MARCH 2016

Perspectives

SPOTLIGHT ON PRIVATE EQUITY

VIEWS ON INDUSTRY TRENDS AND NEWS

Private Equity in the Mid-Market

"Those who cannot remember the past are condemned to repeat it." - George Santayana, Spanish philosopher and poet

Valuation and leverage multiples in the middle-market segment of the North American private equity market have exceeded the highs of the pre-financial crisis era, making us wonder if both sponsors and lenders are suffering from a severe case of selective amnesia, forgetting (or perhaps repressing) the painful years from 2008 through 2010. However, this frothiness appears to be much more pronounced in larger transactions as well as premium quality businesses and has failed to result in a flood of transactions in the lower middle-market.

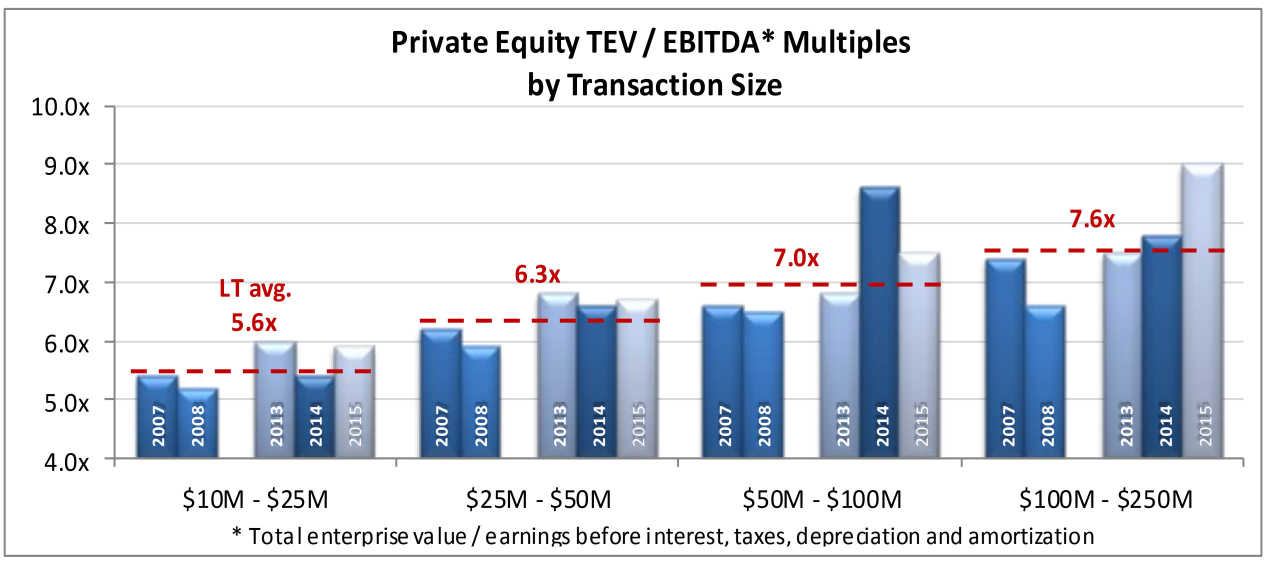
Are we heading for another crash comparable to what occurred in 2008? Although it is possible, and despite the recent market dislocation, we consider it unlikely. However, there is the distinct possibility that many of the high-value high-leverage purchases being completed in the current environment represent excessive risk at a very uncertain point in the economic cycle.

Given the cross-border nature of North American private equity as well as its importance to the Canadian M&A market in general, we believe these trends are instructive for the Canadian M&A market.

This issue of Perspectives will attempt to provide some insight into the underlying factors driving the current market conditions and reiterates our view that it remains a sellers' market and a great time for business owners to consider a sale or other liquidity event. We are pleased to share highlights from data compiled by GF Data and Pitchbook, which both collect statistics for North American middle-market private equity transactions.

Valuation: The Sky is the Limit?

Private equity firms pushed purchase price multiples above levels last observed during the debt fuelled run prior to the 2008 crisis, particularly at the upper end of the middle market ($100 to $250 million) where the average multiple has moved to 9.0x EBITDA, well above the long-term average of 7.6x EBITDA. In addition, businesses with above-average EBITDA margins and sales growth traded at 7.4x EBITDA in 2015, a 23% premium to other buyout targets. This "quality premium" was higher than the historical spread of 6%.



Source: GF Data®

Valuation: The Sky is the Limit? (cont'd)

Similar overheated multiples, however, are less prevalent in the lower middle market where multiples are trending only slightly above their long-term averages. What is behind this discrepancy in valuation multiples between smaller and larger companies?

- **Availability of Leverage** – larger companies are generally capable of supporting greater levels of leverage allowing buyers to use more aggressive bidding strategies.
- **Competition** – both private equity and corporate buyers have mountains of cash to deploy. The focus has been on larger companies which are more likely to 'move the needle' in respect of future portfolio returns or corporate earnings.
- **Risk Profile** – larger companies tend to be more diversified (geographic, customer base, product lines), have more established professional management teams and are generally more capable of withstanding market downturns.

Deal Volume

Despite an increase in valuations and plenty of capital available to support transactions, the number and aggregate value of private equity transactions remained relatively flat in 2015 compared to the prior year.

Why have we not seen a meaningful uptick in private equity activity? Given the positive conditions for M&A we can only point to a short supply of quality targets. For the past 10 years, market pundits have been forecasting a veritable tsunami of succession driven M&A activity as the baby boom generation began to retire. However, the leading edge of boomers (born in 1947) appear to be holding on to their businesses well past the expected retirement age and as a result the wave of succession transactions has yet to materialize.

Although we do not have any data explaining this trend, we have some thoughts based on our extensive experience dealing with mid-market business owners.

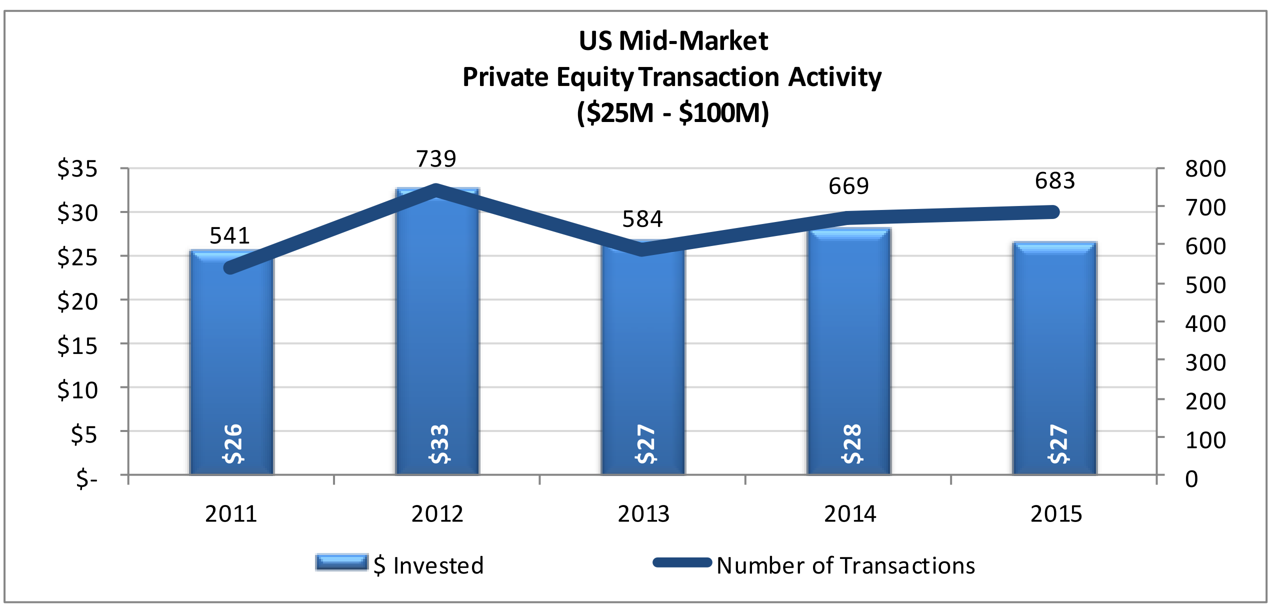
No succession plan in place – not having a qualified management team in place to run the business in the absence of the owner can make the business significantly less attractive to potential buyers and private equity in particular.

Loss of income – in the current interest rate and investment climate, business owners can not reasonably expect to replace the income from their businesses by investing the proceeds from a sale. This is often a significant barrier to selling the company.

Investment alternatives – given the current low interest rate environment and volatile capital markets, many business owners are often not comfortable with the alternatives for investing the sales proceeds and elect to remain invested in their business.

Taxes – the prospect of paying taxes on the sale of a business is often a deterrent for business owners.

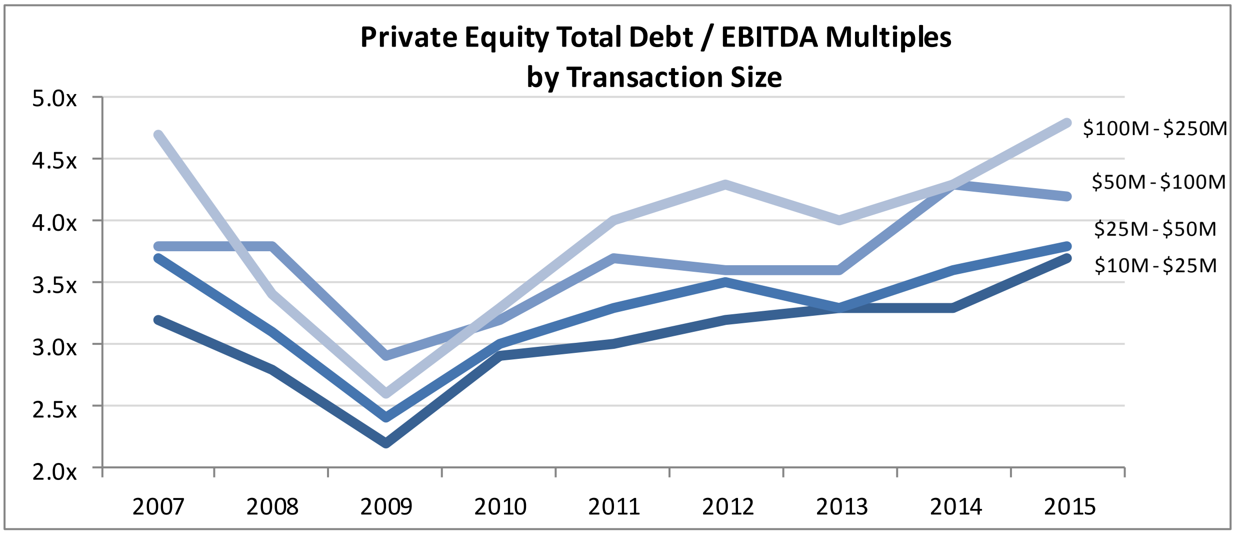
Performance – with the US economic recovery continuing to trend up, many business owners are expecting the recovery to drive improved performance in their operations and further boost the value of their businesses.



Source: Pitchbook—includes private equity buyout transactions

Transaction Leverage: Hits New Highs

Similar to last year's environment, debt financing remains not only cheap but many banks and other lending institutions have become even more aggressive as they compete to deploy capital. This has resulted in leverage multiples for mid-market deals exceeding pre-financial crisis levels. As seen below, this has been true for both smaller and larger transactions.

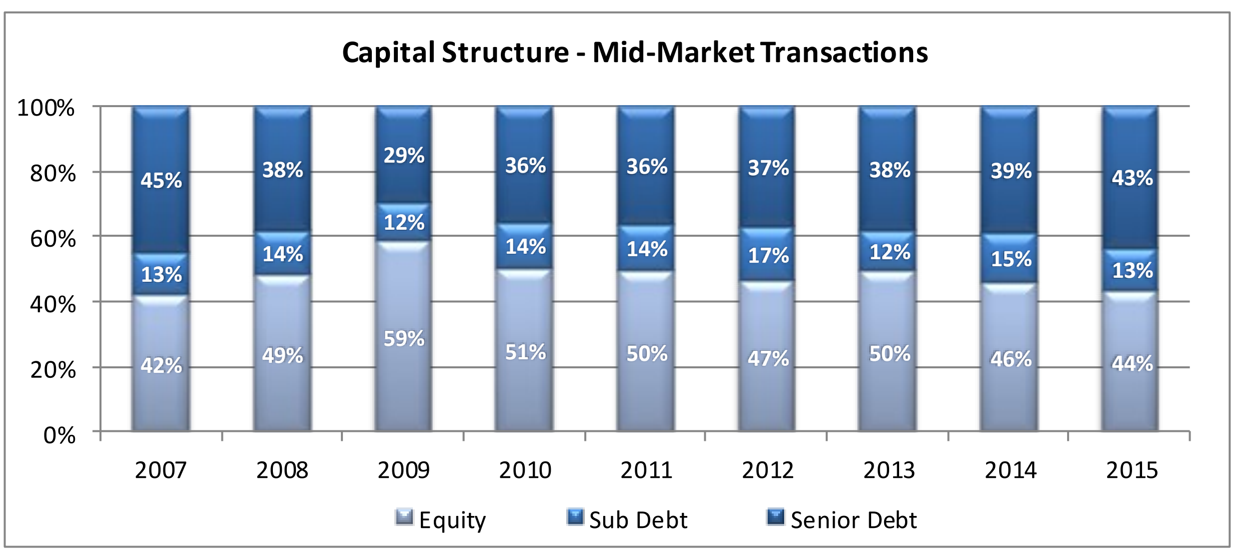


Source: GF Data®

For deals completed in 2015, senior and total debt multiples averaged 3.0x and 4.0x EBITDA, respectively, increasing over a quarter of a turn compared to 2014. Larger transactions ($100 to $250 million) had on average over a full turn of leverage more than smaller transactions ($10 to $25 million). In fact, senior lenders have been particularly aggressive in 2015 in response to competition from other products, resulting in senior-only deals averaging 3.8x EBITDA.

Interestingly, sponsors used existing platform companies to support much higher level of debt compared to last year to complete add-on acquisitions. In 2015, senior and total debt multiples averaged 4.4x and 5.2x, respectively for add-ons, compared to 2.9x and 4.0x debt multiples of last year.

As a result, capital structures have become more aggressive with equity contribution levels having fallen to 43.5%, just a notch above the pre-financial crisis level of 42%. This has allowed private equity firms in many cases to outbid strategic buyers. It will be interesting to see how capital structures are impacted going forward by the US Fed's recent rate hike, the potential for future rate tightening, and the recent spike in yields for high yield debt.



Source: GF Data®

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Valuation by Industry Sector: Mixed Ride

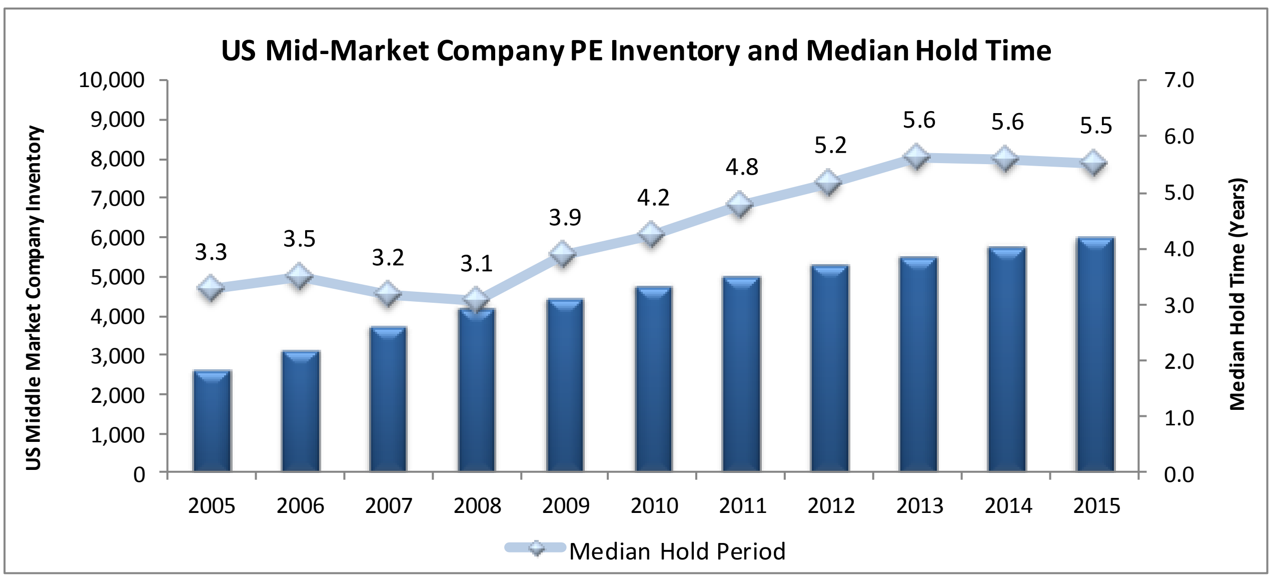
Premium valuation multiples are being realized in sectors with more attractive growth prospects, including technology and healthcare. These sectors are trending well above their long term averages.

Private Equity TEV / EBITDA* Multiples for Selected Industries

Industry	2010	2014	2015	LT Average
Manufacturing	5.9x	6.3x	6.8x	6.0x
Business Services	6.0x	6.5x	6.4x	6.3x
Healthcare Services	6.7x	7.2x	7.6x	7.1x
Retail	6.1x	8.5x	5.8x	6.7x
Distribution	5.5x	7.1x	6.7x	6.3x
Technology	5.5x	9.5x	8.6x	7.8x

Source: GF Data®

PE Portfolio Inventory: Growing Overhang



Source: Pitchbook

There are approximately 6,000 PE-backed mid-market companies, up 131% since 2005. However, a significant portion of this inventory is aging, with 44% having been acquired in 2010 or earlier. In some cases, PE firms have struggled to exit these investments, which has resulted in median hold periods increasing from just over 3 years in 2008 to 5.5 years in 2015. This has resulted in a significant overhang and resulted in a number of zombie funds (pools consisting mostly of unrealized aging investments). The number of zombie funds could grow if PE owners are unable to find buyers.

However, S&P 500 companies have over $2 trillion of cash on their balance sheets and mid-market PE funds have a record $360 billion of dry powder that is itching to find a home. This leads us to believe that there is significant opportunity for M&A activity to pick up as the overhang is cleared and older portfolio investments are finally sold.

Winners of...

Deal of the Year 2015—Private M&A Deal of the Year
Deal of the Year 2014—Private Debt Financing Deal
Deal of the Year 2013—Private Debt Financing Deal
Deal of the Year 2012—Financial Industry Deal

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