CLEARY GULL

MARKET MONITOR

M&A AND FINANCING UPDATE 2nd QUARTER 2019

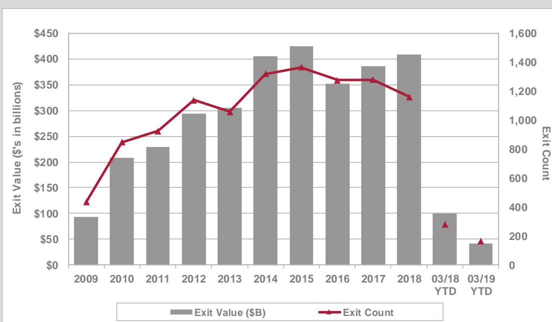
Reduced Private Equity Activity Driving Downward Trend in Transaction Volume

There was a significant pause in private equity exits in Q1 2019. According to PitchBook, private equity firms sold 164 companies during that period, which was 41.2% lower than Q4 2018 and 42.5% lower than Q1 2018. PitchBook noted that the decline in private equity sellers in Q1 was most likely caused by a combination of factors including: 1) stock market volatility; 2) the multi-week government shutdown; and/or 3) private equity firms holding successful investments longer. Another possible factor in the lower volume of private equity exits in 2019 could be the high volume of deals with short hold periods that hit the market in 2017 and 2018, when private equity firms may have been "pulling forward" the sale of both high quality and underperforming assets in order to take advantage of a hot market.

Despite the significant decline in the number of private equity sellers in early 2019, the overall decline in transaction volume for deals under $500 million was less than the last two years as entrepreneurs and corporations took advantage of strong valuation multiples. Through April 2019, the total number of completed transactions under $500 million declined 5.2%, compared to the first four months of 2018, according to Robert W. Baird & Co. This modest overall decline masks significant fluctuations in activity early in the year. In January, transactions under $100 million declined 33% year-over-year. This same size category then experienced a very strong April, posting a year-over-year increase of 76.1% that could signal the beginning of a period of renewed deal volume for the remainder of 2019.

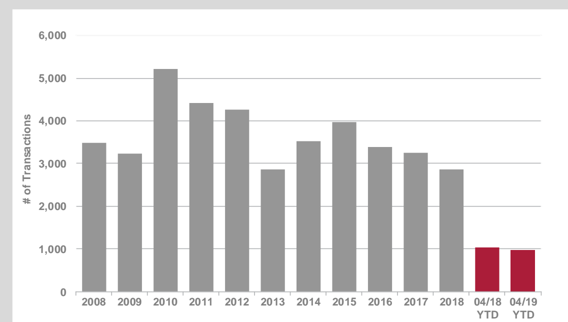
Looking forward, we expect deal volume to continue to improve based on market feedback from corporations and private equity groups that new inbound deal flow has significantly increased at the beginning of Q2 2019. If this increased deal flow results in completed transactions, the market should experience a nice uptick and a strong finish to the year.

U.S. PE-backed Exit Activity



Source: PitchBook

U.S. M&A Deal Volume for Transactions Under $500MM



Source: Robert W. Baird & Co.

Average Platform LBO Debt Multiples for Deals with $10M - $250M of Enterprise Value

TEV	2003 - 2014	2015	2016	2017	2018	2019 YTD	Total
$10M-$25M	3.0x	3.3x	3.2x	3.3x	3.0x	2.5x	3.1x
$25M - $50M	3.3x	3.4x	3.3x	3.6x	3.2x	3.6x	3.3x
$50M - $100M	3.5x	4.1x	4.3x	4.1x	3.8x	3.5x	3.7x
$100M - $250M	4.2x	4.6x	4.6x	5.0x	5.0x	3.4x	4.5x
Total	3.3x	3.7x	3.7x	3.9x	3.6x	3.5x	3.5x
N =	940	162	143	146	158	33	

Source: GF Data®

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$25M - $50M	3.4x	3.7x	3.7x	3.9x	3.6x	4.1x	3.5x
$50M - $100M	3.6x	4.3x	4.2x	4.4x	4.2x	3.9x	3.8x
$100M - $250M	4.1x	4.8x	4.8x	4.8x	4.9x	3.4x	4.4x
Total	3.4x	4.0x	3.9x	4.2x	3.9x	4.1x	3.5x
N =	1854	215	206	217	252	50	

Source: GF Data®

Debt for Add-Ons Masks Contraction in Availability for Platforms

The average total debt/EBITDA multiple for private equity-backed leveraged buyouts ("LBOs") from $10 to $250 million was 4.1x in Q1 2019, which was fairly consistent with the average amount of total debt available since 2015, according to GF Data®.

During the quarter, there was a divergence in debt available for platform and add-on acquisitions. For the first quarter of 2019, the average platform LBO debt multiples for $50 to $100 million and $100 to $250 million enterprise transactions were 3.5x and 3.4x EBITDA, respectively, which was a contraction of available total debt/EBITDA multiples of 0.3x to 1.6x, when compared to the 2018 and recent historical averages.

The reduction in available debt for new platforms has been offset by lender enthusiasm to support add-on acquisitions for existing clients. According to GF Data®, average total debt/EBITDA multiples for add-ons has been 5.1x over the last five quarters.

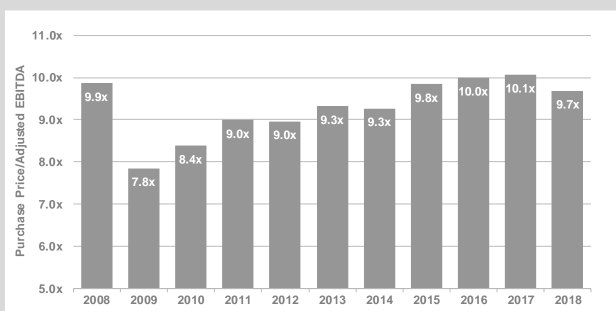
The debt availability gap between add-ons and platforms is most significant in the $10 to $25 million enterprise value transactions where the average total debt/EBITDA multiples was only 2.5x for new platforms. The level of debt available for platforms directly influences average purchase price multiples.

Valuation Multiples Experience a Q1 Pullback

According to GF Data®, Q1 2019 average enterprise value/EBITDA multiples for $10 to $250 million enterprise value LBOs experienced a modest decline to 6.9x EBITDA when compared to the 2018 average of 7.3x. The decline was similar to the dip experienced between the end of 2017 and Q1 2018.

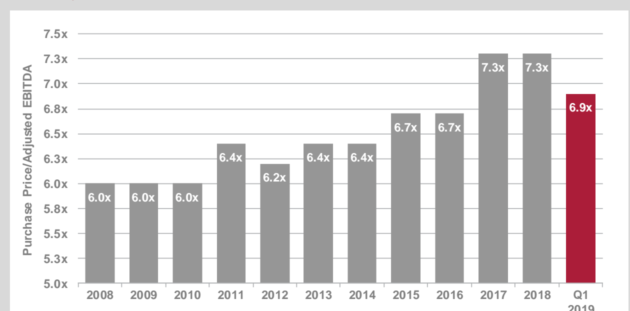
The only surprise in the data was in the $50 to $100 million transaction segment, which declined almost 2.0x from an average of 9.7x to 7.6x EBITDA between 2018 and Q1 2019, leading to a significant decline in the size premium for transactions above $50 million of enterprise value, as compared to smaller deals. For Q1 2019, the size premium was only 1.6x EBITDA, compared to 2.9x for 2018 and 2.3x for the historical average. A deeper analysis of the data reveals that manufacturing and business service deals experienced over a 1.5x EBITDA valuation multiple decline. The release of Q2 2019 data will help to answer the question of whether 2019 is the beginning of a valuation correction or a timing aberration similar to Q1 2018.

U.S. M&A Transaction Multiples



Source: PitchBook

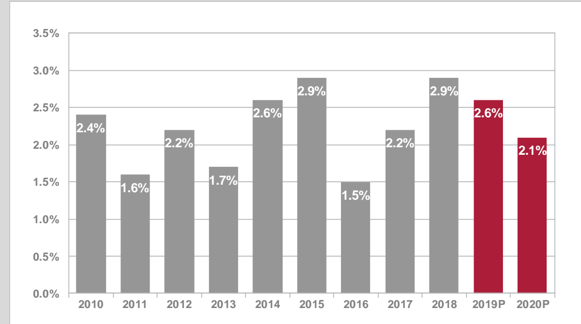
Average Purchase Price/Adjusted EBITDA Multiples for Private Equity-Backed LBOs with $10M - $250M of Enterprise Value



Source: GF Data®

Most economic indicators remain positive despite month-to-month volatility

U.S. Real GDP



Source: Wells Fargo Securities Economics Group

Investment Timing Continues to Drive Market Appeal and Valuation

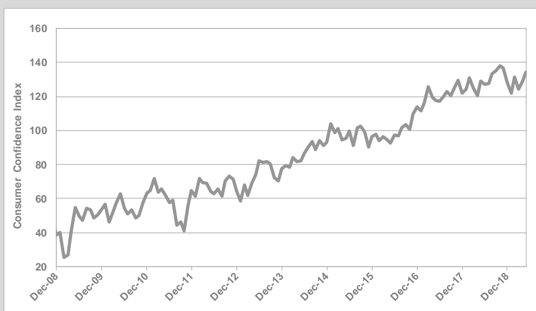
The current economic expansion just became the longest in history, surpassing the 120-month expansion experienced from March 1991 to March 2001. Based on the premise that all good things must end, private equity investors are becoming more selective as they consider new investments in this economic cycle. The selectivity is creating an interesting valuation dynamic between companies perceived as serving recession-resistant markets and those serving markets that are historically cyclical.

Over the last two years, companies serving "A" markets, such as healthcare or regulation-driven services, have continued to ride the "sellers' market" wave, garnering double-digit valuation multiples almost irrespective whether EBITDA was above or below $10 million. In addition, lenders, and especially unregulated ones, have been willing to commit more than 5.0x total debt/EBITDA to companies with a recession-resistant business model. Conversely, we are seeing a "buyers' market" for industrial businesses that have historically experienced a dip in performance at the end of an economic cycle. One of the drivers of the buyers' market for cyclical industrials is lower total facility sizes and funded debt limits of over 1.0x total debt/EBITDA for companies that have traditionally cycled with the economy, as compared to the available leverage for similar industrial businesses in late 2017 and early 2018.

Based on the behavior of some private equity firms, it appears that they are relying more on historical economic patterns than fundamental data. Among the economic data as of May, consumer confidence was close to an 18-year high at 134.1, the unemployment rate of 3.6% was the lowest it has been since 1969, and GDP growth remained positive at 2.6% for 2019 despite the government shutdown early in the year and tariff uncertainty headwinds.

While it is possible the expansion could last a few more years, several private equity professionals commented at ACG Intergrowth that the threat of a recession during the next five years is having a greater influence on investment decisions today than it did 18 months ago. Conversely, we are seeing an uptick in strategic buyer interest for industrial businesses that have been targets on a corporate development "white board" for years because of diminished private equity interest and lower valuations.

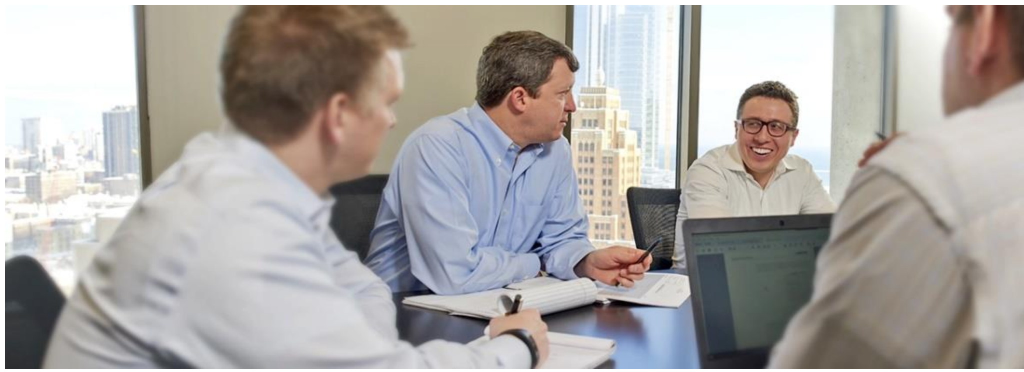
U.S. Consumer Confidence Index



Source: Conference Board

U.S. Unemployment Rate

Source: Federal Reserve Bank of St. Louis



Firm Overview

Founded in 1987, Cleary Gull Inc. is a nationally recognized, employee-owned boutique investment banking firm with a global reach. We advise private equity funds, entrepreneurs, and small publicly traded companies on mergers and acquisitions, private debt and equity financings and recapitalizations and other transactions.

Our talented team has completed hundreds of middle market transactions delivering more than $8 billion in value. With an average of more than 20 years of deal experience, our skilled senior investment bankers bring knowledge, integrity and relentless determination to deliver great outcomes for our clients.

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