

# M&A AND CORPORATE FINANCE OVERVIEW: 2017 ANNUAL

Merger & Acquisition  
Corporate Finance Advisory  
Strategic Consulting

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## Bringing Efficiency to Inefficient Markets

### Executive Summary

Cautious Optimism: Goldilocks Continues to Mint Money but the Bears are Gaining

2017 marked a red-letter year for PE and middle market (MM) deal activity in the United States. Average valuations in the lower MM (deals of \$250.0m or less) appreciated to 7.4x Total Enterprise Value (TEV) to EBITDA in 2017 from 6.8x in 2016. Meanwhile, the aggregate median valuation of U.S. PE deals (deals of \$25.0m to \$1.0bn+) remained flat at record highs of 10.5x. Valuations primarily benefited from intense deal competition driven by bulge-bracket PE firms shopping down market and increased competition from non-traditional participants such as family offices, insurance companies, and institutional pension funds.

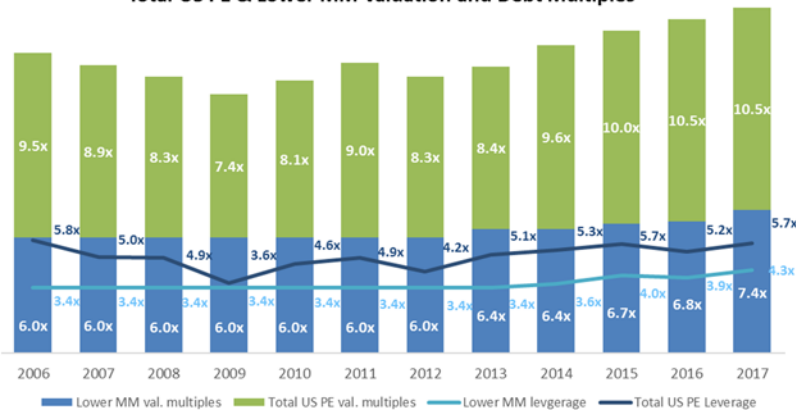
The number of PE deals completed, although down 9% in 2017, was nonetheless robust with over \$538.2bn in capital deployed across 4,053 deals. Add-on acquisitions continued to rise, which supported valuations for smaller MM deals. These deals comprised 64% of buy-out activity in 2017 and are gaining in popularity due to intense competition for the small universe of quality acquisition targets. US PE Fundraising saw a banner year with \$232.7bn in capital raised across 247 funds. Further, median fund size continued to increase and reached \$292.5m in 2017. Headwinds affecting deal-flow included price and quality concerns, whereas tailwinds affecting fundraising included strong investor demand and a friendly financing environment.

A competitive financing environment and a glut of available capital kept deal terms friendly in 2017. This supported higher-leverage multiples across all deal levels albeit with an increase in rep and warranty insurance. Leverage as measured by total debt to EBITDA reached a high of 5.7x for all US PE deals and 4.4x for the lower MM.

The current outlook for 2018 is supportive of a strong PE and MM M&A environment reflecting small and MM business optimism and positive views from PE industry participant. However, competition has caused many industry participants to adjust their strategies in the face of high prices by focusing more on operational efficiencies add-on's, and strategic buy-outs. Further, industry participants, such as KKR, have noted a high risk of recession in the next two years as an increasing downside risk to this outlook. Recession will likely be driven by changes to inflation (and the resulting Federal Reserve policy), the strength of the dollar, and trade policy.

Source: Pitchbook; GF Data®

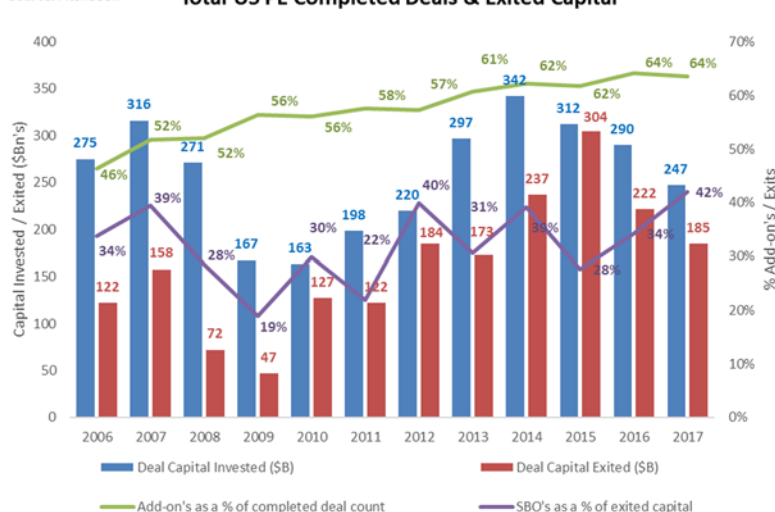
**Total US PE & Lower MM Valuation and Debt Multiples**



Note: (1) Lower MM defined as deals with a TEC of \$10.0 - \$250.0m, Total US PE defined as TEV \$25.0m - \$1.0bn+  
(2) Total US PE multiples are a median; lower MM figures are an average  
(3) 2006 - 2013 lower MM figures use a 2003 - 2012 average

Source: Pitchbook

**Total US PE Completed Deals & Exited Capital**

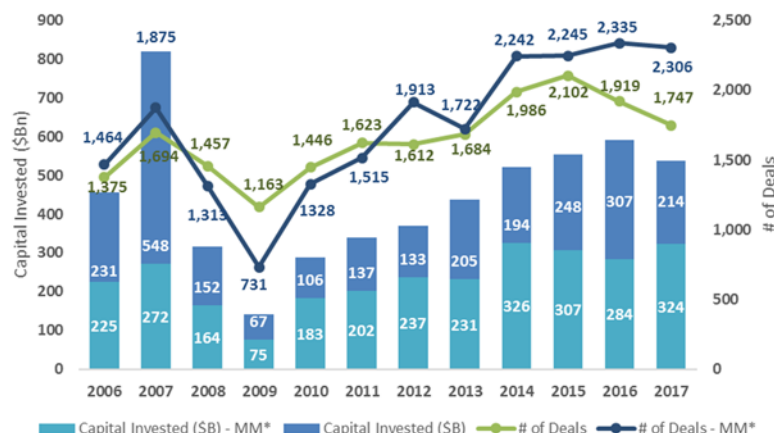


## The View From Above

2017 Was A Banner Year For US Private Equity

Source: Pitchbook

### U.S. Private Equity Deal Flow



Unprecedented valuations and aggressive financing terms saw the PE and middle market (MM) sellers market continue in 2017 despite a decline in completed deals and invested capital. This is in contrast to overall US & Canadian M&A activity, which according to Mergermarket was down 12.3% by deal value to \$1,369.5bn due to a lack of mega deals. According to Pitchbook's *US PE Breakdown 2017 Annual Report*, 4,053 deals were completed across the U.S. in 2017 with an aggregate deal value of \$538.2bn (down 5% & 9%, respectively). Despite sitting on just over a trillion in dry powder globally, the number of completed PE deals declined due to price and target quality concerns. In terms of split, middle market (MM) deals contributed 2,306 (57%) of completed deals and \$324.0bn (60%) of total capital.

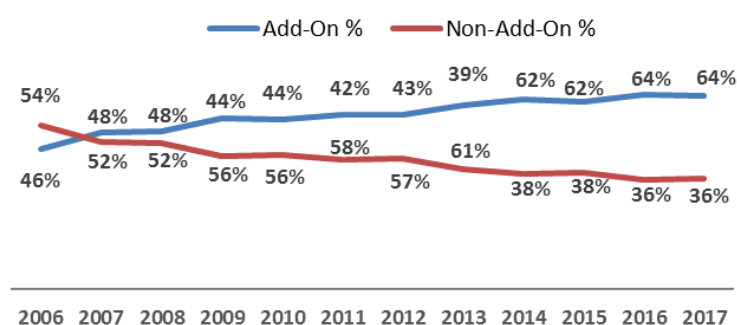
Even though the pace of completed deals has decelerated compared to 2014-2016, competition has sustained high median valuation multiples of 10.5x Total Enterprise Value (TEV) to EBITDA (10.4x for the MM). This figure is flat compared to 2016 but higher than the 10-year average of 9.1x and pre-recession high of 9.5x.

Increasing valuations have further been noted by the Lincoln Middle Market Index (MMI), which saw a compound growth rate in enterprise values of 6% in 2017 compared to 8.5% for the S&P 500. This index measures quarterly changes in enterprise values for 350 MM companies (primarily owned by PE groups) and since 1Q2014 the MMI has appreciated by 24.5%. Changes in enterprise values for healthcare companies have led the index (appreciating 41.2% since 1Q2014) whereas energy (which depreciated 23.2% since 1Q2014) has lagged.

Add-on acquisitions continued to represent the majority of buy-out activity (64%) in 2017. Considering that each platform reaches an average size of three portfolio companies (1 Platform + 2 add-ons) over an average

holding period (5-7 years) belies the notion that sponsors have a limited period to make these acquisitions before liquidating the fund and returning capital to investors.

### Add-On vs. Non-Add-On - % of Deals



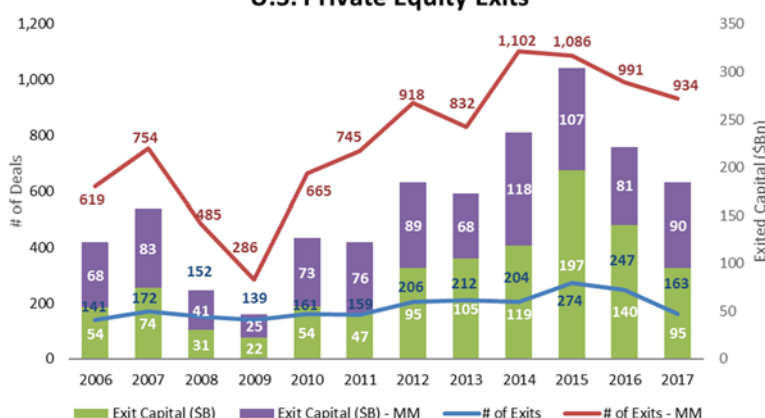
Source: Pitchbook

The grab for add-on acquisitions will likely diminish the investible universe of these assets and will continue to drive up multiples across lower-tier EBITDA thresholds.

Deal exit volume dropped 11% in 2017 to 1,097 exits worth \$184.8bn (compared to \$221.7bn in 2016). Of total US PE exits, 85% of exited deals and 49% of exited capital was attributed to the MM. The decline in the number of exited deals was largely due to the continued decline in corporate acquisitions, which were down 18% at 505 deals worth \$85.1bn. Secondary Buyouts (SBOs) accounted for 50% of exited deal at 548 deals with a value of \$92.3bn in 2017.

Source: Pitchbook

### U.S. Private Equity Exits



Corporate acquisitions and SBO's stand at their lowest and highest completed deal percentages (as recorded by Pitchbook), respectively. This trend is likely to continue given many PE funds are maturing (38% of portfolios are more than five years old) in an environment flush with dry powder, thereby making other PE firms the most likely buyers in an exit. Median deal exit size continued to increase through 2017 to \$221.5m (up 17% over FY 2016) due to the aforementioned increase in deal multiples.

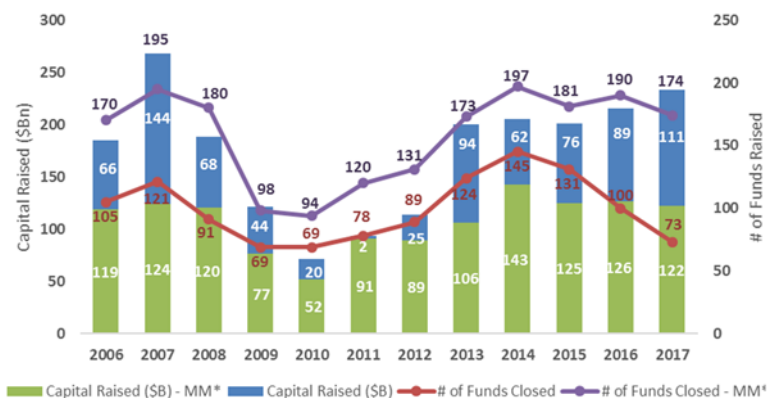
From a sector standpoint, IT PE deals fell the most in 2017 as a percentage of deal value in dollars (from 29% to 18%), whereas healthcare had the largest increase (from 10% to

16%). All other sectors remained flat or increased between 100 and 300 basis points.

Investors' higher risk appetite for PE returns continues to translate into a willingness to provide capital. Capital raised by PE funds in 2017 totaled \$232.7bn (\$24.7bn of which was raised by Apollo's ninth flagship fund) committed across 247 funds. This compares to 2016 when \$215.1bn in capital was raised across 290 funds. Breaking down the figures, the MM accounted for 52% of capital raised across 70% of funds raised.

Source: Pitchbook

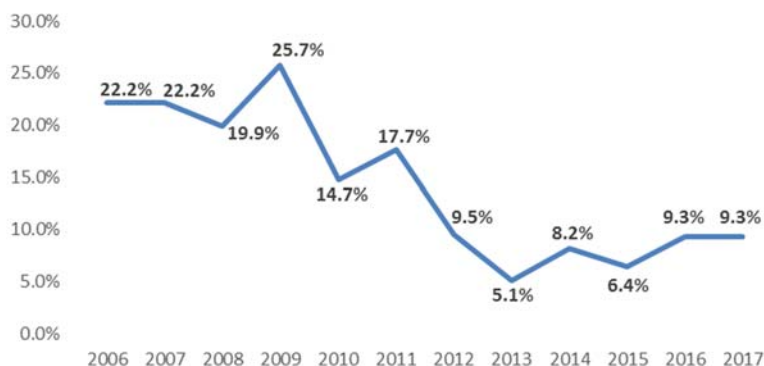
### U.S. Private Equity Fundraising



Median US PE fund size rose 30% in 2017 to \$292.5m. Much of these investments are concentrated in mega-funds with more than \$5.0bn at closing. These funds accounted for 47% of all capital raised in 2017, the highest recorded percentage since 2007 when they accounted for 53% of all capital raised.

Competition has also driven PE firms to consolidate as a way to improve economies of scale and product offerings for clients. This allows the acquirer not only to grow AUM, but also to diversify their fee pool. Continued consolidation will mostly benefit larger industry players. Its effects are already making a mark as the overall number of active US PE firms decreased by 1.3% since 2015 to 4,304 firms at year-end (YE) 2016. Despite this, the number of first-time funds, as a percentage of all funds raised, has continued to rise since the 2013 low of 5.1%.

### 1st-Time US PE funds as a % of all US PE funds Raised



Source: Pitchbook

## Lower Middle Market Close-up

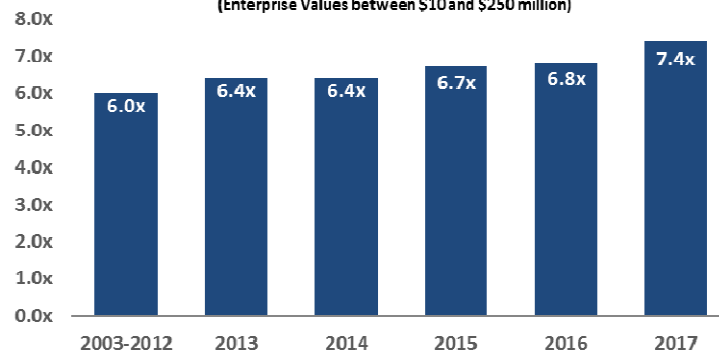
### Valuation Multiples on the Rise

According to data reported to GF Data® (which collects data on MM transactions of up to \$250.0m) from 200 PE funds and deal sponsors across 231 transactions, the average valuation multiple in the lower MM in 2017 was 7.4x compared to 6.8x in 2016. Further, MM valuation multiples ranged from 6.4x for deals with a TEV of \$10.0m-\$25.0m, to 9.2x for deals with a TEV of \$100.0m-\$250.0m.

GF Data® CEO Andrew Greenberg believes that continued appreciation could be frothy market conditions extending to businesses that are more pedestrian and may signal a peak in market valuations. His co-founder, Mr. Graeme Frazier, noted that another reason for high multiples may be the continued trend favoring add-on acquisitions. Yet another reason is likely due to strong MM earnings, which according to a Golub Capital MM report grew 12.8% in Q4 2017 alone.

Source: GF Data®

### Middle Market Valuation Multiples (Enterprise Values between \$10 and \$250 million)



There is a continued re-assertion of the *quality premium*, which GF Data refers to as the valuation reward offered for above-average financial performance. In 2017, this premium was at 20% (down from a record high of 33% in August) and was in line with 2015 and 2016 figures.

Furthermore, GF Data defines businesses with above-average financial performance as those with both EBITDA margins and revenue growth rates at or above 10%, or with one factor above 12% and the other metric at 8% or above. Deals with such characteristics have been more prevalent in larger transactions (\$100.0m+ in TEV).

## Middle Market Deal Structure & Terms

### Leverage Multiples At All-Time Highs

The average total debt multiple on MM deals with a TEV of up to \$250.0m reached 4.4x (comprised of 3.5x senior debt & 0.9x sub-debt) at YE 2017 compared to 3.9x in 2016. Debt multiples ranged from 3.9x for deals with a TEV of \$25.0m-\$50.0m to 4.9x for deals with a TEV of \$100.0m-\$250.0m (vs. median leverage of 5.7x for the entire US PE MM). Leverage has continued to increase driven in part by the competitive financing environment. Lower MM average

debt multiples have been on the rise since 2011-2013, when they averaged 3.4-3.5x.

Bank financing remains plentiful and aggressively structured and priced. This is due to banks continuing to loosen underwriting standards in order to put abundant capital to work in a low-rate but competitive environment. As a result, debt continues to increase as a component of the capital structure in the majority of deals.

This view is echoed by Mr. Graeme Frazier, IV, GF Data co-founder, who has stated that the three main contributors of increased leverage multiples are the need of debt providers to deploy capital, fear of losing market share, and flight to quality.

transaction's capital structure. According to the *Spring 2018 GF Data Key Deal Terms* report, this figure averaged 44% in 2017, which is down from the 2009 high of 53%. In response to the continued erosion of equity in the capital structure, there has been a substantial increase in the utilization of rep and warranty insurance (7.7% of reported deals in 2016 compared to 42% in 2017). Deals containing reps and warranties have also closed at half a turn of leverage higher than deals without (7.7x versus 7.1x).

In addition, indemnification cap levels, the maximum liability for a seller as a percentage of the purchase price, declined to 12% in 2017 from 16% in 2015-2016.

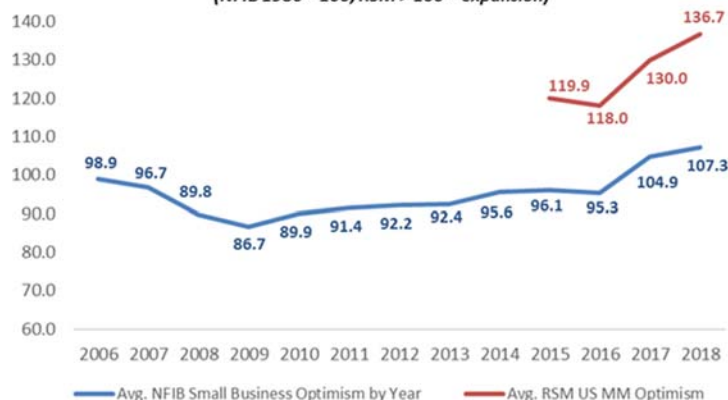
## 2018 Outlook

### *A Tale of Cautious Optimism*

2018 is set to be another promising year of deal activity for PE and the MM driven by small and MM business optimism, continued economic growth and favorable views from PE industry participants. This is despite Intralinks® and FACTSET data, which suggests an alternative view of the next six months and last three months, respectively.

Intralinks Q2 Deal Flow Predictor (which forecasts M&A activity based on the number of M&A transactions that are in preparation for or have begun early stage due diligence) suggests that although, global M&A volume will increase as much as 6% in the next six months, North American volume will decrease by 5% (with a range of -14% to 3%). This is in line with data from FACTSET that noted US M&A activity dropped 17.9% in terms of deals completed in the three months ending February 28<sup>th</sup>. It is important to mention, however, that this is in comparison to a remarkably strong first half for 2017 as well as the overall M&A market, which is having its own challenges surrounding mega-deals.

### Average Small & Middle Market (MM) Business Optimism (NFIB 1986 = 100; RSM > 100 = expansion)

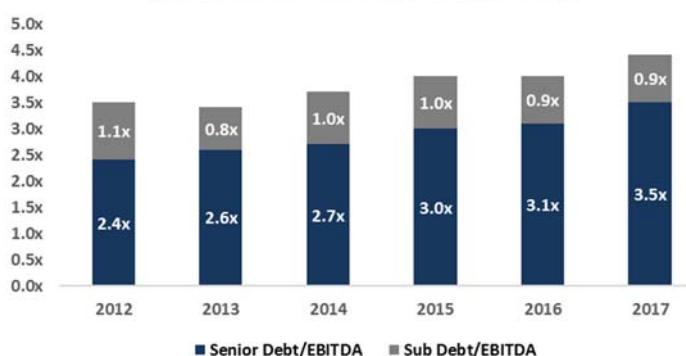


Source: © NFIB Research Center; RSM in partnership with the US Chamber of Commerce

Turning to factors that support 2018 PE and MM deal activity; According to NFIB's Small Business Economic Trends, the Index of Small Business Optimism rose 2.7

Source: GF Data®

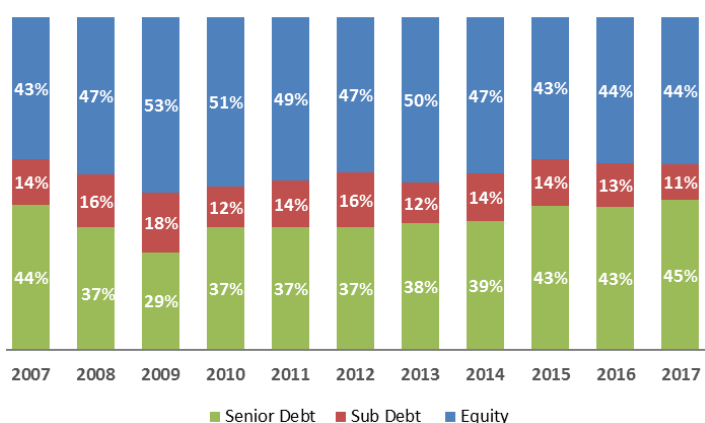
### Debt Multiples by Year (Enterprise Values between \$10 and \$250 million)



High-yield credit spreads remain at a three-year low, thus making debt financing even more attractive as a way to boost returns. According to *Pitchbook*, in 2017 the median debt percentage for all US PE deals increased to 53% of enterprise value (compared to 55% for MM deals of \$250.0m and less). Although sustainable in the current environment, should a recession occur or interest rates rise too quickly, companies purchased in highly leveraged deals will unlikely be able to service their debt.

Source: GF Data®

### Capital Structure Detail (Enterprise Values between \$10 and \$250 million)



The prevalence of cheap debt financing has further eroded the average equity contribution as a percentage of a

points to near Reagan-era highs at 107.6 in February 2018. Given the removal of uncertainty from the passage of recent tax legislation and the current deregulatory environment, this index will likely continue to improve in the short term. Nonetheless, remaining uncertainty on healthcare reform, the stalled pace of deregulation, and a smorgasbord of geopolitical issues could cap the upper bounds of this index for the time being.

Additional metrics that highlight business optimism include data from the Q1 2018 RSM US Middle Market Index (which surveys 700 Middle Market executives) and the SunTrust 2018 Business Pulse Survey (which surveyed 264 businesses with \$2.0m-\$9.99m in revenues and 250 with revenues of \$10.0m to \$250.0m). According to the RSM data, its index is at an all-time high of 136.7 (> 100 notes expansion) supported by the strong economy, a robust labor market, and changes to the aforementioned tax legislation. SunTrust echoed this by noting that 80% of its surveyed participants viewed their firms as strong and 70% thought their business conditions would improve over the next 6 months.

Capital spending (as measured by the NFIB and depicted in the below chart) signaled further business owner optimism with 66% of respondents making capital expenditures (capex) in the last six months. The majority of capex was used to purchase new equipment and vehicles.

#### **Type of Capex**

*(% of Small Businesses Purchasing or Leasing In The Last 6-months)*

<b>Type</b>	<b>Current</b>	<b>1-yr ago</b>	<b>2-yrs ago</b>	<b>10-yr avg.</b>
Vehicles	30	26	24	22
Equipment	45	45	40	39
Furniture / Fixtures	15	16	12	12
Buildings & Land (B&L)	6	7	5	6
Improvements to B&L	15	17	16	15

PE firms were equally as optimistic as business owner's about their 2018 outlook. In a recent Pitchbook survey 75%+ to 90%+ of PE firms surveyed were optimistic of their use of past strategies, which included JV's, buyouts and carve-outs amongst others. In addition, they had a similar outlook for the performance of all industry sectors within their portfolios.

Three other factors conducive to deal making and sustaining high valuations in the short to intermediate term concerned dry powder, the availability of debt, and taxes. First, a large amount of dry powder remains that needs to be invested and PE firms have a glut of aged inventory they will need to liquidate in the near term. As mentioned earlier, global PE dry powder is sitting at just over \$1.0 trillion. This concentration is likely to spur continued mega-fund raises, platform add-on acquisitions, and investment

into less traditional PE sectors such as technology. Second, investors will continue to seek debt financing while rates remain low and creditors are willing to lend. Third, lower corporate taxes will likely boost portfolio returns and corporate spending. These three factors and high optimism on both the part of businesses and PE firms suggests a strong 2018 M&A environment.

Additional trends that are likely to help sustain the current M&A environment include efficiencies gained from AI and the trend of "aqui-hiring", whereby companies are seeking to grow their workforce through acquisitions.

The caveat to the above outlook, however, is that high valuation multiples are forcing industry participants to alter their strategies by focusing more on operational efficiencies, SBO's, and add-on acquisitions. Further, these participants are doing so during a period of increasing recession risk. The US is in its longest-ever economic recovery. Concerns regarding inflation, the strength of the dollar, and economic policies are causing respected market participants such as KKR to predict a 100% chance of a recession occurring within the next two years.

## About Strategic Advisors

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 a result, Strategic Advisors not only has expertise in advisory services but also firsthand knowledge of what stakeholders, investors, and lenders expect and desire.

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.

### Strategic Advisors works with clients across numerous industries. Selected transactions include:

 <p><i>Has Completed a Restructuring of Debt</i></p> <p><i>The undersigned acted as financial advisor and placement agent</i></p>  <p>March 2018</p>	 <p><i>has been acquired by</i></p> <p>GPB Waste OH, LLC</p> <p><i>A newly created entity of</i></p>  <p><i>The undersigned acted as financial advisor to the owner of Iron City Express.</i></p>  <p>September 2017</p>	 <p><i>has been acquired by</i></p> <p><b>Prime Metals and Alloys, Inc.</b></p> <p><b>Amerinac Holding Corp.</b></p> <p><i>The Undersigned acted as financial advisor to the ownership of Prime Metals and Alloys</i></p>  <p>August 2017</p>
<p><i>Restructuring of Debt</i></p> <p><b>East Coast Manufacturer</b></p> <p><i>The undersigned acted as financial advisor to the Shareholders</i></p>  <p>April 2017</p>	 <p><b>CREEKNIDE ENTERPRISES HOLDING, L.P.</b></p> <p><i>With Operating Subsidiaries</i></p> <p>INSIGHT PIPE CONTRACTING, L.L.C. and IPC SERVICES, L.L.C.</p> <p><i>has completed a recapitalization</i></p> <p><i>The undersigned acted as financial advisor and placement agent to the Shareholder of Insight Pipe Contracting, L.L.C. and IPC Services, L.L.C.</i></p>  <p>January 2016</p>	 <p><i>has been acquired by</i></p> <p><b>STONEWOOD</b> CAPITAL MANAGEMENT, INC.</p> <p><i>The Undersigned acted as financial advisor to the management of PCN Network Closings</i></p>  <p></p>
 <p><i>has been acquired by</i></p>  <p><i>a portfolio company of</i></p>  <p><i>The Undersigned acted as financial advisor to the ownership of Gateway Fasteners</i></p>  <p>June 2015</p>	 <p><i>has been acquired by</i></p>  <p><i>The Undersigned acted as financial advisor to the shareholders of LTS Scale</i></p>  <p>May 2015</p>	 <p><i>have been acquired by</i></p>  <p><i>A portfolio company of</i></p>  <p><i>The undersigned acted as financial advisor to the shareholders of Cortina and DMS.</i></p>  <p>October 2014</p>

**Author:** Richard Wilusz, Investment Banking MBA Intern

**Sources:** Pitchbook – US PE Middle Market 2017 Annual, US PE Breakdown 2017 Annual, 2018 Crystal Ball Report, 2018 PE Outlook, Private Market Playbook; GF Data® Key Deal Terms, Spring 2018; NFIB Small Business Economic Trends, February 2018; MERGERS&ACQUISITIONS, S&P Global Market Intelligence – M&A Trends; Lincoln International Middle Market Index; Merrill Corporation M&A Deal Forecaster, Mergermarket FY 2017 Monthly M&A Insider; RSM (and U.S. Chamber of Commerce) US Middle Market Business Index; FACTSET Flashwire US Monthly; Intralinks® Deal Flow Predictor

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Bringing Efficiency to Inefficient Markets

