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The U.S. economy closed out 2016 on a strong note, growing by 2.7 percent during the second half of the year with a strong probability of upward revisions to the Q4 2016 data. The increase in growth was bolstered by sustained gains in jobs and wages, which supported a roughly 3 percent pace of spending throughout last year. While the topline slowed to 1.9 percent to close out the quarter, gross domestic purchases increased by 2.5 percent and final sales to domestic purchasers 2.8 percent.

More encouraging was the rebound in capital expenditures and corporate earning that have lagged since mid-2015. Private fixed business investment—which expanded by 10.7 percent during the quarter—and corporate earnings are up by roughly 7 percent on the quarter. Nonresidential investment advanced 2.4 percent, investment in equipment jumped 3.1 percent and outlays on intellectual property leaped 6.4 percent. Investment on structures declined by 5 percent and residential investment improved by 10.2 percent.

The 4.7 percent average annualized pace of growth in wages to close out the year will likely create some momentum in household spending that will spill over into 2017. The key to 2017 will be the tax and policy changes supported by the GOP-led Congress and the Trump administration. Important areas to watch are the rollback of regulations, comprehensive tax reform, including the abolition of the corporate income tax and the adoption of a destination-based cash flow tax with border arrangement, and the sharp reduction in individual income tax brackets.

By Joe Brusuelas, RSM Chief Economist
A rebound from stagnancy?

There is a palpable air of uncertainty in many areas right now, mostly owing to the turbulent political scene. Will a massive infrastructure bill get passed that could boost the fortunes of construction firms? Will corporate tax reform occur? Will trade policies shift?

Although one can ascribe varying degrees of probability to each of those initiatives, in the end, they remain unrealized. Accordingly, however rosy the outlook may be, given typical animal spirits, the uncertain footing of many deal-makers must not be forgotten. That said, there are currently some positive signs in the U.S. economy that provide some justification for a guardedly positive outlook in 2017. The RSM US Middle Market Business Index (MMBI) rebounded in the final quarter of 2016 from 115.6 to 120.1—the higher above the baseline of 100, the stronger the rate of expansion in the middle market. That figure aligned with general US economic growth, which registered an increase from 1.4 percent to 3.2 percent, based on the Bureau of Economic Analysis’s second estimate of gross domestic product. As noted in RSM’s The Real Economy, much of the bounce in the MMBI can be chalked up to inventory building ahead of the holiday season. On the other hand, survey data does suggest that sentiment around capital expenditures, investments and compensation has improved, while hiring and compensation are both near cyclical highs.

“The immediate reaction was optimistic,” says Mark Gaines, partner in the business and professional services practice at RSM US LLP. “But some of the new administration’s policies that have been stated in the first few weeks haven’t quite been coherent about the overall intent.”

Gaines explains that, quite simply, nobody really knows how many of the policies the Trump administration is promulgating can and will be implemented, and moreover, how long it will take for them to truly affect middle market business products and services (B2B). “There are a lot of things that would seem ostensibly good for middle market B2B businesses, but then talk of tariffs or similar protectionist moves could impact any enterprise that’s global, which would be the majority of the middle market,” Gaines states.

Against a backdrop populated by the ever-present specter of volatility and political uncertainty tinged with hopeful optimism, what these numbers and anecdotes establish is an environment in which businesses will continue to move cautiously, without significantly bullish or bearish maneuvers, in the absence of major shocks or positive catalysts. In brief, it’s a waiting game of sorts, so players will continue to execute on what initiatives are safest or necessary.
M&A DEAL FLOW

Divide widening

The final quarter of 2016 saw the fewest completed transactions within the B2B sector of the past four years, even as deal value rebounded to historically healthy levels. There were 547 mergers and acquisitions (M&A) that closed for approximately $44.6 billion in aggregate value. Only four quarters, since 2013 began, have logged a higher transactional value. Much of this is of course due to blockbuster deals skewing overall totals, which is reflected in the average M&A deal size soaring to the third-highest tally seen in years, a hefty $464.8 million. Even the median size hit a new high of $74.4 million, further testifying to the ongoing phenomenon of a bifurcation in the quality of companies in the market. As deal multiples of valuation-to-EBITDA for M&A hit a new high of 9.9x, coupling that statistic with slackening transactional volume clearly suggests that there is still avid demand for the better businesses that are looking to be bought. Yet, even the composition of multiples hints at the caution on the part of buyers in the current environment—a surge in the equity-to-EBITDA multiple between 2015 and 2016 speaks to acquirers not only sweetening bids but also looking to reduce debt usage somewhat in anticipation of lightening prospective debt loads. It is unlikely that rising interest rates are already impacting buyers’ choices to that extent, given how long they have been anticipated and the probable rate of their increase.

“There are really good companies still going for high multiples,” says Fanelli. “What we observed in the fourth quarter was a decline in the number of companies in the market, first off, as well as a likely prolongation of the time taken for deals to close. That was again partially driven by buyers and businesses delaying as they wished to see how the U.S. presidential election turned out and what potential effects it may have on the middle market.”
Buyout cycle ebbing

“There is still plenty of dry powder available for private equity (PE) firms to invest,” states Fanelli. “They are still in constant buying mode.” Again, the thwarting factor is the typical level of quality amid an expensive environment, which has been the primary driver behind the ebbing buyout cycle. PE firms are as wary of overpaying as ever, especially given uncertainty around the status of the business cycle. Hence the continued prevalence of add-ons, with Fanelli noting that on an anecdotal basis, his clients still state there simply aren’t enough good platform businesses to acquire outright.

“Another aspect you have is slower revenue growth,” Fanelli adds. “So they need to find growth via other means, and if they are purchasing a platform business for $100 million at a 9x multiple, they’re looking to target a fragmented industry where they can expand into new channels or locations and consolidate smaller enterprises.” In short, PE buyout shops are still employing add-ons as strategically as before, looking to extract value via multiple arbitrage and operational improvements by building out their initially expensive platform.

Currently, when it comes to that initial bid, PE firms don’t have many alternatives. “Since their investment timeline is so long term, and they have to eventually fundraise and keep investing, they almost have no choice, even if they don’t see eye to eye with the seller regarding multiples, and whether we are at a new normal or not,” Fanellia says.

B2B private equity deal flow by quarter

Source: PitchBook. Note: Deal values are extrapolated.

B2B add-on activity

Source: PitchBook

B2B private equity deals ($) by sector

Source: PitchBook
Slow but steady

Even if quarterly totals of PE-backed exit activity reveal a selling cycle that is slowly fading, it’s important to note that 2016 still was one of the busier years on record. The extent to which secondary buyouts propped up overall exit volume, even after an even more active 2015, speaks much about the difficulties PE firms currently face. A trend that appears to be cropping up more and more is that of more generalist PE funds selling off their relatively recently acquired holdings to either larger or specialist firms that can wring further operating improvements or, given more ample resources, build the business out to a greater extent.

“2015 was a very good time to sell, and 2016 was nearly as close,” says Fanelli. “If PE firms feel they have achieved part or most of their investment thesis then they are going to go to market now.” Fanelli cites an example from his practice, where a sponsor acquired two businesses within a four-month span that subsequently merged, and then less than three years later sold in 2016. “It’s simply a good time to sell and they had willing and able buyers,” Fanelli says. He goes on to add: “Strategies have been more about an ultimate sale to a PE firm or a corporation. The investment thesis of buying a platform, executing roll-ups, growing the top line and then going public is not as in vogue right now.”
An off year

Ever since the end of 2014, the quarter-over-quarter fluctuation in initial public offering (IPO) activity in the B2B industry has been dramatic, with volume zig-zagging back and forth between five to 10 debuts, and aggregate offering value even more varied. Whenever variability this significant occurs, multiple factors are behind such volatility. In this case, it is not only the extent of volatility observed in public market sentiment and performance, but also the relative attraction of pursuing a private auction instead. As long as appetite on the part of strategic acquirers or PE firms remains keen, there simply aren’t as many compelling incentives to go public, especially when it comes to middle market companies. Even though public equities have been quite bullish lately, there is still enough concern around multiple macro trends to cast a gloom over IPO prospects. Hence, the pipeline does not look set to refill in a sudden surge, but rather will have to wait until a longer period of stable, solid performance in public markets occurs.

B2B IPO PIPELINE

<table>
<thead>
<tr>
<th>Company name</th>
<th>Sponsor(s)</th>
<th>Sector</th>
<th>Amount (S$M)</th>
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<td>Centerbridge Partners, Reservoir Capital Group</td>
<td>Air</td>
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<tr>
<td>Helpful Alliance</td>
<td>N/A</td>
<td>Other</td>
<td>$30</td>
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Source: PitchBook
PE mandates differentiate activity levels

PE firms have distinctly different rationales when it comes to engaging in M&A, as compared to corporate buyers. Not only can they cast a wider net when it comes to sourcing prospective targets on a size basis, should their strategy be rolling up companies in a fragmented niche, but they also can afford fairly pricey targets in hopes of blending down the cost later via add-ons. Elevated levels of dry powder are also contributing to PE sponsors’ determination to stay active. On top of that, given the investment timeline of select funds, they may well enjoy a relatively lengthy period in which to tune up operations. Owing to those factors and more, especially as overall B2B M&A volume slid in the final quarter of 2016, it’s hardly surprising that PE funds’ proportion of dealmaking crested yet again.

“All the PE firms that we talk to,” says Fanelli, “their limited partners are investing with them for the long term. You have seven years to deploy all your capital after you close on your fund. So their job is to inspect and acquire companies, all the time.”

SELECT B2B Q4 2016 M&A/PE TRANSACTIONS

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<tr>
<th>Company name</th>
<th>Buyer</th>
<th>Sector</th>
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<td>Cimpress</td>
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Source: PitchBook
IRS rulings on treatment of termination and break-up fees shows a worrisome change in position

In a pair of rulings, the IRS addressed the treatment of termination fees paid as a result of a broken deal. The rulings addressed the payer and payee respectively and held that the payments resulted in capital gain or loss.

In prior rulings, the IRS had held that such payments represented ordinary deductions providing a tax shield to shelter operating profits. This change in position could saddle a taxpayer with a capital loss upon payment, which is much harder to recognize, and when recognized, only shelters income at capital gain rates. The termination fee at issue in one of the rulings is believed to relate to the terminated 2014 proposed AbbVie Inc.–Shire Plc merger where a termination fee in excess of $1.5 billion was paid. Based upon recent comments by the IRS, it appears they placed significant importance upon the fact that the termination fee was paid under a contract to purchase the stock of a target, which is generally a capital asset. The answer could be different if the fee is not paid under an executed contract or where the contract is for the acquisition of something other than stock (e.g., operating business assets).

A silver lining may be found in the fact that the other ruling held the receipt of a termination fee would result in capital gain, which if ultimately passed through to an individual investor would be taxed at favorable capital gain rates.

To learn more about this development and how it may impact the tax treatment of your next break-up or termination fee paid or received, visit http://rsm.us/2kzQPYQ.

Don't underestimate the importance of working capital

In today’s competitive deal environment—completing a quick, smooth sale at the right valuation is paramount to a seller. Don’t let the working capital mechanism in the purchase agreement be a last minute hurdle to getting the deal closed.

Once due diligence is completed, the finer points of the purchase agreements are being fine-tuned and oftentimes only then does talk of working capital make its way into the conversation. However, when working capital agreements are negotiated late in the sales process they open the seller up to unnecessary negotiations that can delay and, in extreme circumstances, kill a deal.

However, there are ways to keep a deal on track.

• **Talk about the working capital agreement upfront.** Expend the appropriate level of energy early on in the process to ensure working capital does not become an after-thought and a point of negotiation.

• **Consult with the financial advisors who are conducting the due diligence.** This will help sellers spell out for buyers how calculations are run, the disclosure schedule and the specifics of the working capital methodology.

• **Leave nothing open to interpretation.** Ambiguity in the working capital mechanism in the purchase agreement will generally work in the buyers’ favor. Sellers should carefully lay out the working capital definitions and the related accounting principles to avoid post-close surprises.

For more information, visit www.rsmus.com/workingcapital.
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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