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PERSPECTIVES ON THE REAL ECONOMY

By Joe Brusuelas, RSM Chief Economist

The U.S. economy will likely see another year of growth between 2.2 and 2.5 percent, with risk of a slower overall pace of activity. Sales to private domestic firms, which is a good proxy for middle-market growth and the real economy, has expanded by about 2.6 percent during the past two years, well above the 2.2 percent average growth rate of the overall economy during that same time. That trend for the middle market is poised to continue this year.

The major growth engines this year will be the household sector, residential investment and support from government spending. We anticipate household spending will grow at 3 percent, residential starts to increase to 1.45 million units at an annualized pace and the combined lifting of sequestration caps and increased outlays on roads should boost overall growth by 0.2 to 0.3 percent on the year.

The drags on growth will be manufacturing and net exports. Meanwhile, the major question mark will continue to be fixed business investment. Improvement in that area of the economy will depend on oil, energy and commodities finding a price floor. If that doesn't happen, then growth could revert back to the long term trend of 1.5 percent.

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.
Acquisition strategies vital

As public markets displayed increasing volatility through 2015 and concerns continued to arise regarding the strength of the global economy, the business products and services (B2B) industry has been pressured with increasing expenditures in an already low top-line growth environment. “We are not seeing the same year-over-year (YoY) revenue growth that we’ve seen in prior years, and I’m not projecting a lot of revenue growth for my clients in 2016,” states Mark Gaines, a partner in the business and professional services practice at RSM US. As revenues appear to slow, wage costs remain primary expense negatively impacting bottom-lines, a difficult circumstance for executives to offset, given the limited market of talent available for many companies in the industry. According to Gaines, “The challenge is that there is going to be a squeeze between the percentage growth in revenue versus the percentage growth in wage base, and you’re going to see payroll costs continue to climb.” Further, health care expenses also remain a fairly significant labor-side cost impacting the industry as a heightened regulatory environment continues to force employers to increase the level of employee benefits they provide.

The continued slump in oil prices was initially forecasted to help reduce input costs for many transportation and logistics businesses, yet even that hasn’t manifested. “Certain companies in the middle market are benefiting from lower fuel costs and subsequently, higher EBITDA margins. But many customers on the other side are being pressured by these prices, so they are being more selective with whom they buy products from, trying to squeeze the margins on the sales price,” explains Mike Fanelli, a partner in RSM US’s transaction advisory services practice. Foreign currency fluctuations, such as those brought on by a devalued Chinese yuan and various central bank easing measures, are also beginning to become significant headwinds for many companies. Although executives certainly look past short-term fluctuations as they mold their future business strategies, the volatility in exchange rates has become an increasing challenge for companies, especially as they attempt to better understand both the size of currency impacts they can expect and the length of time the current volatility may last, notes RSM US director Harshad Khurjekar. This issue can also potentially become more pronounced for middle-market companies that may not have the proper resources to employ sophisticated hedging strategies.

Despite business headwinds that may be increasingly highlighted in the current economic landscape, the appetite for mergers and acquisitions (M&A) is still present. Volume on a yearly basis was relatively flat in 2015, however, “much of that can be attributed to a more normal state level of activity,” says Milton Marcotte, a practice leader in RSM US’s transaction advisory services practice. Looking across all market sectors, M&A multiples have appeared to have slightly softened, yet B2B valuations remain inflated. PE buyers remain eager to deploy dry powder into quality platform and add-on investments, while corporate acquirers are still in need of synergistic and accretive combinations, sustaining an extremely competitive and expensive B2B deal environment that has been in place over the past few quarters. “I think it’s just a function of a lack of sellers,” says Marcotte. “Our clients would like to be doing more acquisitions, but there are a lot more buyers than sellers and the processes are very competitive, so valuations are high.” As such, the decline in activity seen in the second half of 2015 can likely be attributed to that phenomenon; however, there does not appear to be any extraordinary fundamental changes in the current M&A market.

Moving forward, total activity may soften, yet competition will continue to drive inflated deal valuations. Many of the expenditures explained above will create the need for increased diligence processes in terms of evaluating and understanding target businesses, yet strategic diligence teams will also remain crucial for dealmakers in order to increase the probability of them winning out in auctions with multiple bidders. On a sector basis, quality brands across the B2B technology and digital services space will become coveted M&A targets as executives and PE sponsors position their companies in a digital age where items such as website design and functionality, social media presence and e-commerce become critical business needs, in addition to operational technology investments. According to Marcotte, “If you don’t have an acquisitions strategy, whether it relates to a company, technology or other capabilities, you could be left behind with the way the market is currently moving.”

rsmus.com

B2B AT A GLANCE

B2B M&A deal flow by quarter

Source: PitchBook
Negotiations lengthen deal processes

Just shy of $184 billion worth of completed B2B transactions closed last year across 3,521 deals, a YoY rise of 13 percent in terms of value, with volume coming in slightly higher, but relatively flat. That said, both aggregate value and total deal count experienced a plunge in Q4, unable to escape a trend that has affected the majority of sectors in terms of M&A. Q4 2015 experienced just over $40 billion in deals closed across 764 completed transactions, representing a massive 39 percent QoQ decline in value and a 13.5 percent drop in volume during the same period.

Continued negative rhetoric regarding the global economy and the subsequent action of central bankers to underpin growth, along with heightened volatility across a frothy public equity and high-yield debt market during the final stretch of 2015 induced significant uncertainty. In light of this, the sharp drop-off in Q4 deal activity can be partially attributed to extended deal processes dragging deals out longer as buyers and sellers negotiate price and deal terms in light of the events that unfolded during the back half of 2015. Relative to the past couple of years, the number of buyers has outnumbered the quantity of sellers coming to market, and sellers have consequently maintained lofty exit multiple expectations. “From my perspective, it’s still a seller’s market, and they’re kind of running the show in terms of pricing to buyers,” says Fanelli. While acquirers continue to vet targets to understand the baseline numbers and to ensure strategic future initiatives are in line with the multiples they are forced to pay, unless the volume of quality companies looking to sell increases, the current environment will remain in place.

The median valuation-to-EBITDA multiple came in at approximately 9.5X in 2015, with the median debt percentage used in deals coming in at 60 percent. With lenders becoming more selective and second-tier businesses unable to garner similar multiples to what they may have experienced in recent years, the yearly jump in the above metrics speaks to the increased advantage owners of quality targets hold in the current marketplace.
PE continues to be outbid

Private equity continued to face challenges deploying dry powder last year as they navigated an expensive transaction environment. 2015 saw PE firms invest over $154 billion across 1,364 deals, a YoY decline of near 16 percent and 2.4 percent, respectively. Examining Q4, we saw the same trend from its predecessor quarter continue at a larger scale. $30.5 billion was invested out of PE funds across 284 completed deals, amounting to a decline of 20 percent and 16 percent, respectively, on a consecutive basis. As strategic acquirers can find attractive synergies via numerous business lines and processes of certain targets, they continue to bid prices higher despite stuttering revenue projections, and PE dealmakers continue lose out. This competition is here to stay, which is forcing PE buyers to pick and choose their battles. “They (PE buyers) are trying to be selective and only pay big multiples where they feel like they have a real advantage on the company, really understand the business and feel they can drive up EBITDA and growth,” says Fanelli. If general partners (GPs) hold conviction around the types of operational improvements they can make to target companies, they’ll look to get aggressive and potentially overpay in the short term to close the deal, while looking to make sense of that price over the entire hold period, continues Fanelli.

Looking at deal types, GPs examining the B2B space continue to look for both quality platform investments and add-on deals to help supplement existing portfolio companies and potentially blend down the cost of expensive platforms. With various add-on deals able to be sourced across the lower middle market (LMM), those transactions can many times be completed outside of auctions, and PE buyers can close on them in shorter time frames than higher-priced deals. With this notion, such deals continue to account for a historically high percentage of PE-backed transactions, representing 62 percent of all buyouts in Q4 2015.

B2B private equity deal flow by quarter

B2B add-on activity

B2B private equity deals ($) by sector

Source: PitchBook
Exit activity finishes 2015 strong

2015 exit activity came in stronger than we may have expected with PE firms continuing to focus on selling existing portfolio companies that display growth levels able to take advantage of the present high-multiple growth era. Driven by a spike in PE-to-PE secondary buyouts (SBOs), 397 PE-backed sales were completed last year, a handful higher than the 392 exits we saw come to market in 2014. The 202 SBOs completed during the period represented 51 percent of all PE exits, a considerable amount higher than the 41 percent the exit ramp represented in 2014. With fund managers looking to utilize niche industry expertise that will allow them to rely on more performance-boosting levers in an uncertain environment, the jump in PE-to-PE exits can be attributed in part to certain managers willing to pay aggressive multiples for portfolio companies that fall within their operational focus. Further, Marcotte explains the ability of certain PE firms to acquire LMM businesses and provide them with strong management teams before ultimately exiting to other PEGs after helping professionalize and grow those enterprises. Coupling this phenomenon with the continued yearly increase we’ve seen in the inventory of PE-backed holdings, the context behind the yearly increase we’ve seen in SBOs becomes much clearer. On a quarterly basis, Q4 experienced an influx of PE-backed exits, driven by strategic acquisitions, rather than secondary buyouts. 108 PE-backed sales were completed in Q4, representing a 20 percent QoQ increase over the 90 exits closed in Q3. Continued volatility in public markets could induce certain sellers to speed up exit processes in hopes of protecting the bulk of their exit values. In this scenario, we could see transaction prices being reduced, especially across LMM owners looking to provide themselves with liquidity before a more pronounced softening in multiples hits the market. Moving through 2016 and 2017, this could become a more critical item to consider, yet according to Fanelli, we are yet to see this behavior.
IPO ACTIVITY

IPOs in the B2B industry

The initial public offering (IPO) exit ramp remained little used in 2015 with just $2.4 billion being raised across 18 listings. Total listings were down by just a handful on a yearly basis; however, total offering value was down more than 45 percent compared to the over $4.4 billion raised in 2014. 67 percent of all capital raised via public listings last year was attributed to PE-backed offerings, which raised an aggregate of $1.6 billion via seven IPOs.

In a global equity market trading with considerable chop, exiting via the public markets has simply lost its incentive, given the declining interest by investors willing to bet on new releases. Strategic acquirers are still able to see value where many public investors do not and thus, purchase prices remain elevated moving through that exit ramp. In addition, as we touched on in the previous section, industry-focused GPs are also able to value many companies at a higher valuation than traditional public investors, so if those two exit strategies are viable options, companies will continue to shy away from the IPO process. That said, larger, debt-strapped PE-backed businesses will likely look to the capital markets as a necessary resource should they run into potential trouble servicing future debt payments.

B2B IPO PIPELINE

<table>
<thead>
<tr>
<th>Company name</th>
<th>Sponsor(s)</th>
<th>Sector</th>
<th>Amount (SM)</th>
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<tbody>
<tr>
<td>Intrepid Aviation</td>
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<td>PSAV</td>
<td>Goldman Sachs, Olympus Partners</td>
<td>Media &amp; Info Services</td>
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<td>Cyrus Capital Partners, Luxor Capital Group</td>
<td>Marine</td>
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<td>American Infrastructure MLP Funds, Connected Ventures, Riveria Investment Group, Goldman Sachs</td>
<td>Distributors/Wholesale</td>
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Source: PitchBook
PE-backed M&A slips

PE’s percentage of total B2B M&A came in at 32.4 percent in 2015, a slight decline from the 33 percent financial buyers represented in 2014. On a quarterly basis, Q4 saw PE buyers represent the lowest portion of M&A in the sector since Q3 2013, accounting for 30.5 percent of all business products and services mergers.

PE firms were forced to deploy increased prudence and selectivity in 2015 due to competition from strategic acquirers continuing to price financial buyers out of many transactions. With that, PE deal volume fell at a higher rate than strategic acquirers, which contributed to the drop in the percentage of M&A PE was responsible for. As we saw both 2015 and Q4 PE-backed exits rise, managers remained focused on getting market-ready portfolio companies out the door to take advantage of current valuations, another factor potentially contributing to both PE’s share of total M&A declining last year.

SELECT B2B Q4 2015 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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<td>New Flyer Industries</td>
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<td>Rentokil Initial</td>
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<td>Jensen Hughes</td>
<td>Gryphon Investors</td>
<td>Construction &amp; Engineering</td>
<td>$168</td>
</tr>
</tbody>
</table>

Source: Pitchbook
INSIGHTS YOU CAN USE

5 cybersecurity predictions for 2016

As companies become increasingly reliant on technology to improve efficiency, productivity and mobility, vulnerabilities to cyberattacks are growing. While breaches at large organizations make headlines, no organization is too small to be a valuable target, and most companies will likely suffer a cybercrime at some point.

Security and privacy advisors at RSM US LLP have developed a list of five cybersecurity items that will likely emerge as significant threats to individuals and organizations in 2016. The five predictions are:

1. Cybercriminals will not just go after bits and pieces of data, as has been common practice in the past. Instead, cybercriminals will increasingly seek to build entire profiles from data collected and sell it as entire identities for monetization or for nation states to use for their targeted attacks.

2. The “Internet of things” is still growing as seemingly everything (vehicles, appliances, children’s toys, safety systems and others) a business or consumer purchases is “Internet ready.” Unfortunately, we continue to read about these systems being broken into and either remotely controlled in disturbing ways or used to gather information on businesses or families without their knowledge.

3. Cybercriminals will continue to use social engineering to facilitate their system breach efforts. Postmortem breach reviews indicate that many successful breaches are dependent on attacking the organization’s employees, customers or business partners through social engineering efforts.

4. Health care information has more value per stolen record than most other forms of data theft (bank account, credit card, PII). Health care information is often tied to a social security number, and it is difficult to get a new number issued that does not tie back to the original number. It simply isn’t as easy as getting a new credit card.

5. System security configuration issues continue to be a common source of security incidents and potential breaches. RSM continues to see too many weak security implementations for servers, workstations and other network devices during testing. New systems should be implemented using a National Institute of Standards and Technology (NIST) security reference or other guidelines to create a “base” image. That base image should then be used as a starting point when new systems are implemented.

Approaches to determining an appropriate working capital target

Upon the close of a transaction, the buyer typically assumes the cash-free, debt-free, working capital left over from the seller. This amount is determined based on a mutually agreed-upon working capital amount, defined in the purchase agreement, based on the average historical working capital called the working capital target.

The objective of most buyers is for enough working capital to remain in the business to avoid funding operations post-close with additional cash. Any additional cash infused into the business post-close has the effect of increasing the purchase price for the buyer. So what are some approaches to determining an appropriate target?

Having a deep understanding of the historical working capital trends, seasonality and growth of the business are critical. There are some basic components that will virtually always be included in a working capital target such as accounts receivable, inventory, prepaid expenses, accounts payable and accrued expenses, while cash and debt are virtually always excluded. Some other accounts that are typically excluded from the target are income taxes (prepaid or accrued), non-operational payables (e.g., severance payments) or receivables (e.g., legal settlements). Payables related to interest expenses or fixed assets would also be excluded. There are a number of additional metrics necessary to analyze working capital requirements, including days sales outstanding, days payables outstanding, inventory turnover, working capital as a percentage of sales, any recent changes in vendor or customer payment terms and industry metrics.

The path to success is predicated on both sides having a thorough grasp of the working capital components and the underlying metrics.

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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 1,700 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