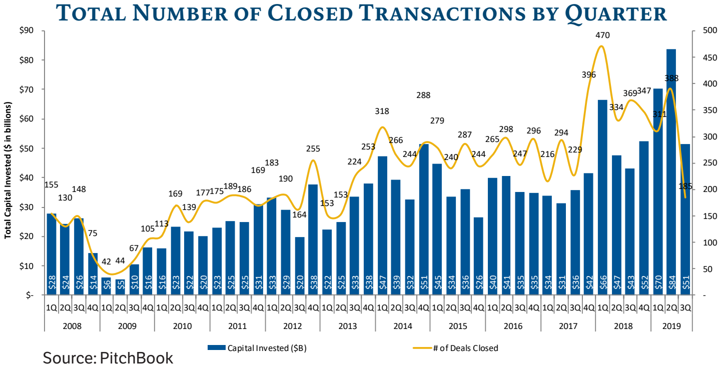
GulfStar Group
Investment Bankers

Middle Market Commentary – Q3 2019

Middle market merger and acquisition activity continues unabated as owners take advantage of favorable economic and financial market conditions that most M&A practitioners believe should be well past their sell-by dates. Overall, North American M&A volume in 2019 is projected to surpass $2.0 trillion for the second straight year. Year-to-date middle market transaction volume through the first three quarters increased year-over-year, though the pace of 2019 activity was skewed more heavily towards the early periods and associated deal count declined. It is too soon to conclude that expectations of slowing growth among middle market companies is damping owner motivation to sell. More likely is that three years of wide-open dealmaking activity has depleted the supply of quality middle market companies available to transact.

Total Number of Closed Transactions by Quarter



Source: PitchBook

Conversations with private equity groups (PEGs) in late 2018 routinely revealed that they were underwriting to a cyclical downturn entering the year. PEGs were in the final stages of emptying their portfolios to take advantage of the highly favorable seller's market, with public market valuations and a cooperative credit environment buoying buyer appetite at favorable pricing and terms. Yet twelve months later, the overall economic outlook may actually be slightly better. This far into an expansion, as tepid as the early years may have been, buyers intuitively feel that the party must be winding down. If a seven-year business cycle is the standard measure, then we blew past that gate a long time ago. However, unemployment rates continue to challenge historical lows, real wage growth and company productivity are accelerating, and inflation remains little more than a theoretical concern. The resulting cognitive dissonance among deal professionals is driving uncertainty despite no specific macro risk. Yet buyers recognize that pricing this uncertainty into their bids risks being shut out of what remains a highly competitive M&A market.

2019 Transaction Environment

Despite the slower transaction pace in 3Q 2019, valuation multiples and deal sizes remain elevated. Most noticeable was the jump in the multiple differential between smaller deals valued at $25 – $50 million and those at $100 – $250 million. Over the last two years, this multiple spread averaged 2.3 times EBITDA. In the third quarter of 2019, it jumped to 3.8 times, supporting the theory that demand for companies with $10 million or more of EBITDA is beginning to meaningfully outstrip supply.

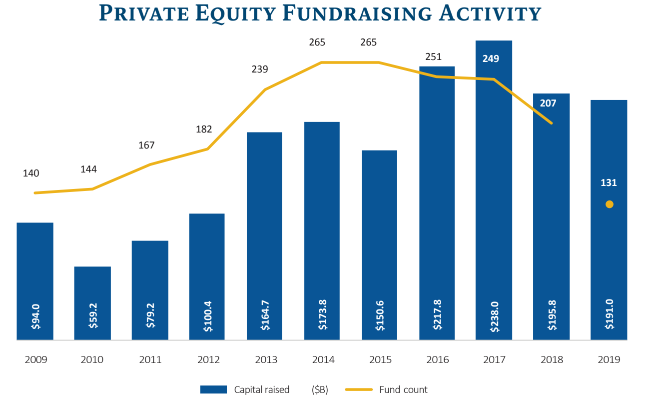
TEV/EBITDA – Quarterly Splits ($25-$50MM/$100-$250MM)

TEV	4Q 2017	1Q 2018	2Q 2018	3Q 2018	4Q 2018	1Q 2019	2Q 2019	3Q 2019	Total
25-50	6.9	6.7	6.6	7.0	7.2	6.9	7.2	6.5	6.88
100-250	9.8	8.5	8.4	8.4	9.6	8.8	9.5	10.3	9.16
Total	2.9	1.8	1.8	1.4	2.4	1.9	2.3	3.8	2.29

Source: GF Data

This trend is compounded by the continued growth in available private equity dollars. PitchBook data anticipates that total 2019 private equity fundraising will substantially outpace that of 2018 and potentially eclipse the previous record set in 2017. The total number of funds, however, is declining as limited partners channel more capital to those with proven track records.

Private Equity Fundraising Activity



Source: PitchBook's Private Market Playbook 4Q 2019

The result is an interesting dynamic whereby larger funds increasingly come down market in search of less competitive (and expensive) acquisition opportunities despite having greater amounts of capital to deploy. It is also fueling a greater emphasis on buy-and-build strategies. Through the third quarter, a full 68% of 2019 private equity buys were add-ons to existing portfolio companies. This figure has consistently trended upward yet leaped to nearly 67% in 2018 after averaging 62% over the preceding five years. With usage of debt approximately consistent (more on this later) and prices continuing to test historical highs, blending down acquisition multiples through accretive add-on acquisitions is one of the few levers available to drive equity returns.

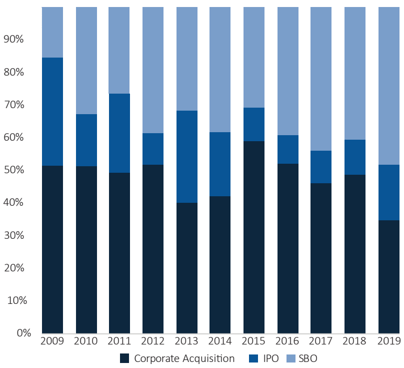
Likewise, 2018 was a record year for private equity exits, indicating that these groups will be working overtime to reconstitute their holdings with growing pools of available capital. This dynamic bodes well for both continued health in valuation multiples and private equity as the dominant force in middle market M&A. After several years of PEGs divesting portfolio companies almost equally

GulfStar Group
Investment Bankers

Middle Market Commentary – Q3 2019

to strategic buyers and other PEGs, the trend in 2019 has skewed heavily towards secondary buyouts as the primary means of exit. For larger portfolio companies, healthy public equity markets meant the greatest proportion of exits via IPO since 2014.

Private Equity Exits ($) By Type



Source: PitchBook's Private Market Playbook 4Q 2019

While strategic buyers seemingly lost ground on private equity exits so far in 2019, their recent willingness to deploy capital signals a more aggressive stance. Using the S&P 500 as a proxy for U.S. strategics, the post-financial crisis trend towards hoarding cash and retiring debt has partially reversed.

The aforementioned record volume of North American M&A activity is a direct result of this corporate confidence, and benefits the middle market either through direct participation or setting benchmarks for transaction values.

The Lending Environment

A supportive lending environment continues to fuel buyout activity. According to GF Data, the use of leverage in the middle market remains effectively unchanged since 2015, ranging from 3.8x to 4.2x EBITDA during this period. Any annual variation was due to minor ebbs and flows in senior lender appetite. After increasing to a recent high of 3.4x in 2017, senior lenders became more conservative in 2018 on the same prevailing sentiment expressed by many buyers. Net interest margin nonetheless tightened in 2018 on continued heavy competition for new loan originations. A 2019 decline in base rates (LIBOR and U.S. Prime Rate) resulted in all-in debt costs that are only slightly greater than those during the Fed-driven recovery period of the mid-2010s. Average senior debt leverage through Q3 2019 increased to 3.3x from 3.0x in 2018. The percentage of equity utilized in middle market buyouts likewise decreased from 49.0% in 2018 to 45.3%, though this primarily served to bring equity contributions back in line with the 45.5% five-year average. Meanwhile, subordinated lenders contributed the same additional 0.8x of leverage as provided since 2016.

Unscientific lender polling suggests that this forward posture will continue into 2020. The migration from traditional regulated senior lenders to business development companies and non-bank debt funds has been complete for some time now, and these groups are generally nimble and creative enough to find opportunities for deploying capital even during economic swings. Adequate equity contribution to a transaction and borrower-specific evaluation of debt service capabilities should enable continued access to senior financing for healthy businesses. Subordinated debt funds seem content to continue offering their additional turn of leverage.

Middle Market Outlook

While overall market conditions seem to be on an even keel, growth among middle market companies themselves unquestionably slowed in the third quarter. The National Center for the Middle Market (NCMM) reported that all key performance indicators declined, though metrics remain more compelling than those for the economy as a whole. Revenue growth across the NCMM's pool of 1,000 reporting companies averaged 5.8% year-over-year, down from 8.8% at this point in 2018. Employment growth likewise declined to 4.1% from 6.4% in the second quarter of 2019.

Despite these declines, owners and managers are far more concerned about global markets than their own. Per the NCMM, 81% have confidence in their local economies, and 76% in the national economy. It is only once the global outlook is considered that confidence falls considerably, to 55%. Therefore, owners contemplating transactions in 2020 more likely will be those focused primarily upon domestic markets, at least until there is greater clarity into foreign revenue pipelines. It is also likely that management teams will see uncertainty surrounding outcomes from the 2020 elections as having material potential impact upon their businesses. Those that consume substantial amounts of power and/or generate emissions (manufacturing, logistics, oil & gas) or rely upon government contracts (healthcare, defense & aerospace), for instance, face potentially substantial changes in regulatory frameworks or revenue models. State and local regulations can likewise have direct impacts upon profitability. GulfStar considers the political noise, which is sure to ramp up throughout 2020, as a primary risk to the recent healthy pace of M&A activity.

GulfStar thus enters 2020 cautiously optimistic. The U.S. economy continues to expand without apparent evidence of over-investment or over-borrowing. Public market valuations serve as encouraging guideposts for private company valuations, debt remains readily available at favorable rates, private equity capital is plentiful and strategic buyers are signaling willingness to invest. As for what will bring this seemingly perpetual boom market to an end, no one has any more idea this year than they did at this point in 2018.