M&A Update

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Q3 2015 Middle Market M&A Summary

Q3 2015 M&A Volume and Valuations Still Tracking Nicely

- Valuation multiples year to date are best in over a decade.
- Strategic buyers still need acquisitive growth. Organic growth alone is not enough.
- PE firms have and continue to build massive amounts of available capital.

Pursant's Thoughts on Q4 2015

- The second half of 2015 is showing signs of slowing deal flow. Is the M&A wave cresting?
- Fed to likely increase rates in Q4 2015 or Q1 2016, which will slow M&A volume slightly.
- Rising capital costs may lead to some softening in valuation multiples.

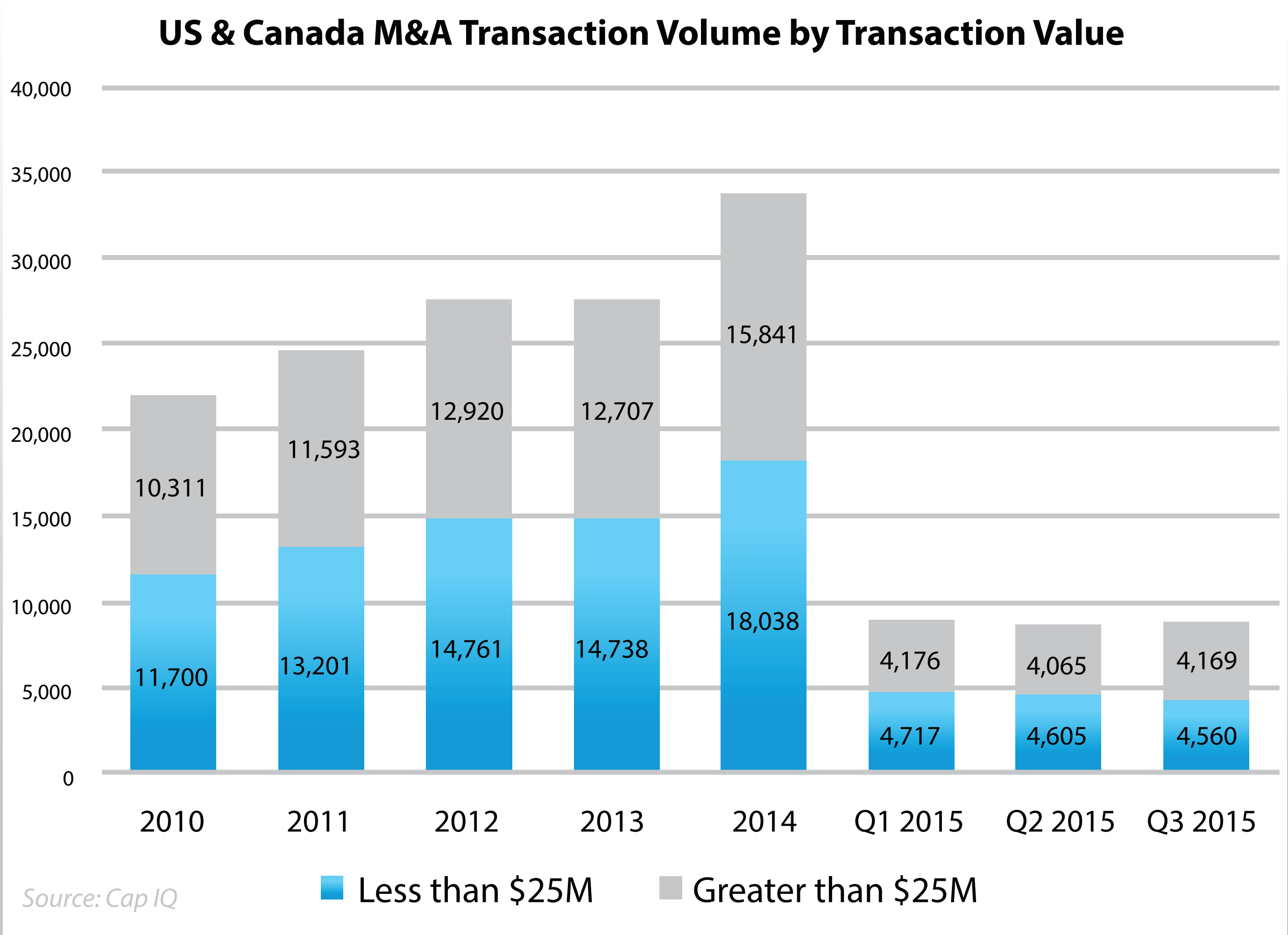
Middle market and lower middle market M&A transaction volume for Q3 2015 remained paced with Q2 2015. Despite the tumultuous markets this summer and the growing belief that the Fed will raise rates in Q4 this year, deal makers remained focused on getting deals done briskly and valuations remained strong for the quarter. The flush and accommodating debt market, lack of organic growth opportunities and overall strength of the North American economy continue to fuel the M&A engine. As 2015 winds down and more deal data rolls in, Pursant is keeping a close eye on the pace of mergers and acquisitions to see if 2015 can still trump 2014's record deal volume and value.

Outside North America, M&A strategies are less straightforward. Structural economic issues remain in China. To deal with it and keep things moving, Chinese central bankers cut interest rates and bank reserve requirements along with devaluing the currency. In Europe, the ECB is still tinkering with the economy to assuage deflation and accelerate growth.

In the US, unemployment continues to drop, sinking to as low as 5.1% in September. Consumer Confidence of 102.6 in September is indicative of an expanding economy and a mostly confident consumer. Initial estimates showed US real GDP grew 1.5 percent—which is still a very sluggish economic growth rate. Regardless, this is deemed real and sustained U.S. economic improvement.

All of this means two things. First, the US remains an economic oasis for investment and M&A; however, there are some partly cloudy skies on the horizon. Second, the US economy continues to improve—slowly, but improvement nonetheless—and with this sustained improvement comes the increasing likelihood that interest rates must and will rise. Current borrowing rates are not indefinitely sustainable. As we stated last quarter, this increase could precipitate a change to the current very low cost of capital, which could then initiate downward pressure on M&A volume and valuations. This turning point will route us to a new slightly lower plateau of volume and valuation.

Chart 1


US & Canada M&A Transaction Volume by Transaction Value

Source: Cap IQ

Chart #1 shows that North American Q3 deal flow in the middle market remained consistent with Q2 despite the calamity in the markets this summer. If Q4 M&A remains brisk, we will meet or beat the level of deal flow in 2014—the best year since 2007. Even if we have reached a peak in deal flow, and even if rates increase in Q4, 2015 will be another strong year for deal flow and likely will set the stage for a healthy Q1 of 2016.

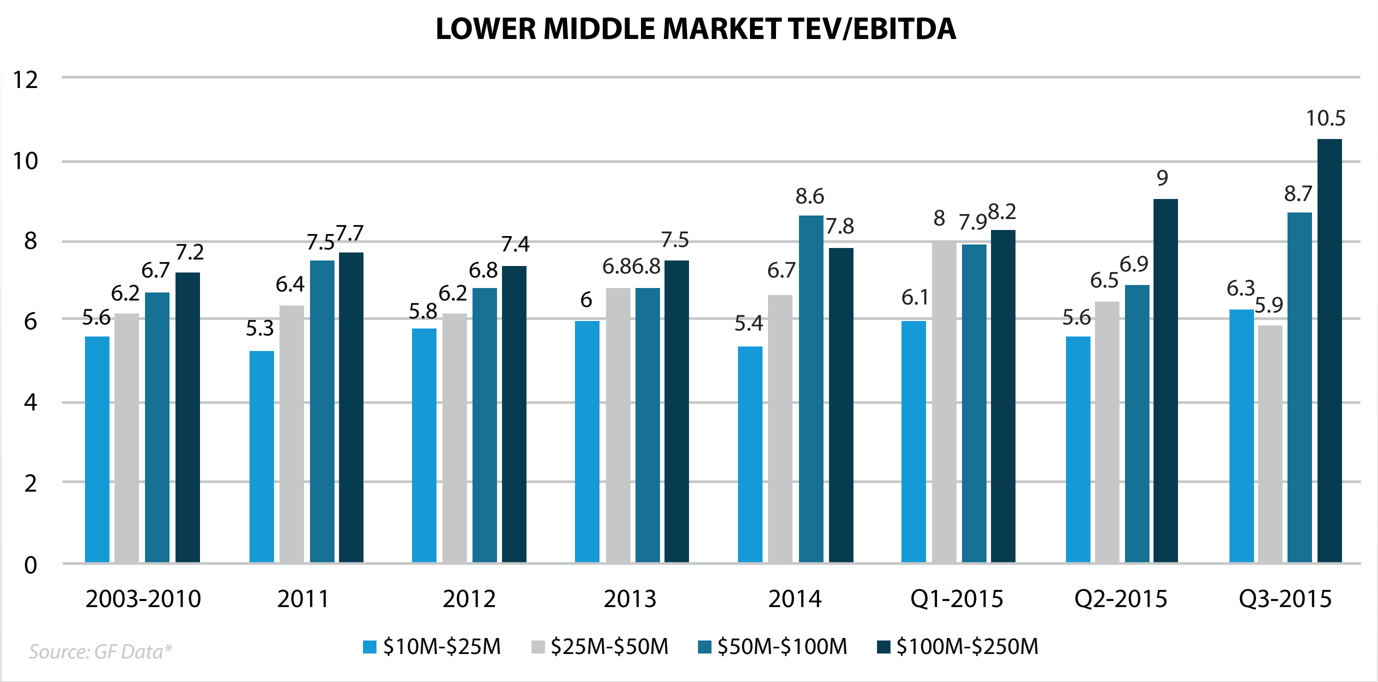
Chart #2 shows that valuation strength continues in the lower middle market. 2015 YTD multiples averaged 6.8x versus 6.7x in 2014. 6.8x is a high watermark when considering the last 10 years. Assuming that this valuation profile remains for the balance of this year, and assuming the Fed raises rates in Q4 this year, we can likely expect Q1 2016 to mark a gradual turn of the tides for valuation.

Chart #3 highlights the unique valuation characteristics of the very broad Business Services sector. Businesses in this sector are generally asset light and much of the enterprise value is wrapped up in customer relationships and talent. The Business Services sector has performed well in 2015, also showing the strongest value over more than 10 years. Overall, the sector is trading at multiples of 6.7 YTD 2015 versus 6.5 in 2014.

Chart #4 shows that overall, companies with above average financial characteristics are trading at 7.6x in 2015 versus 6.9x in 2014. These companies with above average financial characteristics are commanding higher multiples at all levels, on average—almost a full multiple higher than

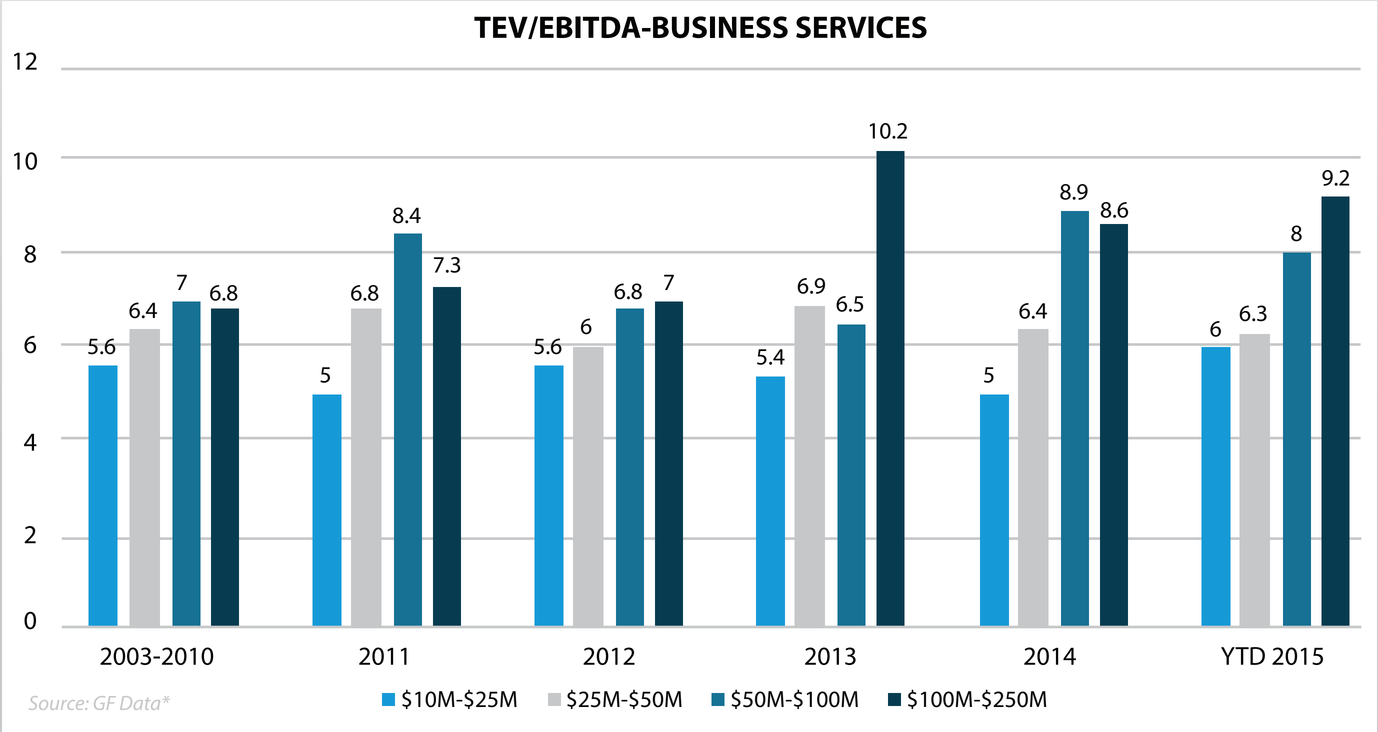
For most businesses, valuation is typically expressed in the form of a multiple of EBITDA (earnings before interest, taxes, depreciation and amortization)—a measurement of a company's ability to generate cash flow. EBITDA figures also serve as a barometer of the company's health and performance. Multiples of EBITDA vary greatly depending on a company's risk profile, the markets in which it operates and the likelihood of continued returns.

Chart 2



*Source: GF Data**

Chart 3



*Source: GF Data**

companies that don't meet the quality premium standards. 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.

YOUR COMPANY COULD BE WORTH MORE THAN YOU THINK

Business owners across the lower and middle market typically understand their industries well. They also generally have a good grasp of how to sell and deliver their products and services. A good owner has a strong handle on his or her financials, but close proximity to the business often creates a disadvantage when

Chart 4 **TEV/EBITDA – BUYOUTS WITH ABOVE AVERAGE FINANCIAL CHARACTERISTICS**

TEV	2003-2010	2011	2012	2013	2014	YTD 2015
$10M-$25M	5.4	5.3	5.6	6.0	5.9	6.3
$25M-$50M	6.1	5.8	6.5	7.4	6.7	7.3
$50M-$100M	6.8	7.7	6.6	7.1	8.5	8.4
$100M-$250M	7.8	7.5	7.7	8.2	7.6	10.3

it comes to looking at the business through the eyes of a strategic buyer. Over the years managing the business, an owner may grow comfortable viewing the business through *that business*' format and lens. This approach allows for an efficient review of financials and performance, but also can impede the ability to appreciate and recognize the full value of a business.

A strategic buyer by definition has a business valuation model that looks beyond the face value of financial statements and almost always beyond the stated net profit of the business. Strategic buyers are often more interested in finding ways to leverage your customer base, product and gross margins in another way.

Following are two illustrative case studies:
Pursant was engaged by a client to provide strategic M&A planning advice and ultimately run a process to sell a logistics business. The company was privately held by a family that ran the business very successfully for several generations. In recent years, as the current generation focused on other business interests, the industry gradually evolved, making the company's business model less profitable. Additionally, the company's largest, most longstanding customer was migrating its logistics operations from an outsourced to an insourced model, putting the account at risk. The business was losing customers and losing money, which the business owners viewed very negatively given their historical perspective of the business.

Pursant analyzed the business from a fresh vantage point and determined that the business, even excluding the largest customer, produced healthy gross margins, had a good customer mix remaining, with limited concentration issues, and great human capital. Based on this insight, we targeted strategic acquirers who had the capacity to easily absorb the customer base and valued the company's talent and service offering. The story ends with a successful exit whereby the owners were able to monetize the value of the customer base and human capital and the buyer had a very accretive tuck-in acquisition without overpaying.

The main industries that comprise the Business Services sector are employment services (35%), services to buildings and dwellings (15%) waste management and environmental remediation (12%), travel services, and investigation and security services (12%) .

A similar example involves a marketing and advertising agency that had experienced some significant customer loss and had been losing money for quite a while due to excessive overhead expense. However, the company still had a great brand and a significant number of long term profitable clients. The owner, looking to retire, was focused on his bottom line and the impact the excessive overhead had on his business over the last decade. His conclusion was that his business had no value due to the negative earnings. Instead, Pursant determined that the business and its associated gross margin were actually quite valuable to a strategic buyer looking to service those clients and pick up some very difficult to attain talent.

Having an inside and intimate view of your business is extremely valuable, but perhaps more valuable is balancing that view with an outside strategic perspective. When looking to sell your business at its optimal value, take off your insider glasses and starting viewing your business through the lens of an outsider.

Strategic Buyer or Financial Buyer – What's the Best Choice?

Our firm is often asked by business owners whether they should sell to a strategic buyer or financial buyer. The answer is "it depends." Here are five things to consider when trying to make this choice:

1. **Return Motivations** – A financial buyer's (investor's) job is to buy low from you in order to generate a targeted return within a certain timeframe to other investors and then ultimately sell at a higher price to somebody else. A strategic buyer is not typically under the same return and timeline pressures. A strategic buyer can usually decide its own proforma return and timeframe. However; under the right conditions, a financial buyer can offer a compelling offer, especially if that buyer already has a presence in your industry.

2. **Monetization Considerations** – Financial investors are less willing to competitively value your company unless they've already identified their investment exit strategy and that often involves selling to other strategic buyers. If you can demonstrate the investment appeal and growth/return metrics of

your industry, this can pique the interest of a financial investor. Strategic buyers immediately know how you fit into their growth strategies and often have no exit expectations to meet.

3. **Ownership Staying with the Business** – Going the financial investor route can come with conditions. You may be required to continue working for the new owner(s) for 3-5 years and building your business according to their return models. This is not a favorable choice if you are looking to exit soon after a sale and have no transaction proceeds wrapped up in the business. However, this works well if your plan is to remain with the business, as you will often have equity in the business and likely will have another "bite at the apple" when the investor sells. A recent Harvard Business School study showed that financial buyer owned businesses performed better long term than strategic buyer owned businesses, so sticking around for that second bite can be a profitable investment of your time.

4. **Leveraging Synergies and Strategic Benefits** – If you have significant strategic business drivers and operational redundancies, a strategic buyer is usually in a position to value the deal more aggressively. Unless a financial investor has a platform in your space or adjacent to it, synergies and strategic opportunities are often off the table.

5. **Due Diligence** – Financial investors generally have an extremely rigorous due diligence process. This is a must because without it, they run the risk of losing credibility with current and future limited partners that fund investments. Strategic buyers generally have less rigorous due diligence processes as they are not usually accountable to parties outside the corporation. Factor in how prepared your company is to survive a rigorous due diligence process.

In short, there is a place for both strategic and financial buyers in every exit strategy. Make sure your buyer pool is filled by those parties that stand to benefit the most from what your company offers their company or investment portfolio.

Pursant's Expectations for Q4

Word on Main Street and Wall Street is that deal flow is starting to soften and that optimal M&A conditions may be starting to crest. This sentiment is being driven largely by eminent interest rate increases. With improving economic conditions including the continuing decline of unemployment paired with job ***and wage*** growth, Fed lending rates are expected to start climbing in December. The rate adjustment is not expected to trigger a spiraling drop in deal flow and valuations, but merely take us to a new lower sustained plateau. With continued anemic real GDP growth of 2-3% in North America, rate adjustments are not expected to be significant, but again, they will begin the crest of the M&A wave.

We expect the pace of corporate M&A to be brisk and sustained, which is indicative of a strategic appetite to use excess financing resources, including cash accounts, to acquire top line growth. If there are synergies either on the sales or cost front, companies can use existing infrastructures to generate additional returns and productivity from accumulated capital. Recently, a respected PE professional told Pursant that the lesser of two evils is to not do a deal than to overpay. PE players still have massive and problematic amounts of dry powder ready for acquisition opportunities as the right ones arise.

As in 2014 and 2013, 2015 was predicted to be the year when baby boomers would start looking to exit their businesses. This has not been the case, and as Cubs fans say in Chicago, "maybe next year." As published in the *Wall Street Journal* recently, the U.S. Census Bureau reported that the number of incorporated firms with owners over the age of 55 accounted for 38% of all business owners in 2013. That number was 29% in 2005. This is being driven by a number of factors, including the younger generation not joining family businesses, people living longer and needing their nest egg to last longer, and businesses still not having fully recovered from the great recession. Regardless, we continue to see more and more business owners starting to plan their exits, which, depending on the business, can take years. Ideally, they can still time an exit transaction with the three ideal exit conditions: i) favorable market conditions; ii) the business being in good shape and on an upswing; iii) being personally ready.

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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