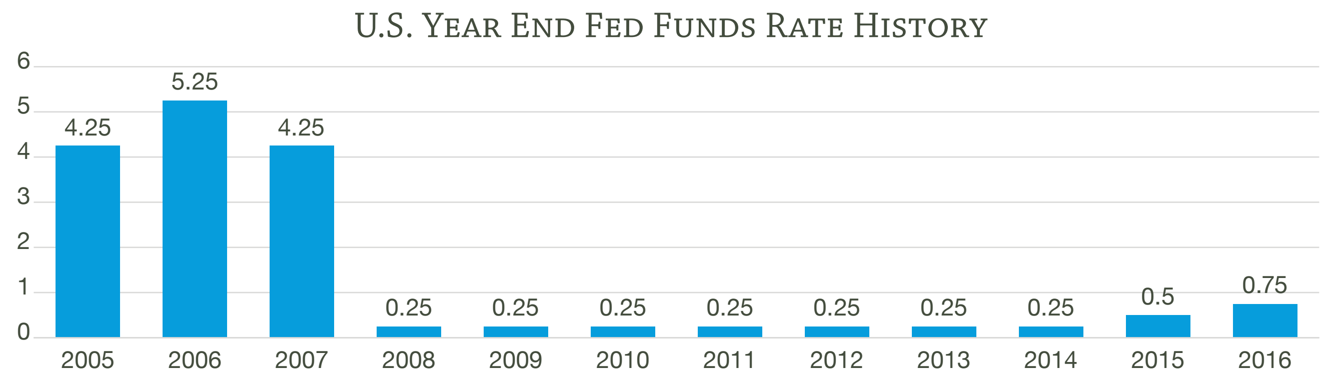



*Chart #3 - The cost of capital affects the market's appetite for borrowing to buy companies. As rates increase, there will be downward pressure on multiples when borrowing is involved.*

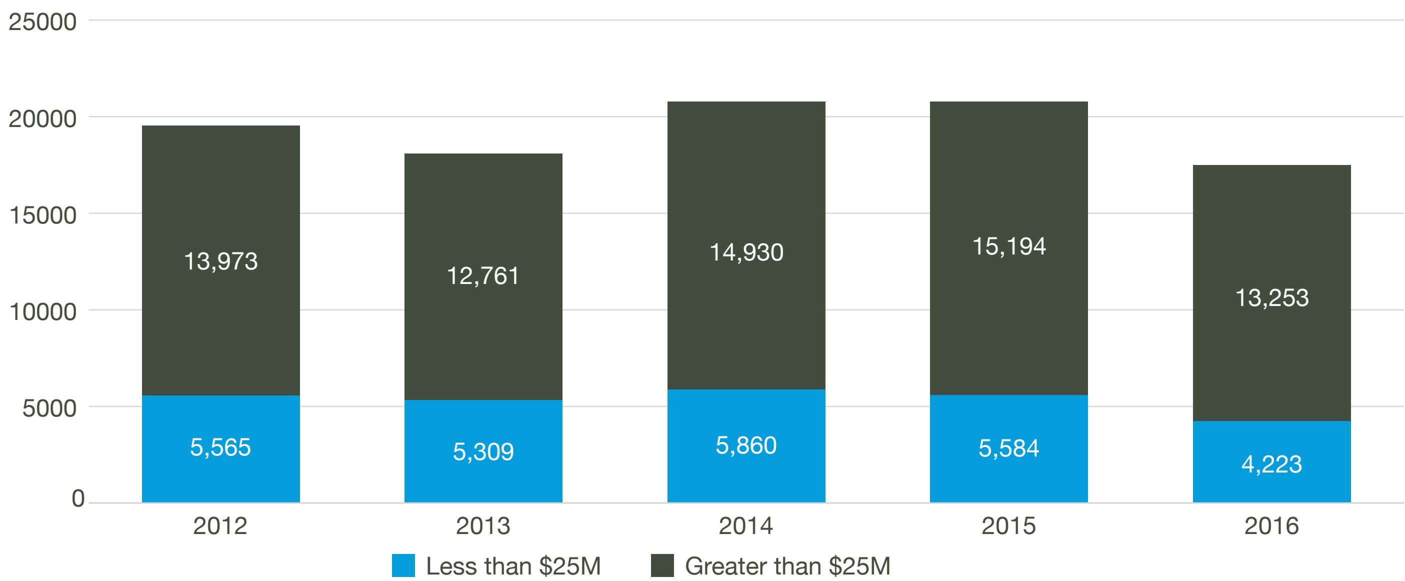


## Reflecting on Strategic Transactions in 2016

1. Political events and related uncertainty slowed deal flow
2. Limited organic growth options (weak economy) fueled M&A
3. Valuation multiples remained firm, even with December 2015 and 2016 Fed rate increases
4. With higher valuation multiples came tougher due diligence
5. More Strategic buyers continued to emerge
6. Cheap capital kept valuations at healthy levels
7. More companies stress-tested, optimized and planned for exit
8. More PE Groups moved downstream to smaller deals (<$3M EBITDA)
9. Fundless Sponsors (sector executives partnering with investors to buy companies) grew in number
10. Non-U.S. (mostly Eurozone) buyers made up a growing percentage of buyers

*Chart #4 - As a result of the uncertainties associated with the election process, middle market deal volume declined compared with 2015, but the level was still healthy.*

### US & Canada M&A Transaction Volume by Transaction Value




*Source: Cap IQ*

*Chart #5 - If you were looking to buy a company in 2016, you could generally plan for a senior lender to provide 2-4x of the acquired company's EBITDA and a junior lender to provide another 1x (depending on deal size).*

### Senior Debt/EBITDA (Business Services)

| TEV | 2014 | 2015 | 2016 |
|---|---|---|---|
| **10-25** | 2.0x | 2.8x | 2.1x |
| **25-50** | 2.0x | 3.0x | 3.1x |
| **50-250** | 3.2x | 2.8x | 4.0x |

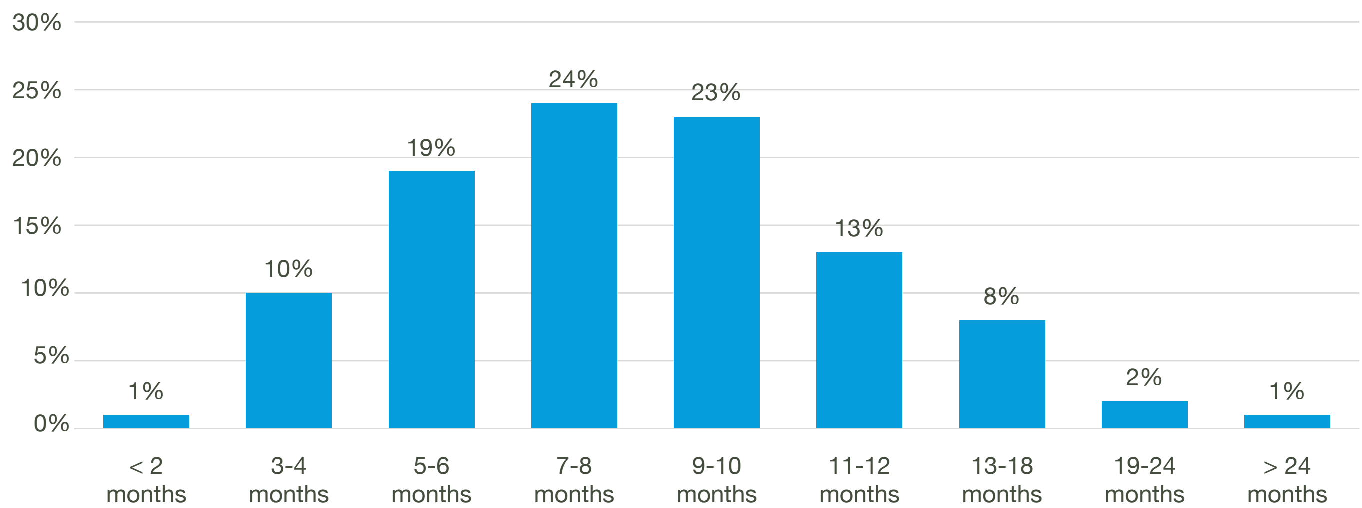
### Total Debt/EBITDA (Business Services)

| TEV | 2014 | 2015 | 2016 |
|---|---|---|---|
| **10-25** | 2.9x | 3.8x | 3.2x |
| **25-50** | 3.2x | 3.5x | 3.6x |
| **50-250** | 3.5x | 4.4x | 5.2x |

*Source: GF Data®*

*Chart #6 - With more lofty valuations in 2016 came more thorough due diligence. It was common for deals to take 5-10 months to close from the time a company went to market.*

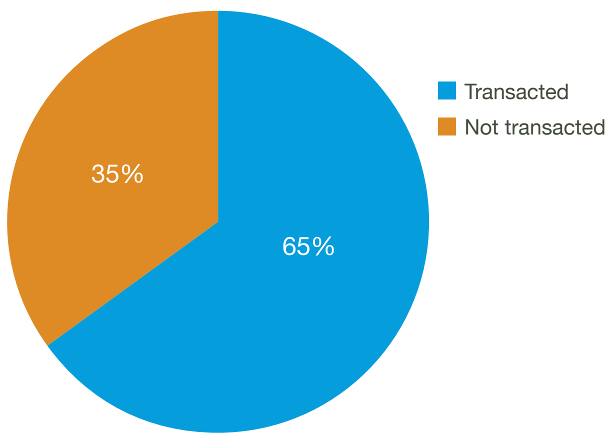
## How Long to Close a Deal?



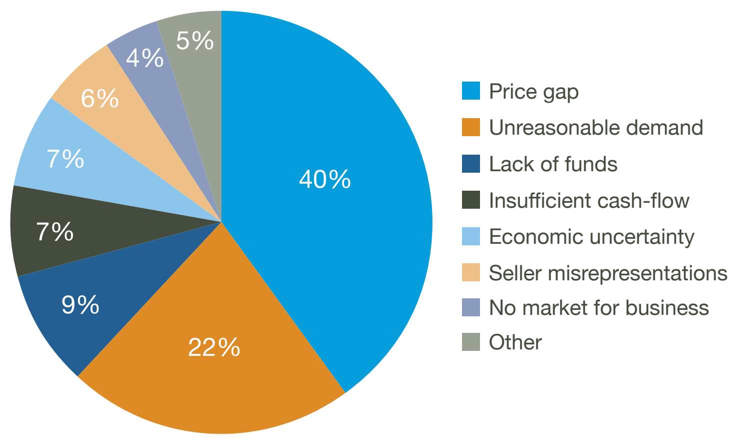

*Source: Pepperdine Private Capital Markets Survey*

*Chart #7 - If you embarked on a sale or acquisition process in 2016, odds are that the transaction did not close approximately one-third of the time. Some firms report this no-close rate to be even higher. The predominant reasons for deals not closing were buyer/seller misalignment on valuation expectations and deal terms.*

## Deals Closing



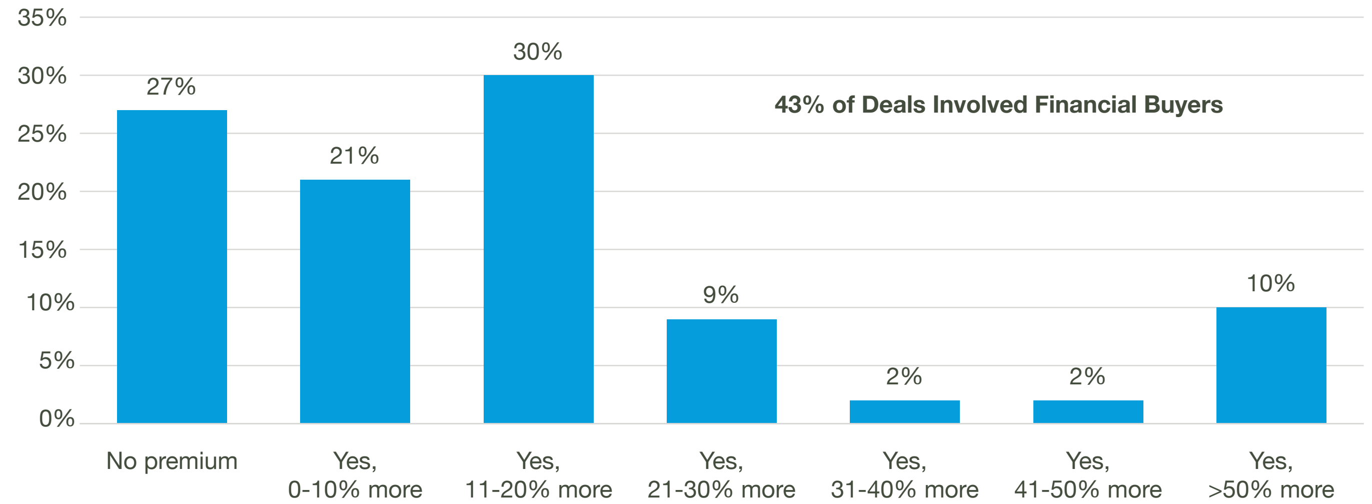

## Reason for Not Closing




*Source: Pepperdine Private Capital Markets Survey*

*Chart #8 - 73% of the time, Strategic buyers were willing to pay more than Financial buyers. Strategic buyers generally have more synergistic opportunities, industry experience and operational experience to leverage in the valuation model.*

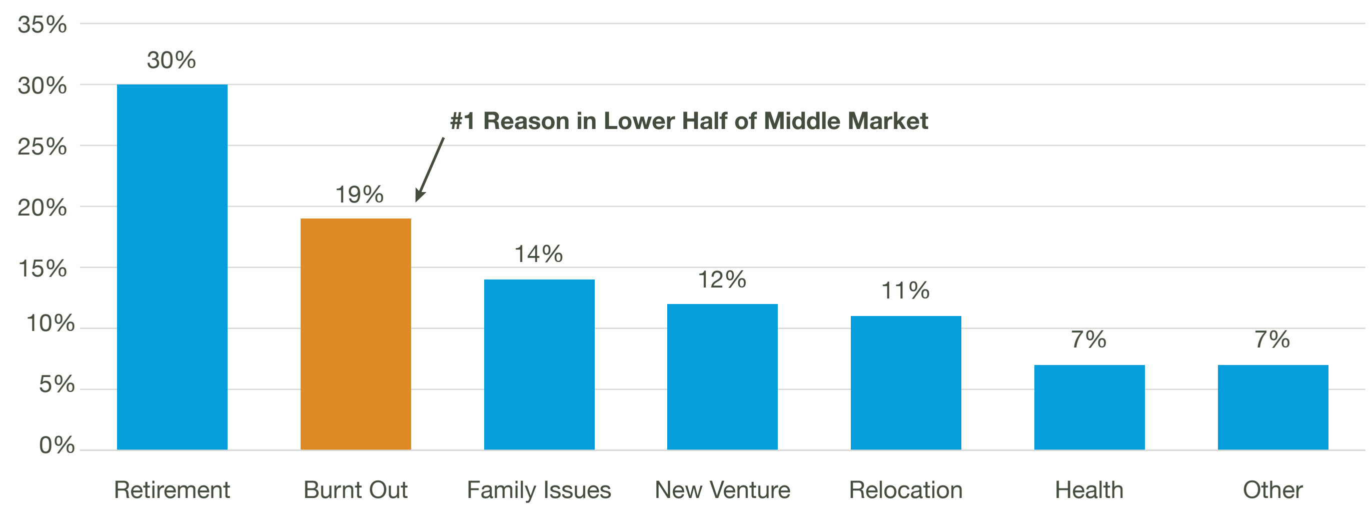
## Percentage of Time Financial Buyers Paid a Premium Over Strategic Buyers




*Source: Pepperdine Private Capital Markets Survey*

*Chart #9 - Overall, retirement remained the #1 reason to sell, but in the lower end of the middle market, owner fatigue (burnout) was the most prevalent reason.*

## Why Owners Are Selling




*Source: Pepperdine Private Capital Markets Survey*

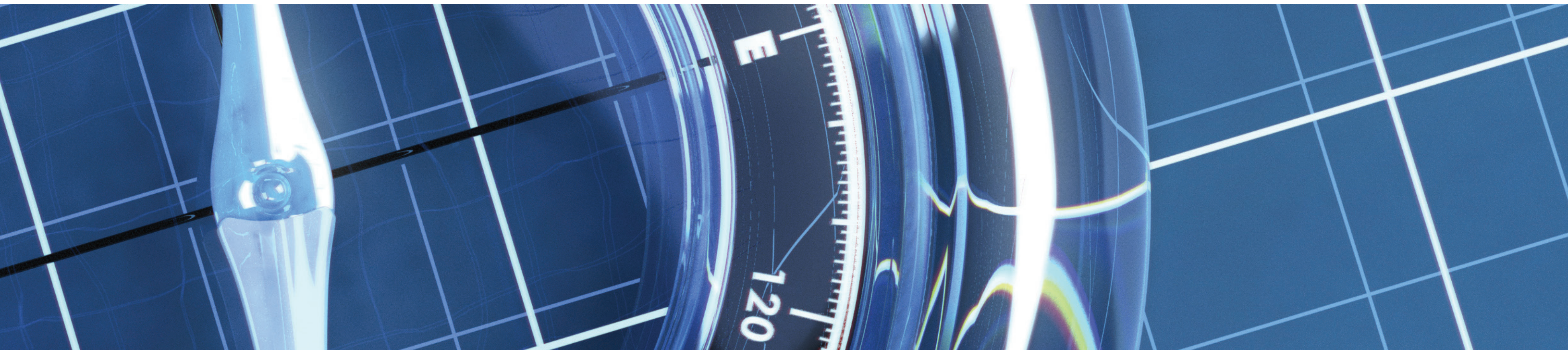
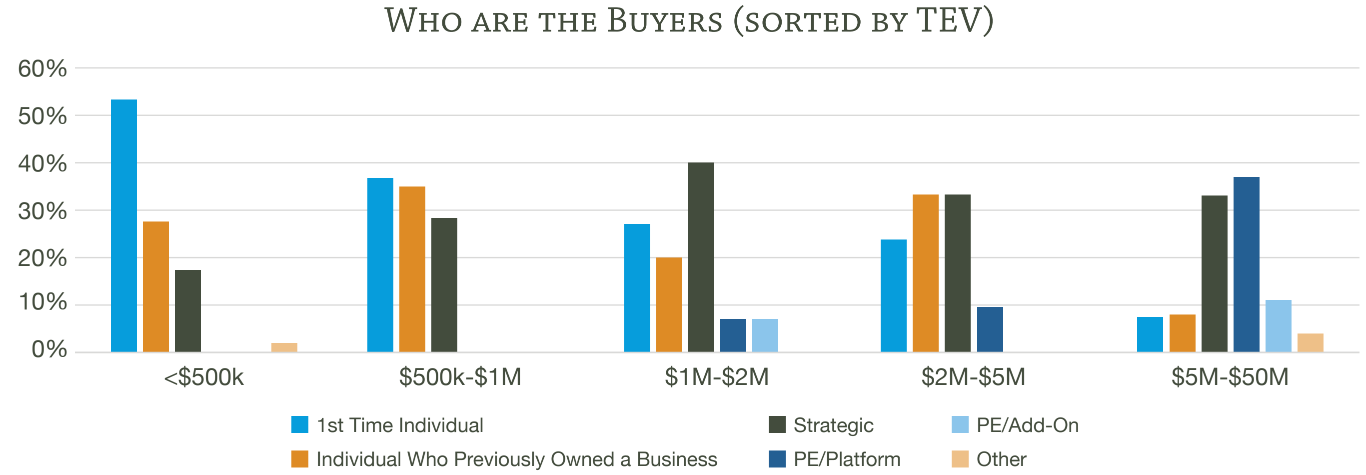
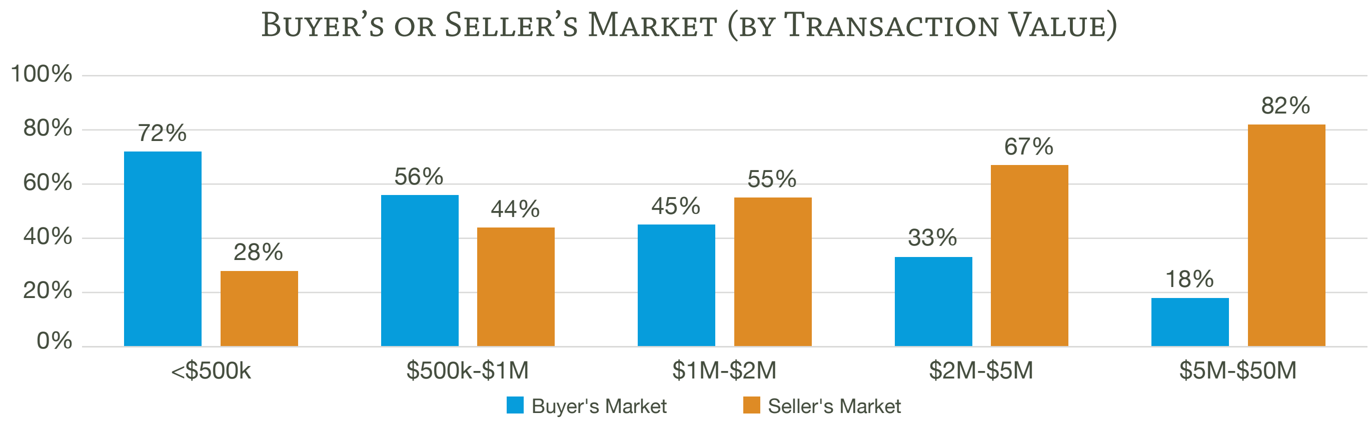


*Chart #10 - Eager to grow top-line revenue, Strategic buyers appeared all across the deal spectrum. With higher transaction costs and the need for bigger returns, PE buyers don't emerge until purchase prices exceed $5M. As expected, individual parties are the most prevalent buyer type for small businesses.*




*Source: Pepperdine Private Capital Markets Survey*

*Chart #11 - Size of transaction generally dictates who has the upper hand in deals. Supply and demand plays a major role here. Demand for good, larger-sized businesses exceeds the supply and the opposite holds true for smaller businesses.*



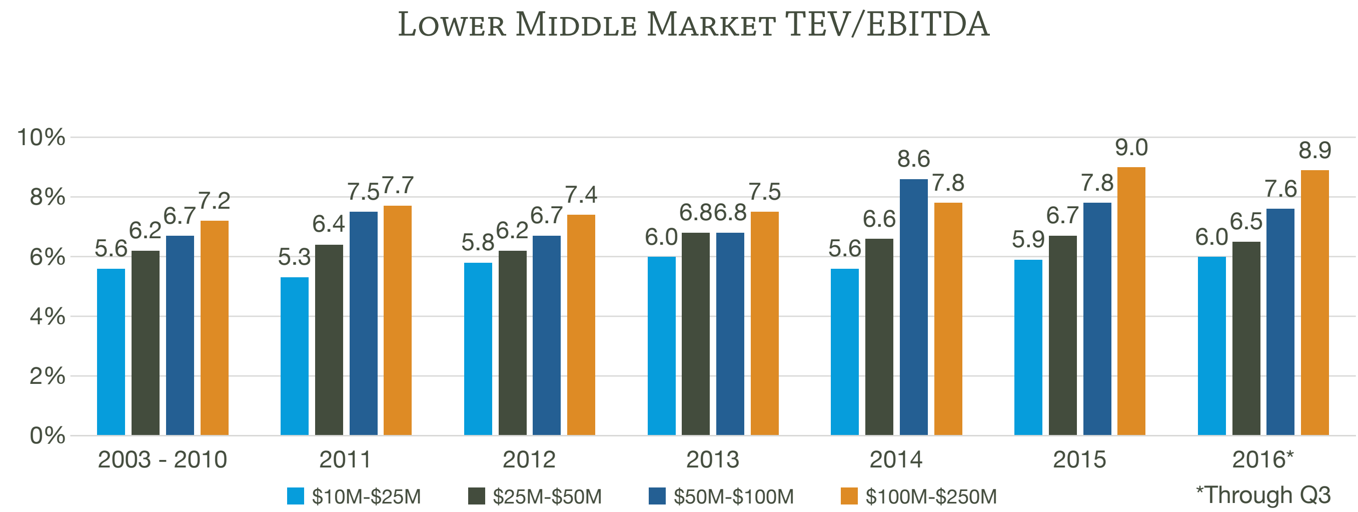

*Source: Pepperdine Private Capital Markets Survey*

Business services companies continued to trade at multiples of earnings. The multiple is driven by the Risk Profile, Size and Quality of the company.

**Business Services Valuation Components**

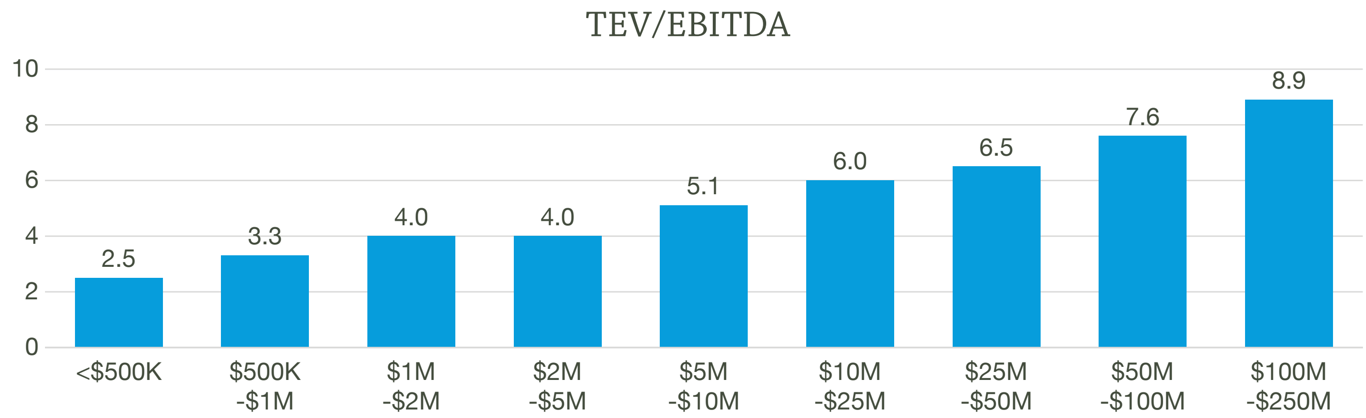
- Multiples of EBITDA (Adjusted, TTM, Run-Rate)
- Risk Profile drives the multiple range
  - ✓ Customer type – growing, stable or declining sector
  - ✓ Customer retention (churn)
  - ✓ Revenue and margin concentrations
  - ✓ Revenue and margin trends
  - ✓ Talent concentrations
  - ✓ Quality of Earnings (Q of E)
  - ✓ Numerous other factors
- Size Premium
  (bigger companies generally have less risk)
- Quality Premium (companies outperforming their competitors in revenue and margin growth command valuation premiums)

*Chart #12 - Lower Middle Market multiples remained at healthy levels in 2016.*




*Source: GF Data®*

*Chart #13 - The chart below shows how average valuation multiples increase relative to earnings (EBITDA) growth when moving from small businesses (<$10M) to the middle market (>$10M).*




*Source: Pepperdine Private Capital Markets Survey & GF Data*

## What to Expect in 2017

1. Increased deal flow with election process behind us
2. Republican sweep being good for M&A (we think :/)
   a. lower taxes
   b. fewer regulations
   c. financial services companies less regulated
   d. generally pro-business
3. GDP growth (3%?) should not negatively impact M&A activity
4. Strategic buyers still buying to augment organic growth strategies
5. Baby Boomers continue the march towards exit
6. Even more Strategic buyers emerging
   a. Citizens Commercial Bank Survey of 600 middle market CEOs
      - 50% surveyed are willing sellers in 2017 vs. 34% in 2016
      - 73% surveyed are serious buyers in 2017 vs. 60% in 2016
7. Softening in valuation multiples once Fed does 2 – 3 more rate increases; otherwise, multiples holding tight
8. Growing demand from non-U.S. buyers
9. Improving access to bank debt for small businesses
10. Trump or Global events can derail any and all of the above

Pursant helps business owners grow the value of their companies and maximize that value in a liquidity event, partial sale or complete exit.

Our Investment Banking, Strategic Transaction Support and Business Value Enhancement business units use a deep immersion process, our expansive networks and experience as owner/operators and dealmakers to optimize businesses, manage strategic transactions and orchestrate liquidity events — vital, integrative initiatives for which our clients may not have the time, manpower or expertise.

To learn more about how Pursant can help you, contact Mark Herbick at mherbick@pursant.com, call 847.229.7000 or visit www.Pursant.com.



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