FALL 2020

PRAIRIE

Prairie Middle Market Perspective

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Cirris Systems Corporation

Overall M&A Market Commentary

Few people will forget the year 2020. The year started with an escape from a protracted China tariff war, a strong U.S. economy and an M&A bull market. The U.S. quickly devolved into a negative environment starting with the political turmoil of the impeachment process, the emergence of a global pandemic, the resulting rapid shutdown of the U.S. and global economies, then the patchwork reopening of the U.S. economy, the civil unrest that resulted in destructive rioting in many U.S. cities, the large brush and forest fires in California, Colorado and other states, a presidential race with intense political bickering between the political parties, the death of Justice Ginsberg creating a controversial Supreme Court opening and President Trump contracting and recovering from the COVID-19 virus. What other calamities can possibly still occur in 2020?

The COVID-19 virus and our success in dealing with the pandemic is the single greatest factor affecting the strength and speed of the economic recovery. The highly contagious, somewhat lethal virus has created ***fear and uncertainty*** throughout the U.S. The pandemic continues to affect the human psyche, the pace of business openings, our ability for normal social interaction and even how we conduct business. The dreaded second wave of the pandemic weighs on the minds of many. Meanwhile, the medical profession has quickly developed multiple successful treatment protocols, helping reduce the virus death rate. In addition, the pace of vaccine and therapeutic drug development has been rapid, with several promising drugs potentially available this year. There are numerous reasons for optimism.

Seemingly decoupled from the pandemic with the exception of certain sectors, the U.S. equity markets have improved at a record pace, making up most, if not all of the value lost from the early pandemic. According to Steve Andrews, an economist with Webster Bank, “We have seen a pretty substantial ‘V’ shaped recovery over the last six months, which is one of the reasons why stocks have performed so well. From here out, the gains will appear more subdued, which have some pundits worrying that the recovery is losing steam. We’re not in that camp. While we have ‘lost’ 15 - 20% of the economy, thanks to

the shutdowns, the other 85% is getting back to a new normal, which has gotten us to this point."

In 2Q20, the M&A market activity continues to be muted. More sellers and their advisors are beginning to consider a company sale, but they are cautious about entering the market. The effects of the pandemic were negative to many companies, but some have benefited. The deals that successfully closed have traded at high valuations. These transaction closings seem to show a bias toward companies with strong operating performance, pandemic resilience and other positive factors. There is also evidence that many of the deals closed in 2Q20 are businesses acquired by strategic buyers or PE portfolio company add-ons. Supporting this assertion, GF Data reports that in 2Q20, new PE platform investments comprise only 45% of PEs new deals down from 75% in the 2017 to 2019 timeframe.

Uncertainty and perceived risk in the economy has had a negative effect on the M&A market. But buyer demand for new deal opportunities remains strong, especially for those companies with good performance during the pandemic. We encourage business owners who are interested in pursuing a sale to seek the counsel of their investment bankers and carefully develop a strategy to approach the market. We believe that well-prepared companies that have shown resilience during the pandemic will be well-received in the marketplace. Preparation is key. Preparation will significantly increase the likelihood of a successful transaction. Prairie Capital Advisors ("Prairie") is ready to assist you in developing a strategy for the sale of your company.

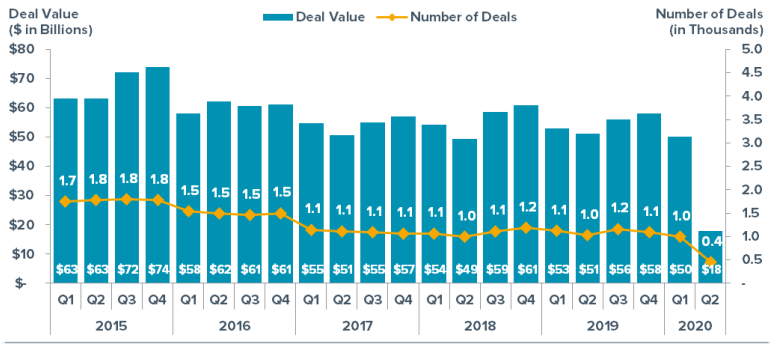
We experienced a continuation of the 2019 M&A bull market through the first few months of 2020 with many sellers achieving premium valuations. As of this writing, it appears as though M&A valuations have not been seriously impacted with successfully closed deals maintaining pre-pandemic valuation levels. Due to the extended period that private company M&A market data is collected, there is a one quarter lag in our information. As a result, the market commentary reflected below considers the 2Q20 data, from the beginning to middle of the pandemic deal environment.

M&A Market Activity

While a portion of the deals closed in 2Q20 were started pre-pandemic, a growing portion of the M&A deal activity in 2Q20 reflects the full pandemic impact. Business owners and their advisors attempted to determine the effects of the pandemic on the economy and their businesses. In most cases, a decision was made to delay a sale until the pandemic uncertainty was better known. As a result, new M&A deal activity in this quarter was dramatically reduced.

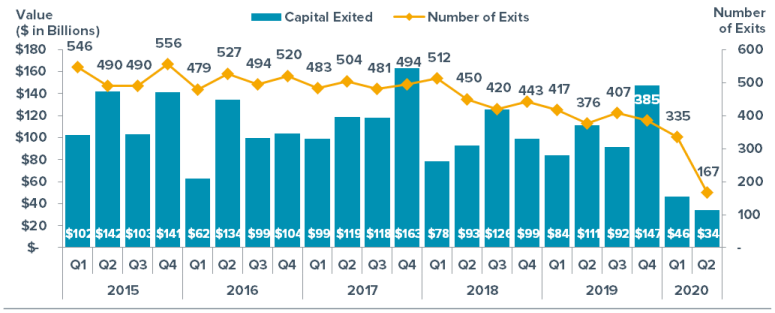
- $18 billion of middle-market deals recorded in 2Q20 was down 64.0% from the value in 1Q20. Additionally, in year-over-year comparisons, 2Q20 deal value was down about 64.7% when compared to 2Q19.
- The number of middle-market closed deals in 2Q20 decreased 60.0% compared to the number of closed deals in 1Q20. Further, in year-over-year comparisons, the number of deals in 2Q20 was also down 60.0% from 2Q19's tally.
- The average middle-market deal size of $48.6 million in the first half of 2020 was 1.9% smaller than the average $49.5 million deal size closed in the first half of 2019.

Total U.S. M&A Deal Volume and Value <$300M Transaction Value
2015 to Q2 2020



Source: Capital IQ

Private Equity Exits
2015 to Q2 2020



Source: Pitchbook

Private Equity ("PE") 2Q20 exit activity showed a similar negative trend as in the overall M&A market. On a year-over-year basis, the number of PE exits in the first half of 2020 decreased 36.7% from the number of exits in the first half of 2019, while the capital exited decreased 58.8% during the same period.

PE-owned companies, like all U.S. businesses were affected by the pandemic. Many PE funds are focused on their troubled portfolio companies and have been less focused on buying and selling businesses. Further, the PEs, like all sellers are looking at the pandemic effects on their companies to determine if the timing is right for an M&A sale. Like other sellers, in most circumstances, PEs seem to have decided to wait to sell their portfolio companies.

Middle Market Deal Valuations

The 2Q20 M&A market data has started to reflect the full effect of the pandemic on the deal business. During early 2Q20, normal business activities slowed, and M&A transactions were dramatically reduced. Given the low transaction volume this quarter, the number of valuation data points is very limited. According to GF Data, an M&A information source, this limited data appears to show that during 2Q20, valuations have not experienced a significant reduction from pre-pandemic levels. There may be an element of "survivors bias" to the current valuation data in that only strong, pandemic resilient company deals have been able to close in 2Q20.

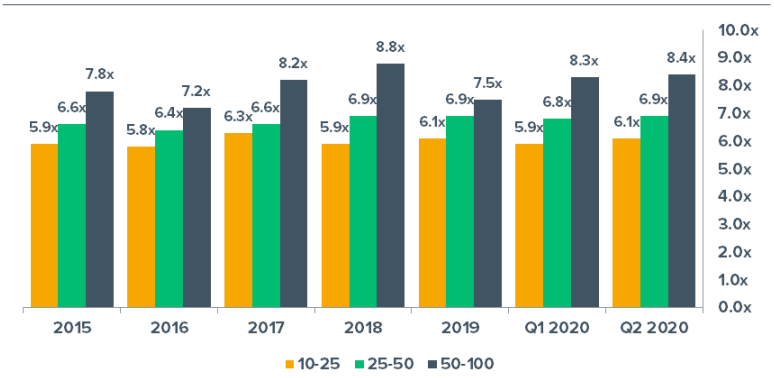
In addition, we believe the continued deal market supply/demand imbalance further helped sustain elevated deal valuations in 2Q20. The abundant PE buyer funds and well-capitalized strategic buyers helped keep valuations in line with pre-pandemic levels. While the 2Q20 deal valuations continue at elevated levels, we believe most active PEs and strategic buyers are bargain hunters. Sellers need to develop a strategy and carefully position their companies in the M&A market to avoid leaving value on the table.

Preparation will be key to justify a higher valuation. Our advice is to seek guidance from an experienced M&A advisor and begin to prepare your businesses for a sale process. Well-prepared sellers with companies that fit with these buyers will still receive strong interest and attractive valuations.

While the 2Q20 data contains a mixture of deals started both pre-pandemic and during the pandemic, the skew is trending more toward pandemic deals. Also, because quarterly data is more volatile than annual data, we suggest focusing on trends rather than actual values in the quarterly data. It is remarkable that valuations have not yet declined during the pandemic.

- Sub-$25 million deal valuation multiples moved slightly higher in 2Q20 to a 6.1x multiple, which is just above the long-run average of about 6.0x for this size category.
- Larger middle-market valuations ($50 to $100 million segment) moved higher in 2Q20 to 8.4x, higher than the long-run average of 8.0x for this segment.
- Valuations in the $25 to $50 million segment moved slightly higher to 6.9x, which is consistent with the level of this size segment for the last two years.

TEV*/EBITDA by Deal Size ($ Millions)
2015 to Q2 2020



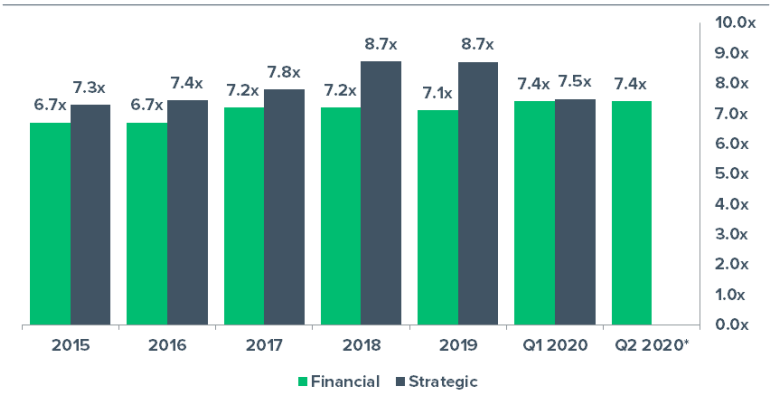
Source: GF Data
**TEV = Total Enterprise Value*

Private Equity versus Strategic Valuations

Strategic buyers continue to be active in the M&A market during the pandemic. Strategic buyers believe that the pandemic provides them with the opportunity to look for deal bargains and make acquisitions to add to their product or service offerings. Depending on the sector and the buyer's "turnaround skills" there are opportunities for strategic buyers to acquire distressed companies that have been significantly impacted by the pandemic. In 2Q20, the data appears to indicate that the strategic community found a few bargains.

- Strategic buyers continue to be active participants in middle-market M&A. In 2Q20, strategic buyers, on average, paid lower prices than financial buyers. Quarterly data is volatile, but it looks like strategic bargain shopping.
- Over the last three years, EBITDA multiples paid by PE buyers have remained in a stable range above 7.0x.
- The valuation long-run data suggest that strategic buyers typically pay more than PEs in the M&A market. However, the current quarter does not reflect that trend. This is likely due to the strategic bargain shopping.
- Prairie estimates that for middle-market deals below $50 million, valuations are generally 1.0x to 2.0x multiples of EBITDA lower than the levels reflected in the chart on below.

TEV/EBITDA Multiple by Buyer Type ($10-250M of TEV)
2015 to Q2 2020



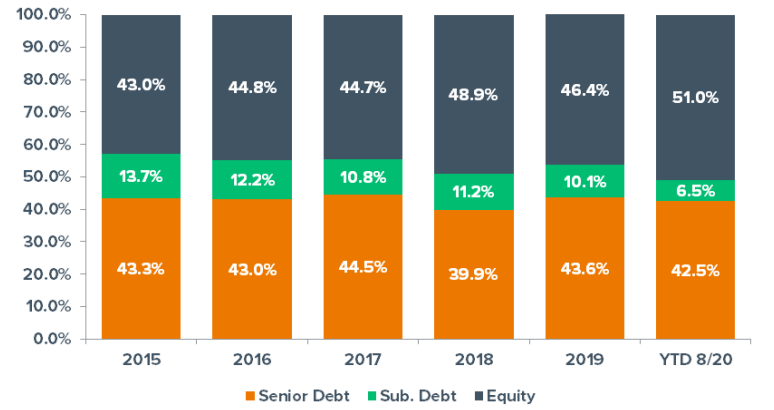
Source 1: Financial Buyers: GF Data ($10-250M TEV)
Source 2: Strategic Buyers: Capital IQ ($10-250M TEV; Excluding outliers defined as transactions with TEV/EBITDA of less than 3.0x and more than 14.0x)
**Due to the limited number of transaction multiples for strategic buyers in this quarter, strategic buyer data was excluded*

Middle Market Leveraged Buy Out Capitalizations

As noted in our prior edition, the use of total debt (the combination of senior and subordinated debt) in a typical acquisition capital structure is trending lower. Due to more conservative lenders and lower debt availability, equity represented almost half of a typical leveraged buyout ("LBO") capital structure in 2Q2020.

- Up until the pandemic, debt capital was readily available. Commercial banks, asset-based lenders, business development corporations ("BDCs") and mezzanine lenders were anxious to support acquisitions and growth financing situations.
- While there is liquidity for new loans, the mid-pandemic lending market is growing more conservative. Deals are seeing less financial leverage, higher debt pricing and more lender driven terms, reflecting the increased uncertainty of the current business environment.
- Uncertainty is leading BDCs to be less aggressive, creating an opportunity for banks. But this same uncertainty is leading banks to be even more conservative, leading to reductions in the amount of debt deployed in deals.
- Mezzanine funds have increased their activity in leveraged transactions in 2Q20, but this capital has a high interest rate that can stress a company's cash flows. Interest-only and payment-in-kind ("PIK") structures still dominate the markets, but in the current environment, the use of equity co-investment structures may increase to match mezzanine returns with the deal risk profile.

Equity and Debt Capitalization
2015 to YTD 8/20



Source: GF Data

Overall Comment on the Financing Markets

The U.S. financing markets continue to be healthy with a watchful Fed ready to step in and support the banking system. Early in the pandemic, lenders were accommodating, providing many borrowers with principal and interest deferrals, along with streamlined loan amendments. The phrase *"amend & extend"* became a popular credit memo term in many banks' lending departments. These lender accommodations are becoming far less frequent and many borrowers are now facing the reality of the new pandemic lending environment.

Government support helped early in the pandemic. The Payment Protection Program ("PPP") loans were essential to support small businesses during the economic shutdown. Over the last few months, these loans were extended and restructured to further support middle-market businesses. Many PPP loan recipients are now beginning the application process to convert the loans into grants, eliminating the repayment burden. Conversely, the Main Street Lending Program has not been as well-received as the PPP loans and has provided limited assistance to larger businesses negatively impacted by the pandemic. Business support programs are hung up in the dysfunctional Congress, with little additional support expected in the near-term.

Banks and unregulated lenders have abundant liquidity to make new loans and support the M&A market, however, uncertainty is creating a more conservative lending environment. While the stock market has recovered quickly from the pandemic shutdown, many lenders expect future revenue and earnings growth to slow as the effects of the pandemic continue to linger through the end of this year and potentially into 2021.

On the new deal front, lenders are requiring more equity in M&A deals, with many expecting at least half of the capital structure in the form of equity. The pre-pandemic "3 x 4" (3x senior debt with 4x total debt) capital structure is now giving way to the new pandemic market "2.5 x 3.5" structure. The pandemic has shifted to a "lenders market" in which the banks are generally dictating the pricing, structure and terms.

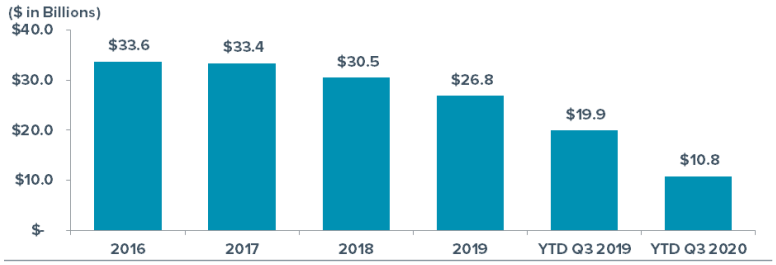
As the pandemic continues, the distressed deal market is expected to grow. More than 60 distressed deal funds are currently raising capital to invest in future transactions. Furthermore, the banks are all expanding their workout groups in anticipation of a growing number of problem credits.

Fortunately, the banks were well capitalized and in good condition before this crisis. While finding credit is more difficult and takes longer to obtain, we still have a strong banking sector supporting the business community. Acquirors will have to accommodate a longer financing process and potentially more conservative and expensive capital structures. This may lead to lower valuations in the near-term.

Total U.S. Middle Market Loan Issuance

- New bank loan issuance for middle-market companies in YTD3Q20 was 45% lower than the $19.9 billion issued in YTD3Q19. The downward trend in new commercial and industrial ("C&I") loan issuance already observed over the last few years was further exacerbated by the pandemic-driven economic slowdown.
- The banking system being essential to the economy, the Fed pledged to any steps necessary to support the banks and maintain sufficient liquidity in the banking system. While banks have abundant funds for loans, loan growth was negatively impacted by reduced economic activity, lower M&A transaction volume and less credit worthy borrowers.
- Up until the pandemic, bank lenders continued to focus on relationship banking, corporate borrowers' lines of credit and areas where they have a competitive advantage like operating business needs, including payroll and checking accounts. Due to regulatory scrutiny and the pandemic, banks are careful in making new loans and are very selective in new leveraged transactions.

Loan Issuance for the Middle Market <$100M
2016 to YTD Q3 2020



Source: Thomson Reuters

Interest Rate Environment

- As stated in our prior edition, the year-over-year comparison of the short-end of the yield curve (Prime and one-month LIBOR) reflects the Fed's support of businesses and the banking system in the early pandemic period. The Prime rate and LIBOR reflect a Fed induced shift lower to support the financial system.
- The pandemic, and the resulting flight to safety has increased the slope of the yield curve in 3Q20, but at a much lower interest rate level. The 2 Year to 10 Year Treasury differential was 34 basis points at the end of 2019 and it is 55 basis points at the end of 3Q20.
- The PPP and the Main Street Lending Programs provided favorable financing for borrowers and these programs have evolved over the last few months. These Federal lending programs and the very low interest rate environment provides creditworthy companies opportunities to borrow at favorable interest rates.

FINANCIAL INDICATORS

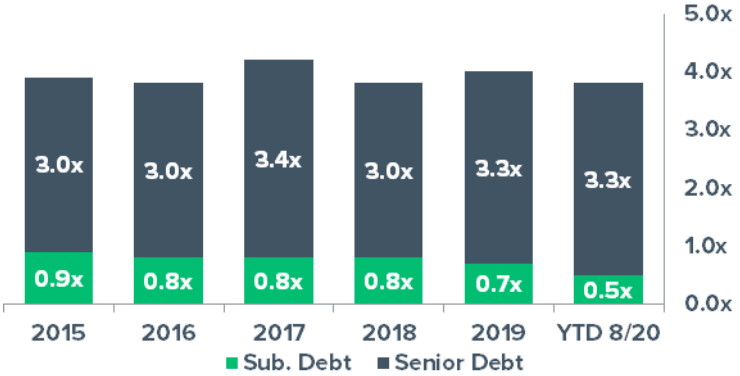
	9/30/2019	9/30/2020	10/15/2020
Interest Rates			
Prime Rate	5.00%	3.25%	3.25%
Libor - 1 Month	2.02%	0.15%	0.15%
Libor - 3 Month	2.09%	0.23%	0.22%
U.S. Treasury - 2 Year	1.63%	0.13%	0.14%
U.S. Treasury - 5 Year	1.55%	0.28%	0.32%
U.S. Treasury - 10 Year	1.68%	0.69%	0.74%
Stock Market			
Dow Jones Industrial	$26,917	$27,782	$28,494
S&P 500	$2,977	$3,363	$3,483
NASDAQ Composit	$7,999	$11,168	$11,714
Commodities			
Gold ($ per troy ounce)	$1,480	$1,888	$1,909
Crude Oil ($ per barrel - WTI)	$53.98	$40.47	$41.24

Source: Capital IQ

Middle Market Debt Multiples

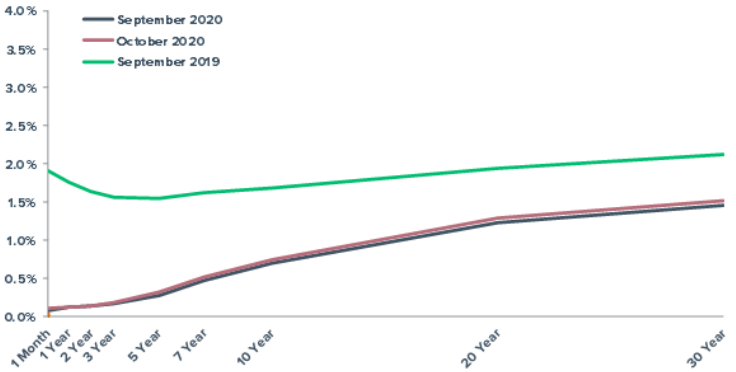
- Average total debt leverage in middle-market deals was 3.8x in the first eight months of 2020, down from 4.0x observed in 2019. While the senior debt component of the total leverage stayed at 3.3x during both periods, more conservative lending behavior will likely lead to a reduction of the senior debt multiple through the end of this year and into early 2021.
- We believe mezzanine capital will play an important role in a leveraged capital structure as we exit the pandemic environment. Over the past five years (2015-2019), on average mezzanine debt represented 0.8x EBITDA in the typical capital structure because banks disintermediated the mezzanine capital. Given more conservative bank lending in the current environment, mezzanine capital will likely become a greater component of the capital structure in the near-term.
- The use of debt capital before the pandemic helped sustain high middle-market M&A valuations. While valuations have generally remained at pre-pandemic levels in the current data set under review, we believe a more conservative lending environment may lead to downward pressure on valuations.
- Regulators enforce credit discipline in the banking community. The regulators limit the amount of Highly Leveraged Transaction ("HLT") exposure that a bank can hold which has resulted in conservative senior leverage levels.

Senior Debt and Sub. Debt/EBITDA – TEV of $10-250 Million
2015 to YTD 8/20



Source: GF Data

Yield Curves – U.S. Treasuries



Source: Capital IQ

Financing Pricing

Bank Financing	Upfront Fees	LIBOR Spread
Asset Based Loans	25-50 bps	150-200 bps
Cash Flow Loans (Now Subject to 1% LIBOR Floor)		
EBITDA less than $10M		
Unleveraged Loans	0-50 bps	200-300 bps
Leveraged Loans	75-150 bps	350-475 bps
Cash Flow Loans (Now Subject to 1% LIBOR Floor)		
EBITDA more than $10M:		
Unleveraged Loans	0-50 bps	200-300 bps
Leveraged Loans	100-150 bps	400-525 bps
Mezzanine Debt	**<$10M EBITDA**	**>$10M EBITDA**
Upfront Fees	2.00%	2.00%
Current Pay Coupon	11.00%-13.00%	10.00%-12.00%
Payment-in-Kind (PIK) Interest	0.00%-3.00%	0.00%-2.00%
All in IRRs	14.00%-17.00%	10.00%-13.00%

***Source**: Pricing is based on guidance provided by a number of commercial and mezzanine lenders*

***Note**: Warrants and other yield enhancements comprise the incremental return required to meet the all-in internal rate of return ("IRR")*

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Transaction Highlight

M&A Advisory

CIRRIS SYSTEMS

was acquired by

Schleuniger

Advisor to the Seller

About Cirris Systems Corporation

Founded with a single testing product in 1984, Cirris has grown to become a leader in the development and production of wire and harness test equipment, including testers, adapters, software, accessories and custom products. Headquartered in Salt Lake City, Utah, the company serves customers in over 20 countries on all seven continents. Prior to the transaction, Cirris Systems Corporation was an employee-owned company.

Cirris Systems Corporation has been acquired by The Schleuniger Group. The Schleuniger Group is a subsidiary of the Swiss publicly-traded firm The Metall Zug Group, an industrial holding company headquartered in Zug, Switzerland.

About Prairie Capital Advisors

Prairie offers investment banking, ESOP advisory, valuation advisory and financial reporting valuations to support the growth and ownership transition strategies of middle-market companies. Headquartered in Oakbrook Terrace, Illinois, the company is a leading advisor to closely-held companies nationwide.