



GULFSTAR GROUP

INVESTMENT BANKERS

Middle Market Commentary

At the end of the first quarter of 2015 (1Q2015), we thought that the total number of completed deals in the middle market in 2015 might rival the 245 transactions reported to GF Data in 2012. In 1Q2015, 51 mid-market deals were completed, 30 percent above the 41 deals completed in 1Q2014. However, the pace of activity slowed down in 2Q2015. Only 49 closed deals were reported, while there were 53 closed deals in 2Q2014. The mid-year results, 103 closed deals in 2015 compared to 94 in 2014, portends a year-end deal count in the 220 to 230 range if the current pace is maintained.

The slow-down in the level of activity does not result from a lack of buyers. Corporate balance sheets are still flush with cash and private equity firms continue to operate with plenty of dry powder for platform and bolt-on acquisitions. The lenders also continue to cooperate. GF Data's Leverage Report indicates that debt for mid-market deals is readily available. At 4.0x EBITDA during the first half of 2015 (1H2015), transaction leverage multiples are the highest they have been during the 2011-2015 period and well above the reported average of 3.5 during the 2003-2010 period (see Table A). However, debt multiples were lower for smaller companies and higher for larger ones.

So, the market is active, but not as active as we would have predicted, given current conditions. The likely explanation is seller reluctance to come to market. Normally, we find that seller reluctance is related to current conditions affecting valuations: EBITDA multiples, the company's current performance (EBITDA margins and growth), the current industry outlook, macroeconomic policy conditions, or the stage of the business cycle. Interest rates are low, the US economy continues to improve, albeit at a slower rate than the long-term average, and most industries, with the exception of upstream

energy, are showing improvement as the overall economy improves.

One might conclude, therefore, that the culprit is valuation multiples. GF Data provides a partial answer to this question. GF Data reports that, in the middle market, size along with three other factors affect multiples. The size differential, as shown in Table B, is prominent and has been present throughout the period covered by GF's data base. The additional factors they have identified are (i) the identity of the selling owners (institution versus individual/family), (ii) above average financial characteristics (EBITDA margins and growth rates), and (iii) continuation of management post-close. It appears that buyers are more discriminating in the current market.

In Table B, the average EBITDA multiple for 103 transactions 1H2015 was 6.8x, exactly the same as 2014, and well above the average in 2011, 2012 or 2013. GF breaks deals into four size ranges by total enterprise value (TEV) in millions of dollars: 10-25, 25-50, 50-100, and 100-250. A significant size premium has been evident in the GF data base for as long as data has been collected. The clear market message is that size directly affects multiples. In 1H2015, companies in the 10-25 range sold for average multiples of 5.9, while companies in the 100-250 range sold for average multiples of 8.6, a premium of more than 45 percent. Across all four groups, GF Data reports that companies with above average financial characteristics sold for 7.4 times, on average, and all others sold for 5.4. Clearly the market is willing to pay a premium for quality as well as size. Finally, average multiples in all four size categories were well above their long-term averages. Consequently, we believe the data indicates that the market continues to be very favorable for high quality companies.

TABLE A

TOTAL DEBT/EBITDA—SPLITS BY PERIOD

TEV	1Q	2Q	3Q	4Q	1Q	2Q	N =
	2014	2014	2014	2014	2015	2015	
10-25	3.1	3.9	3.3	2.9	3.9	3.6	105
25-50	3.3	4.1	3.4	3.5	4.3	4.1	73
50-100	4.8	3.7	5.5	4.2	3.9	4.2	55
100-250	4.5	4.0	4.5	4.2	4.2	5.2	34
Total	3.6	4.0	3.7	3.7	4.0	4.0	
N =	33	46	38	52	53	45	267

Source: GF Data Resources

TABLE B

TOTAL ENTERPRISE VALUE (TEV)/EBITDA

TEV	2003					1H		Total	N =
	-10	2011	2012	2013	2014	2015			
10-25	5.6	5.3	5.8	6.0	5.4	5.9	5.6	875	
25-50	6.2	6.4	6.2	6.9	6.7	7.4	6.3	650	
50-100	6.7	7.5	6.8	6.8	8.6	7.5	7.0	463	
100-250	7.2	7.7	7.4	7.5	7.8	8.6	7.5	202	
Total	6.1	6.4	6.3	6.5	6.8	6.8	6.3		
N =	1273	211	245	153	205	103		2190	

Please note that N for 2003-10 encompasses seven years of activity.

Source: GF Data Resources