BSCAI
M&A WATCH
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ISSUE 11 | Q2 2019

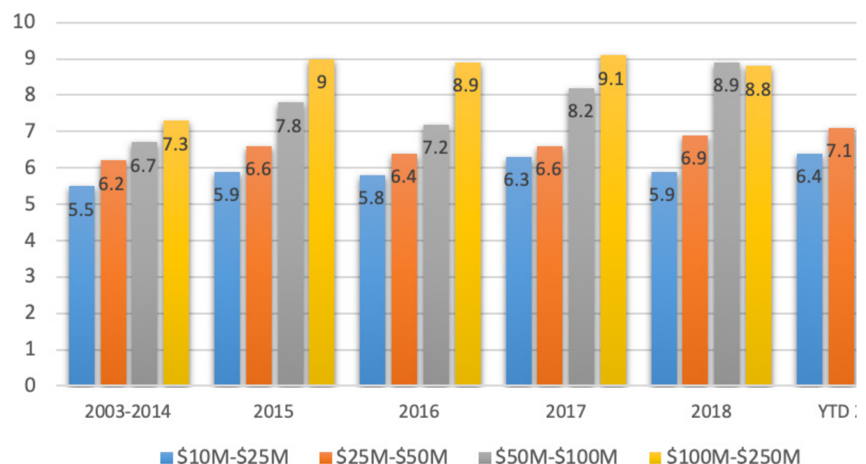
2019 Middle Market M&A Activity Was Strong, but the Lower Middle Market Shows Signs of Slowing

Overall, middle market M&A activity for the first six months of 2019 remained on par with activity during the same period last year, but looking ahead, there is some evidence to suggest dealmaking conditions will tighten in the second half of this year. For example, popular data room provider Merrill is reporting a slowdown in data room development in the lower end of the middle market. It remains to be seen as to whether this slowdown is temporary.

There are growing concerns that continuing US and China trade tensions will impact both the economy and M&A. This dynamic has certainly dampened global growth, and inflation has stalled in the US. At the same time, equity markets have recovered after their slump in early 2019, and the US Federal Reserve cut interest rates for the first time in a decade. Despite all of this uncertainty, dealmakers have remained largely unfazed and many actually have an increased appetite for acquisitive growth.

For the first half of 2019, valuation multiples continued to hold strong, bolstered by the abundance of Buyers compared to Sellers in the market and cheap capital. As expected, Q2 2019 multiples rebounded from the drop in Q1 2019, a pattern similar to the first half of 2018.

Chart 1



Source: GF Data®

Chart 1 shows that lower middle market EBITDA multiples—measured as Total Enterprise Value (TEV)/EBITDA— for transactions YTD through Q2 2019 averaged 7.6x, compared with 2018 overall at 7.3x. Valuations over the past 18 months have remained elevated but within a fairly tight trading range: 7.1-7.5x.

H1 2019 Highlights

- Overall M&A activity in H1 2019 is on par with H1 2018, but there are signs of slowing in the lower end of the market
- Lower Fed rates keep M&A borrowing costs low, bolstering valuation multiples
- Favorable macroeconomic indicators have helped M&A, but positive business sentiment is diminishing

Pursant's Thoughts on H2 2019

- Lower middle market M&A should remain largely unaffected by Asia supply chain issues and Brexit drama
- Potential future Fed rate cuts could lower deal borrowing costs further
- It will remain a Seller's market, but there are signs of that shifting in the not too distant future

The BSCAI M&A Watch 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

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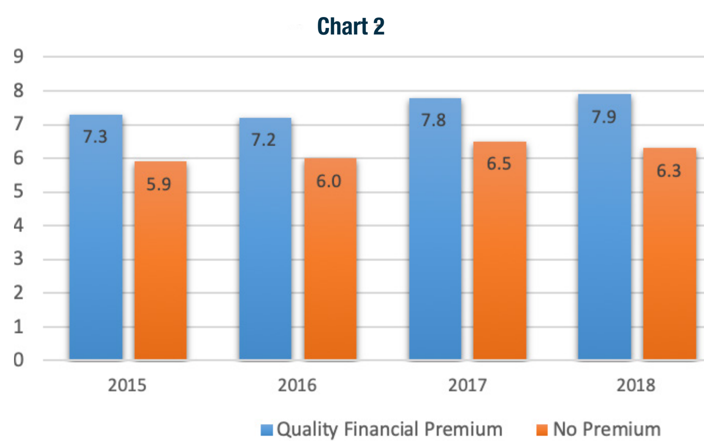
The Quality Financial Premium—Last quarter, we highlighted "size premiums": a scenario in which a smaller middle market company might "jump" to a higher tier of valuation multiples. This occurs when the company is viewed as a "platform" size acquisition, which is typically when Total Enterprise Value (TEV) exceeds $50M; otherwise, it would be a considered a "tuck in." This quarter we are turning the spotlight to the "Quality Financial Premium," which generally occurs when a business' trailing twelve-month (TTM) EBITDA margins and revenue growth rates are both above 10 percent, or one is above 12 percent and the other is at least 8 percent. Outliers on the high side are excluded from this calculation. Chart 2 shows that if there are two virtually identical companies being acquired, the company with more impressive revenue and margin growth rates will command a full one multiple (1x) premium.



Source: GF Data®

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.

The US Macroeconomic Picture for Q2 2019 and its Impact on M&A

GDP—The US economy grew by an annualized 2 percent in the second quarter of 2019, slightly below a preliminary estimate of 2.1 percent and following a 3.1 percent expansion in the previous three-month period. The period reflected lowered metrics for state and local government spending, exports, private inventory investment and residential investment that were partly offset by an upward revision to personal consumption expenditures (PCE). Even a moderate 2 percent GDP growth rate is good for M&A sentiment. A healthy economy keeps dealmakers confident about sustainable returns on their deals and motivates Buyers to augment revenue growth with acquisitive growth.

Inflation—The US annual inflation rate finished Q2 at 1.8 percent from a four-month low of 1.6 percent in June and above market consensus of 1.7 percent. The rate saw a boost from food prices and a range of other goods while energy deflation eased. We watch this key indicator as it influences Fed behavior and its management of interest rates, which effect M&A.

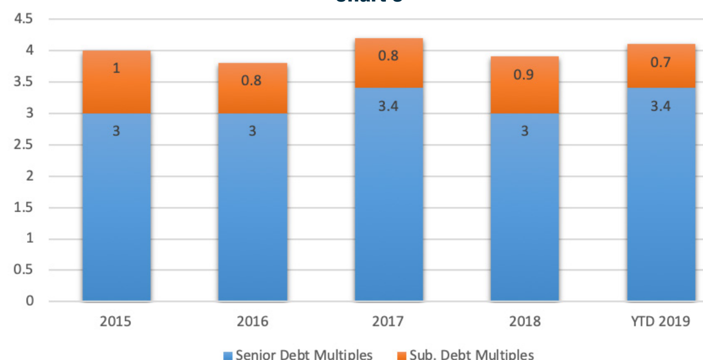
Business Confidence—The Institute for Supply Management's Manufacturing (ISM) Purchasing Managers Index (PMI) in the US finished Q2 2019 at 51.2, down from 51.7 in June, missing market expectations of 53.4. The latest reading pointed to the weakest pace of expansion in the manufacturing sector since August 2016. Sentiment remains upbeat about expanding business strength, but at soft levels. July was the fourth straight month of slowing PMI expansion. 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 further the number is from 50, the greater the level of change.

Fed Lending Rate—The federal funds rate finished Q2 at 2.25 percent, down from 2.5 percent the previous quarter at a time when the The Fed wants to take no chances that the economy will deteriorate. This benchmark rate is an indicator of the economy's health. The Fed Funds Rate is critical in determining the U.S. economic outlook and controls interest rates including loans from M&A transactions. The lower the rate, the higher the rate of return. The higher the rate, the lower the rate of return, thus putting downward pressure on valuation multiples.

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 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 3 shows that lenders, especially senior lenders, are eager to support M&A transactions and that Buyers are still willing to lever-up for M&A as a result of the low cost of capital. The affordability and abundance of capital and Buyers' willingness to borrow for deals are surely helping multiples stay at these frothy levels. Combined senior and sub debt multiples in the first half of 2019 averaged more than 4x EBITDA.

Chart 3



Source: GF Data®

Search Fund – An "Emerging" Buyer in M&A Transactions

Scott Glickson – Pursant Managing Director

In the 1980s, there was an emerging, small and unique pool of Buyers. That pool has since grown significantly, particularly in the last decade, and today there is a large and very relevant Buyer pool across lower middle market M&A transactions. This pool of Buyers comprises individuals seeking to acquire a privately held company. These individuals are backed by investors who support the individual's efforts to locate, acquire and manage a business. The investor support is financial as well as in the form of mentorship, leadership and guidance. Buyers using this model are referred to as Search Funds or by the acronym ETA, which stands for "Entrepreneurship Through Acquisition."

While the search fund concept was popularized at the Stanford Graduate School of Business during the 1990s/early 2000s, the term "Search Fund" originated at Harvard Business School in 1984. Today Search Fund and ETA models are widely and well known among business schools and the private investment community. According to a 2018 study by Stanford, from the mid 1980s through 2017, more than $900 million of equity capital was invested into more than 300 documented Search Funds, while other sources cite even frothier figures.

Search Funds commonly target companies in fragmented industries, with sustainable market positions, a history of stable cash flows and significant potential for further growth. Businesses being acquired generally fall within the $10M to $25M valuation range. The process from launching a Search Fund to making the acquisition averages between 18 and 24 months.

How it Works

Searchers begin by seeking investors to provide capital to fund the search process. Investors receive ownership units in the search fund. When raising the initial investor capital, Searchers present a 12 to 24 month budget illustrating the costs associated with the pursuit of a business to acquire. Those costs include salary/draw for the Searchers (typically one to two people per Search Fund), office rent, travel costs, research costs, pre-acquisition due diligence expenses and legal fees. Once a company is sourced and the Searchers are prepared to make the acquisition, the Search Fund investors have the right to participate in the acquisition financing based on their pro-rata unit allocation in the Search Fund. Typically, the initial investors do not have an obligation to participate but rather have the right of first refusal. The Search Fund principals often assume key operating roles in the acquired company, which gave rise to the phrase "Entrepreneurship Through Acquisition." In other cases, Search Fund principals remain passive and start a new journey to acquire another business; such principals are typically referred to as "Independent Sponsors."

Why Search Funds Work for Investors

The current seller-favorable market has an overabundance of buyers/investors desperately seeking deal flow. With Search funds, investors get access to private investments in growth orientated businesses. Usually investors are family, friends or other people within the Searcher's personal network.

Why Search Funds Work for Searchers

The most common profile of a Searcher is a recent business school graduate from one of the country's elite MBA programs. Searchers typically have limited operational experience but are high energy, high IQ, extremely driven and are connected to a network of people with access to capital and who are willing to provide mentorship and guidance. They give up the pursuit of more traditional post MBA career paths with sizeable signing bonuses and compensation packages. Instead, Searchers are seeking the entrepreneurial experience of owning and operating a company. Initially this results in lower compensation; however, the Searcher is seeking the professional and financial gains associated with growing an asset and monetizing it in the future.

Why Search Funds Work for Sellers

For Sellers seeking a full exit and transition away from the business, Search Funds are excellent options. Searchers relocate to the company site to run and manage the operations and typically seek a short (12 months or less) transition from the Seller to ensure effective passage of knowledge, processes and key relationships. The business owner/CEO can take comfort in knowing they are being replaced by a vested, highly motivated, high potential, talented young person who has a network of capital providers that also provide guidance and leadership.

All signs suggest that Search Funds are here to stay, will continue to increase in prevalence and can become a great Buyer in the right situation.

Don't Get Stuck – Make Sure Your Exit Strategy and Exit Planning Are Aligned

Richard Curry – Pursant Managing Director

Contemplating selling your business is a huge turning point in an owner's life. It is likely the biggest decision that you will make, and the decision likely affects not only you but your loved ones and many others. The act of exiting the business through a sale requires certain planning steps, preferably taken years in advance and reviewed frequently to ensure the plan is viable and still responsive to your expected outcome. This article will review key considerations when initiating the Sales process.

Exit Strategy

Consider which strategy you will execute in your exit; most common options include:

- Sale to a Strategic or Financial Buyer
- Transferring the business to a family member or trusted individual(s)
- Sale to the employee management team (MBO)
- Initial Private Offering (IPO)
- Shutting down and liquidating the business

All of these options have pros and cons and require different exit plans. In this article, we will address the first option, Selling to a Strategic or Financial Buyer, the most likely outcome for most.

Strategic Buyers are already in your industry and will understand the desirability of your services, markets, management and employee structure and overall capabilities. The customer base, internal metrics and synergies created through a sale combination can be rapidly identified and forecasted.

At face value, strategic Buyers are seen as the preferred type of Buyer, but financial Buyers can offer compelling advantages in certain situations. Financial Buyers can have many reasons for executing a transaction in your industry; the circumstances dictate the purchase price (i.e. platform investment vs tuck-in acquisition to complement closely related holdings). Usually the objective for a strategic Buyer is to exit acquisitions made within a definite time horizon, having had adequate time to grow the business either as a standalone investment or part of a bigger portfolio of investments. A financial Buyer, in general, has a much more structured process, has definitive investment criteria and is generally more risk averse in terms of deal structure. They are also likely very keen to retain the owner and principals for longer periods of time in order to nurture important client relationships and provide stability to the management team. Oftentimes, seller reinvestment (rolled equity) is required within the deal structure, which can be compelling for some Sellers.

Exit Planning

A good exit plan is a series of actions steps and research that will yield the best outcome when you employ your strategy of selling to a strategic or financial Buyer. Here are the keys to preparing and executing your plan:

1. Start your planning as far in advance as possible. This will allow you to execute actions that will enhance the value of your company on the market. Any client mix or personnel shortcomings will take an extended period of time to rectify.
2. Plan to work backwards. Researching the various legal, tax and other costs associated with a sale will allow you to come to a valuation figure that dovetails with your post-transaction lifestyle and expectations. This requires a firm understanding of what your net proceeds will be at certain levels of valuation. (*This topic is discussed in our* ***Q2 2018 newsletter*** *article titled "Deal proceeds – It's all about what you keep."*)
3. Plan to obtain professional assistance. Depending on the size and complexity of your business, engaged professionals can provide valuable assistance to ensure that your plan is well grounded. These services range from estimating tax liabilities, legal costs, and transaction costs; providing debt retirement planning; estimating valuations and delivering business optimization advice. The costs for the services you incur should not harm the value of the company, as these costs are always added back (add-backs) to the earnings. Additionally, when the right the professionals are engaged for guidance, their expense easily becomes an investment due to contributions toward making a better deal and optimizing sale proceeds.
4. Plan for emotional turmoil. The decision to sell your company is probably the biggest financial decision of your life. Prepare yourself mentally and emotionally for the separation anxiety and Seller's remorse. This cannot be understated. Seek out proper advice on what to expect post transaction from others that have experienced it.
5. Plan to avoid the following negative mindsets:

   a. Buyers will not see the worth that I see. You don't know until you secure professional advice. You may be surprised what your company is worth *(This topic is discussed in our* ***Q3 2015 newsletter*** *article titled "Your Company could be worth more than you think")*.

   b. There will be plenty of Buyers out there when I am ready. This could be true or false. By delaying your planning, thereby delaying knowledge acquisition, you may open the door for external factors to influence the Buyer pool size when you are ready to transact. The economy largely dictates many transactional points; be aware of trends as you plan.

   c. I don't want to stay on and work for others. Of course you don't. that's the reason you have been an owner! However, there are circumstances that may require a post transaction transition period. Be flexible. The Buyer may have a very enjoyable and lucrative function that they may want you to fill.

In summary, you must plan, above all, to be realistic. Listen to the advice and qualified valuation estimates that you receive when you seek assistance with your plan. The market ultimately decides the value of your enterprise. The best you can do is to continue to optimize the value of your company while following a realistic plan that is based on professional advice, purposeful action and informed market awareness.

Level Setting Expectations if You Are Going to Buy a Business

Brian Steffens – Pursant Managing Director

There are a lot of first-time or infrequent acquirers in the market today. We have spoken with scores of business owners while sourcing acquisitions on behalf of our Acquisition Strategy Management (ASM) practice clients and at other events and conferences. In the absence of experience, establishing realistic acquisition outcome expectations can be challenging. Here are 5 of our ten advised best practices for setting acquisition expectations in a market with an abundance of Buyers:

1. The perfect company does not exist, so stop looking for it. First-time Buyers spend a lot of time early in their search looking for the perfect company. A company is a combination of hundreds of related and unrelated attributes. Each attribute can be ranked high to low on a spectrum of desirability with respect to risk, fit and upside opportunity. When this analysis is done, you will find that all companies have issues—some more than others. You will rarely find a company that is issue-free and if you wait for one to come along, you may never make an acquisition. Successful Buyers learn how to structure deals to mitigate risk rather than seeking the risk-free deal.
2. The journey is not linear. You need to be flexible. The M&A journey is filled with peaks filled with numerous calls and meetings and cavernous valleys where you may go weeks without an actionable next step or interesting opportunity. Targets you have been in conversations with may go dark, whether temporarily or for good, without a word, and then resurface as if nothing happened. It is critical to remain positive, prescriptive, and patient. Creating a sense of urgency with a proprietary, passive Seller is counterproductive and only leads to them resenting the process and bowing out of the discussions. Keep in mind that very few Sellers dedicate time and resources to a sale effort, at least initially. Sellers naturally want to keep discussions very close to their chest to reduce the likelihood of their employees discovering the plans. A Seller's sale timeline is often misaligned with yours. It does not mean that they are not working in good faith and towards the same goal. It's just at a different and often inconsistent pace. Remember, Sellers only sell once, where Buyers may buy multiple times, so be prepared for many starts and stops as you work towards a deal.
3. Be prepared to share. Buyers often have a misconception that Sellers are ready, willing and able to quickly share their company's financial information, analysis and secret sauce with them. The reality is that most are not. An effective way to get a passive seller to open up is by sharing with them first. Have your story nailed. How did you get into business? Why do customers and employees choose you versus someone else? What are some of your biggest challenges or concerns? Be prepared to share some of your key high-level financial metrics: topline revenue, revenue mix, and growth. It's a sign that you are entering into this conversation as equals, in good faith, and working towards a common solution. You should be searching for and trying to make personal connections with the Seller. Remember that there are lots and lots of Buyers out there. What makes you special? Make it succinct but personal. You want the Seller to continue to want to talk to you because they trust you. That is how you can then get them to share their more sensitive information, which you will need to advance the conversation to valuation and structure.
4. Don't be surprised that you have to chase targets. When I first started out in corporate development for a family office, the lack of people that call you back or provide any actionable feedback shocked me. I felt we had a good story to tell, solid research, a thoughtful and compelling strategy and most importantly we had the capital to deploy. I naively thought companies would be lining up to engage in conversations with us. A decade plus later from those humble beginnings, I take this rejection and lack of response in stride. It's part of the process. The silence is one of the biggest struggles for many first-time Buyers. Don't stress those that don't want to talk to you. While they think they are a one-of-a-kind business, there are others that once discovered and engaged in conversations will meet your strategic criteria. It truly is a numbers game at the end of the day. The more times you cycle through a list, the better traction you will have. You will also discover new businesses that were missed in earlier research. You cannot compel a middle market business owner to talk to you regardless of how much money you are prepared to offer. During the pursuit of acquisitions, keep in mind that statistically, it's not a matter of if an owner will sell, it's a matter of when. Patience and persistence is critical.
5. Marketplace relationships and connections are helpful, but they do not guarantee a pipeline of deals. Your relationships and notoriety can be a double edge sword. Target companies may have a preconceived view of you, your people, your company and your brand. This bias can be the result of an ill-fated intersection many years prior. As a result, you may never get a chance to even talk to the target. Additionally, they may be unwilling to talk to you because you are viewed as a competitor. They may be concerned that you are simply trying to gather market intel. While having companies and people in your CRM is helpful, it will never take the place of hard work to continuously find different ways to connect with the companies that you feel are a fit with your strategy.

Check out the Q3 2019 issue of the Pursant Deal Insider for five more best practices for setting acquisition expectations.

Pursant's Expectations for Q3 2019

As mentioned earlier, there is evidence to suggest that M&A dealmaking may slow in the second half of 2019, but that remains to be seen. For the balance of the year, the Fed appears poised to make further rate cuts. If the domestic economy performs at current levels, the stage will be set for a healthy M&A climate through the balance of 2019. There are negative variables that could offset these positive factors such as Brexit uncertainty and protracted and increasing China trade tensions, but lower middle market M&A tends to be less affected by geopolitical issues.

For Buyers, capital is cheap and there are many good performing companies out there (rising tides raise all boats). The challenge is motivating owners to sell when times are good. Another challenge for Buyers is that increased competition for purchasing companies is creating high valuations. In spite of the heavy competition for acquisitions and limited supply, it is important for them to stay in the game. Dealmaker consensus appears to be that once the economic tide turns, which it must eventually (maybe in 2020?), the market will shift to being more neutral and eventually Buyer favorable. If you are not already in the game at that time, you will miss out on the first mover advantage.

For Sellers, the market will likely remain in their favor for the balance of 2019, but 2020 could likely prove to be a different story, especially with 2020 being an election year and the beginning of related future economic policy uncertainty. Pursant's position remains that if selling is in your near future, from a market perspective, now is the optimal time to strike.

Upcoming Speaking Engagements

November 20, 2019
ISSA North American Annual Convention – Las Vegas
Mark Herbick, Founder and CEO, Pursant
Session: M&A in the Jansan Sector

Mergers and acquisitions (M&A) activity in the Jansan Sector is robust. This session will enlighten you about current market conditions, how to best capitalize on them as a Buyer or Seller, and what the future holds for M&A in the near-term.

November 21, 2019
BSCAI Annual Convention – Las Vegas
Mark Herbick, Founder and CEO, Pursant
Session: Knowing, Growing and Capturing the Value of Your Business

There is a better than 50% chance that a sale of your business is in your future. The time for that sale often arrives without warning. Meanwhile, you continue to work in and on your business and grow it. But, are you simultaneously growing enterprise value so that when that sale time comes you can capture maximum value? Do you have clarity on what that value is? This session walks through the business value drivers that you need to be focusing on, how BSC companies typically are valued and through the case study method, shares stories of how the better operators have grown and attained the maximum value for their businesses in a sale.

Pursant is an investment banking, financial and management consulting firm that supports and executes middle market M&A related initiatives and helps business owners grow enterprise value.

We use a deep immersion process, our expansive networks and experience as owner/operators, dealmakers and financial professionals to effectively deliver on these critical initiatives 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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