Q2 2015 EDITION

Pursant
INSPIRED PURSUIT

M&A insider

Q2 2015: M&A Volume and Valuations Staying Strong

- Continued M&A volume in Q2 has 2015 tracking to be best year since 2007
- Slow organic growth and cheap capital continue fueling M&A activity
- Abundant and inexpensive capital contributes to continually high multiples

Pursant's Thoughts on H2 2015

- The second half of 2015 should be as strong as the first, barring an economic downturn, sharp interest rate increases or geopolitical instability
- It is likely the Fed will increase rates in Q3, but M&A should remain healthy
- The US will remain an M&A oasis amidst the turmoil in China and Europe

Q2 2015 Middle Market M&A Summary

Middle market M&A transaction volume for Q2 2015 remained strong. String together Q1 and Q2 2015, and you have a year on pace to be the best on record. M&A confidence among dealmakers for the balance of 2015 remains high. Valuation multiples remain frothy as well.

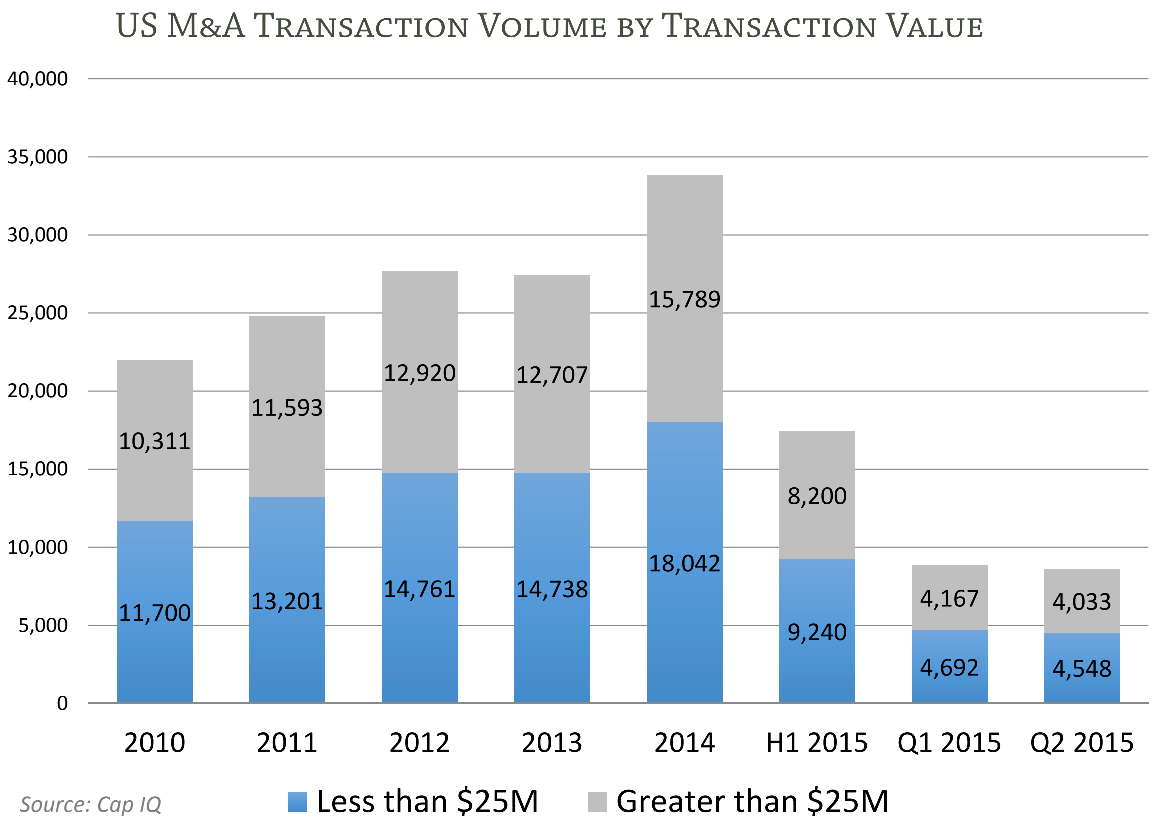
Despite economic issues in China and Europe, the US economy continues to improve, slowly but surely. Unemployment dropped ever so slightly to 5.3 percent at the end of June. Consumer Confidence of 99.8 in June is indicative of an expanding economy and a mostly confident consumer. US GDP expanded 2.3 percent in Q2 2015 after a revised anemic 0.6 percent rise in Q1 2015. The GDP expansion was fueled by consumer spending growth, while business spending declined.

Most economists feel that because of this sustained economic improvement, the Federal Reserve will increase the federal funds rate in September from the near zero rate that has held steady since December 2008. Fed Chairman Janet Yellen stated that the increase will be cautious and gradual. This increase could mark the turning point in the current very low cost of capital, which could then start initiating downward pressure on M&A volume and valuations. However, there is no need for alarm in the M&A world, as the Fed appears to be mindful of not tightening too much or too soon, for fear of choking off the economic recovery.

(Continued...)

Inside this edition of the M&A Insider:

Chart #1

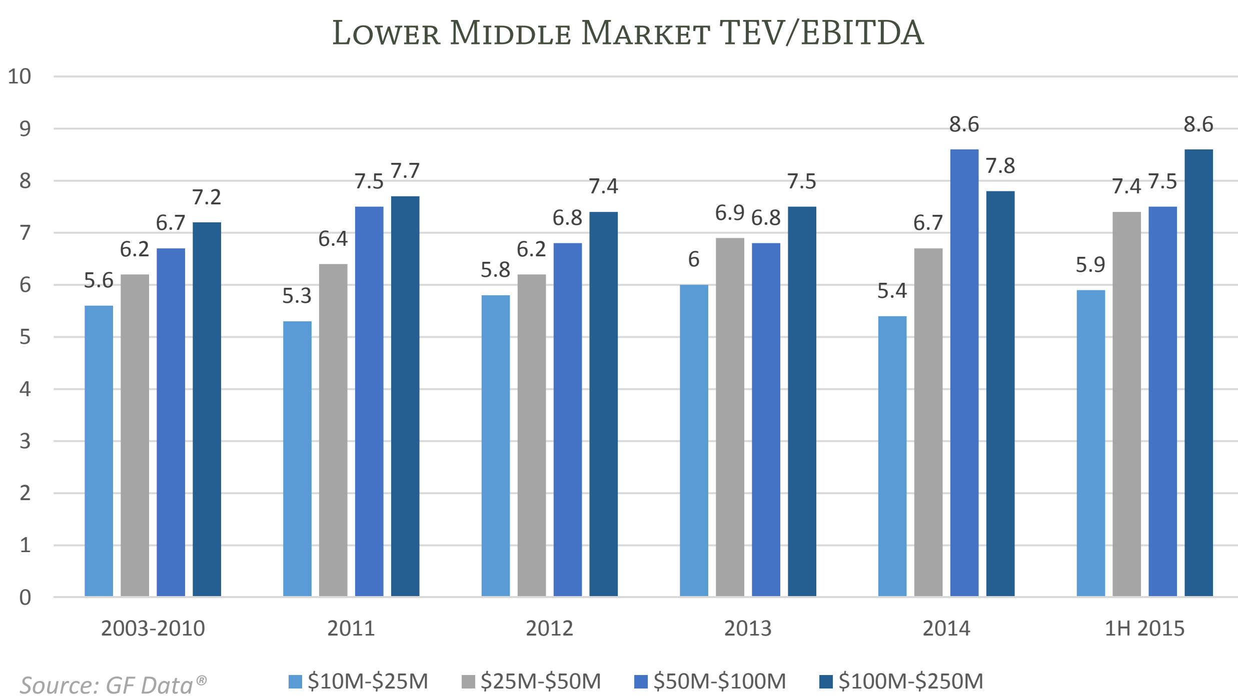


Source: Cap IQ

Chart #1 tells the story of the ongoing brisk M&A pace in North America. Two questions remain: will this blistering pace continue through the balance of 2015; and are we at the peak of the seller-favorable phase of the business transfer cycle? The answer to both is a likely yes.

Chart #2 shows how frothy multiples are still applying in valuations of companies in the lower middle market. The data shows that, with the exception of companies in the $50M-$100M range, companies throughout the lower middle market have managed to grow valuations by approximately 10 percent over a strong 2014.

Chart #2



Source: GF Data®

For most 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 shows that the low cost of capital continues to be a driver of favorable M&A conditions. The total leverage (senior and junior debt) used for sub $50M transactions decreased slightly, while it increased for transactions with TEV above $50M. The breakdown between Senior and Junior debt is roughly 75 percent (senior) 25 percent (junior).

Chart #4 shows that the market still appreciates a company whose revenue and earnings grow at double digit rates. These companies with above average financial characteristics are commanding higher multiples at all levels. The "quality premium" is reserved for companies that have above average financial characteristics, defined as TTM EBITDA margins and revenue growth each exceeding 10 percent. Approximately two-thirds of companies have fallen into this category in 2015, up from approximately 50 percent in 2014.

Chart #3

TOTAL DEBT/EBITDA-SPLITS BY PERIOD

TEV	Q1 2014	Q2 2014	Q3 2014	Q4 2014	Q1 2015	Q2 2015
$10M-$25M	3.1	3.9	3.3	2.9	3.9	3.6
$25M-$50M	3.3	4.1	3.4	3.5	4.3	4.1
$50M-$100M	4.8	3.7	5.5	4.2	3.9	4.2
$100M-$250M	4.5	4.0	4.5	4.2	4.2	5.2

Source: GF Data®

Chart #4

TEV/EBITDA-BUYOUTS WITH ABOVE AVERAGE FINANCIAL CHARACTERISTICS

TEV	2003-2010	2011	2012	2013	2014	1H 2015
$10M-$25M	5.4	5.3	5.6	6.0	5.9	6.2
$25M-$50M	6.1	5.8	6.5	7.4	6.7	7.8
$50M-$100M	6.8	7.7	6.6	7.1	8.5	7.9
$100M-$250M	7.8	7.5	7.7	8.2	7.6	9.6

Source: GF Data®

Junior debt is debt that is unsecured or less secure, coming in behind (subordinated to) senior secured debt. Junior debt carriers a much higher interest rate to compensate for its less secure status, but provides buyers with the additional leverage that may be needed to compete for deals and close them.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Due Diligence – The Ultimate Corporate Stress Test

Before a marriage ceremony, there is a rehearsal. Before the big game, there are practices. Before your house is sold, you make repairs. Before your business enters a sale, liquidity event or capital raise process (hereafter referred to as a "Transaction"), you need to prepare for due diligence.

Too often business owners going through a strategic transaction find themselves saying, *"I wish I had better prepared my business for due diligence. I wish there were fewer surprises. I wish I knew earlier what I know now. I wish I had invested the time and resources to put my business through due diligence before actually going through due diligence."*

Doing a due diligence trial run before the real deal can yield huge dividends. This should happen months or years in advance of a Transaction. Failure to prepare leads to broken processes and/or value erosion. Proactively preparing for a Transaction results in an efficient diligence process, which mitigates uncertainties and surprises. Preparedness instills buyer confidence and contributes to rapid deal completion, both which contribute to *maximum enterprise value*.

For this issue of the M&A Insider, we are only reviewing the phase of due diligence in which the Income Statement is analyzed. Throughout the due diligence process, it is important to constantly remind oneself to look at the business through the lens of a buyer. This mindset will help pre-empt and prepare to address questions/requests as well as ensure business opportunities are clearly articulated. A typical due diligence list will cover these areas of the business:

- **CORPORATE, ORGANIZATIONAL AND GOVERNANCE**
- **FINANCIAL INFORMATION (HISTORICAL AND PROJECTED), PIPELINE AND BACKLOG**
- **TAXATION**
- **REGULATORY**
- **CONTRACTUAL AGREEMENTS**
- **PROPERTY, REAL ESTATE AND EQUIPMENT**
- **INTELLECTUAL PROPERTY**
- **LABOR RELATIONS**
- **ENVIRONMENTAL MATTERS**
- **INSURANCE**
- **LITIGATION**
- **GENERAL/OTHER**

For the second bullet above related to the Financial review phase of due diligence, focus in on the ten following areas:

1. Income Statements for the last three fiscal years and for each month of the most recent fiscal year
2. Financial projections that illustrate performance beyond the current year
3. Sales pipeline projections
4. Current backlog for opportunities won but not yet installed or reflected in the financials
5. Quality of earnings understanding with detailed support for any pro forma EBITDA adjustments and/or add-backs for all periods
6. Detailed trial balances as of the year-end date for each of the three most recent full fiscal years and the interim YTD period
7. Revenues and margins by customer, product line, geography and any other manner in which the business is monitored/managed
8. Top customer specific details, such as length of relationship and account type and historical customer count roll-forward, with detail about customer wins and losses
9. Costing analysis for each contract by location, detailing all allocated costs including labor, along with the supporting cost drivers, rates and assumptions
10. Historical and projected working capital analysis

Many former business owners express regret about not having fully embraced the preparation process pre-emptively, before initiating a Transaction. The consensus is that due diligence would have gone smoother. Financial flaws in their business would have been identified sooner and earnings would have improved.

It is never too early to begin your preparation. If you have not yet started collecting your thoughts about the points discussed above, we strongly encourage you to begin. It is absolutely normal for your thinking to evolve over time in advance of a Transaction; the important thing is to begin.

Most Private Equity Groups and other professional buyers judge the value of potential acquisitions by assessing the strength of a company's value drivers, the most important of which is its management.

Strong Management Team - A Top Driver of Business Value

One of the biggest misconceptions business owners have is that the value of their business is directly tied to their personal involvement in managing operations. In fact, nothing could be further from the truth. The attractiveness of the business to a buyer is what is transferable to that buyer, not the ongoing management prowess of the seller. If the owner/seller has a management team that can't sustain the growth of the company without his personal involvement, the business carries significant risk and, as a consequence, represents little value to a buyer. To some owners, this may seem counterintuitive and an assault on their egos, but it's a fact. If the business can't survive and grow without the owner's daily intervention, its value will be diminished dramatically, no matter how much it has grown or generated profits in the past.

Peter Drucker, the world's foremost management consultant, held that a fundamental requirement for creating a successful enterprise is "building a top management team long before the new venture actually needs one and long before it can actually afford one."

Most Private Equity Groups and other professional buyers judge the value of potential acquisitions by assessing the strength of a company's value drivers, the most important of which is its management. These savvy investors recognize the value of top-notch management teams and don't always bring in star outside managers to run the companies they buy. In fact, many prefer to acquire a company with strong management in place. Creating, motivating and retaining great managers is key to capturing future business value. Without a strong, motivated and secure management team, the risk to falling short of projected earnings is just too high for professional buyers. Such acquirers also realize that strong management builds the workforce to their higher standards, from the top down. They are the nucleus of a top performing organization.

Management team development is indispensable to business growth and generation of transferable value. A good succession plan will help the owner evaluate existing management based on their current performance and ability to further develop the company. Additionally, for an owner's eventual transition to be successful, management must remain after the owner's departure. Third-party buyers will insist on it, and if insiders (key employees or children) assume the reins, they must be capable of managing the company if the owner is to get paid what the business should be worth. For this reason, part of every transition plan is the creation of a succession plan with incentives for managers to perform well and stay after the owner moves on.

Owners should realize that because strong management is key to maximizing transferable value, they need to assess how good their current team really is and upgrade it where required.

Owners should realize that because strong management is key to maximizing transferable value, they need to assess how good their current team really is and upgrade it where required. A company's management is a distinguishing feature and can be the impetus for getting that premium valuation.

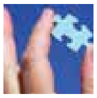
Pursant's Expectations for Q3 and Beyond in 2015

Barring any major moves by the Fed or significant geopolitical events, we expect Q3 2015 deal flow to remain healthy and valuations to remain strong.

We have seen business owners that are increasingly receptive to the idea of a sale or partial liquidity event. Owners are starting to recognize that when the broader market has tail winds favoring the seller, when their business is healthy and they are personally ready, they need to seize the opportunity and monetize the value of their business.

For the sellers, this optimal timing will continue to align well with buyers' appetite and continued desire for acquisitive growth due to the fact that organic growth percentages are generally low. As we have stated in the past, acquisitions will continue to emphasize strategic fit, synergies and the need to acquire good people in the process. Creative deal structures will address these criteria accordingly. Buyers will continue to demand thorough and professionally prepared information, furthering supporting the need for owners to put their businesses through a corporate stress test.







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, Financial Services and Strategic Advisory business units use a deep immersion process, our expansive networks and experience as owner/operators to successfully optimize operations and manage strategic transactions — vital, integrative initiatives for which our clients may not have the time, manpower or competencies.

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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