Prairie Middle Market Perspective

SPRING 2022

PRAIRIE

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Overall M&A Market Commentary

The extraordinary 2021 M&A market saw record levels of middle-market deal activity, even with significant transaction processing constraints toward the end of the year. Deal resources including quality of earnings accountants, representation & warranty insurance providers, lawyers and even investment banker time were in scarce supply. The whole deal community shifted to close the deals already in process rather make new business pitches and prioritized higher-quality, larger deals over smaller, lower-quality deals. This produced a new business "backlog" that was supposed to prime the 2022 M&A market and sustain the M&A bull market.

While 2022 had strong prospects to be another record year in middle-market M&A, economic and business ***uncertainty*** has increased significantly and seems to have already affected the deal market. Economic uncertainty started in 2021, as the unexpectedly robust post-pandemic recovery and excessive government stimulus spending created outsized demand for goods and services. This resulted in shortages across all sectors of the economy, logistical bottle necks and supply chain issues. Scarce labor across the economy led to pay increases to attract workers and wage inflation. The supply chain issues and shortages led to increased costs of almost all raw material inputs, further exacerbating the inflationary environment. Increased global demand for energy in the post-pandemic environment, coupled with an intentional move to place greater reliance by the U.S. on foreign energy sources, led to further domestic inflationary pressure from higher energy costs. By the end of 2021, U.S. inflation was at a 40-year high. While this inflation was dubbed "transitory" in early 2021, it soon became apparent that many costs, like wage increases, were more permanent in nature, creating a complicated, persistent inflation problem. The Russian invasion of Ukraine, new 2022 COVID-19 lockdowns in China and an increasing trend towards "reshoring" in the U.S. will further complicate the U.S. inflation problem in 2022 with the anticipated additional energy market and global supply chain disruptions.

The U.S. Economy remains strong but is facing headwinds because of inflation, raw material shortages, labor availability and other issues. The March 2022 Jobs report showed significant jobs growth. However, total U.S. employment remains below the pre-pandemic levels—the unemployment rate and number of people employed is still not at the levels of late 2019. Further, the March average annual wage growth of 5.6% is well below the March annual average Consumer Price Index of 8.3%, meaning the workforce lost ground on purchasing power because of inflation. Consumer spending drives around 70.0% of the U.S. economy, so real wage growth and employment are important factors. According to Reuters, even with record amounts of savings, U.S. consumer spending was flat in February, largely due to inflation-induced price

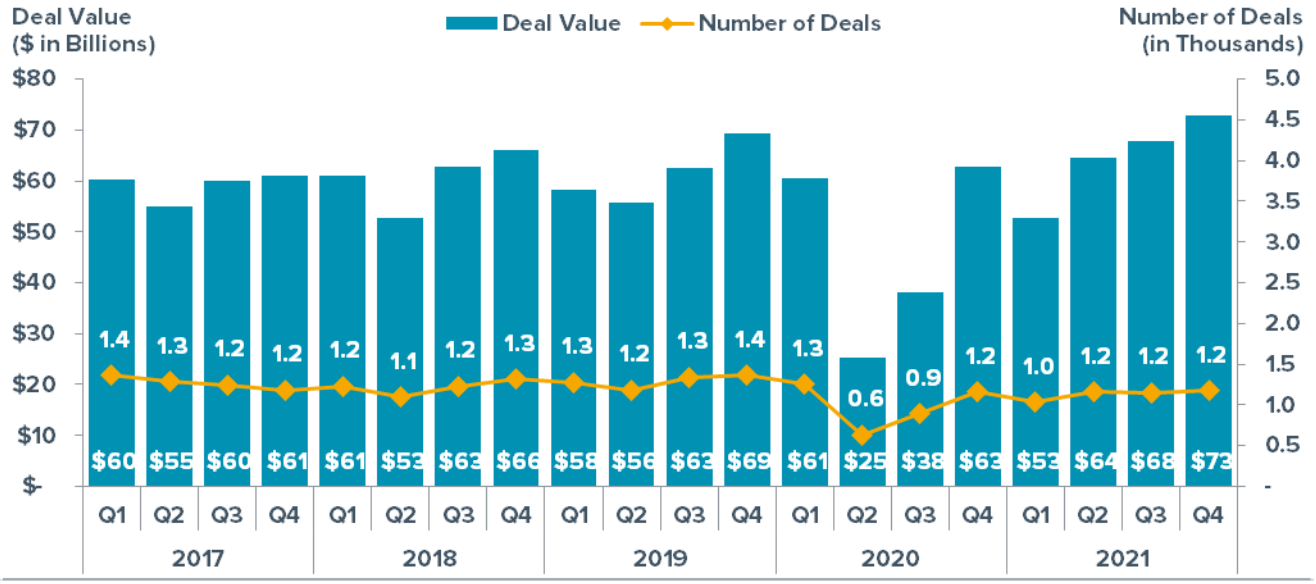
pressures and concerns about the future. The March Michigan Consumer Sentiment survey was 59.4, the lowest reading since August 2011. Reduced living standards due to inflation was listed as the primary cause of consumer pessimism. Further, the March 2022 Ipsos Right Direction/Wrong Track polling data showed that 61.0% of the sample thinks the U.S. is on the wrong track with the economy and indicated jobs as the survey participants' major concern. Clearly, the consumer is becoming worried about the future, which does not bode well for the economy.

The odds of a recession are increasing. In mid-March, Goldman Sachs put the probability of a recession in the next year as high as 35.0%, citing weakening consumer sentiment, higher oil and commodity prices and the war in Ukraine. Adding to the near-term recession argument is the inversion of the treasury yield curve during the last week of March. At the end of March, the 2-year U.S. Treasury yield was about 3 basis points higher than the 10-year U.S. Treasury. Since late March, the 2-year Treasury has bobbed both above and below the 10-year yield. According to MarketWatch, an inverted yield curve is "a phenomenon widely described as a reliable indicator of future recession, albeit with a lag that can stretch to a year or more." We will continue to watch the yield curve for an inversion and its signal on a potential recession.

So, what do all these factors mean for the middle-market M&A? There is still strong demand for acquisition opportunities by both strategic and financial acquirors. Valuations continue to be at elevated levels for companies of all sizes in a wide variety of industries. There is abundant financing available for acquirors to make deals, but as the Fed raises interest rates and financing costs increase, valuations will start to decline. The market is still very receptive to new deals, but a waning consumer segment, continuing inflation issues and a potential recession will negatively impact the M&A market. While we are predicting 2022 will be another strong M&A market, we believe the "sellers' market" window is beginning to close. Company owners with a desire for a liquidity event should begin to consider their alternatives immediately and make plans to enter the market in 2022.

Due to the extended period that private company M&A market data are collected, there is a one-quarter lag in our information. As a result, the market commentary reflected below is limited to the data through 4Q21. Our 1Q22 data is still preliminary and will be reviewed in the next quarterly newsletter .

Total U.S. M&A Deal Volume and Value <$300M Transaction Value
2017 to 2021



Source: Capital IQ

M&A Market Activity

M&A dollar and deal volume during 2021 showed a strong recovery from the pandemic-afflicted year of 2020. Recorded deal value for 2021 was $258 billion, up from the $187 billion recorded in the pandemic year 2020 and the highest annual dollar volume since 2015. Deal activity hit full steam in 2021. If not for the late 2021 capacity issues, the volume of activity may have been even higher. While we believe many deals shifted to 2022 from late 2021, our preliminary read on 1Q22 activity shows deal volume down about 30.0% compared to 1Q21. Perhaps inflation, labor availability, supply chain problems, the Ukraine war and other issues are already affecting the early 2022 M&A market.

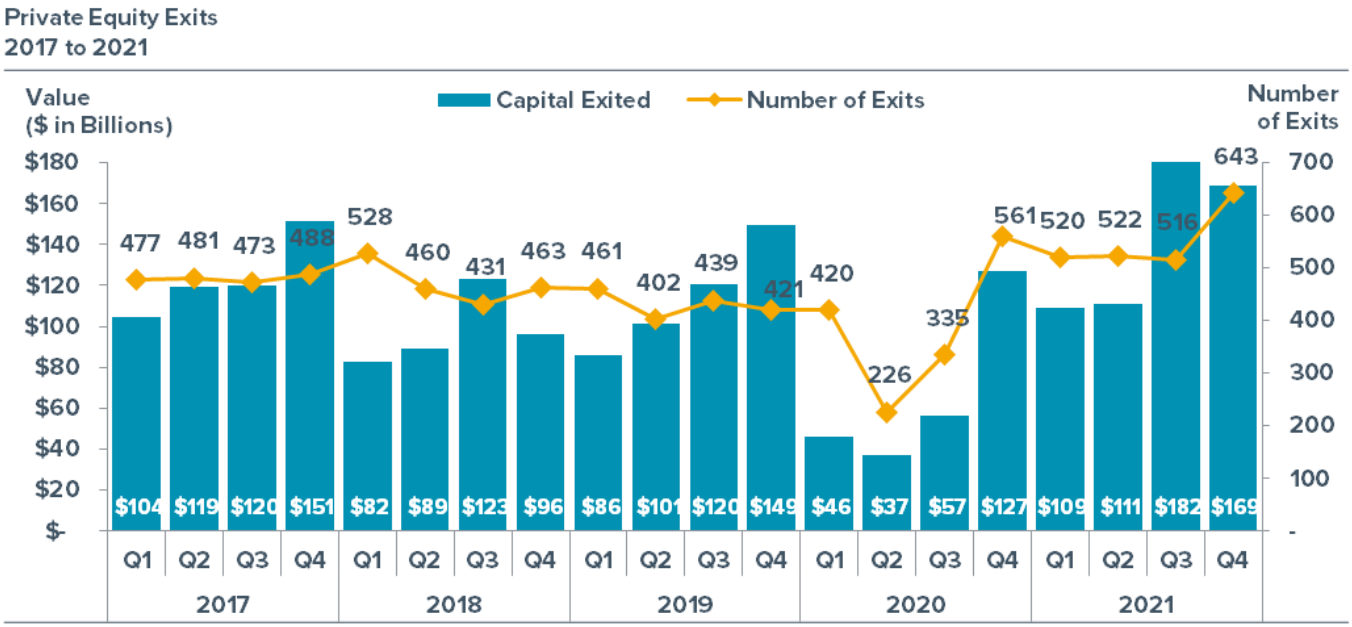
- $73 billion of middle-market deals were recorded in 4Q21, up 15.9% from the value in 3Q21 and, in year-over-year comparisons, 2021 deal value was up 38.0% compared to the pandemic year 2020.
- The number of middle-market deals closed in 4Q21 was flat to the number of deals closed in 4Q20. In year-over-year comparisons, the number of deals in 2021 was up 15.0% from the pandemic year 2020.
- The average middle-market deal size of $56.1 million in 2021 was about 20.0% greater than the average $46.8 million deal size closed in 2020.

Like the overall M&A market, private equity ("PE") exit activity was strong in 2021. The number of PE exits in 4Q21 increased 24.6% from the number of exits in 3Q21, while the capital exited decreased 7.4% during the same period. Our data suggest that the PEs also experienced scarce deal market resources in the 4th quarter, shifting some of the closings forward into 2022.

Strong buyer demand for good-quality, well-prepared companies was unabated in 2021. Both strategic and financial buyers continue to actively participate in the M&A market with plenty of resources to consummate deals. While the current M&A market is still strong, there appear to be growing headwinds, which could reduce future activity and valuations.

Middle Market Deal Valuations

Middle-market deal flow in 2021 showed characteristics of an extraordinary M&A bull market. Abundant PE fund commitments, well-capitalized strategic acquirors, a rapidly recovering economy and plentiful low-cost financing produced favorable M&A market conditions. Many sellers entered the 2021 market, taking advantage of these favorable market conditions. Even with the rapid escalation in M&A activity, the demand for good acquisition assets exceeded the number of available companies helping sustain valuations.



Source: Pitchbook

It appears this trend will continue into early 2022. There is strong demand for deals and abundant financing for transactions, which should support valuations in the short run. However, inflation and other economic issues could begin to put a drag on the M&A market, which could negatively impact valuations later in the year.

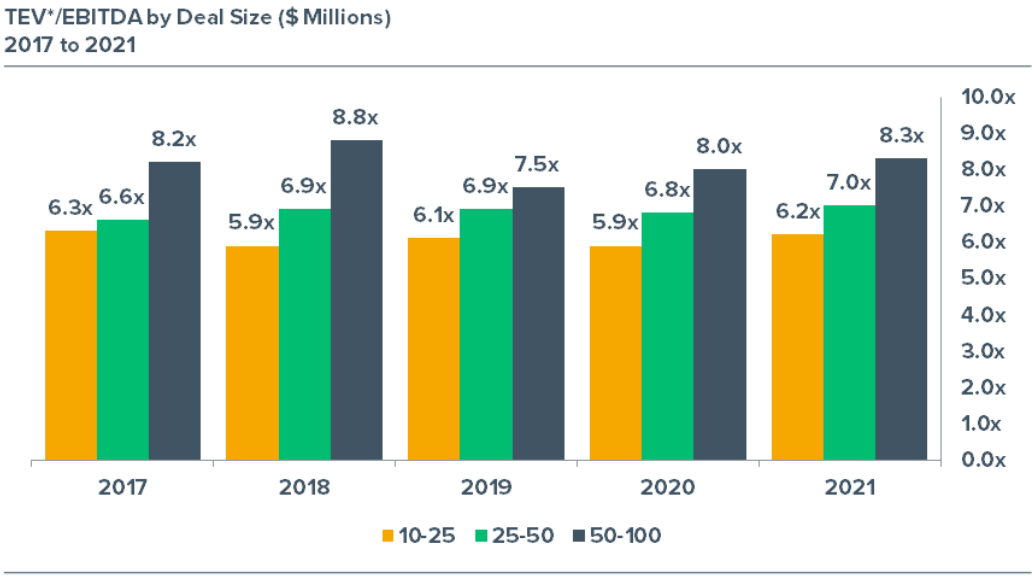
PE buyers are the M&A market juggernauts, striving to deploy over $3 trillion of undeployed, time-limited fund commitments. In Jamie Dimon's annual letter to JPMorgan shareholders, he made the following observations germane to PEs: "The role of banks in the global financial is diminishing. Possibly more important: The role of public companies in the global financial system is also diminishing. In addition to banks' shrinking global role, you can see that the number of public companies, which should have grown substantially over the past decade, is remarkably reduced. Instead, U.S. public companies peaked in 1996 at 7,300 and now total 4,800. Conversely, the number of private U.S. companies backed by private equity companies has grown from 1,600 to 10,100—a remarkable increase." The importance of PE buyers in the M&A market cannot be understated.

Our strategic acquisition data includes deals made by public companies, privately-owned companies and PE-owned strategic acquirors. On the strategic buyer front, we believe that inflation and supply chain issues have momentarily distracted the strategic buyers and have caused them to be more conservative in acquisitions. However, their distraction has been more than offset by the aggressive PE community. Our data suggest that 4Q21 valuations are rapidly returning to, and in some cases exceeding, the pre-pandemic levels.

We may be near the end of the "sellers' market," which makes preparation an even more important part of the sales process. Sellers and their advisors must develop a compelling investment thesis and a well-thought-out company positioning strategy to complete a successful sale. Sellers must be well-prepared and ready for a rigorous deal process. The time and effort invested upfront in preparing for a sale will ensure that sellers receive strong buyer interest and attractive valuations in this turning M&A market.

The 2021 annual data show a return to the "enthusiastic" valuation trends observed in the pre-pandemic period of 2017 and 2018. The low interest rate environment and strong demand by acquirors supported these valuations.

- 2021 deal valuation multiples for the sub-$25 million category came in at 6.2x, slightly above the long-run average for this size category. Smaller deals are easier to finance, which helps support valuations in a narrow range.
- Larger middle-market valuations ($50 to $100 million segment) in 2021 moved to 8.3x, only exceeded by the pre-pandemic 2018 multiple high of 8.8x for this size category.
- Valuations in the $25 to $50 million segment also moved significantly higher to 7.0x, which is higher than the five-year average.



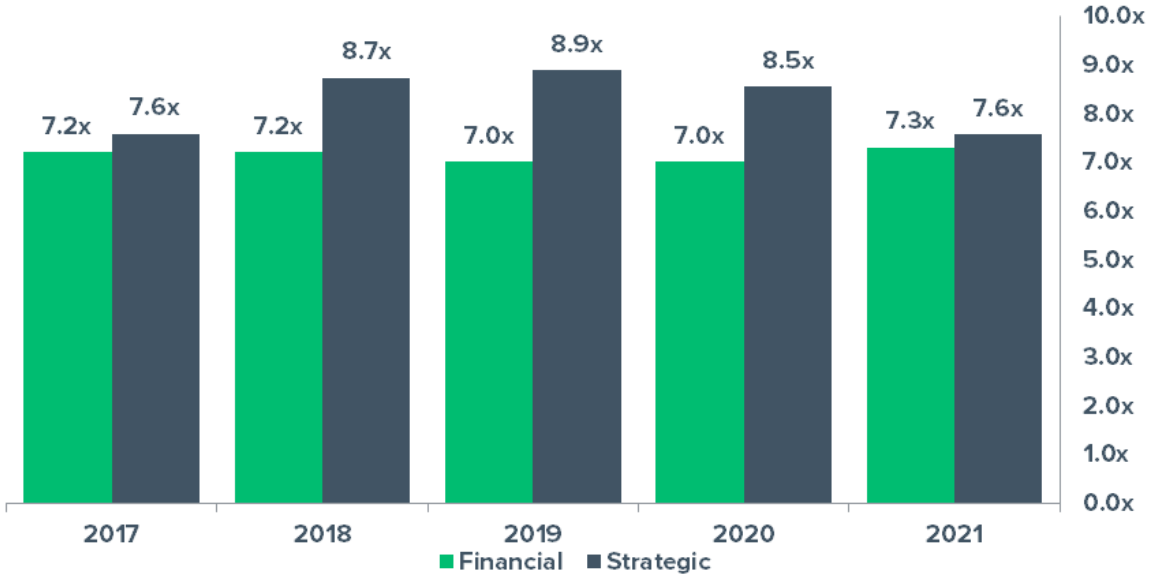
Source: GF Data
**TEV = Total Enterprise Value*

Private Equity versus Strategic Valuations

Strategic buyers are always a major factor in the M&A market. Synergistic cost savings, access to new customers and other revenue opportunities provide strategic buyers with the ability, but not the need, to pay more than the typical financial buyer. It appears current market conditions have changed strategic buyer behavior. Our 2021 data show that the strategic buyer community has pulled back on aggressively pursuing M&A transactions and is choosing to pay less of a premium to acquire businesses. As we cited last quarter, we believe inflationary pressures, labor issues and supply chain disruptions, which picked up momentum in the second half of 2021, may have caused strategic buyers to focus more on their own operations. While still making acquisitions, the strategic buyers appear to be more conservative in their offers to buy companies, thus avoiding the complications of making high-priced acquisitions facing similar issues.

- Strategic buyers continue to be active participants in middle-market M&A. In 2021, strategic buyers, on average, paid a slightly higher multiple of cash flow than PEs.
- Over the last five years, EBITDA multiples paid by PE buyers have remained in a range centered around 7.0x. The valuation data through 2021 indicate PEs are currently paying slightly above trend for new deals.
- The valuation data of the last few years suggest that strategic buyers tend to pay a premium of at least 1.5x when compared to PE firms in the M&A market. But in the current market, the strategic premium is greatly reduced.
- Prairie estimates that for middle-market deals below $50 million, valuations are generally one to two multiples of EBITDA lower than the levels reflected in the chart below.

TEV/EBITDA Multiple by Buyer Type ($10-250M of TEV)
2017 to 2021



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)

Middle Market Leveraged Buy Out Capitalizations

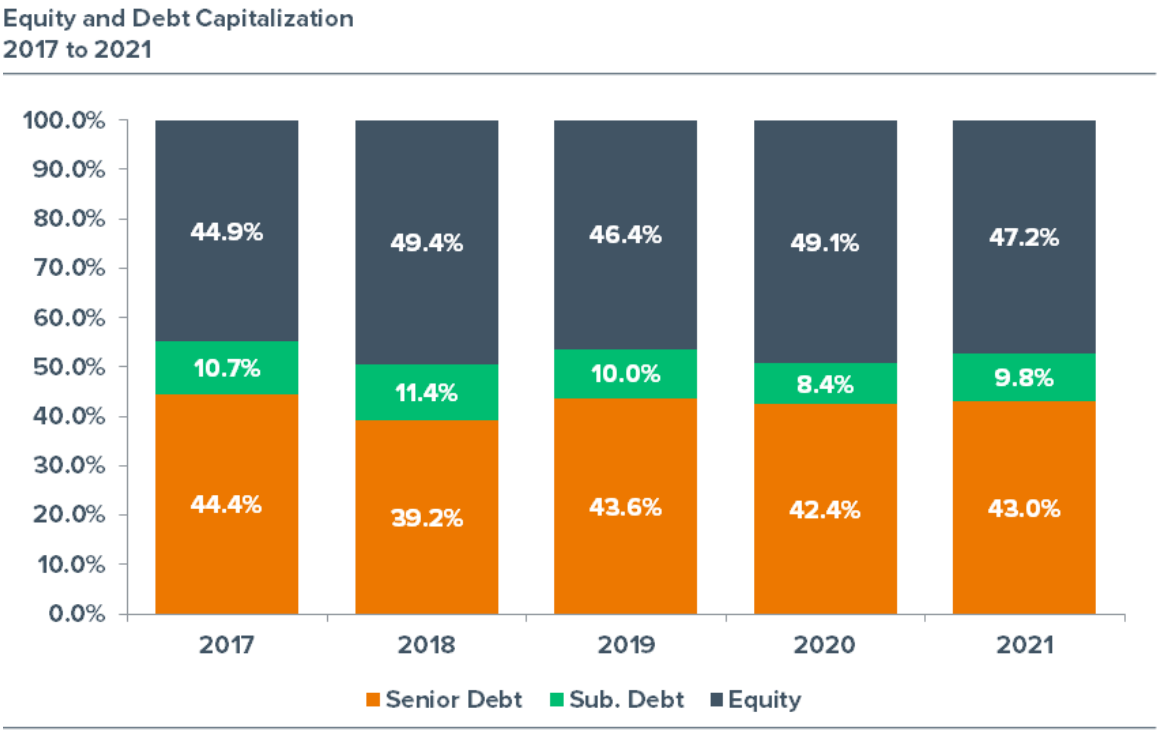
Middle-market deal capitalizations are conservative, with equity comprising just under 50.0% of the typical deal capital structure. Debt capital has been abundant throughout 2021. Almost every segment of the lending market has attempted to increase the capacity of their lending operations to accommodate more deal flow but, like other areas of the economy, finding employees has been difficult. Commercial banks, asset-based lenders, business development corporations ("BDCs") and mezzanine lenders continue to support acquisitions and growth financing situations.

- There is strong loan availability in the current market, but generally with terms more conservative than before the pandemic. Deals are seeing less financial leverage, higher debt pricing and more lender-friendly terms, reflecting the perceived uncertainty and overall business risks in the current environment.
- BDCs are becoming a bigger factor in the deal market and are being more aggressive in pursuing new lending opportunities. The reemergence of the BDCs has begun to force more aggressive deal structures and better loan pricing for borrowers.

Mezzanine funds have continued to be active in leveraged transactions in 2021. 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.

Overall Comment on the Financing Markets

Through the end of 2021, the U.S. economy continued to grow and recover as we emerged from the pandemic. The final 4Q21 Commerce Department estimate of GDP growth was 6.9%, with the full year 2021 clocking in at 5.7%. The increasing inflation problem, continuing supply chain issues and labor shortages are beginning to take their toll on the economy. Reflecting these concerns, The Conference Board, in their March 10, 2022, report forecasts GDP growth to slow in 1Q22 to 1.7% with full year 2022 GDP to be 3.0%.



Source: GF Data

The escalating inflation problem has caused the Fed's planned 2022 tapering process to take on new urgency. While the Fed began the process and bumped rates by 25bp in March, soon-to-be Fed Vice Chair Lael Brainard figuratively pulled the "fire alarm" in a speech on April 5th. She suggested a far more rapid reduction in the Fed's huge portfolio of treasuries and mortgage-backed securities, coupled with more dramatic increases in short-term interest rates. These comments were further verified by the release of the March FOMC minutes on April 6th.

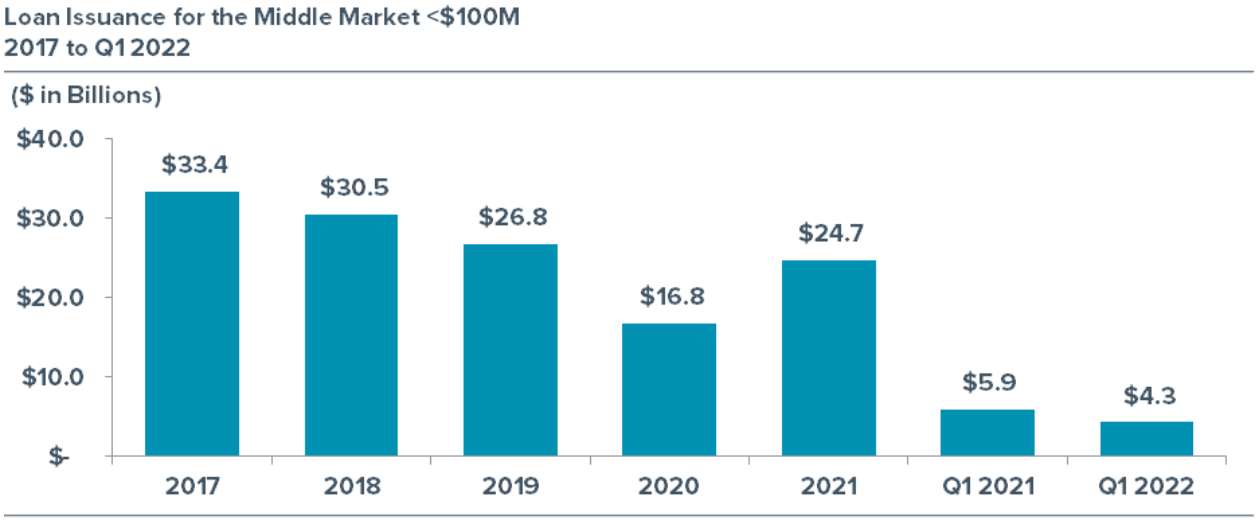
The 10-year U.S. Treasury yield is up almost 100 basis points from the beginning of 2022, with further interest rate increases expected. Higher interest rates will affect borrowing costs and negatively impact deal structures and valuations.

The U.S. equity and debt capital markets are far more volatile in early 2022. Increased inflation and the Fed's planned strategy to increase interest rates and sell its securities has already weighed heavy on the equity markets. As of early April, the S&P 500 is off 5.0%, and the NASDAQ is down 9.0% from the beginning of the year. Interest rates and corporate earnings drive public market valuations. The Fed has maintained an M&A- and equity market-friendly low interest rate environment since the recession and continued to do so during the pandemic. An FTL Consulting lender survey released in February 2022 contained the following comment: "Notably, many more respondents said that the federal financial relief programs and Federal Reserve Bank policies meant to counter the economic effects of COVID-19 were excessive. In retrospect, it appears that the policies intended to mitigate the economic blow from COVID-19 have gone too far and are now contributing to accelerating inflation, full risk-on mode in leveraged credit markets, as well as very depressed levels of defaults and restructuring activity." The Fed is now removing the market-friendly support, returning us to a more normal, higher interest rate environment, which will have a negative impact on the M&A market.

Bank loans are still available, albeit with more conservative terms and higher interest rates. Competition for M&A and growth financing opportunities is still fierce. With proper preparation, credit-worthy issuers should have little problem attracting capital. While debt capital is readily available, acquirors will have to be prepared for a longer financing process and potentially more conservative and expensive capital structures.

Total U.S. Middle Market Loan Issuance

- New bank loan issuance for middle-market companies in 2021 at $24.7 billion is up almost 50.0% from 2020's volume. The increase in new commercial and industrial ("C&I") loan issuance reflects a robust economic recovery from the pandemic and a record M&A market. Similar to the M&A market, 1Q22 loan volume was softer than 1Q21, reflecting greater uncertainty in the deal business.
- At the beginning of the pandemic, the Fed pledged to take any steps necessary to support banks and maintain sufficient liquidity in the banking system. As a result, banks have weathered the pandemic and have abundant liquidity for loans.
- 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, such as operating business needs (including payroll and checking accounts). Due to regulatory scrutiny and the pandemic, banks are cautious in making new loans and are very selective in new leveraged transactions, leaving that market segment to the BDCs.



Source: Thomson Reuters

Interest Rate Environment

And so, it begins. In early March 2022, Chairman Powell said the Fed would begin raising rates in 25 basis point increments six to eight times until inflation is under control. This strategy was further modified by soon-to-be Vice-Fed Chair Brainard on April 5th, who previously wanted to avoid raising rates too rapidly. She suggested the policy will include a speedy reduction in the Fed balance sheet and rate moves higher than the 25 basis point increments.

- The first increase of 25 basis points was made in the March 22 FOMC meeting. The yield curve started shifting higher, and the Prime Rate was increased by 25 basis points.
- The slope of the yield curve at the end of 2020 and continuing into 2021 was upward-sloping and reflecting increasing but normal inflation expectations. The 2-year to 10-year Treasury differential was 34 basis points at the end of 2019, 80 basis points at the end of 2020 and 89 basis points at the end of 2021. As of the end of March, the 2-year to 10-year treasury differential was less than zero or around zero, suggesting the dreaded "inverted yield curve" a reliable predictor of a recession in the future.
- Once the Fed taper actions begin, the very low interest rate environment will end. The current low interest rate environment provides credit-worthy companies the opportunity to borrow now and lock in attractive long-term fixed rate debt .

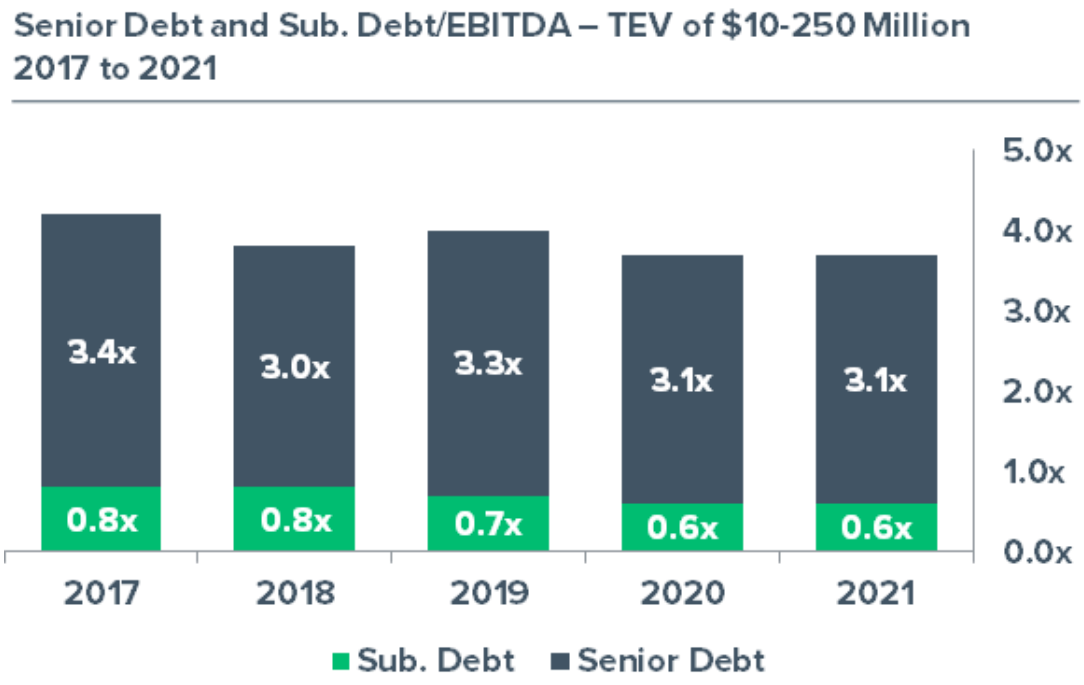
FINANCIAL INDICATORS

	3/31/2021	3/31/2022	4/12/2022
Interest Rates			
Prime Rate	3.25%	3.50%	3.50%
Libor - 1 Month	0.11%	0.45%	0.55%
Libor - 3 Month	0.19%	0.96%	1.04%
U.S. Treasury - 2 Year	0.16%	2.28%	2.39%
U.S. Treasury - 5 Year	0.92%	2.42%	2.66%
U.S. Treasury - 10 Year	1.74%	2.32%	2.72%
Stock Market			
Dow Jones Industrial	32,982	34,678	34,220
S&P 500	3,973	4,530	4,397
NASDAQ	13,247	14,221	13,372
Commodities			
Gold ($ per troy ounce)	1,716	1,954	1,976
Oil ($ per barrel - WTI)	59	99	100

Source: Capital IQ

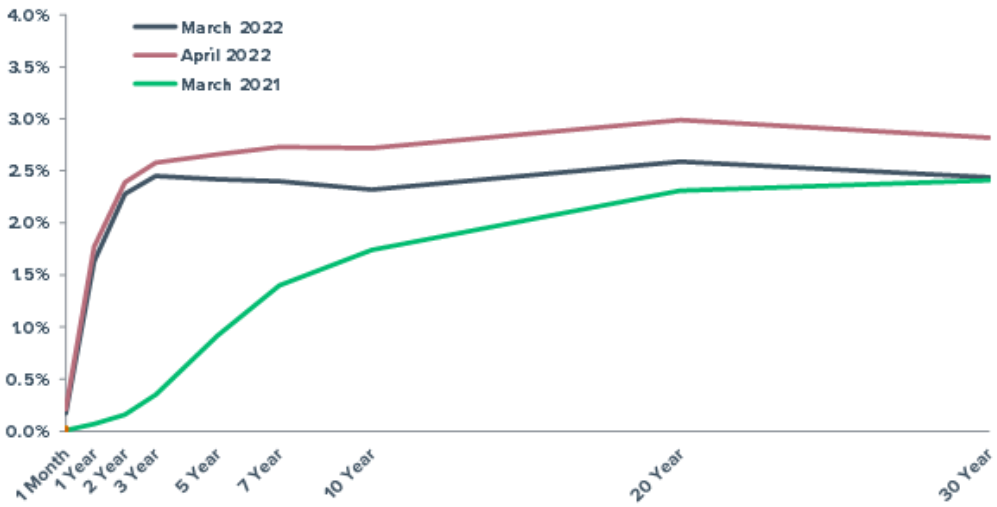
Middle Market Debt Multiples

- Average total debt leverage in middle-market deals declined to 3.7x in 2021, down from the 4.0x average in the pre-2020 time. While the availability of loans is very strong, the pandemic, inflation and business uncertainty has caused more conservative deal structures in late 2021.
- Mezzanine capital played an important role in a leveraged capital structure in the pandemic environment. While mezzanine is more expensive capital than senior debt, its return structure matches the risk profile of companies operating in the post-pandemic period better than a similar amount of equity.
- Over the past five years (2015-2019), mezzanine debt averaged about 0.8x EBITDA in the typical capital structure. In 2019, banks and BDC lenders started to disintermediate the mezzanine capital as they searched for new lending opportunities. Beginning in 2020 and continuing through 2021, even with a conservative bank lending environment and increased mezzanine fund pitching activity, mezzanine capital continues to become a slightly smaller component of the typical capital structure.
- The use of inexpensive debt capital helps sustain high middle-market M&A valuations. We believe once the Fed taper begins and interest rates move higher, this will limit the increase in deal leverage levels.



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")*

M&A Advisory

DEERFIELD CONSTRUCTION GROUP, INC.

was acquired by

ADB

A Portfolio Company of

WARREN EQUITY PARTNERS

Advisor to the Seller

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ELENCO Learn by doing.

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Transaction Highlight

About Deerfield Construction Group, Inc.

Incorporated in 1993 and headquartered in Lockport, Illinois, Deerfield is a telecommunications construction company. Since its inception, the Company has been one of the leading and preferred contractors at the forefront of the construction, maintenance and upgrading of the Midwest's cellular, wireless and microwave systems for many of the region's carriers. With its vast expertise and knowledge, coupled with its highly trained and safety-oriented staff, Deerfield prides itself on completing projects in the most efficient and timely manner, at the highest level of quality of any telecommunications contractor.

Deerfield Construction Group, Inc. was acquired by ADB, a portfolio company of Warren Equity Partners.

Terrel Bressler, Managing Director

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About Prairie Capital Advisors

Prairie offers investment banking, ESOP advisory, valuations & opinions 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.