GulfStar Group
Investment Bankers

Middle Market Commentary

Although many sellers were expected to push off end-of-year closings in anticipation of federal tax changes, the completed deal volume for the final quarter of 2017 was up over the corresponding quarter of 2016 (68 deals in 2017 versus 57 in 2016). Valuations continued to climb in this seller's market with the average EBITDA multiple in Q4 2017 reaching an unprecedented 8.1x. According to GF Data, the biggest trends of 2017 were the continuation of the seller's market and the increase in rep and warranty insurance, which led to significant decreases in indemnification caps.

The size premium persisted in 2017 (see chart below). Companies valued in the $10-$25 million range sold at an average of 6.9x EBITDA in Q4 2017 (6.4x for the full year), while those in the $100-$250 million range sold at an average of 9.8x EBITDA (9.2X for the full year). The market continues to be strong for sellers across all size categories, as multiples remain above their long-term averages (2003-2017) in all enterprise value ranges.

TOTAL ENTERPRISE VALUE (TEV)/EBITDA

TEV	1Q 2016	2Q 2016	3Q 2016	4Q 2016	1Q 2017	2Q 2017	3Q 2017	4Q 2017	N =
10-25	5.9	6.1	5.5	5.8	6.0	5.8	7.0	6.9	161
25-50	6.1	6.7	6.4	6.4	6.4	7.1	6.1	7.0	121
50-100	6.9	8.5	6.9	6.4	6.8	8.6	8.7	8.9	96
100-250	7.8	8.6	10.9	9.4	8.3	9.0	9.3	9.8	73
Total	6.5	7.1	6.6	6.8	6.6	7.3	7.5	8.1	
N =	51	76	36	57	64	51	48	68	451

Source: GF Data®

In the middle market, GF Data refers to the reward in valuation for above-average financial performance as the quality premium. Quality is linked to higher EBITDA margins and growth rates. Buyout transactions involving quality firms constitute more than half (57%) of the entire GF database, and these firms received, on average, greater EBITDA multiples than other firms in the database. This quality premium has been rising during the period studied by GF Data (2003-2017). While the average quality premium in the full period (2003 – 2017) is 10%, it has consistently risen in recent years, resulting in an average quality premium of 20% in 2017 and during the 2013-2017 period.

Approximately 80% of the transactions in the GF Database involve target firms in four industry groups. These industries and the 2017 average multiple for each are manufacturing (6.9x), business services (7.5x), healthcare services (8.1x), and distribution (7.6x). Valuation multiples were higher than long-term averages for all industries.

In addition to industry groups, GF Data also provides information on the cost to the buyer as well as the price to the seller. This difference arises because of the buyer's transaction costs. The buyer's returns are based on its all-in costs including transactions costs. In 2017, transaction costs averaged 0.27x EBITDA, making the average all-in cost to the buyer 7.7x EBITDA.

GF Data's Leverage Report further illustrates the relationship between increased valuations and debt multiples, which remained at the elevated levels established earlier in the year – senior debt averaged 3.5X and total debt averaged 4.3x for 2017. The availability of debt to fund a transaction and grow the target directly impacts the buyer's ability to pay higher multiples. A ready indicator of healthy market valuations is the availability of senior debt for buyout transactions. For 2017, senior lenders provided 3.6x EBITDA to the average small buyout ($10-$25 million), while the largest deals ($100-$250 million) received 3.8x EBITDA. In 2017, total debt (senior and sub) in the average small deal was 4.1x, while in the largest transaction category it was 4.8x. The increase in transaction multiples also resulted in higher equity contributions as a percentage of capital (equity share averaged 47% in Q4).

GF Data's Key Deal Terms report for Q4 2017 demonstrates the further decline of indemnification caps as the use of rep and warranty (R&W) insurance continues to surge. Indemnification caps dropped from an average of 15.9% of Total Enterprise Value (TEV) in 2016 to 12.1% in 2017. Over the past year, the average indemnity cap for firms in the $10 - $25 million range decreased slightly from 19.4% in 2016 to 16.4%, and the average indemnity cap for firms in the $25 - $50 million range decreased slightly from 13.5% to 11.6%. The decrease in indemnity caps becomes more dramatic in the $50 - $100 million range, where the average decreased from 19.6% of TEV in 2016 to 8.4% in 2017. While the average indemnity cap for the largest firms increased from 4.3% in 2016 to 6.0% in 2017, the level of indemnity for these transactions was already low and consistent with significant reliance on R&W insurance.

Following on the strength of 2017, GulfStar expects the middle market M&A environment in 2018 to be an even stronger seller's market. Business owners should continue to make the most of these favorable conditions – increased valuation levels reflected in high EBITDA multiples, readily available debt, private equity dry powder, and a strong macro-economic environment – while they last. GulfStar actively represents businesses in energy, manufacturing, distribution, retail, consumer, healthcare, software, technology, and business and industrial services, where buyer interest continues to be strong.