

DEAL insider

M&A and Strategic Transaction Insights

THE INVESTMENT BANK THAT ALSO BUILDS THE VALUE OF YOUR BUSINESS



Q2 2018 Highlights:

- M&A activity steady in Q2 2018 and multiples holding at elevated levels
- June Fed rate increase didn't dampen heated deal pace
- Favorable macroeconomic indicators help M&A

Pursant's Thoughts on Q3 2018

- No changes or surprises are expected for Q3 and the balance of 2018
- Affordable capital will help keep valuations healthy
- Affordable capital is driving buyers to borrow to do deals

Q2 2018 Middle Market M&A Activity Continues at a Heated Pace

The middle market as a whole remains robust for M&A and strategic transactions, and the lower middle market is no exception. The brisk pace of M&A in the lower middle market is largely being driven by solid macroeconomic indicators, record levels of available capital in the form of equity and cheap debt, and larger strategic and financial buyers coming down market to find cheaper deals. For financial buyers, the buy and build strategy (acquisition of a platform company plus bolt on companies) has become one of the best ways to create enterprise value—especially in the highly fragmented sectors that populate much of the lower middle market.

Lower middle market valuations are strong at an average of 7.0x EBITDA for H1 2018, according to GF Data. It was previously thought that rising interest rates would dampen multiples. This has not happened yet. Higher quality companies are getting acquired at a premium to the rest of the lower middle market at an average of 7.7x EBITDA.

Market valuations have topped out, but the strong activity and valuation tailwinds are expected to continue at least through the balance of 2018.

Transaction Multiples – Chart 1 shows that Lower Middle Market EBITDA multiples, measured as Total Enterprise Value (TEV)/EBITDA, remain stable, with an average of 7.0x for transactions YTD through Q2 2018. The \$50M-\$100M transaction multiple reflects a

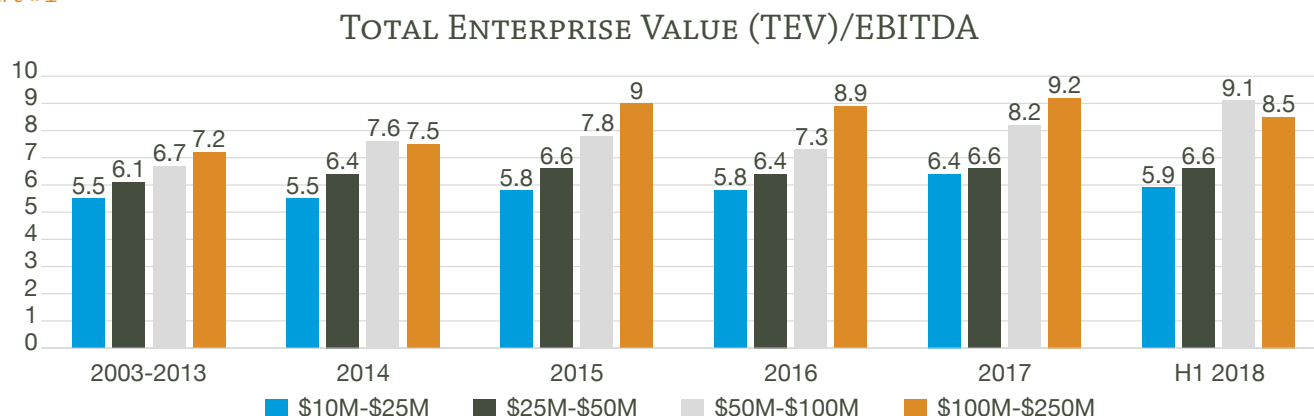
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The Pursant Deal Insider is a quarterly publication offering analysis of the marketplace and climate for middle market mergers, acquisitions and strategic transactions. Our emphasis is on transactions with a total enterprise value of less than \$250M.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

significant increase, but due to the low sample size in this range, we feel this is a data anomaly and not a true trend. One of the biggest influencers of multiples is the cost of capital. There was a 25 basis point increase in June this year,

pushing the Fed Funds rate to 1.75-2.00. This is the second Fed rate increase in the first half of 2018. Rising rates have yet to derail lofty valuations. As 2018 plays out and further rate increases follow, multiple softening may begin.

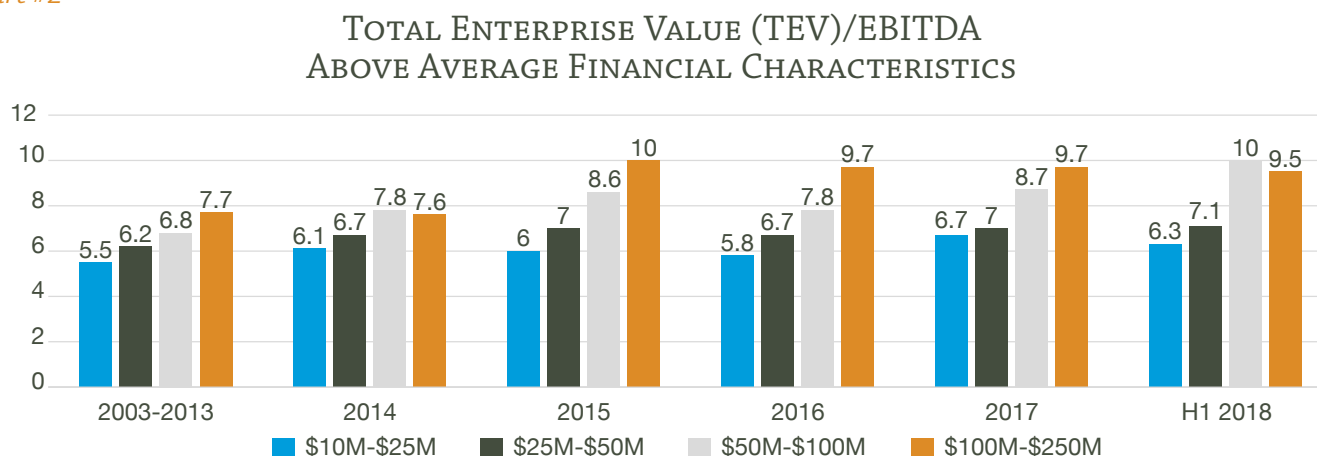
Chart #1



The Quality Premium – The reward in valuation extended to above-average financial performers is at a healthy 26 percent for the first half of 2018 (Chart

2). Better financial performers (as defined below) were valued at an average of 7.7x, compared to an average of 6.1x for the balance of the lower middle market.

Chart #2



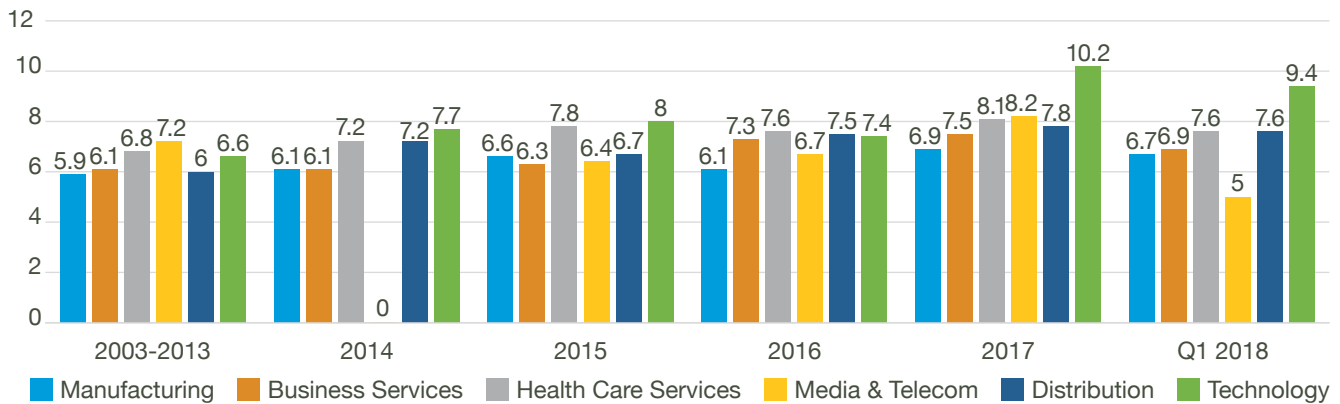
We define better financial performers as businesses with TTM EBITDA margins and revenue growth rates both above 10 percent, or businesses with one of those metrics above 12 percent and the other metric at least 8 percent. Outliers on the high side are excluded.

The Middle Market by Business Category – When looking at the lower middle market by category, we can clearly see some valuation differentiation when comparing growth sectors (i.e. Healthcare and Technology) to more mature sectors that don't benefit from the same rate of growth. 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

TOTAL ENTERPRISE VALUE (TEV)/EBITDA BY CATEGORY



Source: GF Data®

The US Macroeconomic Picture for Q2 2018

GDP – The US economy advanced by an annualized 4.2 percent on quarter in the second quarter of 2018—well above an upwardly revised 2.2 percent expansion for the first quarter of 2018 and in line with market expectations. It is the strongest growth rate since the third quarter of 2014. Growth was largely driven by consumer spending and increased durable goods orders. This growth rate is good for business and adds fuel to the M&A fire.

Consumer Sentiment – The University of Michigan’s consumer sentiment for the US stood at 98.2 in June 2018—slightly above May’s 98.0. The Sentiment Index has been virtually unchanged across all three months of Q2. The persistent strength is due to favorable assessments of jobs and incomes. While consumers anticipated rising interest rates during the year ahead, those expected increases were associated with a modest decline in longer term prospects for the national economy. For the year ahead, consumers anticipate small additional declines in the unemployment rate and higher wage gains. Consumers also anticipate an uptick in inflation during the year ahead, partly due to rising energy prices and partly due to tariffs.

Business Confidence – The Institute for Supply Management’s Manufacturing PMI in the US rose to 60.2 in June of 2018 from 58.7 in the previous month, beating market expectations of 58.4. The reading pointed to the strongest expansion in the manufacturing sector in four months, as production and inventories rose faster while new orders and employment eased slightly. Faster increases were seen in production, inventories,

new export orders and imports. Also, supplier deliveries slowed and price pressures eased. On the other hand, new orders and employment rose, but at a slower rate.

The 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 farther the number is from 50, the greater the level of change.

Unemployment – The US unemployment rate is holding steady at 4.0—a 17-year low. The number of unemployed decreased by 121,000 to 6.59 million and employment fell 37,000 to 155.18 million. The economy added 213,000 jobs despite worker shortages and mounting U.S. trade tensions.

Fed Lending Rate – With continued improvement in economic and labor conditions, the Fed raised the Federal Funds rate 25 basis points to 1.75-2.00 in June. This move is consistent with its forecast. This moves the Fed Prime Rate to 5.00%. The Federal Open Market Committee expects that further gradual increases in the target range for the Federal Funds Rate will be consistent with sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee’s symmetric 2 percent objective over the medium term.

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 more favorable or less favorable phases of the business transfer cycle. The business transfer cycle is continually moving through periods that do or do not

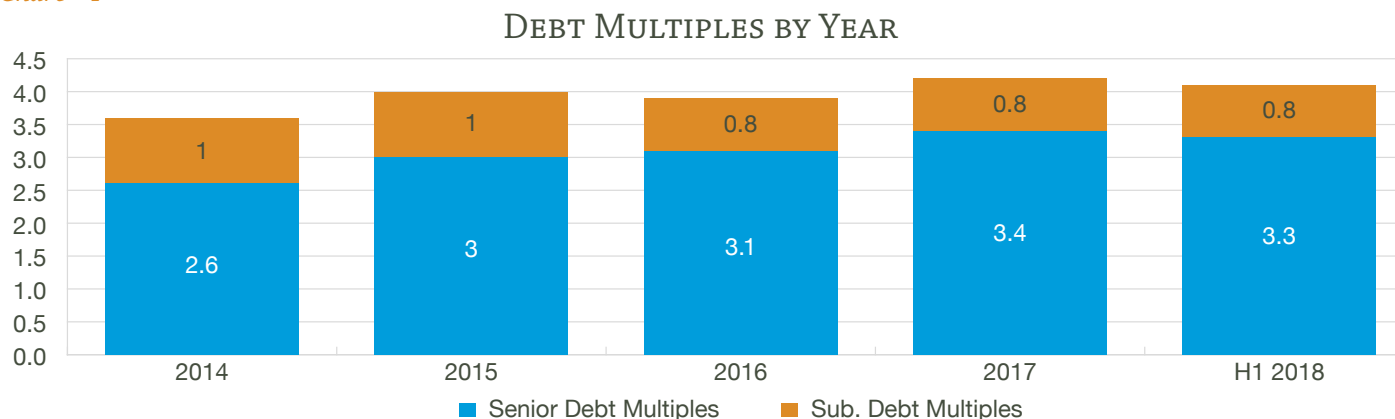
favor Sellers. *Given low interest rates and good macroeconomic conditions, we are still solidly placed in a phase of the business transfer cycle that favors the Seller for valuation purposes and Buyers for access to affordable capital to fund M&A activity.*

Leverage Multiples – Chart 4 shows that lenders are still 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 Q2 2018 averaged more than 4x EBITDA, with softening of these borrowing trends in sight.

To learn more about using leverage in a strategic transaction, see our article “Leverage Buyout Model – Why Buyers Use It and What A Business Owner/Executive Needs to Know About It” in our Q2 2017 issue of the *Pursant Deal Insider*.

Chart #4



Source: GF Data®

Building a Winning Deal Team

Scott Glickson – Pursant Managing Director

The decision to buy, sell or raise capital for a business is typically one of the most significant decisions made by a business owner or executive. Whether a Buyer, Seller or raising capital, assembling the right team is one of the most critical pieces to ensuring that key transaction objectives are efficiently achieved.

The first step to assembling your team is to take inventory of the deal making capabilities that exist within your organization. Oftentimes organizations realize that while specific capabilities can be found across the organization, lacking are the full suite of skills, competencies and experience in executing and managing M&A processes. As a result, to augment internal capabilities, business owners look outside their company’s walls to round out their team.

The following discusses functions business owners and executives most commonly outsource when building their team to pursue M&A opportunities.

Legal Counsel – When we say “legal counsel” we mean a deal specialist, not your day-to-day business attorney.

This is akin to selecting a heart surgeon for heart surgery rather than a general practitioner. It is key to select an experienced, deal-focused legal advisor. Strategic transactions cover a diverse set of matters, many of which are unknown at the start of the deal process. To maximize the outcome of the transaction, your deal team should include a transaction focused legal specialist who has the expertise to understand and navigate the unique complexities of a transaction, balancing your risk management needs with the desire to get a deal done.

Accounting/Tax Advisor – Accounting and tax advisors play a wide array of roles for all parties involved in a transaction. Undoubtedly, there will be accounting and tax considerations. Again, much like your chosen legal counsel, your tax advisor should have deal expertise. The best tax advisors will help you structure the deal to optimize your tax position.

Deal Advisor (as a pre-readiness consultant) – Buyers, Sellers and those raising capital can benefit from certain deal advisors (investment bankers and brokers) that

also have the expertise needed to help you **prepare** for strategic transactions. It is a best practice to perform an independent, formal and “inward looking” assessment of your company before a transaction. However, most internal personnel lack reference points with which to perform this “self-evaluation,” leading to an exercise that is half-hearted or bypassed entirely. Because self-evaluation is “self-imposed,” it often never gets out of the “to-do” pile.

The following discusses pre-readiness preparation from the perspective of different parties:

- **Seller with a long-range exit expectation** - This Seller is seeking a diagnostic exercise to identify value-enhancing action steps and specific initiatives to make their business more valuable and attractive. This begins with a high-level review of the entire business, typically performed within a few days. The results of the review help shape the strategy that best optimizes the value the business. An optimization strategy could include everything from basic changes in financial reporting to more complex initiatives like changes/additions in key personnel and restructuring operations, delivery, fulfillment, production, etc.
- **Seller with a near term exit objective** - This Seller is looking to eliminate or mitigate any key deal issues that would surface during a Buyer’s diligence. This is a mildly intensive and invasive exercise done close in timing to bringing the company to market. It

mirrors a Buyer’s pre-acquisition diligence and can run several weeks to a few months.

- **Buyers** - Buyers are seeking to ensure that their organization is prepared to properly acquire and integrate. Much like the preparation done by a long-range Seller, this process begins with a high-level review of the entire business, typically performed within a few days. The results of the review help shape the strategy that ensures acquisition and integration success.

Deal Advisor (as Investment Banker or Broker) -

The Deal Advisor’s role is to (i) prepare Sellers/Buyers for a transaction, (ii) match Sellers and Buyers and (iii) facilitate the selling/buying process. Executing strategic transactions requires a broad range of abilities including specialized transaction knowledge, willingness to make a very large time commitment, the right network and a proven track record of negotiating deals and getting them done. The best deal advisor will help you successfully close your deal at the best terms to allow you and your management team to focus on what you do best—successfully running your company.

To summarize, doing deals is a team event and having the right team in place to execute your M&A initiative is key to success and optimizing outcomes. While there are likely opportunities to leverage personnel from within your organization, it is necessary and beneficial to augment your team with external experts.

Deal Proceeds—It’s All About What You Keep

Brian Steffens – Pursant Managing Director

Business owners early in the deal process tend to have a laser focus on the value of their businesses. They will talk about their friend’s business that recently sold or point out a recent article quoting a high multiple for valuation. At this stage of discussions, Pursant will share information on where deals are closing in an owner’s industry for businesses of similar size and risk profiles. Jaws visibly drop when the conversation shifts to the most important number in any transaction for a Seller: Net Cash Proceeds—the net amount of cash a Seller will ultimately put in its bank account, and the timing of that cash influx.

When business owners learn of the importance of Net Cash Proceeds, it leads to much dialogue, as it directly impacts the ongoing lifestyle of owners and family

members. In some cases, Net Cash Proceeds can vary greatly from a headline grabbing purchase price or multiple and can leave a business owner disappointed.

This article highlights common puts and takes impacting middle market sellers when arriving at Net Cash Proceeds. We will make a number of assumptions to help illustrate how the calculation works.

For the purposes of this article, let’s assume a purchase price of \$20 million dollars. For simplicity, let’s assume that the owner does not have any partners (100% owner of the business). In most middle market M&A deals, the business is transferred to the Buyer “debt free – cash free.” What this means is that the Seller will keep the cash the business has on its balance sheet and will retire any 3rd party debt. Let’s

assume balance sheet cash on hand at closing is \$750,000 and 3rd party debt (term debt and LOC) to be \$3.5 million.

Deferred payments have a big impact on the total net proceeds and the length of time before a Seller will see the money. Deferred payments take many different forms, from being guaranteed to 100% contingent. Common deferred payments are escrow holdbacks for potential rep and warranty liabilities, seller notes with interest, and contingent performance based earn-outs attached to revenue, gross profit, EBITDA or another metric or milestone. For the purposes of this example, let's assume a 20% guaranteed seller note and a 5% escrow holdback.

Next in line is Uncle Sam. There are several variables that impact how much tax a Seller will be responsible for at closing and in the future as deferred payments are received. Such variables include: deal structure (asset or stock), tax basis in the business, type of business (S-Corp or C-Corp), jurisdiction of the business, and structure of the deferred portion (personal income or capital gains). Sellers will want to work closely with a deal advisor and tax advisor to model this out and minimize as much tax as possible. In this example, let's say the taxes payable are \$4.5 million.

Purchase price adjustments are common, with the most common being driven by net working capital. This adjustment arises as a result of a difference between the net working capital delivered (the net amount of trade receivables plus inventory less trade payables) and what was agreed to in the Purchase Agreement. During the negotiations of the Purchase Agreement, the Buyer and Seller mutually agree to a working capital amount that will transfer with the business. It is referred to as a "peg." Generally, 60 to 90 days post-closing, the actual working capital delivered at closing is calculated and there is an adjustment up or down to the purchase price accordingly. For purposes of this example, let's assume that the net working capital peg is \$3 million and 90 days post-closing it is determined that the company transferred \$3.4 million. In this example, the Seller will receive an additional \$400,000 from the Buyer.

For advising you in this endeavor, your lawyer, accountant, investment banker and other experts will be owed money or may have been paid some portion of your proceeds. The investment banker fees should become relatively easy to calculate once a purchase agreement framework is drafted. A Seller should be proactive in asking legal and accounting advisors for updates on the fees they are accruing and whether they anticipate any overruns. It is safe to assume that the more complex the deal or the structure, the higher the legal and accounting fees will be. For purposes of this example, let's assume combined advisory fees of \$775,000.

The below schedule walks through the calculation of Net Cash Proceeds based on the assumptions we've made.

Deal Specifics	
Revenue	25,000
Adjusted EBITDA %	16.0%
Adjusted EBITDA	4,000
Transaction Multiple	5.00
Purchase Price	20,000
% at Close	80.0%

Net Cash Proceeds at Closing	
Purchase Price	20,000
Cash on the Bal Sheet	750
Less: Bank Debt	(3,500)
Less: Rep/Warranty Holdback	(1,000)
Less: Contingent/Earnout	(4,000)
Less: Taxes	(4,500)
Add/Less: Purchase Price Adj (WC)	400
Less: Advisory Fees	(775)
Net Cash Proceeds on Closing	\$7,375
Net Cash Proceeds after Contingent Period	\$12,375

Keeping just \$12.375M of \$20M may come as a shock to the Seller that has not planned ahead for this scenario. To avoid surprises, it is important to plan and prepare ahead of time. Work with your advisors and do your homework at the outset of a process and as Letters of Intent (LOIs) start arriving. Doing this will ensure that expectations are clear throughout the process and result in more satisfactory outcomes for all parties.

Financing Your Deal – Debt and Equity Financing

Richard Curry – Pursant Managing Director

The ability to effect growth either through organic means or acquisitions is contingent on the amount of capital available to a business. If your company is highly profitable and/or large, it likely has access to a surplus of capital, making it relatively easy to execute strategic transactions.

Many smaller companies in the middle market do not find themselves in such a strong capital position and therefore must look for sources of capital to fund the growth strategy. This involves deciding where the capital should be derived. In this article, we will examine the advantages

and disadvantages of Debt and Equity financing. There are a variety of other sources of financing available in the market, but depending on the sophistication and scope of the growth strategy, there is likely to be a combination of Debt and Equity financing arranged to meet the goal.

Debt financing is broadly defined as the borrowing of funds from creditors with the stipulation of repaying the funds plus interest at a specified time in the future. The lender derives its reward from the interest that is paid during the lifetime of the loan. The advantages of debt financing include:

1. The Owner remains in full control of the Enterprise. There is no dilution of ownership or control. The Owner retains the right to run the business as they choose without outside interference.
2. The lender does not retain an interest or claim in the enterprise after the loan is satisfactorily retired.
3. There is the certainty on the financial impact to the enterprise's financial modeling, as the costs of the loan in terms of principal and interest are known.
4. The interest costs are tax deductible.
5. There are no reports to investors or input required from investors to take tactical or strategic actions needed to keep the enterprise moving.
6. Debt financing is cheaper than equity financing.

Disadvantages of debt financing include:

1. The enterprise may not have an adequate credit rating to secure the loan.
2. In most cases, collateral or assets will have to be pledged to secure the loan. The collateral may not be sufficient or there may be an impact to the enterprise in the event of default.
3. The company's cash flow model becomes more rigid in respect to the repayment discipline required.
4. Too much debt can unbalance the debt/equity ratio, making additional loans from debt or equity financing sources more expensive and difficult to obtain.
5. Along with collateral and asset pledges, the debt finance source will often require a personal guarantee from the Owner.

Equity Financing is broadly defined as the sourcing of funds from an individual or entity that will participate in the profits (and losses) to the extent of their share. Under these conditions, the investor becomes an "owner" in the company and will have a voice in how the company is run and operated. Some advantages of equity financing include:

1. The company has no structured obligation to repay money acquired through equity financing. There are no additional financial burdens placed on the company and the increased cash flow allows the company to pursue its growth strategy.
2. There are advantages in avoiding flotation costs once predictable sources of equity financing are found. Flotation costs are the costs associated with raising funds and, depending on the complexity of the transaction, can be significant.
3. May open up opportunities to borrow funds through other avenues (i.e. debt financing) as the debt to equity ratio remains unaffected.

Disadvantages of equity financing includes:

1. The Owner is yielding a portion of control on his/her business.
2. Obtaining financing through equity investors is more complicated than through debt creditors.
3. The funds derived through an equity finance arrangement are expensive. The investor expects a high rate of return due to the potential risk to the investor if the company does not perform well.
4. The Owner will spend unaccustomed and potentially significant time speaking with or "reporting to" the investor. Depending on the amount of capital involved and the sophistication of the investor, this could be an intricate and intrusive process.
5. There will likely be a time when the investor wishes to monetize his/her investment. This may disrupt the working capital structure of the company if the exit event is not carefully planned.

Hybrid financing: Many companies examine and execute financial strategies that combine debt and equity financing to fund their growth strategies. The issue then becomes determining the proper combination of debt

and equity. Significant financial analysis is required to determine the optimal combination; research and modeling should be initiated to determine the company's optimal balance of debt/obligation to outside investors. There are various models and formulae that can be used for this exercise, but it should be cautioned that these models do not take nuances into consideration.

Pursant's Expectations for Q3 2018

Valuations and volume for lower middle market transactions were at a strong pace in the first half of 2018. An abundance of capital and a healthy economy are expected to keep this trend alive in Q3 and the balance of 2018.

Buyers and Sellers have good visibility into the sustainability of this favorable market and are willing to pull the trigger on M&A deals. As we discussed, the Fed appears to be patient in its approach to rate increases. The resulting affordable capital will help keep valuations healthy and relatively stable, but not increasing.

Buyers and Sellers often ask us how long multiples will stay at current levels. The elevated transaction multiples in the middle market are supported by the low cost of capital and a disproportionate number of Buyers versus Sellers.

In summary, much care should be exercised by an Owner seeking sources of growth capital. The process of selecting a capital source is stressful and must be approached as objectively as possible by the Owner. Under current economic conditions, the time is ripe for considering bold growth strategies.

Until one of these two variables change, we don't see multiples falling. Such a large percentage of lower middle market companies are owned by Baby Boomers. As such Owners continue exiting the business world and most do not pass down ownership to the next generations, the deals will keep coming for quite some time.

The overall economy is strong, keeping strategic businesses performing well and flush with cash for M&A. PE Buyers are still seeking to deploy a record amount of capital overhang (see the Q1 2017 Deal Insider for more on this) that has been sitting idle for years now and they continue their robust fund raising activity.

All of this sets the stage for us to remain in a very favorable (mostly **Seller** favorable) phase of the business transfer cycle in Q3 2018.



Pursant helps companies grow enterprise value by managing their M&A related initiatives and ultimately monetize that value in a sale transaction.

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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