Middle Market Investment Bankers

Bringing Efficiency to Inefficient Markets

2012

M&A AND CORPORATE FINANCE OVERVIEW

Fourth Quarter

Merger & Acquisition
Corporate Finance Advisory
Strategic Consulting

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STRATEGICADVISORS
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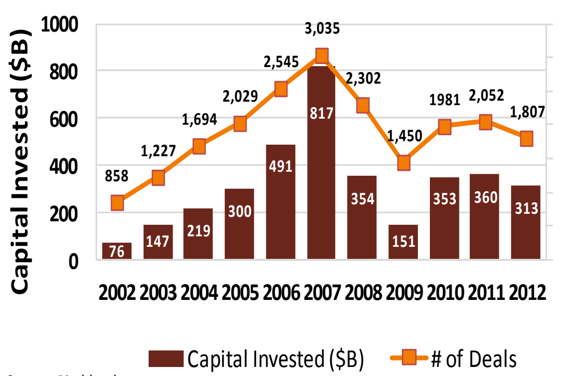
Strategic Advisors is a middle market investment banking firm that helps clients achieve financial and business goals by providing merger and acquisition advisory, corporate finance advisory and strategic consulting services. Along with many years of experience in advising middle market clients, our 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

❖ Going into 2012 it appeared the U. S. private equity (PE) industry may finally have been primed for a full-fledged recovery. Many PE professionals predicted that the industry would rebound significantly from the depths of 2009. Instead, both deal flow and capital invested reversed course, falling 14% and 13%, respectively. In their 2013 Annual Private Equity Breakdown, Pitchbook notes that deal-making declined throughout the year before the predicted resurgence in activity in December ahead of the impending tax hikes. While changes in the tax code undoubtedly compelled some investors to close deals before January 1, it is interesting to note that the fourth quarter has been the most active period for both deal-making and capital invested for the last four years.

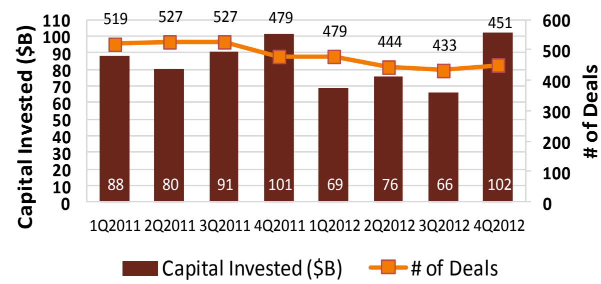
U.S. Private Equity Deal Flow



Source: Pitchbook

❖ The first quarter of the year has traditionally seen a slowdown in deal making. Pitchbook believes it may be even more pronounced in 2013, as the robust deal activity in 4Q 2012 was undoubtedly the result of investors pushing to execute deals before January 1, 2013. However, several industry forces, including a mountain of dry powder and a deep inventory of aged PE–backed portfolio companies, seem to suggest that deal making should eventually accelerate.

U.S. Private Equity Deal Flow

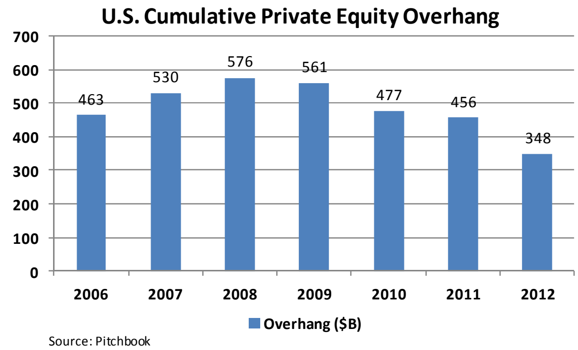


Source: Pitchbook

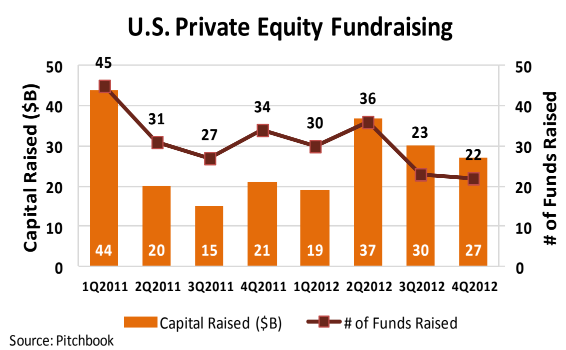
❖ The Small Business Optimism Index as reported by National Federation of Small Businesses (NFIB) has increased .9 points to 88.9, still one of the lowest readings in the survey's 40-year history. The NFIB notes that while 2 million jobs were created in 2012, the population grew by 3 million, so many dislocated workers did not find a job. They further state that consumer sentiment remains depressed. While expectations for business conditions improved five points to a negative 30, it was still the fourth-lowest reading in the survey's history. Small business owner pessimism was expected in light of higher taxes, rising health insurance costs, and increasing regulation. These factors continue to make it difficult for the small business owner to make commitments to new spending and hiring.

❖ 2012 private equity activity is clearly lower than in recent years. Pitchbook notes that the amount of capital invested in the fourth quarter decreased by 6 from the previous quarter, despite the increased activity in the fourth quarter driven by the impending tax increase. Private equity groups (PEGs) continued to be dissuaded from completing transactions due to the high degree of economic uncertainty that exists today. However, this trend will likely change as PE firms will have to make a concerted effort to prudently invest their more than $348 billion of dry powder.

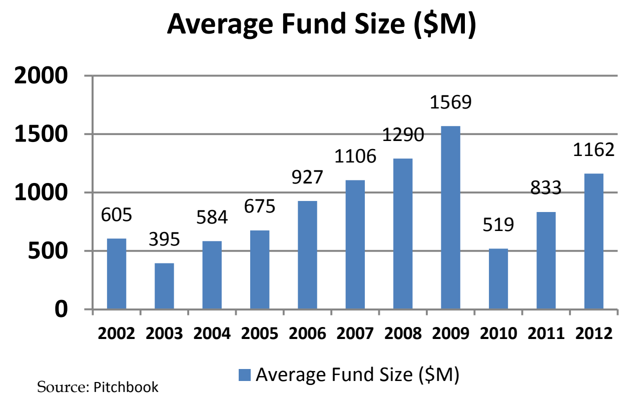
- One of the most important aspects of capital overhang is the large proportion of dry powder that is currently held in the 2007 and 2008 vintage funds. There is still more than $100 billion held in these vintages, which will evaporate over the next two years if not invested.



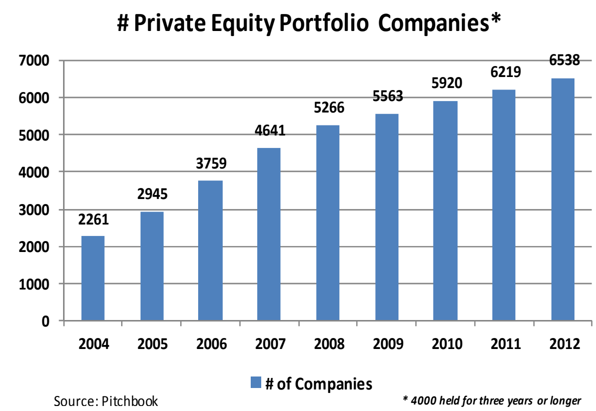
- In the remainder of this report we will examine fourth quarter activity and review the year to date. Some of the highlights include a further drop in deal volume, which has been in a steady decline for over a year; and the lowest level of PE investment since 2009. Pitchbook, in their fourth quarter Private Equity Breakdown, notes that the only positive sign was the steady level of fundraising. This is normally a leading indicator of activity to come.



- Fundraising was relatively strong in the first half of 2012, particularly in the 2Q 2012, but petered out in the last two quarters. Part of the reason for the muted fundraising in the second half of the year was investors' focus on deal-making. Fund sizes have more than doubled since 2010 and average fund sizes have once again ticked up over 1 billion.



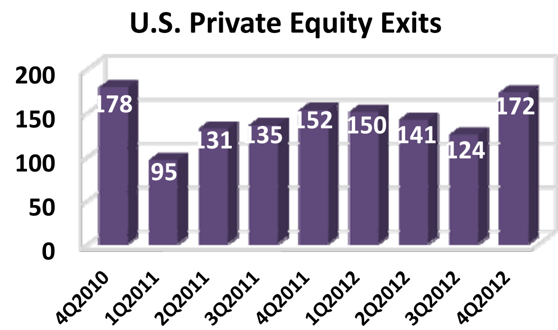
- PEG's have a significant inventory of PE-backed companies sitting in their portfolios, approximately 65% of which have been held for three years or longer. The median holding period for portfolio companies has risen 53% to 5.33 years since 2007, while the median age of a PE-backed company is now 4.9 years.



- Prolonged holding periods are now part of an ongoing sea of change in private equity, as the emphasis shifts from financial engineering and multiple arbitrages to revenue growth and operational improvements.

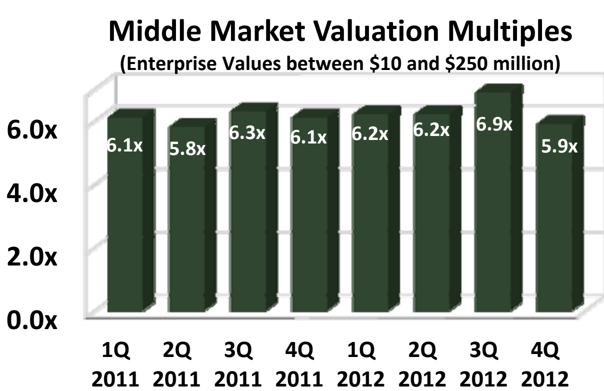
- For the sixth consecutive quarter, U.S. PEGs exited over 100 investments. Since hitting a nadir of 233 exits in 2009, activity rebounded strongly and is back to pre-recession levels. The number of quarterly exits has remained remarkably steady for the last six quarters.

❖ PE firms executed 172 exits in the fourth quarter, with capital exited totaling $53 billion. Sales to strategic acquirers (corporate acquisitions) remained the most common exit strategy.



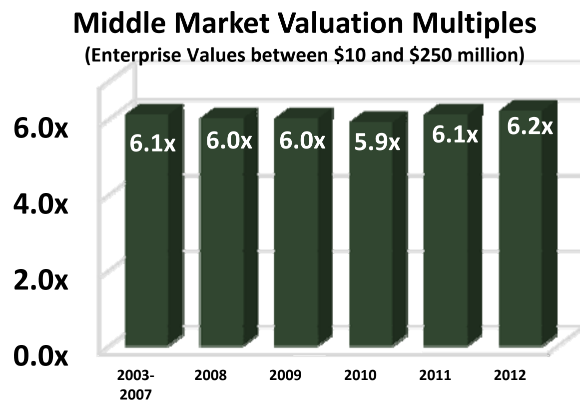
Source: Pitchbook

❖ U.S. middle market transaction multiples for businesses sold to financial firms averaged approximately 5.9x EBITDA in the fourth quarter of 2012, declining from 6.9x in the 3Q 2013. GF Data Resources makes an interesting observation that individual owners of small businesses were tax-motivated sellers, eager to complete their transactions by year end, and more than willing to concede price in an effort to complete their transaction. Larger ($50-250 million) and higher quality transactions continue to demand a premium. Also, there is a premium for above- average financial performance.



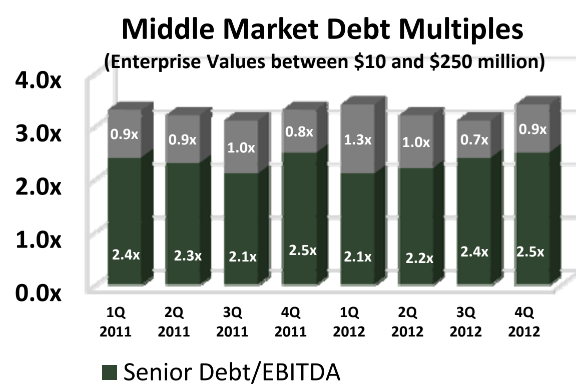
Source: GF Data Resources

❖ Looking at the year-to-date rather than the individual quarter smoothes out the spike, but the trend is still unmistakable. Valuations for 2012 are up. Given the significant private equity overhang and the scarcity of high quality deals, financial buyers are working hard to find platforms to invest in. Buyers are often paying a quality premium for a business with above-average financial characteristics.



Source: GF Data Resources

❖ Leverage multiples increased slightly to the mid threes for total debt and the mid twos for senior debt. More liberal debt structures continue to be available for larger deals. Senior debt spreads over LIBOR have been 5.3% to 5.6% throughout 2012.

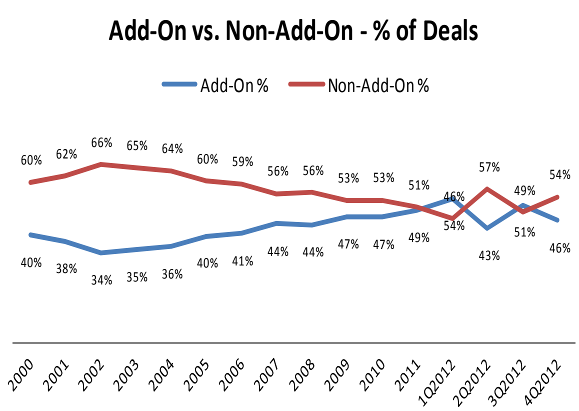


Source: GF Data Resources

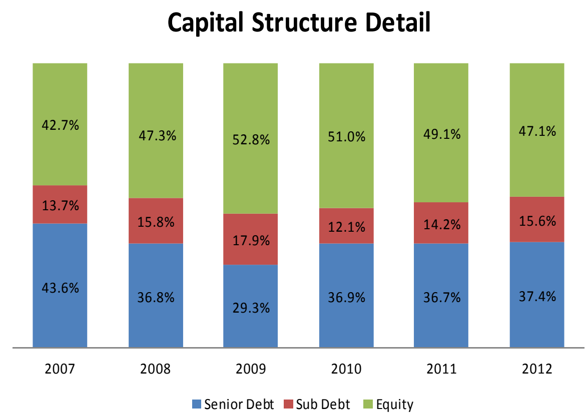
❖ The growing presence of the one-stop financing approach, as well as an increasing number of mezzanine lenders, continue to become a greater part of capital structures and stand ready to fill any void in the market. Mezzanine investors are more aggressively pricing transactions (current interest) with the average spread over LIBOR of 12.4% in the fourth quarter of 2012.

- Although bank financing is plentiful and aggressively priced, banks have become more conservative on structure, resulting in senior debt accounting for only about one third of an average buyout transaction's capital structure. These conservative leverage ratios continue to establish upper limits on financial buyer valuations.

- Add-ons accounted for 48% of the buyout activity in the fourth quarter of 2012. Add-on deals are being used as a means of increasing the operational capacity of portfolio companies, but PE firms are increasingly viewing add-ons as a viable way to put capital to work as well. Most PE firms are espousing a "buy and build" strategy, so it is not surprising to find that the proportion of add-on deals have increased steadily in recent years. Pitchbook believes the slight drop in the 4Q 2013 is likely an anomaly, as investors focused their attention on completing large platform acquisitions before the new year.



Source: Pitchbook



Source :GF Data Resources

- The equity contribution to a capital structure in the fourth quarter of 2012 made up 47.1% of a transaction's capitalization.

- In forecasting M&A activity in the near term there may be a pause in M&A activity in 1Q 2013. However, glimmers of hope are beginning to emerge, creating some optimism for the second half of 2013. The abundance of dry powder and the aging PE portfolios should provide the stimulus for a more robust year in the M&A market.

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Andy Bianco, Managing Director and Founder
Matt Steve, Senior Associate

Sources: Pitchbook - The Private Equity 2013 Annual Private Equity Breakdown; GF Data Resources February 2013 Report; NFIB Small Business Economic Trends, February 2013

Important Information

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