M&A insider

Q4 2014 EDITION

2014 Is the Best Year for M&A Since 2007

- M&A volume up 20% over 2013
- Valuations still strong, but…
- “Quality” characteristics required to demand valuation premiums

Pursant’s Thoughts on 2015

- 2015 deal volume should be strong and an improvement over 2014
- The pure seller’s market may be coming to an end
- Affordable capital is abundant, but rates will likely increase in late 2015
- **Preparation is necessary to achieve valuation premiums**

2014 Year-End Middle Market M&A Summary

The fourth quarter of 2014 showed continued strength in volume in the middle market (see chart #1 below): there were 20% more deals than in the same period in 2013. Additionally, 3rd and 4th quarter 2014 North American deal volume exceeded first-half levels, setting the stage for a strong start to 2015. The U.S. M&A market typically does not have the capital capacity for strong back-to-back years as it relates to deal volume; however 2015 is expected to be another banner year due to the sustained surplus of capital by strategics and continued pressure on private equity groups to deploy committed capital and monetize portfolio holdings.

While deal volume in 2014 signaled the best year since 2007, chart #2 illustrates mixed messages as it relates to business values. The data shows that companies with less than $50M in Total Enterprise Value (TEV) have shown some compression. Companies that have above average financial characteristics (defined as having TTM EBITDA margins and revenue growth each exceeding 10%) are demanding a “Quality” premium due to their short supply. Chart #3 shows the Quality premium companies can fetch.

Chart #1

US M&A TRANSACTION VOLUME BY TRANSACTION VALUE

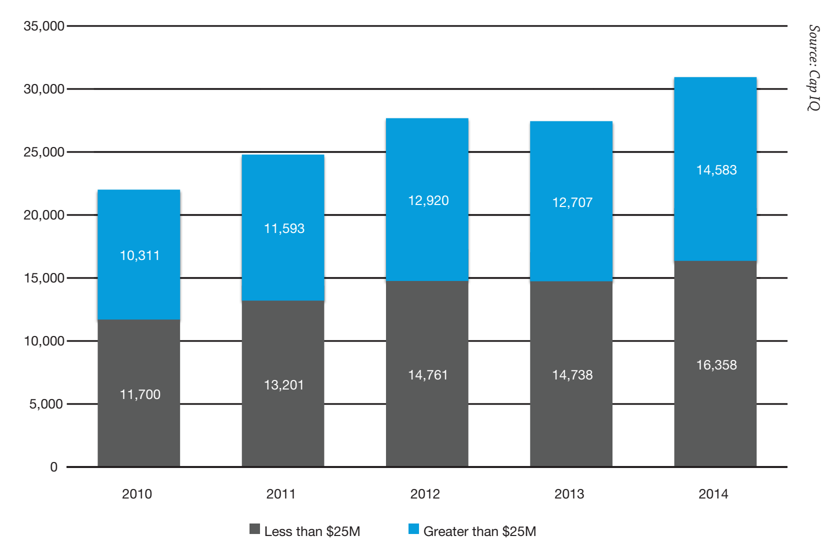
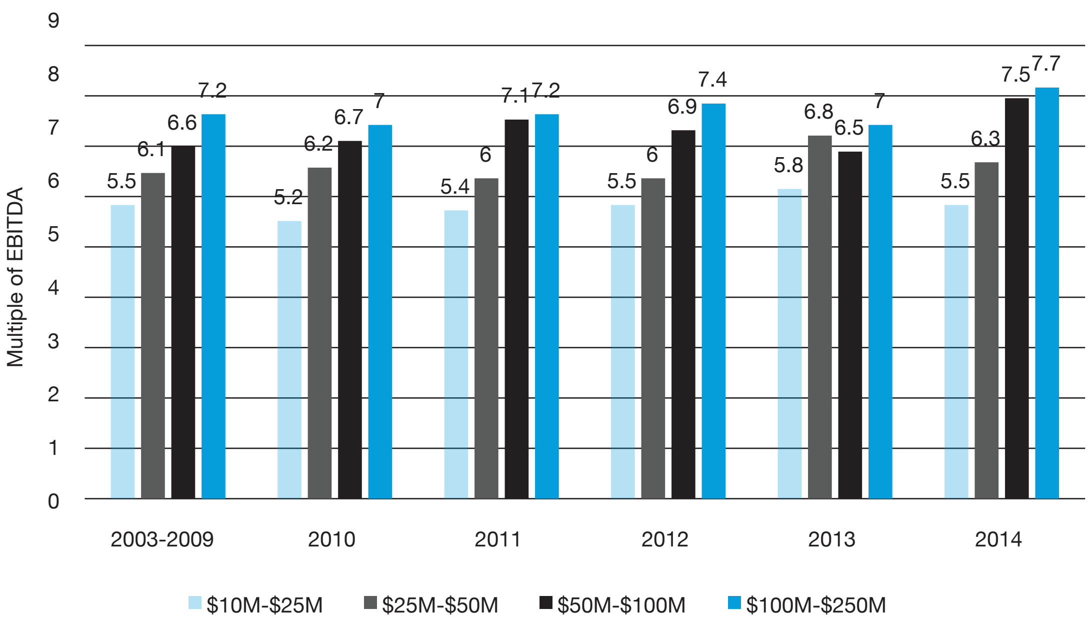


Chart #2

LOWER MIDDLE MARKET TEV/EBITDA



Source: GF Data®

Chart #3

TEV/EBITDA – BUYOUTS WITH ABOVE AVERAGE FINANCIAL CHARACTERISTICS

TEV	2003-09	2010	2011	2012	2013	2014
$10M-$25M	5.4	5.3	5.3	5.6	6.1	5.9
$25M-$50M	6.1	6.1	5.8	6.4	7.4	6.5
$50M-$100M	6.7	6.8	7.4	6.6	7.1	7.7
$100M-$250M	7.7	6.8	7.5	7.7	8.2	7.8

Source: GF Data®

Chart #4

2014 TRANSACTION MULTIPLES OF EBITDA

EBITDA	Manu.	Construction & Engineering	Cons. Goods & Services	Wholesale & Distribution	Business Services	Basic Materials & Energy	Health Care & Bio Tech	IT	Financial Services	Media & Entertain.	Avg.
$0-$1M	4	3.5	4	4.5	4	3.3	5.5	6.5	5.5	n/a	4.5
$2M-$5M	5	4.5	5.5	6	5.3	4	6	8	6.5	5	5.6
$6M-$10M	6	5.5	5.8	6	7	5	7	8	7	7.5	6.5
$11M-$25M	7.5	6	6	6.3	8	5.5	8	9.5	9	8.3	7.4
$26M-$50M	7.5	6.5	7	n/a	9	n/a	8	10	10	n/a	8.3
>$50M	8	6.8	9	8	10	7.3	8	10	10	n/a	8.6

Source: 2014 Pepperdine Private Capital Markets Survey

Sector Snapshot: Business Services

The business services sector consists of companies that do not produce a tangible commodity. These are companies that primarily provide B2B services including facility maintenance and management, security, marketing and advertising, consulting, legal and accounting services, logistics and shipping, human resources, staffing and leasing. The business services sector is highly fragmented. Most services are labor intensive and have very low capital needs. All of these characteristics create a unique valuation scenario within the broader middle market. Chart #4 demonstrates the variability of EBITDA multiples at which companies trade in this sector.

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 they operate and the likelihood of continued returns.

Is the Seller's Market Coming to an End?

In recent years, middle market sellers often were called into the market, meaning buyers sought them out and compelled them to act. The balance of many would-be business sellers held the belief that the favorable environment was not going to go away anytime soon. They remained unmotivated due to macro conditions, and instead waited until their own circumstances dictated that it was time to sell.

For the first time in years, the market may be showing signs that these sidelined sellers are now motivated to act. Business owners may be beginning to feel that the current mix of economic, industry and capital market conditions will not last forever–-an impetus to sell.

How would we test this hypothesis? We would see smaller and less strong firms move first. For example, if your business is worth four times EBITDA in this market and your growth prospects are limited, you are not leaving behind a lot of untapped value by heading for the exit. Supporting this theory, transaction activity for the 4th quarter of 2014 showed a significant increase over the 3rd quarter for businesses valued at under $500,000, according to The International Business Brokers Association (IBBA). This report also showed that these businesses traded in a range of 1-3x EBITDA in this period.

While the seller's market may not have ended quite yet, the data hints that conditions will not likely improve and that the market is beginning its turn towards more balance.

WHAT SHOULD BUSINESS OWNERS BE THINKING ABOUT IN 2015?

Create a plan to get your business into the "Quality" premium league. Here are **10 Things That Can Make Your Business More Valuable than That of Your Industry Peers (continued)**

1. RECURRING REVENUE

The more revenue you have from recurring contracts or subscriptions, the more valuable your business will be to a buyer. Even if subscriptions are not the norm in your industry, try to find creative ways to command some form of recurring revenue. It will make your company much more valuable.

2. SELL SOMETHING DIFFERENT

Buyers buy what they cannot easily replicate, which means that companies with a unique product or service that is difficult for a competitor to knock off are more valuable than a company in a commoditized industry.

3. GROWTH

Buyers looking to fuel top line revenue growth through acquisition will pay a premium for your business if it is growing much faster than the rate of your industry growth overall.

4. CACHÉ

Tired old companies often try to add sex appeal by acquiring a trendy young company. If you are the darling of your industry trade media, expect to get a premium acquisition offer.

5. LOCATION

If you have a great location with natural physical characteristics that are difficult to replicate (imagine an oceanfront restaurant on a strip of beach where the city has stopped granting new licenses to operate), you'll attract industry-savvy buyers who are interested in your location as well as your business.

6. DIVERSIFICATION

Acquirers pay a premium for companies that naturally hedge the loss of a single customer. Ensure no customer amounts to more than 10 percent of your revenue and your company will be more valuable than an industry peer with just a few big customers.

7. PREDICTABILITY

If you've mastered a way to win customers and can predict the conversion rates throughout your sales funnel, your secret customer-acquiring formula will make your business more valuable to an acquirer than is an industry peer who doesn't have a clue where its next customer will come from.

8. CLEAN BOOKS

Companies that invest in audited statements have financials that are generally viewed by acquirers as more trustworthy and, therefore, worth more. You may want to get your books reviewed professionally each year even if audited statements are not the norm in your industry.

9. A 2IC

Companies with a second-in-command who has agreed to stay on post-sale are more valuable than businesses in which all the power and knowledge rest in the hands of the owner.

10. HAPPY CUSTOMERS

Being able to objectively demonstrate that your customers are happy and intend to re-purchase in the future will make your business more valuable than an industry peer that does not have a means of tracking customer satisfaction.

Like a rising tide that lifts all boats, your industry typically defines a range of multiples within which your business is likely to sell. Whether you fall at the bottom or the top of the range comes down to factors that have little to do with what you do, but instead are tied to how you do it.

Speaking of Clean Books...

In May 2014, the international and U.S. financial accounting standard setting boards jointly developed a new standard for revenue from contracts with customers. In the US the standard is titled *ASC606 – Revenue from Contracts with Customers* and internationally (also known as IFRS) the standard is referred to as *IFRS 15 – Revenue from Contracts with Customers*. The standards take effect for the 2017 fiscal year for public companies and 2018 fiscal year for non-public companies.

The standard was designed to consolidate and establish common principles for recognizing revenue which will be applied consistently to all customer contracts across the international community. The purpose is to enhance consistency, transparency and comparability across industries, business models, companies, transactions, jurisdictions and capital markets. Under the new standard, companies will apply a five step model to determine revenue recognition.

Liquidity Options for the Privately Held Business Owners

Business Owners can have a need for capital for many reasons. The need can be to buy out a partner, grow the business, "take some chips off the table", diversify personal holdings or other reasons. Now is an excellent time for business owners to source capital as the equity and debt markets are eager to find places to put dollars to work. There are numerous options for business owners to create liquidity short of an outright sale of the business. These options include various types of recapitalizations as well as selling certain assets or parts of the business. Recapitalizations can be done with debt, equity or a combination thereof. These options have their pros and cons, so it's important to carefully weigh the pluses and minuses of each and determine how it will impact your business and personal life before deciding on which is best for you.

Common debt recapitalizations include:

- Leveraged dividend;
- Leveraged buyout of minority equity interest;
- Growth capital investment through a debt instrument (term loan, line of credit, subordinated debt)

The advantages of a debt recapitalization include providing liquidity without diluting the remaining shareholder, tax advantages due to the deductibility of interest and a lower cost of capital than equity.

Disadvantages include increased risk as a result of interest expense and debt amortization and the possibility that creditors might attack the transaction if the debt proceeds flow out of the business and to the shareholders.

Equity recapitalizations can include:

- Buyout of minority interest by an outside investor;
- Growth capital investment from an outside equity investor

The advantages of an equity recapitalization with a minority stake include providing current liquidity while maintaining upside participation and control of the business while limiting the risk of additional debt. Additionally, an equity recap provides the potential to partner with "smart money" such as a private equity group or a family office.

Disadvantages of this type of transaction include the limited number of investors due to the fact that the offering is a minority interest, influence on strategic decisions by the new partner, increased legal and accounting fees, a lack of a control premium on the valuation of the stock and taxable income due to the capital gain from the sale of stock.

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Sale of assets or business pieces can include:

- Sale of a division to a joint venture partner;
- Sale of non-core divisions;
- Sale of non-core equipment or facilities;
- Sale-leaseback of core equipment or facilities
- Sale of Assets (ex. business segment, equipment, IP, customer lists, etc.)

The advantages of an asset sale or disposition of a piece of the business include the potential to unlock value and to focus resources on core business operations which will provide a greater return on capital.

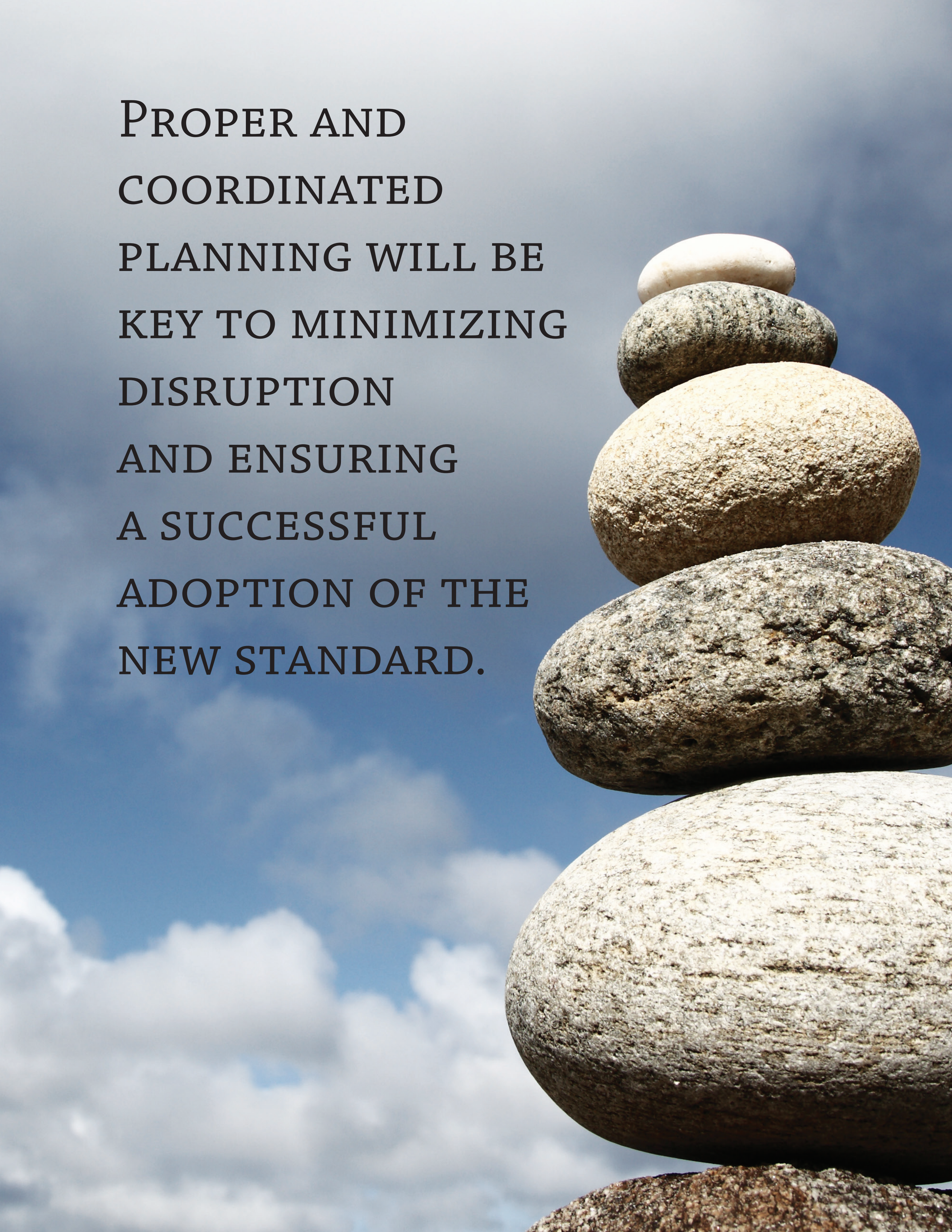
Disadvantages can include the lack of future participation in the upside of those assets and possibly selling too cheaply or too early. Additionally, there can be tax implications.

So what is the best option for you?

For many business owners, equity financing can be more difficult to come by. Investors are hard to find for businesses that don't have scale or a proven track record. Debt financing can be a great solution for small businesses in a variety of different situations – starting a business, expanding a business, weathering a financial storm or investing in sales or marketing. With the right education, the right loan product and a clear plan to pay back the loan, debt financing can often be the best option for small business.

Consult a qualified professional when determining the best liquidity option for you.

Proper and coordinated planning will be key to minimizing disruption and ensuring a successful adoption of the new standard.



Preparing for the New Standard

IFRS 15 – Revenue from Contracts with Customers

The Impact / Who's Affected

The standard applies to all entities and all contracts with customers for the transfer of goods/services. There are a few specific contract types excluded (e.g. lease agreements, insurance contracts and financial instruments) which will continue to be governed by existing standards. While the new guidance primarily affects the accounting and financial statement disclosures relating to revenue, it is expected that complying with the new standard will require adjustments to processes, controls and technology platforms/business systems.

The following provides examples illustrating how the new standard could impact your organization:

- Compensation – Changes to revenue recognition patterns and timing will likely impact incentive and bonus arrangements.
- Covenants – Debt (or other arrangements) covenant calculations will be impacted by changes to revenue recognition.
- New Processes and Controls – Under the principle based approach, entities will use more judgment, make more estimates and have additional disclosures, all of which require additional and/or new processes and controls.
- Specific Industries – Companies that use industry specific guidance, such as software (deferred revenue recognition) and telecommunications (bundled services), will no longer have industry specific guidelines and instead will apply the common principles under the five step model to determine revenue recognition.

Action Step

All of this may sound very confusing for many; therefore, organizations should now begin to focus on understanding the implications of these changes. Proper and coordinated planning will be key to minimizing disruption and ensuring a successful adoption of the new standard. Generally, a company's finance/accounting function manages transitions to new accounting standards. Given that the emphasis of this standard is on revenue (making it relevant across the entire organization), the best practice would be to establish a project management team led by the finance/accounting function but with meaningful representation from all key business functions.

Planning activities should include:

- Understanding the new standard
- Evaluating the impact to both financial and business practices, policies, procedures, controls, systems and reporting/disclosures
- Considering other implications such as lender covenant calculations, contract negotiations, tax implications and performance measurement.

Once planning is completed, companies can shift activities to developing the appropriate adoption and implementation strategy.

Pursant's Expectations for 2015

We expect sustained healthy deal flow in 2015 due to strong macroeconomic conditions, access to abundant affordable capital and the remaining stockpiles of investment capital being held by PE groups and cash on corporate balance sheets. Some macroeconomic indicators we follow are:

- GDP growth – 2014 was at 2.4% vs. 2.2% in 2013
- Consumer sentiment – Rising and at 98.2% in January 2015
- Unemployment – Decreasing and at 5.6% in December 2014
- Business Growth – Most businesses surveyed expect revenue growth in 2015 and one third expect double digit growth
- Business Spending – 7-10% increase in business spending on equipment and facilities is expected
- Cost of Capital - Low borrowing costs for business, but an increase should be coming in late 2015!

The stage is set for further strength in M&A during 2015. Some predict a possible slow-down for a quarter to integrate the tremendous activity of 2014, but nearly all of the indicators that drive M&A deal flow seem positive, at least for the first half of 2015. Numerous activity surveys including a recent survey conducted by Mergermarket project growth in M&A deal count in 2015.

Pursant's discussions with buyers continue to reveal a strong desire for acquisitive growth. We feel that 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, earlier in their review of each acquisition opportunity, including deep transactional and financial analysis.

Our firm continues to see an increase in the number of "exit planning" engagements as business owners start the process of understanding the true value of their businesses and how to improve that value. The businesses that are better positioned in advance of the sale process will be rewarded with higher valuations, smoother and less intrusive pre-closing due diligence, and a quicker deal cycle to close the transaction.

Pursant helps business owners grow the value of their companies and maximize that value when they exit.

Our Investment Banking, Strategic Advisory and Executive Search business units use a deep immersion process, vast industry network and experience as owner/operators to successfully manage M&A transactions, raise capital, pursue business optimization strategies and recruit talent — 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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