



# STRATEGIC ADVISORS

Middle Market Investment Bankers

*Bringing Efficiency to Inefficient Markets*

# 2017

## M&A AND CORPORATE FINANCE OVERVIEW

First Half

Merger & Acquisition  
Corporate Finance Advisory  
Strategic Consulting

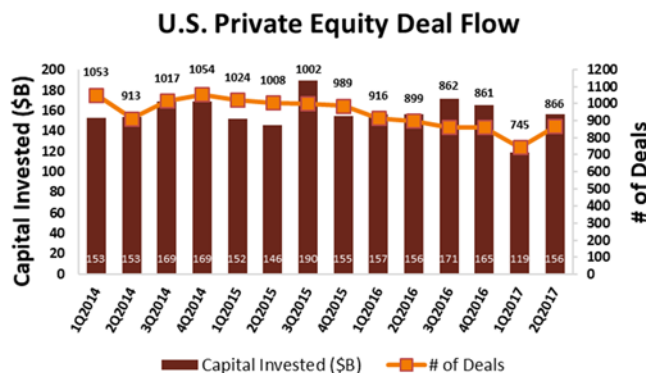
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Strategic Advisors is a middle market investment banking firm that helps clients achieve financial and business goals by providing merger and acquisition advisory, corporate finance advisory and strategic consulting services. Along with many years of experience in advising middle market clients, our Managing Directors have experience investing in and managing portfolio companies. As such, Strategic Advisors not only has expertise in advisory services but also firsthand knowledge of what stakeholders, investors and lenders expect and desire.

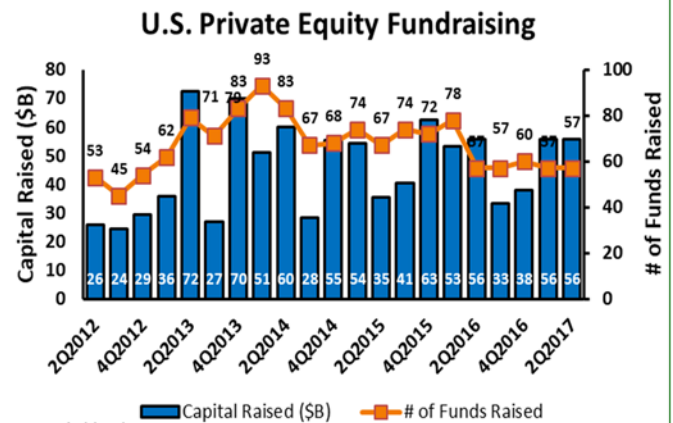
## Merger and Acquisition Overview

- ❖ The characteristics of the extended seller's market experienced in Q1, such as unprecedented valuations and aggressive debt availability by non-bank lenders, have transitioned into Q2. According to Pitchbook's *2Q 2017 Private Equity Breakdown*, 866 deals were completed across the U.S., bringing the total of the first half of 2017 to 1,602 completed deals with an aggregate deal value of \$275 billion. Even though the pace of deal making decelerated when compared to the past three years, valuations are on track to achieve new heights. Thus far in 2017 average EBITDA multiples were 10.5x. Even though they slightly regressed from the post-crisis high of 10.7x, rekindled PE firm focus on quality targets could perhaps reverse the trend.



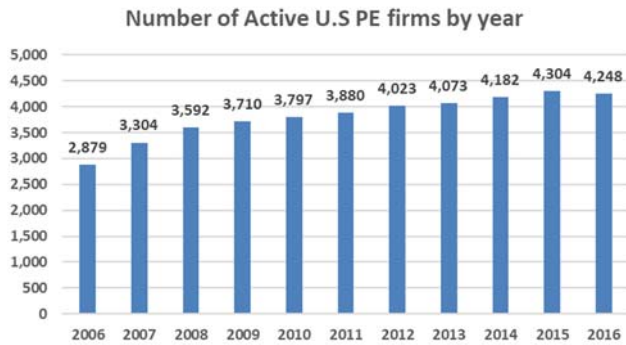
Source: Pitchbook

- ❖ Investors have a higher risk appetite for PE returns, and this bullishness is translated into a willingness to commit greater amounts of capital to this asset class. Since Limited Partners seek higher returns, more capital was injected into PE funds in 1H2017: \$113.35 billion was committed to 117 funds. Among the different fund sizes, the sub-\$100 million funds continue to be the less-funded ones. On the other hand, mega-funds with more than \$5 billion at closing accounted for 50% or more of all capital raising, further demonstrating the desire of LPs to invest more.



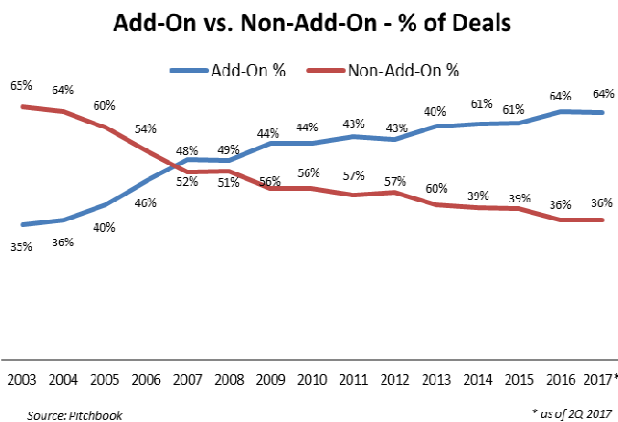
Source: Pitchbook

- ❖ If mega-funds continue growing at this rate in the second half of 2017, it will be the first time since 2007 that such funds would comprise more than 50% of the overall capital raised.
- ❖ The Financial Services Industry, which includes PE funds, is experiencing a continued trend of consolidation especially among the biggest players. The goal of such strategy is to increase the value proposition for the client by acquiring competitors with expertise in alternative niches and offering a one-stop-shop solution, providing LPs with a variety of ways to invest (i.e. hedge fund, fund of funds, credit growth investments). This way the acquirer will not only grow AUM, but subsequent fees as well. One example is from February of 2017, when SoftBank Group Co., Japan's largest multinational communication and internet company, acquired NYC-based private equity firm Fortress Investment Group for \$3.3 billion in cash. The consolidation will mostly benefit the largest players in the industry, but its effects are already making a mark. There were 4,248 PE firms as of the end of 2016, a decrease of 1.3% from the historical high of 4,304 a year prior.



Source: Pitchbook

- ❖ Pitchbook notes that add-on acquisitions continue the upward trend, with such deals representing 64% of buyout activity so far in 2017. Considering that each platform reaches the average size of three portfolio companies (1 Platform plus 2 add-ons) over an average holding time of 5.7 years, sponsors have a limited time frame to make these acquisitions. Then they have to realize the sale and return money to investors, which suggests a likely plateau in the near future. Lastly, the above-average size of the funds raised in the past few years, especially the ones raised by mega funds, signifies that the universe of investable add-ons will diminish.



Source: Pitchbook

\* as of 2Q 2017

- ❖ Secondary Buyouts (SBOs) seem to be the favorite option for exits as they accounted for 232 deals with a value of \$31.1 billion. Exits through corporate acquisitions recorded \$47 billion in exit value spread across 214 deals through the first half of 2017. In the second half of the year more corporate acquisitions are expected as a result of earnings remaining strong and debt markets favorable.

Exit size is trending upward with a median of \$230M, representing a 14.2% increase from 2016, while weaker activity still prevails thus far in 2017.

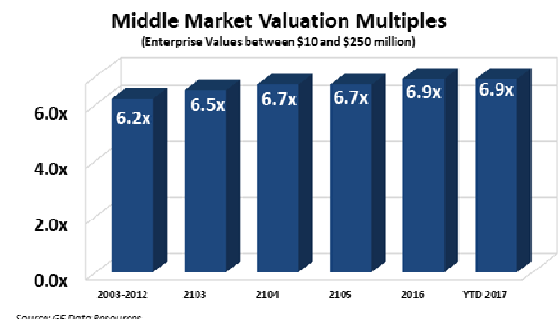
- ❖ From a sector standpoint, the healthcare and consumer space exits are not as prominent as they were last year, but considering the heavy investments made in such sectors from 2010 to 2013 and the fact that the median hold time is 5.4 years, greater activity is expected. In the first six months of 2017, the financial services sector showed the greatest amount of exited capital with an impressive \$15.7 billion, which was the same amount recorded for all of 2016.



Source: Pitchbook

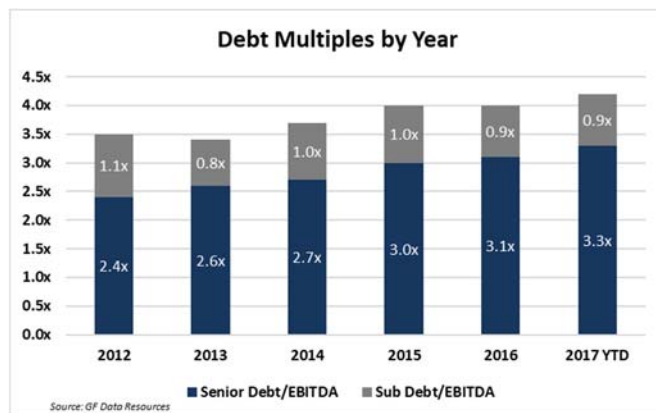
\* as of 2Q

According to the GF Data® M&A report as of August of 2017, there were 45 transactions completed in the \$10-250 million range of Total Enterprise Value, representing an evident decline in the past three quarters. The U.S. middle market transaction multiples for businesses sold to private equity groups averaged approximately a valuation of 7.4x in 2Q17, while the average for the first half of 2017 held up at 6.9x.



Source: GF Data Resources

- ❖ There is a continued reassertion of the *quality premium*, which GF Data® refers to as the valuation reward offered for above-average financial performance. This premium is at a record high 33% year-to-date, an incredible figure when considering that the range for the past two years was approximately 20%. Furthermore, GF Data® defines above-average financial performance as both EBITDA margins and revenue growth rates at above 10%, or with one factor above 12% and the other metric at least 8%. Deals with such characteristics have been more prevalent in larger transactions (\$100-250 million TEV), as the quality premium is reflected in the 10.3x multiple. Companies in the same group (ex-premium) generated an average multiple of 8.8x. On the other hand, smaller transactions of \$10-25 million averaged a 6.4x multiple for above-average performers and 5.6x for their counterparts.
- ❖ Average debt on deals completed in 2017 year-to-date was 4.3x for total debt and 3.3x for senior debt. While valuations have been lingering at high levels, debt levels are slowly but surely strengthening even further, as overall total and

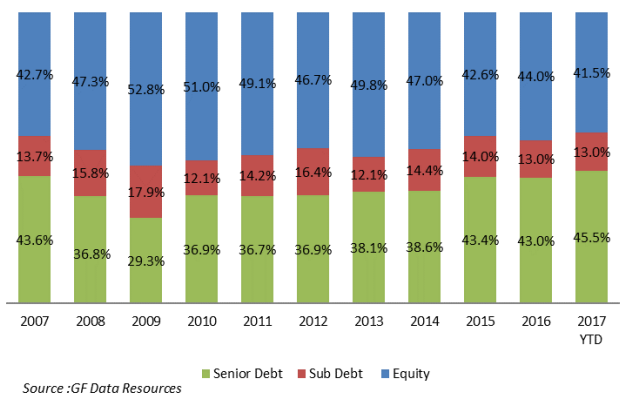


senior debt levels have never been higher. Historically, debt multiples have been on the rise since 2011-2013, when they averaged 3.4-3.5x, through 2015 and 2016, when they averaged around 4.0x.

- ❖ Bank financing is plentiful and aggressively structured and priced. Banks and other debt providers continue to push the outer limits on overall debt. The average capitalization now accounts for more than half an average buyout transaction's capital structure.

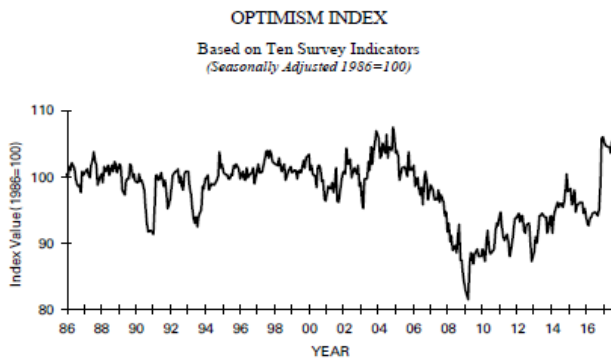
- ❖ According to Mr. Graeme Frazier, IV, GF Data® co-founder, the three main contributors to increases in leverage multiples are the need of debt providers to deploy, fear of losing market share, and flight to quality.
- ❖ High-yield credit spreads are at a three-year low. Higher leverage constitutes higher returns. According to Pitchbook the median debt percentage has increased to 56.3% of enterprise value and the median debt-to-EBITDA ratio has increased to 5.9x. Some suggest the emergence of additional risk, since a potential downturn could translate to lower debt-servicing ability.
- ❖ The equity contribution to a capital structure during the first six months of 2017 averaged 41.5% of a transaction's capitalization

Capital Structure Detail



- ❖ Several factors conducive to deal making remain in place. First, there remains a large amount of dry powder that needs to be invested. The investment window is now closing on those funds raised during the financial crisis between 2007 and 2011. Second, investors seek to access debt while rates remain low with ready availability. Finally, the deal sourcing seems to be improving, with the deep inventory of aged PE-backed portfolios and the development of the secondary buyout market.
- ❖ PEG's have a significant inventory of PE-backed companies sitting in their portfolios for three years or longer. The median holding period for a portfolio company remains in excess of five years.

❖ According to NFIB's Small Business Economic Trends, the Index of Small Business Optimism remained virtually unchanged, increasing only by 0.1 points to 105.3 in August and signaling continued owner optimism. Since there isn't any progress on the political front in D.C with pressing issues such as healthcare and tax reform, experts interpret this event as a mere "relief rally." Small business owners appreciate the fact that thus far in the new administration, there haven't been any costly federal regulations, unlike the past eight years.



**OPTIMISM INDEX**  
Based on Ten Survey Indicators  
(Seasonally Adjusted 1986=100)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
<b>2012</b>	93.7	94.5	93.1	94.2	94.0	91.9	91.5	92.7	92.7	93.0	87.2	88.0
<b>2013</b>	88.8	90.9	90.0	91.7	94.0	94.0	94.4	94.0	93.8	91.5	92.2	93.8
<b>2014</b>	94.0	91.6	94.0	94.8	96.2	95.4	96.0	95.9	95.3	96.0	97.8	100.3
<b>2015</b>	97.7	98.1	95.7	96.5	97.9	94.6	95.7	95.7	96.0	96.0	94.5	95.2
<b>2016</b>	93.9	92.9	92.6	93.6	93.8	94.5	94.6	94.4	94.1	94.9	98.4	105.8
<b>2017</b>	105.9	105.3	104.7	104.5	104.5	103.6	105.2	105.3				

❖ According to the August 2017 GF Data® Key Deal Terms report, there is an increase in mechanisms needed to bridge the economic gaps in this extended seller's market. One such example is the substantial increase in the utilization of rep and warranty insurance, as this metric increased from 7.5% of reported deals in 2016 to 34.0 % year-to-date. Also, the report shows that deals containing rep and warranties have closed at half a turn higher than deals without one, 7.2x versus 6.7x. Notably, these figures remained static for the past 18 months.

❖ Indemnification caps have declined across the board whether or not the deals contained rep and warranty insurance. The drop was more prevalent in the \$50-250 million Total Enterprise Value (TEV) deals, dropping by an astonishing 8% compared to only 3% in deals with a \$10-50 million TEV.

❖ Even though small business owners may find it difficult to anticipate the factors that will affect their business, especially when considering public policy uncertainty, capital spending is on the rise with 60% of respondents making capital expenditures. Of all purchases, the majority of funds were disbursed for new equipment and vehicles. Uncertainty brought by legislative gridlock in Washington D.C places additional emphasis on taxes, as they continue to be the most important concern among small business owners.

**TYPE OF CAPITAL EXPENDITURES MADE**  
Percent Purchasing or Leasing During Last Six Months

Type	Current	One Year Ago	Two Years Ago
<b>Vehicles</b>	24	22	22
<b>Equipment</b>	42	42	43
<b>Furniture or Fixtures</b>	9	12	13
<b>Add. Bldgs. or Land</b>	7	5	7
<b>Improved Bldgs. or Land</b>	16	16	14

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When considering a sale of your business, the acquisition of a business, or the restructuring or recapitalization of your balance sheet, the best pathway for achieving your expectations is a well-run process that addresses all your business and personal goals. Strategic Advisors is accustomed to working with business owners to determine the best pathway to achieve their goals and objectives. Give us a call to discuss your possibilities.

**Author:** Domenick Cristino, Investment Banking MBA Intern

**Sources:** Pitchbook – U.S Private Equity Breakdown 2Q 2017; Pitchbook – US PE Middle Market Report 2Q 2017; GF Data® August 2017 M&A Report; GF Data® Leverage Report August 2017, GF Data® Key Deal Terms Fall 2017, NFIB Small Business Economic Trends, August 2017.

#### **Important Information**

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