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By Joe Brusuelas, RSM Chief Economist

The growth path of the U.S. economy late in the business cycle has slowed and the rate of expansion will do well to reach 2 percent on an annual basis even after what is shaping up to be a modest rebound to near 2.5 percent growth in the second quarter. The RSM US Middle Market Business Index rebounded to a cyclical high of 129.8 in the first quarter, a reflection of business optimism related to the possibility of significant corporate tax reform and the Trump administration’s proposed spending plan.

The combination of slowing productivity and demographic headwinds have caused the long-term growth path to ease to 1.5 percent per year, down from 3.3 percent per year growth a decade ago. Despite a fairly bright consumer outlook—our forecast is for household spending to increase at a 3 percent pace this year—there remains the potential for significant retrenchment if policymakers fail to deliver on tax and spending promises.

Mergers and acquisitions

The term structure of interest rates is not yet particularly favorable to mergers and acquisitions (M&A) activity. While we anticipate the Fed will lift rates by a minimum of 50 basis points this year, the combined impact of safe haven moves into dollar-denominated positions and chasing of yield by international investors continues to suppress rates at the long end of the curve. Thus, conditions remain in favor of sellers as opposed to buyers in the market.

Industrial products and manufacturing

On a near-term basis manufacturing is showing signs of a rebound amid solid new orders data. Corporate earnings have improved modestly and there are signs fixed business investment is improving as well.

OTHER RESOURCES

The Real Economy

A monthly publication to help the middle market anticipate and address the unique issues and challenges facing their businesses and the industries in which they operate. We also release a Global Edition on a semi-annual basis that addresses issues affecting business on a global scale. Read more.

The RSM Middle Market Business Index (MMBI)

The RSM Middle Market Business Index developed in partnership with Moody’s Analytics, is designed to accurately reflect business conditions in the U.S. middle market, while providing a statistically significant measure of the health and outlook for these businesses. Read more.
Dealmaking to even out as tensions ease?

- In the wake of the first quarter of 2017, after a particularly tumultuous year, dealmaking eased off across both North America and Europe following steady quarterly declines since an active 2015.

- Year-over-year figures remained down in both value and volume. Globally, M&A volume slid by 43 percent year over year, while value plunged by just under 60 percent; in North America, activity dropped by near 38 percent relative to Q1 2016 and aggregate value dropped 68 percent; in Europe, the declines from Q1 2016 to Q1 2017 were more evenly matched, with transaction volume declining by close to 48 percent, and total value sliding near 44 percent.

- A low supply of worthwhile businesses in a high-priced, still-cautious environment remain the most obvious driver behind diminishing M&A volume.

- The broader economic backdrop suggests easing tensions, especially as significant political fears remain unrealized in the wake of Dutch and French elections that seemed to veer the eurozone more toward the status quo. Trade uncertainties could still contribute to delays in overall transaction closing times.

- At 129.8 in Q1 2017, the RSM US Middle Market Business Index indicated that in the world’s largest market business sentiment is still waxing positive, while the labor market tightens.
M&A DEAL FLOW

Is the M&A environment set to normalize?

Especially as the scope of these datasets has been expanded to include both North America and Europe, it is important to note key metrics such as transaction multiples and median deal sizes will accordingly be affected by the differing economic prospects in each region. That said, given the similarities between those markets, overall trends still by and large hold steady relative to prior editions that used only U.S. data. Transaction multiples still stay relatively high, with an intriguing pop in the proportion of debt to earnings before interest, taxes, depreciating and amortization (EBITDA) in particular for Q1 2017. It is tempting to ascribe too much import to that jump given it is based on only a quarter’s worth of data, but it seems safe to conclude that in the context of the slump in transaction activity, buyers are still willing to tap debt markets to meet lofty prices and get deals closed, as the businesses getting bought and sold in the current environment tend to be healthy enough to either carry or justify increased debt servicing.

“We are still in a time period of slow revenue growth,” says Michael Fanelli, partner with transaction advisory services at RSM US. “The overall fundamentals seem healthy in totality from a cost base, especially infrastructure spend, prospective capital expenditures, and prospective wages and employment. It’s just a matter of finding the right matches and having enough companies of quality in the marketplace at the right time to actually be able to close a higher number of deals.” As Fanelli notes, it is still a seller’s market, with plenty of private equity dry powder and cash on strategics’ balance sheets combining for a powerful upward pressure on valuations and corresponding transaction sizes.

Average and median M&A deal size (SM)

Source: PitchBook

Deal multiples

Source: PitchBook, *As of 3/31/2017

M&A transactions (count) by sector

Source: PitchBook

M&A transactions ($B) by sector

Source: PitchBook

Debt/EBITDA

Equity/EBITDA

Valuation/EBITDA
Pricing likely culprit behind PE decline

Tighter regulations and desire to avoid higher propensities for risk already entail the usage of a fair amount of equity. Thus, even though there is plenty of dry powder for PE investors to deploy, they are loath to further augment their equity contributions and depress eventual return multiples typically generated by leverage in the usual buyout model. Furthermore, simply examining the elevated levels of PE activity in both North America and Europe within the business products and services (B2B) sector over the past few years yields the conclusion that the pipeline of market-ready prospects may currently be refilling. “From a private equity perspective,” says Fanelli, “buyers are still just actively looking for good companies to invest in, especially when it comes to backing platform companies and having an additive strategy in fragmented subsectors. So if they’re not as active as they want to be, they aren’t finding enough quality companies.”

However, Fanelli also states that the pipeline is refilling, with middle market PE buyout shops raising new funds and preparing to tackle even more operationally challenged, unbanked businesses within the lower middle market. Deal sourcing and grappling with the relatively expensive environment has led to greater innovation and diversity in the approaches PE buyers are adopting.
“Some clients are not playing in auction processes at all,” Fanelli states. “They are just focusing on significantly leveraging operating partners and executives that they’ve networked with just to find companies that are not looking to sell per se today, and develop relationships so they are positioned to acquire in the future.”

On the other hand, there are PE buyers that are still paying up. “Some state that they don’t know if multiples have peaked or if higher prices are going to persist into a new normal,” according to Fanelli. “Regardless, if or when multiples diminish significantly five years from now, they’ll still be investing, so deals could leverage themselves out over time.” The typical length of PE hold periods can afford that luxury, although the fact median buyout price tags have only continued to rise and rise over the past few years—with that spike in Q1 2017 assuredly exacerbated by smaller sample sizes—can’t be easy to swallow. Hence the continued prevalence of add-ons, as Fanelli points out. Their popularity doubtless continues to contribute to the services subsector accounting for the majority of PE activity, as that area can be more fragmented than others and offer opportunities for typical PE operational tune-ups.
PE sellers still positioning

Although Q1 2017 exit volume was quite subdued on a historical basis, it’s important to note the role played by timing, particularly as the volume of secondary buyouts has been crucial in the past, yet would be affected from the same factors contributing to diminished deal flow noted above. At the same time, other factors are at play, as Harshad Khurjekar, director with transaction advisory services at RSM US, states: “There are PE funds that acquired companies in the last two to three years that still haven’t achieved their strategy for that particular platform. Whether they intended to acquire and integrate smaller companies to increase their geographic footprint or embrace similar strategies, those fund managers’ portfolios may be in more of a middle phase.” Even if it is a seller’s market, Khurjekar points out that given the outlook is not definitively optimistic, some businesses may be wary of going to market right away and not receiving the right pricing.

“If it were five or six years ago, it would be different,” Fanelli states. “But it is a very similar marketplace today as it was last year and the year before. In general, from an overall exit multiple perspective, some things haven’t changed dramatically enough.”
IPO ACTIVITY

Resurgence in IPO value

Of the four B2B initial public offerings (IPOs) completed in the U.S. in Q1 2017, all were of companies backed by PE firms. Moreover, all went public for fairly hefty sums, leading to a boom in the median IPO size even as Q1 remained the slowest quarter on record in terms of volume over the past four years. Clearly, the overall decline in IPO volume remains the more significant longer-term trend to note, with public markets’ unprecedented strength and historically low volatility in Q1 2017 forming an encouraging backdrop that doubtless helped the debuts. The IPO window may be more open than at any time last year, but it is still worth pointing out that market participants’ nervousness around the lack of palpable market reactions to events that have historically sparked volatility has yet to abate. This in turn could continue to discourage all but the most intrepid of prospective listers. Another longer-term trend to highlight, interestingly, is the extent to which PE-backed businesses have driven overall US B2B IPOs in general, which is likely driven more by the traditional PE operating model more than anything else.

B2B IPO PIPELINE

<table>
<thead>
<tr>
<th>Company name</th>
<th>Sponsor(s)</th>
<th>Sector</th>
<th>Amount (SM)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gardner Denver</td>
<td>AlpInvest Partners, Kohlberg Kravis Roberts</td>
<td>Machinery</td>
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<tr>
<td>Emerald Expositions</td>
<td>Onex</td>
<td>Media &amp; Information Services</td>
<td>$263.5</td>
</tr>
<tr>
<td>intrepid Aviation</td>
<td>Centerbridge Partners, Reservoir Capital Group</td>
<td>Air</td>
<td>$150</td>
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</tbody>
</table>

Source: PitchBook
Proportionally, PE firms stay more active

“It may well be more pronounced outside of B2B,” says Fanelli, “but I expect an increase in PE shops carving out business units from larger publicly traded entities. While the overall public markets are performing well right now, there are certain businesses that should consider divesting to PE firms. If a corporation is in the transformation stage of its life cycle, it can be supportive operationally to divest a unit and let it develop outside of the public gaze as it is painful on a quarterly earnings basis during times of development.”

With the caveat that there were only eight total carveouts in North America and Europe in Q1 2017, the proportion thus far has definitely favored Fanelli’s contention, with financial buyers accounting for five of those eight divestitures. In fact, that percentage as well as the still-elevated level of PE’s proportion of overall M&A speak to the unique drivers of PE firms’ investment pace—they have mandates to deploy capital and will, even if at a slower pace, still cut deals as long as they are justifiable based on longer holding periods in order to put money to work.

SELECT B2B Q1 2017 M&A/PE TRANSACTIONS

<table>
<thead>
<tr>
<th>Company name</th>
<th>Buyer</th>
<th>Sector</th>
<th>Amount (SM)</th>
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<tr>
<td>International Data Group</td>
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<td>Media &amp; Information Services</td>
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<td>Amber One</td>
<td>Arcus Infrastructure Partners</td>
<td>Construction &amp; Engineering</td>
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</table>

Source: PitchBook
The value of RSM’s middle-market leadership

Focusing on the middle market, RSM US provides integrated transaction advisory, tax, assurance and consulting services. Our work with 500 middle-market technology companies gives us a deep understanding of the key trends impacting the industry. In addition, we have performed due diligence on more than 1,850 deals in the past five years, over 200 of which were technology transactions. This in-depth knowledge provides our private equity and strategic buyer clients with industry-specific due diligence considerations.

The following list shows a detailed breakdown of the PitchBook industry codes for the B2B industry.

1. BUSINESS PRODUCTS AND SERVICES (B2B)

   1.1 Commercial products
   1.2 Commercial services
   1.3 Transportation
   1.4 Other business products and services