Q4 2017 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:

Q4 2017 Deal Insider – 2017 Overview

Overall, 2017 was another solid year for middle market M&A and strategic transactions. While broader middle market M&A deal volume was down for 2017 when compared to 2016, the lower end of the middle market representing transactions of less than $250M in total enterprise value (TEV) was more consistent with 2016. With more clarity on tax policy with the Tax Cut Jobs Act (TCJA) now firmly in place, we are teed up for what most predict will be an even better 2018. Here are our top take-aways from 2017:

1. Lower Middle Market ($10M-$250M TEV) M&A volume was largely unchanged compared to 2016 whereas the broader middle market was down.
2. A deal friendly Trump administration kept dealmakers cautiously optimistic, but in the absence of policy clarity, many remained on the sidelines.
3. Having limited organic growth opportunities, companies continued looking to make acquisitions to accelerate growth.
4. Valuation multiples were at a sustained high plateau, even with a 75 basis point Fed rate increase.
5. With higher multiples, due diligence remained rigorous.

(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 insights to help them prepare for such transactions in order to maximize transaction outcomes.

6. There are more companies Stress-Testing, Optimizing and Exit Planning to prepare for a liquidity event in the near future.

7. An abundance of uninvested capital (dry powder) kept financial buyers moving downstream to smaller deals.

8. Non-U.S. (mostly Eurozone) buyers made up a growing percentage of the buyers.

This year-end 2017 Pursant Deal Insider provides data and insight into what business owners need to know to be a successful buyer and/or seller in 2018.

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.

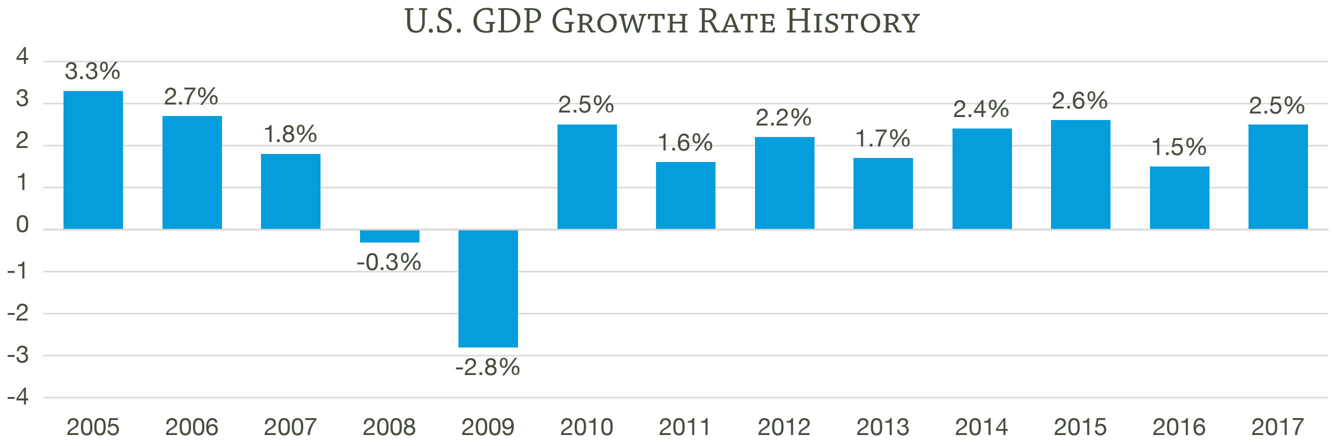


Chart #2 - Low unemployment rates are tough for employers, but a sign of economic strength, which helps drive robust M&A activity.

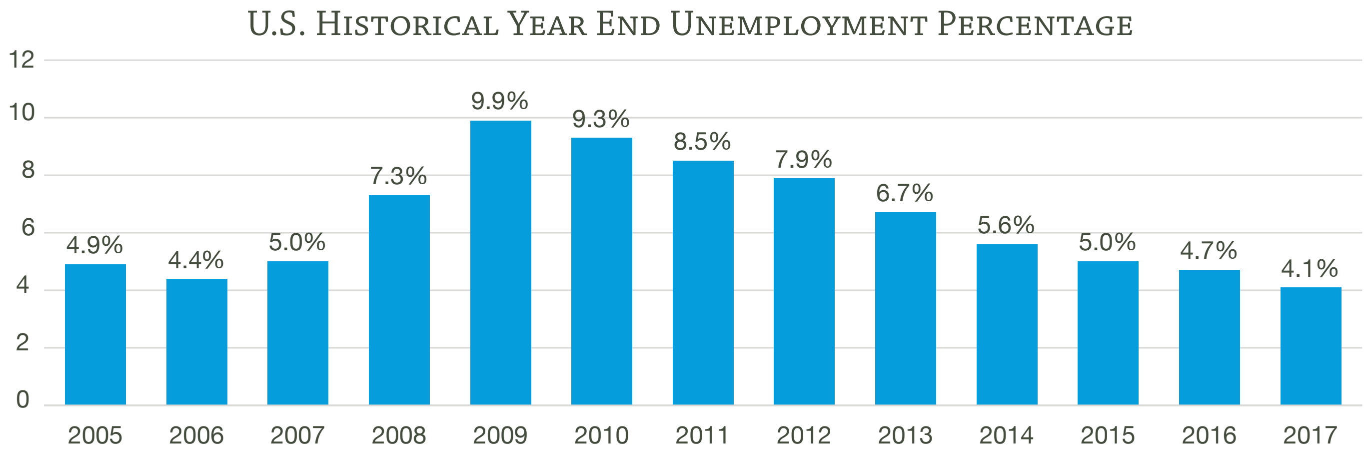


Chart #3 - The cost of capital affects the market's appetite for borrowing to buy companies. As rates increase, there will be downward pressure on valuation multiples when borrowing is involved.

U.S. Year End Fed Funds Rate History

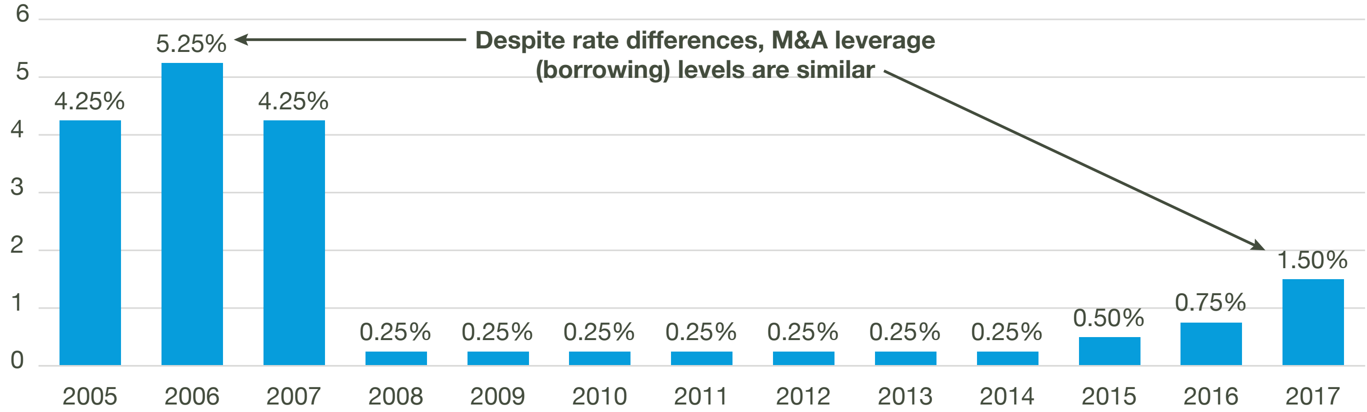


Chart #4 - If you were looking to buy a company in 2017, you could generally plan for a senior lender to provide 2-4x of the acquired company's EBITDA and a junior lender to provide another 0.5-1x (depending on deal size).

Senior Debt/EBITDA (Business Services)

TEV (in millions)	2014	2015	2016	2017
10-25	2.0x	3.0x	2.3x	4.4x
25-50	2.0x	3.0x	2.6x	1.8x*
50-100	2.8x	2.5x	3.5x	4.1x
100-250	4.4x	3.2x	3.8x	4.0x

Total Debt/EBITDA (Business Services)

TEV (in millions)	2014	2015	2016	2017
10-25	2.9x	4.0x	3.1x	4.7x
25-50	3.2x	3.5x	3.8x	3.7x
50-100	3.4x	3.8x	4.8x	4.5x
100-250	3.8x	5.3x	4.9x	4.9x

** The sampling size here was very small and as a result, not a true average and more of a data anomaly.*

Source: GF Data®

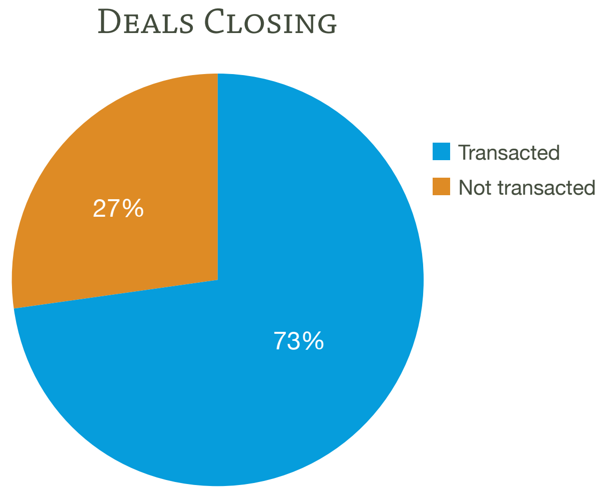
Chart #5 - With more lofty valuations in 2017 came more thorough due diligence. It was common for deals to take 5-10 months to close from the time a company went to market.

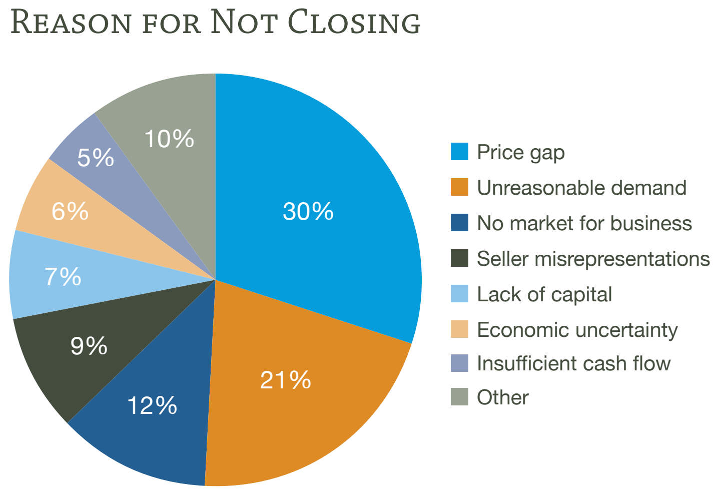
How Long to Close a Deal?

Deal Size	Months To Close	LOI To Close
<$500k	6	2
$500k-$1M	6.5	2
$1M - $2M	7.5	3
$2M - $5M	9	3
$5M - $50M	10.5	3.5

Source: Pepperdine Private Capital Markets Survey

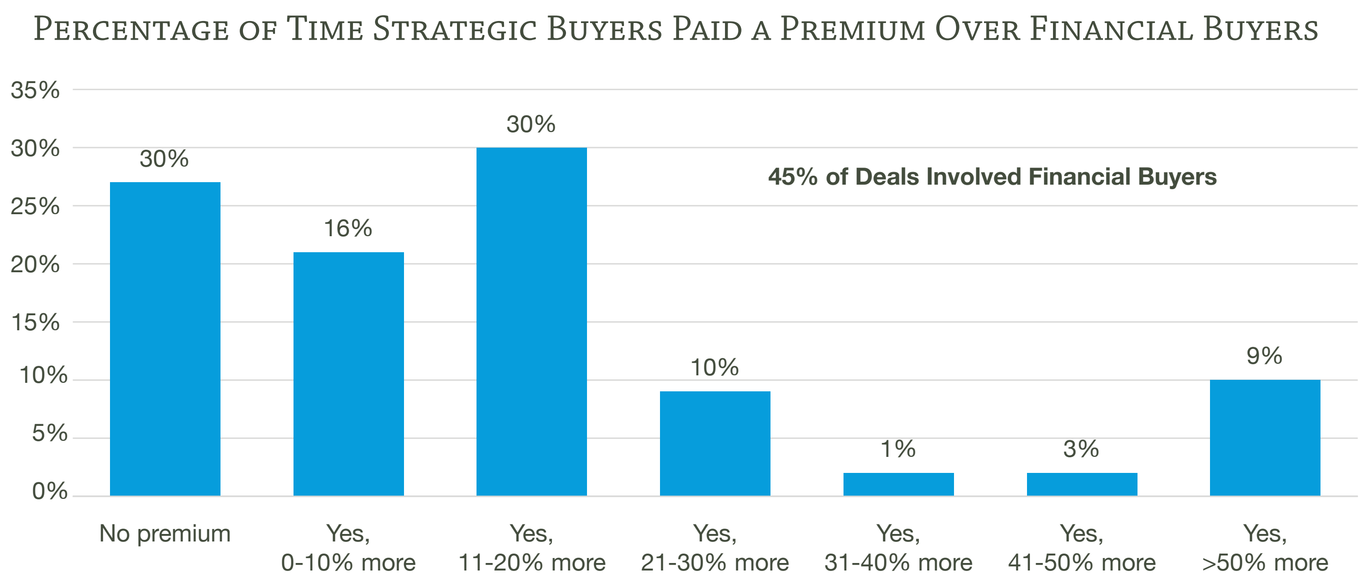
Chart #6 - If you embarked on a sale or acquisition process in 2017, odds are that the transaction did not close approximately a quarter of the time. The predominant reasons for deals not closing were buyer/seller misalignment on valuation expectations and deal terms.





Source: Pepperdine Private Capital Markets Survey

Chart #7 - 70% 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, improving their proforma return.



Source: Pepperdine Private Capital Markets Survey

Chart #8 - Overall, retirement remained the #1 reason to sell in 2017. With 10,000 baby boomers retiring each day, this trend is expected to continue.

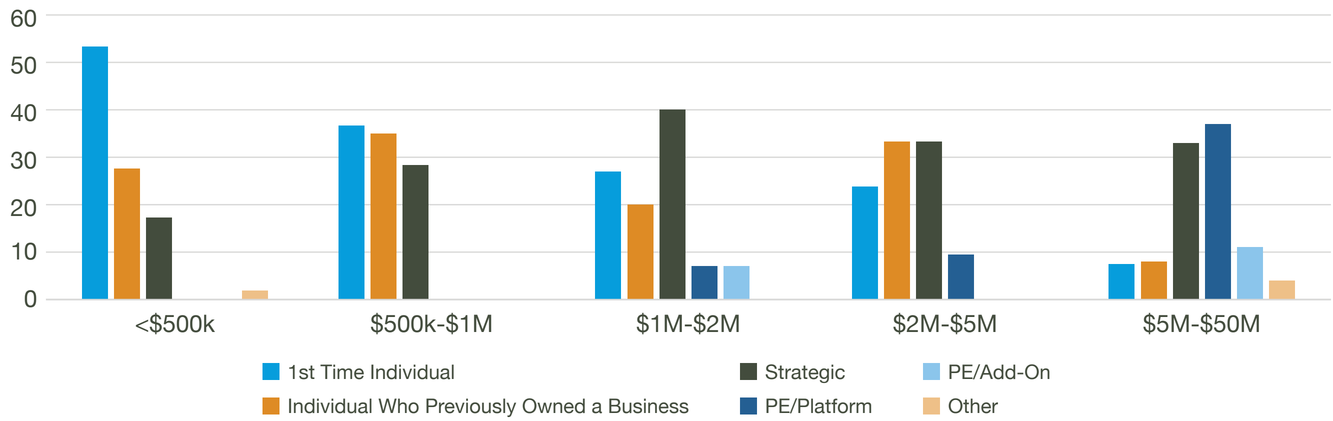
Why Owners Are Selling

Deal Size	#1 Reason	#2 Reason	#3 Reason
<$500k	Retirement	New Opportunity	Burnout
$500k-$1M	Retirement	Burnout	New Opportunity
$1M - $2M	Retirement	New Opportunity	Health Issues
$2M - $5M	Retirement	Burnout	Family Issues
$5M - $50M	Retirement	Family Issues/Burnout	

Source: Pepperdine Private Capital Markets Survey

Chart #9 - Eager to grow top-line revenue, Strategic buyers appeared all across the deal size spectrum. With higher transaction costs and the need for bigger returns, PE buyers generally don't take interest until purchase prices exceed $5M. As expected, individual parties are the most prevalent buyer type for small businesses.

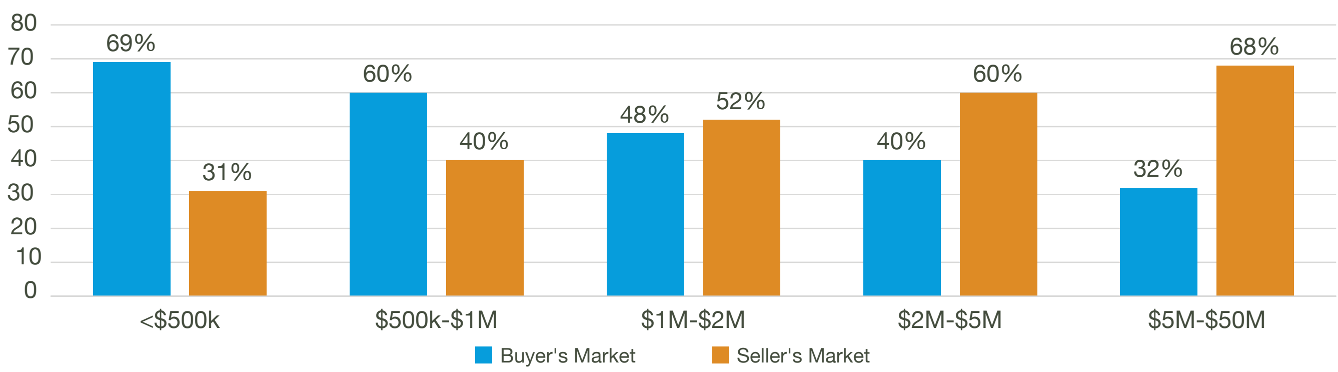
Who are the Buyers (sorted by TEV)



Source: Pepperdine Private Capital Markets Survey

Chart #10 - 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.

Buyer's or Seller's Market (by Transaction Value)



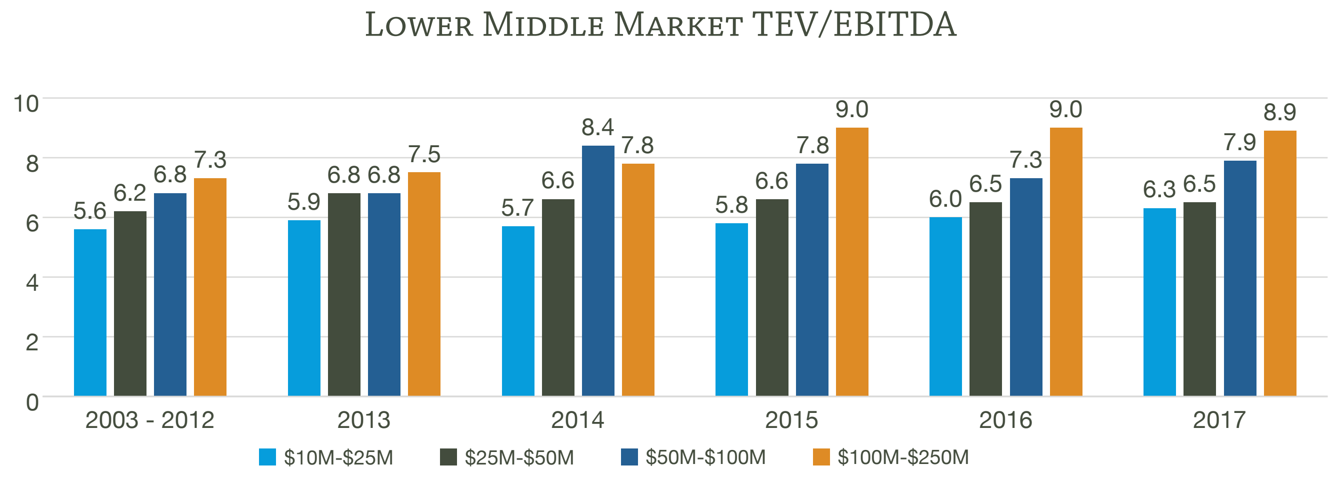
Source: Pepperdine Private Capital Markets Survey

Most lower middle market companies trade at multiples of earnings (EBITDA). The multiple is driven by the Risk Profile, Size and Quality of the company.

Common Valuation Components

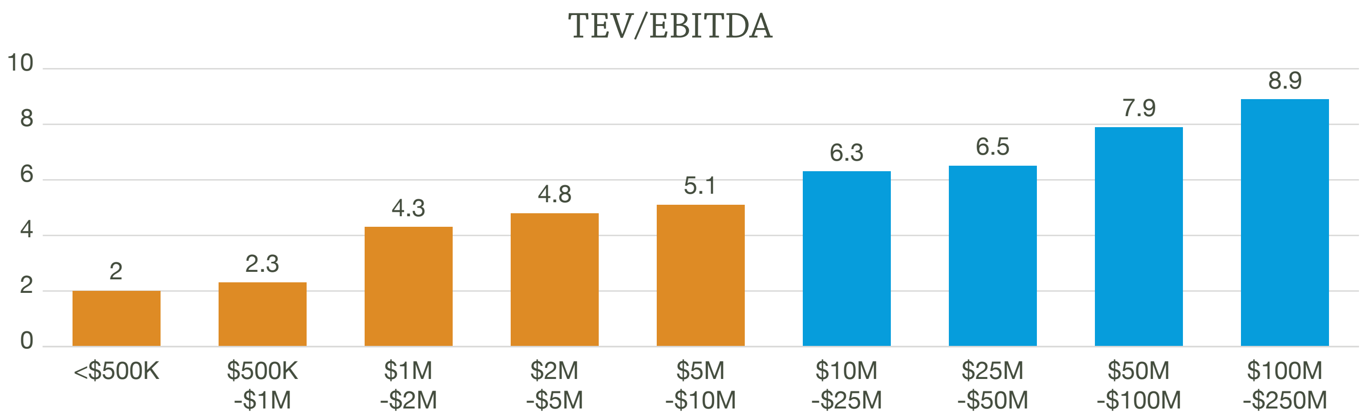
- Multiples of EBITDA (Adjusted, TTM, Run-Rate)
- Recurring, repeat or non-recurring revenue
- Asset-light or asset-heavy business
- Mature, declining or growing sector
- Risk Profile components that drive the multiple range
  - ✓ Customer type (mature, declining or growing sectors)
  - ✓ Customer retention
  - ✓ Customer concentration
  - ✓ Revenue and Margin trends
  - ✓ Talent concentrations
  - ✓ Quality of Earnings (Q of E)
  - ✓ Numerous other factors
  - ✓ Size compared to competitors
  - ✓ Earnings and revenue growth when compared against competitors

Chart #11 - Lower Middle Market multiples remained at healthy levels in 2017.



Source: GF Data®

Chart #12 - The chart below shows how average valuation multiples increase relative to earnings (EBITDA) growth when moving from small businesses (<$10M) to the lower middle market (>$10M).



Source: Pepperdine Private Capital Markets Survey & GF Data

Tax Cut & Jobs Act (TCJA)M&A Implications

1. Increased deal flow resulting from removal of tax uncertainty
2. More $ in Seller pockets as Corporate tax rate goes from 35%-21%
3. Flow through entities may be able to deduct up to 20% of income from the sale
4. Buyer can deduct up to 100% of certain acquired assets in year one
5. Expect more asset (vs. stock) deals and 338(H)(10) transactions as a result of #4 above
6. More favorable taxation makes timing good for corporate divestitures
7. Cash on balance sheets growing as $2T is repatriated at 15.5% rate
8. Financial buyers to re-strategize with the new cap on deductibility of interest expense
9. Financial buyers also likely to hold acquired companies longer with minimum capital gains treatment period increased from 1 to 3 years

What to expect in 2018

Below is our list of ten deal-related expectations for 2018. The general sentiment is that M&A activity in the middle market will surpass 2017 levels; however, both buyers and sellers should be mindful that the current political landscape is driving a more favorable M&A climate. If the political party mix changes materially later this year, that could put a damper on M&A as the two political parties have differing views on many policies that effect M&A.

1. Macroeconomic M&A drivers mostly positive
2. GDP growth of 2.5-3% should not negatively impact M&A activity
3. According to a recent Deloitte survey, 76% of CEOS and 70% of PE leaders see deal flow growing in 2018
4. Positive TCJA implications driving deal flow
5. Reasonably priced debt favors M&A activity and multiples
6. Three to four 25 basis point Fed rate increases. Any more and multiple compression likely
7. Financial buyers still have a lot of capital to deploy
8. Baby Boomers continue the march towards exiting (10,000 a day)
9. Growing demand from non-U.S. buyers
10. Domestic and Geopolitical events could derail 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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