LM+Co Capital
Middle-Market Investment Banking

Q1 2017

We are pleased to present LM+Co Capital's Q1 2017 Middle-Market Update. This newsletter offers a recap of 2016 activity and an overview of key trends impacting current US Mergers and Acquisitions (M+A) and Capital Markets.

Deal Flow Observations

Corporate M+A accounted for 80% of M+A deal value in 2016, the highest percentage since 2010. US Private Equity (PE) continues to struggle to compete with large strategics on valuations primarily due to the record amounts of cash on their balance sheets. PE firms have been increasingly reliant on add-on transactions as a way to blend down the aggregate acquisition multiple for the assets in their portfolios. Add-ons made up 57% of all buyout activity in 2016, slightly up from 2016.

Further, PE firms must be able to envision a path to a profitable exit, usually seven to ten years, and cannot justify higher purchase price multiples paid by strategics. In addition, the higher mutliples being sought by the market now require substantially higher equity contributions which, theoretically, reduces their overall IRR.

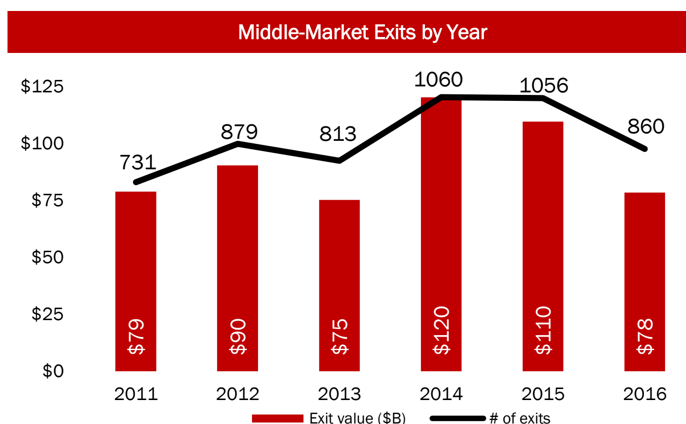
In 2016, the middle-market also exhibited increased disparity between size segments. The upper middle-market (transactions between $500 million and $1 billion) experienced significantly lower deal flow, with deal value and volume decreasing 20.3% and 28.5% from 2015, respectively. With increased competition and fewer quality assets available at the top end of the market, PE firms have continued to look for relative value in smaller companies in the lower middle-market (transactions between $25 million and $100 million).

Deal value in the lower middle-market increased 21.3% in 2016 on approximately the same number of transactions. We expect deal flow in the lower middle-market to remain a focal point for PE firms that lose out on the limited number of quality assets in the upper middle-market.

As a result of the increased focus in the lower middle-market in 2016, PE firms, on balance, have used less debt to fund transactions. Lower middle-market firms often do not have the same attractive metrics as their larger peers, such as a defensible market position or dominant market share in its industry and, therefore, command lower valuation multiples and can support less debt. While less debt usage may result in lower returns from distributions, this easing of transaction leverage could also lead to a healthy re-balancing of leverage and purchase prices in the once frothy middle-market. We continue to believe that deal flow will be supported by the "baby boomer' generation selling out of their family businesses amid favorable market conditions.

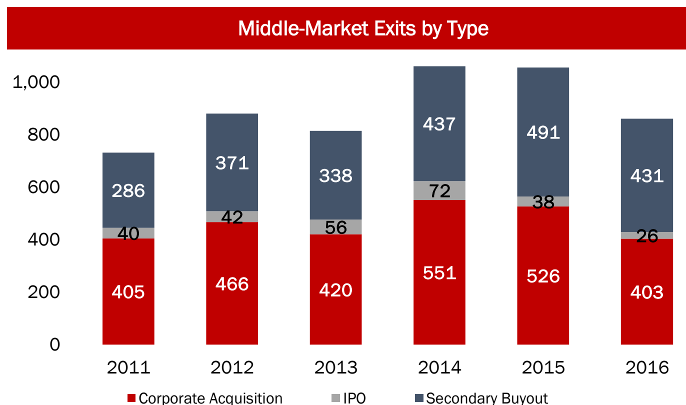
Middle-Market Exits

Similar to the deal flow environment witnessed in 2016, middle-market exits decreased but remain relatively healthy compared to the prior five years. PE-backed exits totaled $78.5 billion across 860 portfolio companies in 2016, marking another yearly decline in activity. As the current middle-market portfolio company inventory remains relatively young, PE firms will continue to focus on improving and growing their portfolio companies and, accordingly, the exit market is expected to remain subdued.



Source: Pitchbook, transactions between $25 million - $1 billion

The sale of assets to another financial sponsor or strategic buyer continues to be the most popular form of exit activity. While secondary buyouts and corporate acquisitions are responsible for roughly the same number of exits, the majority of exit activity by dollar value is attributed to corporate acquisitions. This highlights the ability of strategic buyers to pay top dollar for larger, quality assets.

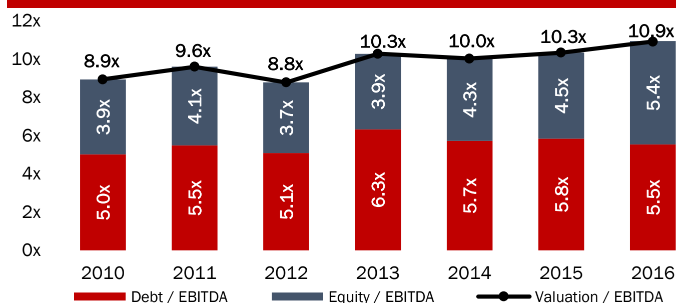


Source: Pitchbook, transactions between $25 million - $1 billion

M+A Outlook

2016 deal multiples remained at historic levels as median valuation-to-EBITDA multiples reached 10.9x. We anticipate these valuation levels to be sustained as competition for quality assets remains intense. In 2016, PE firms reached into their pockets more often, with equity-to-EBITDA multiples rising to a six-year high of 5.4x due to increased competition for limited assets. Median all-in-debt-to-EBITDA multiples were 5.5x in 2016 as companies remained highly leveraged. For 2017, we anticipate multiples to remain high as PE firms aggressively compete for a limited supply of quality assets. We also anticipate PE firms looking further into lower middle-market assets to find relative value as M+A multiples for the overall PE market appear extended.

Median EBITDA Multiples for US M+A



Source: Pitchbook, transactions between $25 million - $1 billion

In 2016, lower middle-market valuations rebounded among many sectors with Retail, Business Services, Distribution, Media + Telecom all receiving higher multiples, while Technology valuations fell in line with their 10-year average. With the current economic outlook, we expect buyers to reward companies offering solid margins and positive earnings outlooks with higher valuation multiples.

Total Enterprise Value (TEV) / EBITDA by Industry Category

Industry	2003-2011	2012	2013	2014	2015	2016	Total
Manufacturing	5.9x	5.9x	5.9x	6.3x	6.6x	6.2x	6.0x
Business Services	6.3x	5.9x	6.5x	6.5x	6.4x	7.4x	6.4x
Healthcare Services	6.9x	7.1x	7.5x	7.8x	7.8x	7.6x	7.2x
Retail	6.5x	5.9x	7.4x	8.5x	5.6x	7.5x	6.7x
Distribution	6.0x	6.6x	6.8x	7.1x	6.7x	7.4x	6.4x
Media + Telecom	7.7x	11.4x	6.1x	NA	6.4x	7.3x	7.5x
Technology	6.4x	7.2x	10.0x	9.1x	8.0x	7.4x	7.5x
Other	5.9x	6.3x	6.0x	6.8x	5.9x	7.4x	6.1x

Source: GF Data, transactions between $10 million - $250 million

Capital Markets Outlook

While overall lower middle-market valuations increased in 2016, a size premium still exists in the market. Firms with TEV's between $100 million and $250 million received a 3.0x valuation multiple premium compared to firms with TEV's between $10 million and $25 million.

TEV / EBITDA by Size

TEV	2003-2011	2012	2013	2014	2015	2016	Total
10-25	5.6x	5.8x	6.0x	5.6x	5.8x	6.0x	5.7x
25-50	6.2x	6.2x	6.8x	6.6x	6.6x	6.4x	6.3x
50-100	6.8x	6.7x	6.8x	8.4x	7.8x	7.3x	7.0x
100-250	7.3x	7.4x	7.5x	7.8x	9.0x	9.0x	7.8x
Total	6.2x	6.3x	6.5x	6.7x	6.7x	6.9x	6.4x

Source: GF Data, transactions between $10 million - $250 million

Debt markets remained highly active in 2016 despite subdued economic growth and a volatile election cycle. We expect the Federal Reserve to raise rates two to three times during 2017. Recently, the economic outlook has improved amid renewed optimism for corporate tax reform and increased infrastructure and military spending. We believe the capital markets will remain supportive of companies looking to capitalize on this optimism.

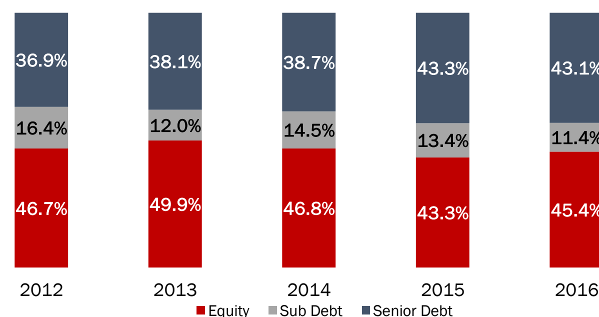
Valuation Drilldown

TEV	ALL	Buyouts Only	Buyouts Only: Platform	Add-Ons	Indiv/Family Seller	PEG/Corp Seller	Above Average	Post-Closing Mgt.	PEG/Corp, Above Average and Mgt.
10-25	6.0x	5.9x	5.9x	5.9x	5.9x	6.2x	5.9x	5.8x	6.6x
25-50	6.4x	6.3x	6.3x	6.5x	6.5x	5.6x	6.7x	6.3x	5.7x
50-100	7.3x	7.5x	7.4x	7.5x	7.6x	7.3x	7.9x	7.6x	8.7x
100-250	9.0x	9.3x	9.2x	10.8x	9.4x	9.1x	9.6x	9.3x	9.1x
Total	6.9x	6.8x	7.0x	6.3x	6.7x	7.2x	7.3x	6.9x	8.0x

Source: GF Data, transactions between $10 million - $250 million

Buyout transactions of companies that combine several attractive qualities (selling party of sponsors or corporations; management teams that stay on after closing; exhibiting above-average financial performance) continue to command a valuation premium of approximately 1.0x TEV-to-EBITDA. In 2016, we also observed an increased use of equity in transactions, as PE firms competed for a limited amount of quality assets. We anticipate this trend reversing slightly in 2017, as PE firms can only tolerate so much expansion of equity capital contributions before their return outlooks become jeopardized.

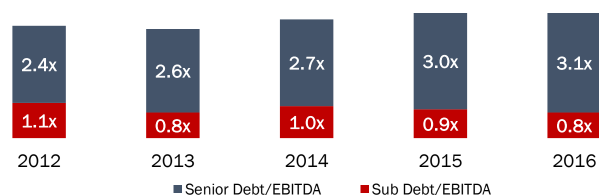
Equity + Debt Contributions



Source: GF Data, transactions between $10 million - $250 million

Senior debt continues to be highly utilized in transactions as the appetite among PE firms for leveraging junior capital wains. We expect senior lenders to continue to aggressively compete for asset-based deals and employ alternative lending strategies such as stretch term loans and First-In-Last-Out (FILO) tranche facilities in order to get challenging deals done in the lower middle-market.

Debt Multiples



Source: GF Data, transactions between $10 million - $250 million

As highlighted below, subordinated debt pricing appears to have stabilized due to steady competition in the lending market combined with consistent demand in transactions. Notably, borrowers' appetites for Paid-In-Kind (PIK) interest to supplement coupon rates in deals involving junior capital appears to be increasing.

All-In Sub Debt Pricing 2015				
TEV	Coupon	PIK	WBR/FEES	TOTAL
10 - 25	11.6%	1.9%	2.3%	15.0%
25 - 50	11.6%	1.9%	1.5%	14.7%
50 - 100	11.2%	2.3%	1.7%	14.7%
100 - 250	11.1%	0.8%	1.8%	13.2%
Total	11.4%	1.9%	1.9%	14.6%

Source: GF Data, transactions between $10 million - $250 million

All-In Sub Debt Pricing 2016				
TEV	Coupon	PIK	WBR/FEES	TOTAL
10 - 25	11.8%	2.1%	2.0%	14.6%
25 - 50	11.6%	2.0%	2.0%	14.8%
50 - 100	11.4%	2.7%	1.9%	14.8%
100 - 250	10.8%	1.8%	1.9%	13.5%
Total	11.5%	2.2%	2.0%	14.5%

Source: GF Data, transactions between $10 million - $250 million

Conclusion

Overall deal flow in the US middle-market slowed in 2016. We expect 2017 deal flow to be in line with 2016 levels as various trends remain steady in the market. We expect valuations to remain high, as middle-market PE firms aggressively compete for quality assets. Roll-up strategies and renewed focus on maximizing EBITDA of existing portfolio companies continue to be a trend in the middle-market. While large assets are sought after and valuations are high, we anticipate buyers further pushing down into the lower middle-market to find relative value. For these reasons, we expect continued concentration and above average deal flow in the lower middle-market.

It remains to be seen, however, what effect the current administration's initiatives to (i) renegotiate NAFTA, (ii) withdraw from the Trans-Pacific Partnership Trade Agreement, (iii) reverse financial regulations and (iv) lower corporate taxes will ultimately have on the market. In theory, the proposed changes appear to support growth in the US and may in fact stimulate further extension of credit to corporate borrowers. Increased spending on the military and US infrastructure will have a domino effect and stimulate growth. The real question is how investors will react during 2017 with such economic uncertainty coupled with the realization of almost certain rate increases throughout the year.

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With more than 30 years of investment banking, accounting and financial advisory experience, Richard leads LM+Co Capital. He has substantial M+A (sell-side and buy-side) as well as Capital Advisory (debt and equity) experience and has raised in excess of $2 billion of senior and subordinated debt and equity capital for companies in the middle-market.

LM+Co Capital is a boutique investment banking and financial advisory firm specializing in middle-market transactions, including traditional M+A, Capital and Financial Restructuring Advisory. Our professionals have more than half a century of collective transactional experience, developing creative solutions for clients under specific and often significant time constraints.

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