



# GULFSTAR GROUP

## INVESTMENT BANKERS

### Middle Market Commentary

Based on current market insights and the results of the most recent GF Data M&A report (for M&A transactions between \$10 million and \$250 million through June 30, 2018), there are four primary characteristics that describe today's M&A environment: (1) valuations remain strong for sellers despite a slight drop in deal volume this quarter (2) the size premium persists (3) debt availability continues to drive purchase price and transaction structure, and (4) the use of rep and warranty insurance expands across the board.

While average valuations remain steady at historically unprecedented levels (7.4x in Q2 '18 versus 6.8x in Q1 '18), the only incongruity in this first half is deal volume (47 deals in Q2 '18 versus 63 in Q1 '18 and 57 in Q2 '17). Although this drop seems at odds with current anecdotal impressions of a strong M&A market, it is more important to assess annual and long-term comparisons rather than quarterly. Current period valuation multiples for all enterprise value ranges in Q2 '18 are higher when compared to both Q2 '17 and the corresponding long-term average for 2003-2017, pointing to the continuation of a strong seller's market.

#### TEV/EBITDA—QUARTERLY SPLITS

	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	
TEV	2016	2016	2017	2017	2017	2017	2018	2018	N =
10-25	5.5	5.7	6.0	5.7	7.0	6.9	5.7	6.1	165
25-50	6.4	6.2	6.4	7.3	6.0	6.9	6.6	6.6	120
50-100	6.9	6.4	6.8	8.6	8.7	8.8	8.8	9.6	99
100-250	9.8	9.4	8.3	8.7	9.3	9.8	8.6	8.4	68
<b>Total</b>	<b>6.6</b>	<b>6.7</b>	<b>6.6</b>	<b>7.2</b>	<b>7.6</b>	<b>8.0</b>	<b>6.8</b>	<b>7.4</b>	
<b>N =</b>	<b>38</b>	<b>60</b>	<b>65</b>	<b>57</b>	<b>52</b>	<b>70</b>	<b>63</b>	<b>47</b>	<b>452</b>

SOURCE: GF DATA®

The size premium – the spread in valuation multiples between \$10-\$50 million and \$100-\$250 million transactions – has never been higher (a spread of 3.4x EBITDA in Q2 '18). Companies valued in the \$10-\$25 million range sold at an average of 5.9x EBITDA in Q2 '18 (6.4x for 2017), while those in the \$100-\$250 million range sold at an average of 8.5x EBITDA (9.2x for 2017).

Buyout transactions involving quality premium firms – those with above-average financial performance – constitute more than half (57% historically) of the entire GF database. These quality premium firms exhibit greater EBITDA margins and revenue growth rates than similar size firms in the database. This quality premium has been rising during the period studied by GF Data (2003-2018). While the average quality premium in the full period (2003 – 2018) has been 11%, it has consistently risen in recent years. In 2016, 2017 and the first half of 2018, quality premium firms sold for multiples that, on average, were 22% greater than other firms with similar EBITDA.

Approximately 80% of the transactions in the GF Database involve target firms in four industry groups. These industries and the Q2 '18 average multiple for each

are manufacturing (6.7x), business services (6.9x), healthcare services (7.6x), and distribution (7.6x).

One industry group that GulfStar believes will receive increasing attention due to macro changes in the economy is distribution. While the growth of Internet purchases by consumers has adversely affected brick-and-mortar retailers, it provides an opportunity for distributors, who structure their business models to participate in the on-line revolution. Middle market distributors can compete effectively in the new economy if they can offer one or more of the following for their customers: high-touch customer service, a hard-to-disrupt niche or added value. Serving a specialty niche is especially important to private equity firms pursuing a distribution-focused investment thesis. Another factor that makes distribution attractive to the private equity industry is that it tends to be fragmented, creating opportunities to achieve the efficiencies through consolidation and process improvement – two traditional growth strategies employed by private equity firms. This trend creates an outstanding opportunity for middle market distributors to transact with private equity firms. GulfStar currently represents several middle market distributors that are capitalizing on this trend.

The availability of debt to fund a transaction and grow the target directly impacts the buyer's ability and willingness to pay higher multiples. As shown in GF Data's Leverage Report, senior debt for all closed deals in Q2 '18 averaged 3.2x EBITDA and total debt averaged 3.9x. While lenders normally provide more debt to larger transactions, in Q2 '18, senior lenders provided 3.9x EBITDA to the average small buyout (\$10-\$25 million), while the largest deals (\$100-\$250 million) received only 3.2x EBITDA. In Q2 '18, total debt (senior and sub) in the average small deal was 4.1x, while in the largest transactions it was 4.2x.

Typically included in a purchase agreement are indemnification caps, which limit the total amount payable by the seller in the event of an indemnity claim. Indemnity caps increased from an average of 11.8% of Total Enterprise Value in 2017 to 15.8% in 2018, reflecting higher post-closing risk exposure to sellers. Over the past year, the average indemnity cap increased slightly for firms in all size ranges (10-25 = 21%, 25-50 = 13.9%, 50-100 = 10.9%, and 100-250 = 6.9% respectively). On the other hand, Rep and Warranty (R&W) insurance allows the seller to transfer post-closing risk from indemnity claims to an insurance company. Reliance on R&W insurance continues to rise across the board (43% of all deals in 2017 to 47.3% in the first half of 2018).

In conclusion, it is not unusual to see a decrease in deal activity in the second quarter of the year, as most deals are initiated early in the first quarter and close towards year-end (a result of the six-to-nine-month sale cycle). GulfStar expects the middle market M&A environment to remain a strong seller's market through the end of 2018 and will continue to actively represent middle market businesses in energy, manufacturing, distribution, retail, consumer, healthcare, software, technology, and business and industrial services. The firm has a high level of pending transactions going into 2019.