MAY 2017

Perspectives

SPOTLIGHT ON PRIVATE EQUITY

VIEWS ON INDUSTRY TRENDS AND NEWS

Private Equity in the Mid-Market

"Only when the tide goes out do you discover who's been swimming naked." - Warren Buffett

In our last Perspectives newsletter (March 2016), we noted that valuation multiples for middle-market North American private equity transactions exceeded the highs seen in 2007/2008 leading up to the financial crisis. In particular, it was noted that private equity acquirers were paying significantly higher multiples for larger companies and those exhibiting above average profit margins and growth. While there are no obvious signs of an impending correction we pondered the long term sustainability of the lofty multiples we are seeing and question whether buyers have all but forgotten the difficulties of the post-crisis years.

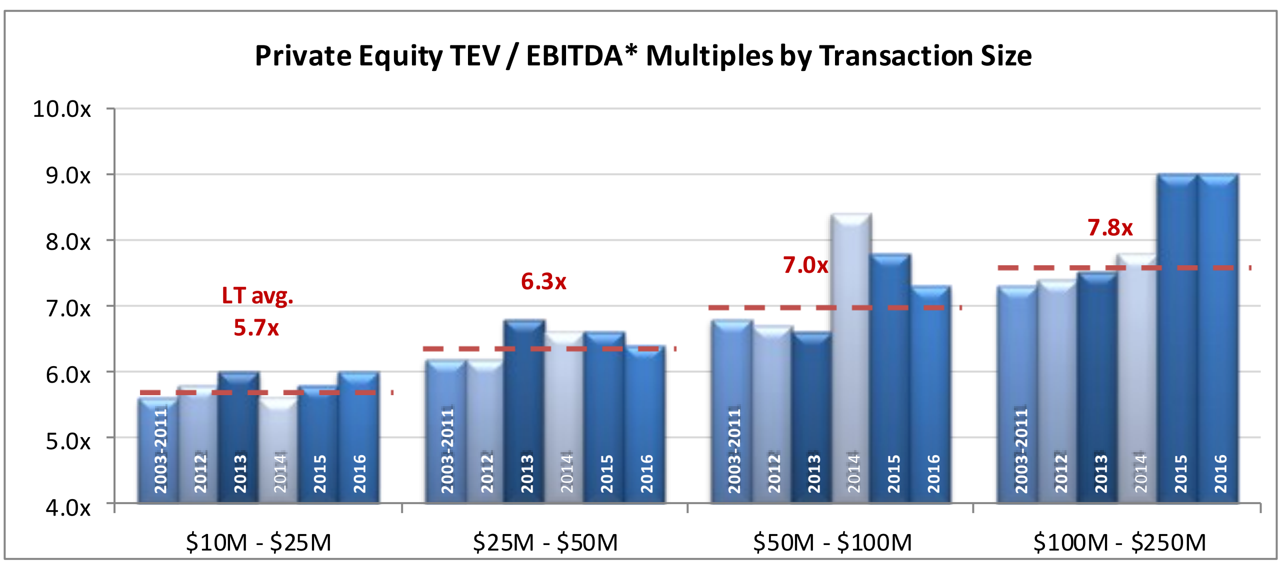
The market's perspective on valuation is constantly evolving and typically moves in cycles. As we review the 2016 data, it appears as though the availability of cheap and plentiful leverage along with intense competition for deals continues to underpin high valuations. We wonder when these near-record multiples will revert towards the historical mean. As we saw in 2008, when the credit cycle tightens and valuation multiples drop, private equity investors and their portfolio companies could be in for some pain.

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. 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.

In this issue of Perspectives, we will look to shed some light on the transaction activity from 2016, how it compares to earlier years and explore some of the factors behind the data.

Valuation: Are We There Yet?

Breaking down the transactions by enterprise value highlights the premiums larger companies typically command, with long-term averages ranging from an average of 5.7x EBITDA for companies valued $10M - $25M to 7.8x EBITDA for companies valued $100M - $250M.



**Total enterprise value / earnings before interest, taxes, depreciation and amortization*

Source: GF Data®

Valuation: Are We There Yet? (cont'd)

The data also reconfirms something we are seeing in the market - valuation multiples in recent years are generally in-line with their long term averages for the lower half of the mid-market ($10M to $50M), while multiples for the deals in the upper half of the mid-market ($50M to $250M) remain significantly higher than their long term averages. At the high end of the mid-market ($100 to $250 million) deals were completed at an average multiple of 9.0x EBITDA in 2016, which is more than a full turn of EBITDA above their long term average.

Buyers will typically place a size premium on large companies for a number of reasons, including the following:

- A more competitive deal landscape
- Generally more stable and professionally managed operations
- Lower concentration risk (customers, geography, products/ services, etc.)
- Greater credit availability from lenders
- Better ability to finance and integrate future add-on acquisitions

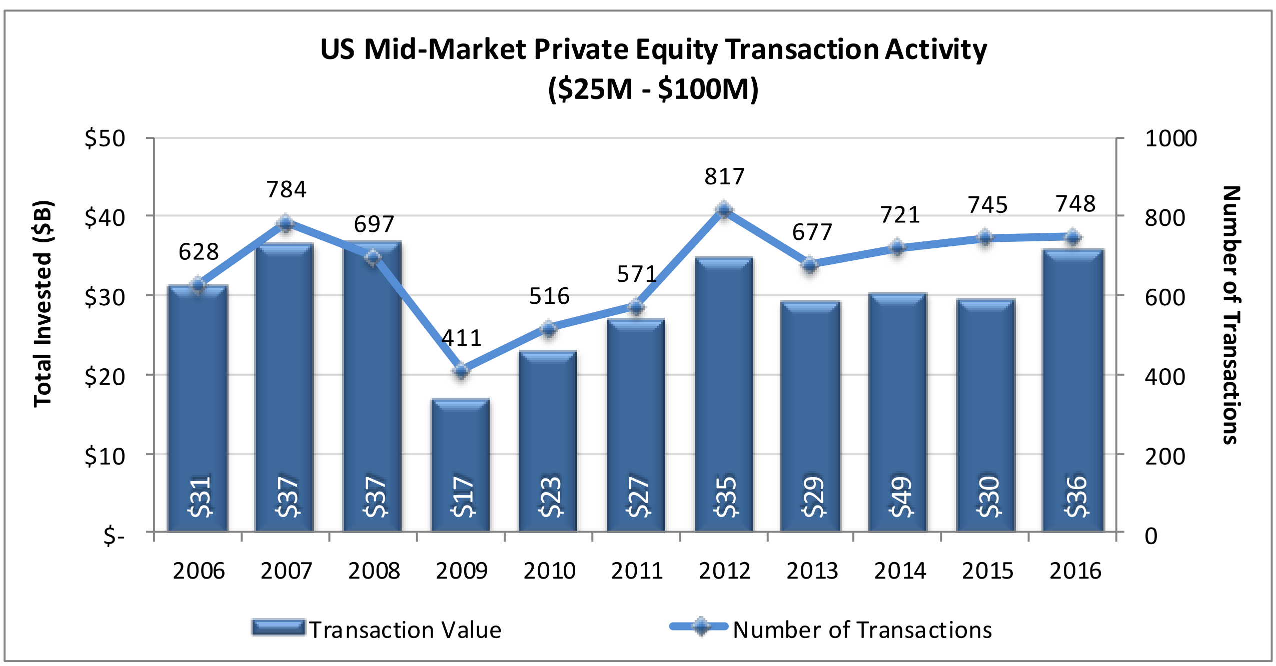
However, the significant departure from the long term averages we have seen in 2015 and 2016 can also be partially explained by the higher average premiums paid for targets with above average financial characteristics (referred to as "Quality Targets"). GF Data defines Companies as Quality Targets if over the trailing twelve month period their (i) EBITDA margins and revenue growth are each above 10% or (ii) one of either EBITDA margin or revenue growth is above 12% and the other is above 8%. Approximately 59% of all 2016 private equity transactions tracked by GF Data were for Quality Targets (compared to the historic average of 57%) and these transactions were completed on average at a 19% valuation multiple premium to all other transactions. This premium remains well above the 2003-2011 average of 7% but have cooled somewhat from the 24% premium seen in 2015.

Deal Volume - Is This the New Normal?

2016 recorded 748 U.S. mid-market private equity transactions. Despite deal valuations and leverage levels at or near record highs and the market awash in cheap capital, we have yet to see transaction volumes reach the high water mark of 817 transactions set in 2012. However, current activity represents a strong recovery from the post-financial crisis lows in 2009 to 2011.

The long awaited wave of succession driven transactions as the baby boomer generation transitions into retirement has yet to hit. The earlier peak in deal volume noted in 2012 was primarily driven by the expected increase in tax on capital gains in the U.S. and we have seen volumes settle back into a range that appears to be the "new normal".

Deal activity in Canada has generally tracked the trends we are seeing in the U.S., although we didn't experience the same tax-driven volume bump in 2012 and the 2009 decline and subsequent recovery has perhaps been less pronounced.



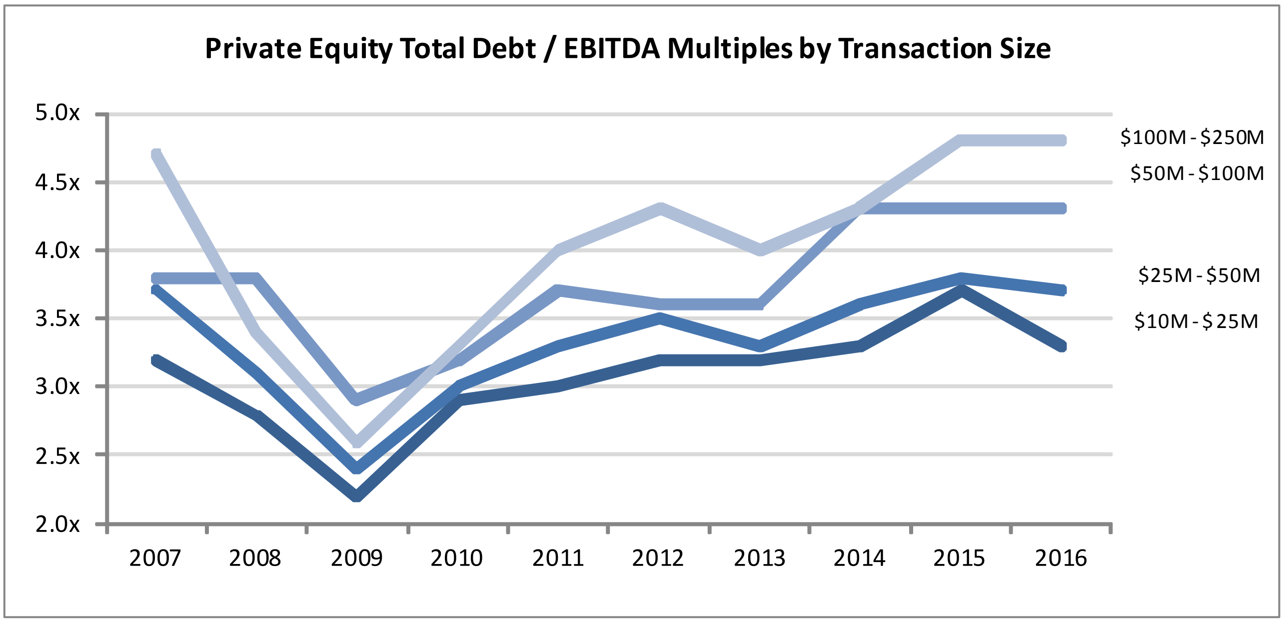
Source: Pitchbook—includes private equity buyout transactions

Transaction Leverage

"What, me worry?" - Alfred E. Newman (MAD Magazine)

In 2015, we saw total debt to EBITDA multiples rise to levels in excess of where they were pre-financial crisis in 2007, and leverage remained relatively unchanged at those levels throughout 2016. We noted that this is partly driven by lenders aggressively looking to deploy capital and private equity buyers utilizing the debt capacity made available to them in order to bid more aggressively. While these debt levels caused a significant amount of pain last time round, resulting in a spike in defaults between 2008 and 2011, it appears that both lenders and private equity borrowers feel more comfortable that this time "it will be different".

We remain interested to see how financial markets and deal activity are impacted by the new Trump administration and its "pro-business" agenda.



Source: GF Data®

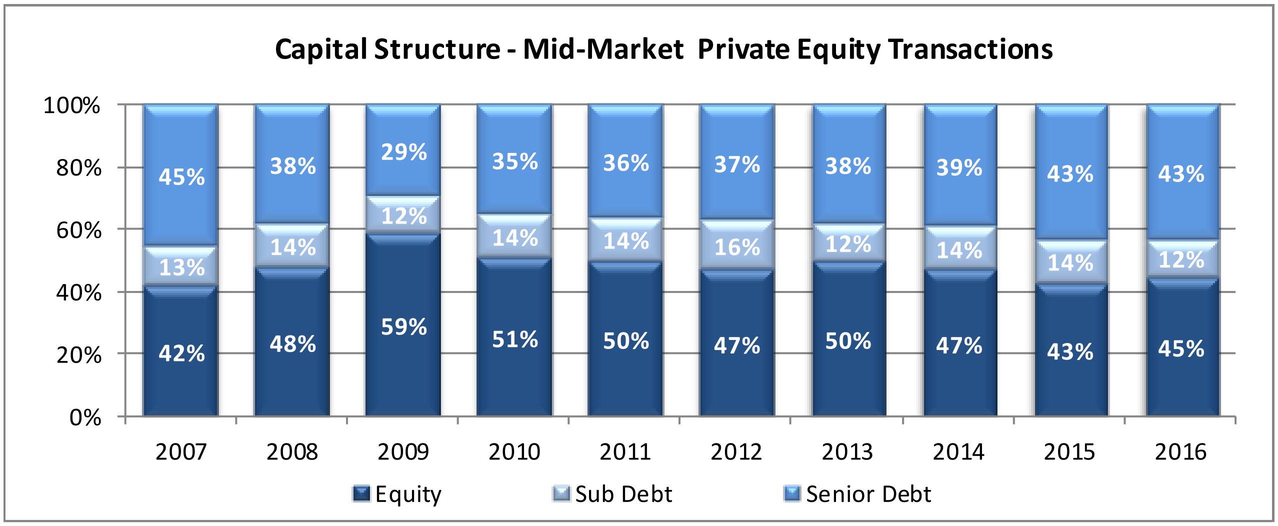
In 2016, leverage levels remained relatively unchanged from 2015 with senior and total debt ratios averaging 3.1x and 3.9x (compared to 3.0x and 3.9x in 2015), respectively. We note that buyers are essentially "doubling down" by maintaining higher debt to equity levels and also paying higher multiples. Larger transactions ($100M to $250M) averaged 4.8x EBITDA of total debt, a 1.5x EBITDA premium over small transactions ($10-25M), which is up from the 1.1x spread in 2015.

Private equity buyers continue to utilize more leverage for add-on deals compared to new platform investments. The total leverage on add-on transactions averaged 4.1x EBITDA compared to approximately 3.8x EBITDA for platform acquisitions completed in 2016.

Canadian banks and other private lenders have also aggressively been looking for opportunities to deploy capital. As a result, leverage available for Canadian mid-market deals feels as though it too is at an all-time high. However, we do not typically see Canadian lenders extend leverage up to the levels seen in the U.S., particularly towards the upper end of the U.S. mid-market.

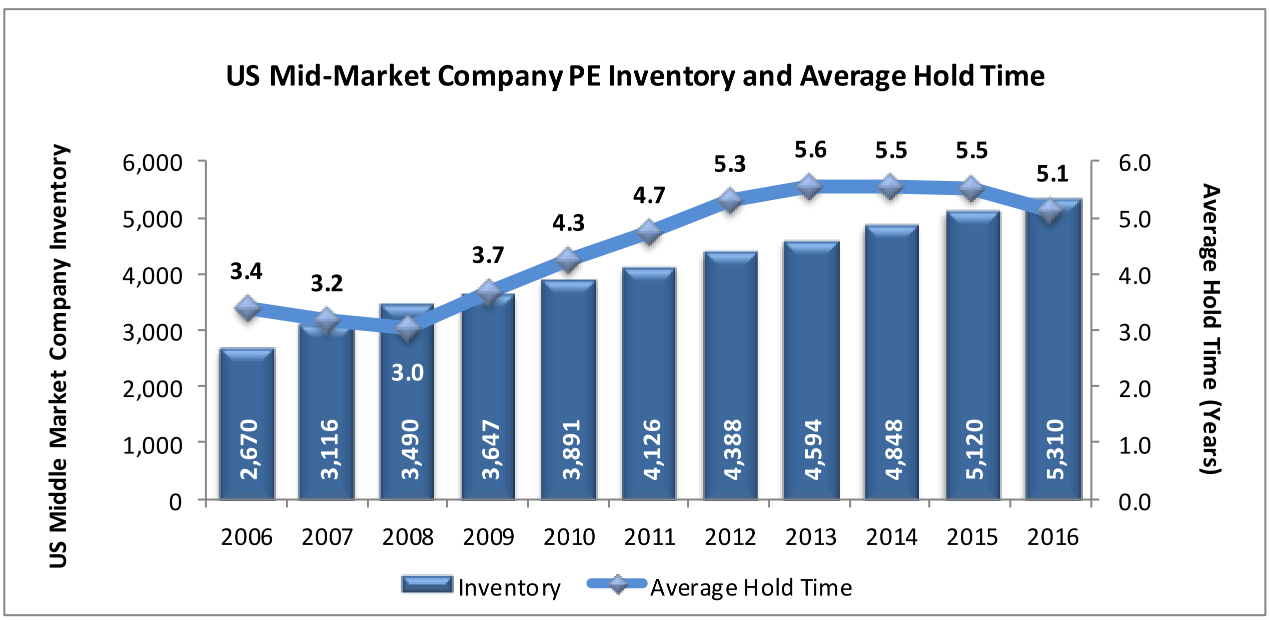
The following chart shows the average capital structure used to finance the North American mid-market private equity acquisitions in recent years. The equity contribution has remained near historical lows and well below the more conservative capital structures seen during the period following the financial crisis.

Transaction Leverage (cont'd)



Source: GF Data®

PE Portfolio Inventory: Time for Profit-Taking?



Source: Pitchbook

The inventory of companies held by mid-market private equity groups edged a little higher in 2016, settling in at approximately 5,300 companies. Interestingly, in 2016 we also saw the first significant decrease in the average hold time over the past 8 years. Having hovered around 5.5 years for the past 4 years, the average age of companies held in inventory dropped to 5.1 years in 2016. However, this remains well above the average hold period of approximately 3 years prior to the crash in 2008. Perhaps the first decline in average age is indicative of private equity taking advantage of strong market conditions to complete exits.

While the decline in hold periods is noteworthy, it is still early to conclude this is a permanent departure from the recent norm. The average investee company held in inventory is now of 2011 vintage, which was still a somewhat 'soft' year for private equity acquisitions. As we get further into 2017, we will see companies acquired in 2012 (a bumper year for private equity acquisitions before the new U.S. capital gains tax rules came into effect) approach the 5 year holding-period milestone. As this happens, we would expect private equity owners to increasingly look for liquidity options in order to crystallize returns on their investments.

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Asim Siddiqui is a Director at Crosbie & Company and has over 15 years of corporate finance and M&A advisory experience. For over 30 years, Crosbie has built its reputation and expertise by providing independent advice and investment banking services to private and public companies, business owners, families and shareholder groups, as well as Boards of Directors.

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