GulfStar Group
Investment Bankers

Middle Market Commentary

Middle market M&A got off to a slow start in the first quarter of 2016 according to information from GF Data[1] with only 46 closed transactions, compared to 66 in 1Q2015. 2Q2016 activity improved slightly as 58 transactions closed, up from 54 in 2Q2015. For the first half of 2016, there were 104 completed deals at an average multiple to EBITDA of 6.7x. Valuations for companies in the lower middle market ($10 to $250 million in value) were essentially flat compared to the 6.8x and 6.7x of 2014 and 2015, respectively. However, EBITDA multiples for all transactions in the $10 to $250 million range remain above their long-term average of 6.3x (2003 – 2016).

The size effect continues to materially impact middle market valuations. Companies valued in the $10 to $25 million range sold at an average of 6.0x EBITDA, while those in the $100 to $250 million range sold at an average of 8.3x EBITDA (see chart below). Generally, 1H2016 was good for sellers in the four size categories; multiples were above their long-term averages (2003 – 2016) in all but the $25 to $50 million range

TOTAL ENTERPRISE VALUE (TEV)/EBITDA

TEV	2003–2011	2012	2013	2014	2015	YTD 2016	Total	N =
10-25	5.6	5.8	6.0	5.6	5.9	6.0	5.7	972
25-50	6.2	6.2	6.8	6.6	6.7	6.1	6.3	736
50-100	6.8	6.7	6.8	8.6	7.8	7.5	7.0	507
100-250	7.3	7.4	7.5	7.8	9.0	8.3	7.6	230
Total	6.2	6.3	6.5	6.8	6.7	6.7	6.3	
N =	1484	247	162	216	232	104		2445

Please note that N for 2003-11 encompasses nine years of activity. SOURCE: GF DATA®

The quality of a firm's historical financial performance also affects the multiple that buyers are willing to pay. GF Data tracks two measures of financial performance:

1. Profitability as measured by trailing twelve month (TTM) EBITDA margin
2. Growth as measured by TTM revenue growth rate

Companies are classified as above average financial performers (quality firms) if either (a) both metrics are greater than 10% or (b) one is greater than 12% and the other greater than 8%. Buyout transactions involving quality firms constitute more than half (57%) of the entire GF database, and they receive, on average, greater EBITDA multiples than the other firms in the database. This quality premium has been rising during the 2003 – 2016 period studied. While the average quality premium in the full period is 6%, it has recently risen to 14%, 9%, 23% and 15% in the years 2013 – 2016, respectively.

Approximately 80% of the transactions in the GF database are concentrated in four industry groups. These industries and the 1H2016 multiple for each are manufacturing (6.4x), business services (7.1x), healthcare (7.0x), and distribution (6.9x). With the exception of healthcare, these multiples all exceed their long-term averages.

Sourcing capital to close a transaction is crucial for buyers, and the availability of senior debt for buyout transactions is a ready indicator of how active the market will be. In 2Q2016, senior lenders provided 2.9x EBITDA to the average small buyout ($10 to $25 million), while the largest deals ($100 to $250 million) received 3.5x EBITDA. In 2Q2016, total debt (senior and subordinated) in the average small deal was 3.3x, while in the largest transactions it was 4.2x. Overall, transaction leverage is up slightly year over year, due largely to the influence of non-bank lenders providing an increasing share of deal financings. The correlation between availability of debt and deal size is reflected directly in the multiples paid by buyers.

GF Data provides information on the total cost to the buyer as well as the recognized value to the seller, a difference that arises due to transaction costs. Buyer returns are affected by these all-in costs and include transactions costs, which in 1H2016 averaged 0.2x EBITDA, increasing average all-in buyer cost to 6.9x EBITDA.

The most significant change to deal terms in 1H2016 involved the level of indemnifications as a percentage of enterprise values. The impact of this change is also influenced by the size effect. The average indemnity cap for small firms rose to 25.9% from 18.2% in 2015, while for firms in the $25 to $100 million range it was 10.0% and for large firms just 4.0%. It is not a coincidence that the use of representation and warranty insurance in middle market transactions increased five-fold from 2011 to 2015, as estimated by insurer Marsh, McClennan & Co.

In summary, although the 2016 transaction count may be down slightly, GulfStar views the resilience in valuations as encouraging given that the average multiple remains above its long-term average and consistent with those from the strong 2014 and 2015 periods. These conditions are expected to persist through year-end. In the Texas geographic market, banks continue to actively reduce exposure to the upstream and midstream energy sectors while remaining supportive of quality transactions in other sectors and industries. Importantly, restructuring opportunities within the upstream sector are finally presenting themselves after a long period of indecision. GulfStar continues to actively represent businesses in downstream energy, manufacturing, retail, consumer, healthcare, software, technology, and business and industrial services, where buyer interest continues to be strong.

About GF Data®[1] - GF Data provides data on private equity sponsored M&A transactions with enterprise values of $10 to 250 million. GF Data gives private equity firms and other users more reliable external information to use in valuing and assessing M&A transactions. GF Data collects transaction information from private equity groups on a blind and confidential basis. Two hundred and thirty five private equity firms have provided information on deals included in this report. Market data is proprietary to GF Data and may not be reprinted, reproduced or used without the permission of GF Data Resources LLC or GulfStar Group.