By Joe Brusuelas, McGladrey Chief Economist

The U.S. economy staged a strong rebound in the second quarter, with growth accelerating to 3.7 percent. This has created some momentum into the third quarter of the year. We anticipate a 2.5 percent rate of growth in the current quarter (inventories and trade are a major drag on growth) and a slightly faster pace in the final three months of the year. The major drag on growth continues to be decelerating foreign demand and a stronger dollar. The hesitation by the U.S. Federal Reserve (Fed) to lift the federal funds rate by 25 basis points at the recently concluded September meeting is clearly linked to concerns about the global economy, China and emerging markets.

**Keys to growth**

U.S. households appear to be releasing some pent-up demand, which has resulted in strong demand for autos and services, and top-line retail sales have advanced at a 5.3 percent three-month annualized pace. All of this suggests the consumer will be the primary driver of growth in the second half of the year. U.S. household spending is currently tracking at 3.6 percent in the current quarter.

**M&A activity**

Mergers and acquisition activity should be boosted by continued low rates into 2016, bolstering activity in business products and services (B2B) and consumer products (B2C) markets in particular, and overall acquisition activity in general. While financial conditions have tightened somewhat during the past couple of months, interest rates will continue to be low for a long period of time. Conditions supporting an increase in acquisitions of cash-strapped firms, based on any interest rate shock, are still at least two to three years away. Meanwhile, acquisition activity is likely to pick up in the oil, energy and mining sector, which will see a cash crunch, as liquidity is curtailed by large institutions after a renewed leg down in oil prices.
**Valuations remain primary concern**

Although the U.S. business products and services (B2B) sector continues to see healthy deal activity, the sector as a whole is going through a transitional period. Buyers continue to pay frothy multiples to close deals, yet from a performance perspective, many companies may not warrant those heightened multiples. “There continues to be a slowdown on the size of growth, in terms of speed and margin compression. There is some inflation in health care, benefits and labor costs and probably some increasing in pricing, but there is definitely a slowdown on the top line,” says Milton Marcotte, practice leader of transaction advisory services at McGladrey.

Adding to this, bottom-line cushions expected by B2B companies from subdued energy prices appeared to be offset by some of the same costs mentioned above, along with forex volatility in certain currencies abroad. While the transitional period could lead to a slowdown in B2B deal flow, the middle-market B2B market should outperform other industries, “simply due to there being more quality companies available for sale in that market,” notes Michael Fanelli, partner with transaction advisory services at McGladrey.

As energy prices have moved lower than many expected, the sector has not seen the boost in anticipated profit, due to a lower theoretical input cost. “The amount of the decrease in energy prices is not enough to dramatically impact certain companies, depending on the industry,” states Mark Gaines, partner with the business and professional services practice at McGladrey. Fanelli says that B2B products companies, which have fuel as a primary expense, will likely benefit the most from the current oil price level, yet even those businesses have not seen the predicted results in his view. “The drop in fuel is not the same as the drop in oil, so it is not enough to move the needle as much. It is also offset by other expenses, such as wages and benefits.”

Another headwind continuing to be a greater-than-anticipated issue for multinational B2B companies is ongoing currency volatility abroad. Despite the recent paring back in the dollar, the U.S. is still an outperforming economy, and a Fed decision to move rates higher will likely attract foreign capital into the country, propping up the domestic currency. With events unfolding, such as the recent devaluation in the Chinese yuan, U.S. companies are being forced to put hedges in place to protect their bottom lines—an added expense, but a very necessary one. “I expect the U.S. growth rate will outperform all of its major trade partners, the inflation rate will remain stable and the U.S. employment rate will continue to improve, all of which will attract capital to the country,” says McGladrey chief economist Joe Brusuelas. “If you’re a company and you’ve got exposure to the global economy, you need to think about effective hedges as a form of insurance that you hope you never have to use, and the premium that one pays is well worth it.”

A pending U.S. interest rate rise has been an exhausting topic of discussion in both public and private markets, but it isn’t likely to be the sole catalyst that will derail M&A activity, especially given that rates have been at historically depressed levels for quite some time. “Banks have been very aggressive and I see that continuing,” states Marcotte, referring to the lending environment. “Rates may creep up a bit, but I do not see a major impact from that.” Normalization around interest rates would obviously cause debt to become more expensive, yet a 25 basis points hike, as many expect the Fed will start with, shouldn’t derail buyers zeroing in on attractive deals. From the private equity (PE) side, fundraising efforts have also been very strong over the past couple of years, and firms are constantly looking for targets to use their accumulated dry powder. Aggressive lending and PE firms hunting for quality deals should offset the potential negative impacts of an initial rate hike. Yet even with that, the cost of debt alone shouldn’t be a near-term issue for buy-side M&A players. As mentioned, the capital to make deals in the B2B space is certainly available, so a potential slowdown in the market will not be due to an inability to finance deals. Instead, the overarching concerns moving forward will remain valuations, the quality of companies looking to come to market and pinches in global economic growth.

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**B2B M&A deal flow by quarter**

![B2B M&A deal flow by quarter](image-url)
**Slowdown on the horizon**

Driven by a continued appetite to find synergistic acquisition targets, B2B M&A activity in Q2 remained relatively strong. While counts were down, compared to the unexpected uptick seen in Q1, aggregate capital invested was up a rather impressive 49 percent quarter on quarter (QoQ). Indeed, various nations abroad have seen economic growth slow, yet the U.S. is coming off a second quarter that saw gross domestic product grow by approximately 3.7 percent, and thus, the continued relative strength of U.S. B2B M&A doesn’t come as a major surprise.

The significant jump in Q2 total invested capital was certainly a positive note, but this number may be a bit inflated, due to a couple reasons. “Average deal size is larger, so a few big deals have overstated that number,” states Fanelli, referencing the $377.5 million figure (90-plus percent QoQ) recorded for the period. Also, heightened valuations are still very much present in the market, notes Harshad Khurjekar, director with transaction advisory services at McGladrey. “Even with deal counts down (10 percent QoQ), the valuations are still much higher, which is why capital invested has gone up.”

As deal multiples have remained elevated for a significant period, B2B M&A could see a slowdown, as we progress over the next couple of quarters and move through 2016. “We are in a low-growth mode, so we will see cost increases and tepid growth,” says Marcotte. “Valuations will not go up as high, and I think valuations and M&A activity may actually soften, as well.” Investment banks appear to share the same sentiment, as they look to push client businesses to market in order to take advantage of the current multiple environment. “Investment bankers say that now is the time to try to sell,” explains Marcotte. This notion also extends to PE firms looking to offload previous investments. “Controllers are working at getting their portfolio companies ready for sale. Along the same lines of talking to investment banks, they are projecting that the market is going to get soft, so they need to spend the next couple of months getting ready,” Gaines adds. As always, there is the potential for the expected trend to deviate, at least in the very near term, according to Khurjekar. “I think activity will be similar to what we’ve seen in the first half,” Khurjekar says in reference to the second half of 2015. “It could soften a little bit, but I expect it will be the same for the most part.”

Despite the hunger of PE to find quality portfolio companies and strategics’ continued hunger to grow via acquisitions, valuations will continue to cause rifts. Khurjekar notes certain companies having inflated revenue expectations, in turn, causing buyers to either pause transactions altogether, or significantly delaying the entire sale process. He also points to purchase disputes halting deals stemming from negative impacts, including currency exposure for multinationals and increasing labor costs affecting bottom lines. These concerns will remain in the deal environment for the foreseeable future.
Private equity deal flow remained active and healthy through Q2, with total deal value jumping 7.3 percent QoQ to $40.2 billion across 325 transactions; this came in just a tad under the 331 PE deals closed in Q1. When comparing the previous quarter’s activity to the same period last year, total value is still down near 11 percent, and counts are actually up slightly. Although total deal value has jumped from Q1 to Q2, this could be attributed to a few outliers in the broader market. The decline in QoQ counts is modest, yet that number has moved consistently lower over the past four quarters. Fanelli adds, “From a B2B perspective, the good companies have already closed, so there may be fewer deals being closed because there are just fewer companies being put out in the market and possible discrepancies between buyers and sellers.”

The current PE business model appears to be unchanged, with add-on transactions remaining the preferred deal type, accounting for 61 percent of all PE buyouts in Q2. “It seems to be more of the same, where PE is focusing on add-ons of family-owned businesses and selling assets to corporates. That trend seems to be continuing for the most part, and that has to do with valuations of the companies out there,” says Fanelli. The B2B market is also complementing this trend, in Marcotte’s view. “The PE model is really going toward buy and build.” Some investors, he continues, “won’t even do a platform deal unless they know ahead of time that they’ve got the add-ons available. If they can’t get add-ons done, it’s not a very good multiple, when they are already paying a high price and need to blend the cost down.” While valuations may soften, moving through the end of the year, activity should remain healthy. “PE firms still have the appetite and need to invest their dry powder capital. So while it will probably be fruitful for the whole marketplace to slow down a little bit, which would potentially lower valuations and right-size seller expectations, it could just be temporary, and volume may not necessarily decline dramatically,” says Fanelli.

Activity looks set to stay healthy

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Private equity exit activity

Caution on the rise

PE exit activity slowed considerably in Q2, with 72 total exits recorded for the period, a decline of over 23 percent on a consecutive basis and more than 15 percent, compared to the same period last year. Strategic acquisitions and secondary buyouts (SBOs) were relatively even in terms of total exits during Q1, yet SBOs edged exits via strategics in Q2. Two PE-backed initial public offerings (IPOs) were completed during the quarter, compared to none in Q1.

Although selling activity has subsided, the PE seller’s market should still hold some legs over the next two to three quarters. That said, the decline in quality companies, along with inflated valuation expectations, will cause buyers to act much more cautiously before completing deals. “PE firms are still not comfortable with the multiples sellers think they can get, so I think the seller’s market will actually slow down a bit. Sellers have expectations in terms of what type of multiple they can actually get, and it will take some time before these expectations are adjusted,” explains Gaines. One support that should help sellers continue exiting portfolio companies, albeit at a slower pace, is the increased focus on sell-side diligence. “I expect the trend of doing sell-side due diligence to continue and therefore, allow more companies to go through a successful sales process,” states Marcotte. Previously, the lack of these diligence projects could have severely hindered these businesses from completing sales at all, yet as certain bankers are requiring these projects prior to entering engagements, sell-side diligence is allowing tier 2 and tier 3 companies to actually get into the market.
B2B IPO activity dropped rather drastically since the end of 2013 and has remained subdued. Q2 saw six companies hit the public markets, raising an aggregate $1.4 billion. While this number is certainly up from the $74.8 million raised through a single IPO in Q1, it’s still far off from the near-$4.6 billion raised through 11 offerings we saw in the final quarter of 2013. In terms of PE, only two of the six completed IPOs in the quarter were PE-backed exits, yet those two offerings accounted for over 83 percent of capital raised.

“The values are so good at the PE and strategic level that the IPO market is not as attractive, especially with the costs and complications associated with the process, so it’s just not as attractive as other exit ramps,” says Marcotte on the softening IPO market. With strategics continuing to look for synergistic acquisitions in place of organic growth, and PE firms looking aggressively to find quality add-on deals, B2B IPO activity should remain subdued over the next few quarters.

### B2B IPO pipeline

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<th>Company name</th>
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Source: PitchBook
**Public-to-private activity**

### Private equity as % of overall M&A activity

![Chart showing private equity as % of overall M&A activity from Q1 2013 to Q2 2015.](chart.png)

**Solid fundamentals remain**

PE saw its percentage of total B2B M&A transactions creep higher in Q2 on a QoQ basis, accounting for nearly 33 percent of all Q2 M&A deals in the sector. While their percentage of B2B deals jumped, this was driven primarily by a slight decline in non-PE-sponsored M&A, which is understandable, given the various currency risks and foreign economic uncertainties multinationals must address. The median M&A deal size in the sector dropped a bit from previous quarters. This could partially explain the bump in M&A attributed to financial buyers, as PE firms looking for add-ons could have found deals a bit more affordable. With corporate acquirers holding the resources they have to finance transactions, strategics will continue to control the bulk share of M&A in the sector. Inflated multiples are a major concern to most buyers, yet according to Marcotte, “the fundamentals are still there for good M&A in the marketplace.”

### Select B2B Q2 2015 M&A/PE transactions

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<tr>
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<td>TellApart</td>
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Top accounting due diligence observations for business and professional services

1. Revenue recognition, especially related to target companies that derive the majority of revenue from large or lengthy projects, including project estimation, deferred revenue and customer deposits. Also, sales of bundled service packages that include multiple element arrangements. Important to differentiate whether these arrangements include software as a service, common in certain consulting businesses recently, such as Salesforce.com or other customer relationship management (CRM) systems, to determine if SOP 97-2 guidance is applicable, or alternatively, if they simply fall under a subscription revenue model—such as ASU 2009-13. Important to be able to determine if a value can be assigned to any of the individual services provided to clients or software.

2. Partner and owner compensation (historical versus future and valuation or cash requirements of the business), including types of compensation, such as salary versus dividends.

3. W-2 vs. 1099 employee function and reporting.

4. Employee utilization analysis and net realization by employee.

5. Employee turnover and ability to hire and retain qualified professionals. Treatment of severance and establishing “normal business” levels of severance payments when a company operates a semi-variable staffing model.

IRS issues proposed regulations impacting fee waiver taxability

The Department of the Treasury and the IRS issued proposed regulations aimed at addressing their concerns over the increased use of fee waivers with respect to private equity management fees. Fee waivers in exchange for a larger carried interest, common in private equity, provide for capital gain income taxed at favorable capital gains as opposed to the normal ordinary income tax rates. While the proposed regulations continue to accept carried interests as viable under current law, the regulations would attack fee waivers that lack the appropriate entrepreneurial risks and would treat the receipt of the interest as a disguised payment for services. This may result in immediate taxation at ordinary income rates as opposed to the current treatment of deferred capital gain.

The proposed regulations focus in large part on a facts and circumstances definition of entrepreneurial risk providing a number of factors for consideration. In general, an interest would not carry significant entrepreneurial risk if the allocation associated with the interest is reasonably certain to be met.

If finalized, these proposed regulations will significantly impact most private equity firms that have utilized fee waivers and may also impact waivers occurring under existing agreements. Therefore, it is essential that private equity firms seek appropriate tax advice on the treatment of any existing or future fee waiver agreements.

For more information, visit www.mcgladrey.com and read our full article, “Disguised payments for services regulations may impact private equity deals.”

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The value of McGladrey’s middle-market leadership

Focusing on the middle market, McGladrey provides integrated transaction advisory, tax, assurance and consulting services. Our work with 3,000 middle-market business and professional services companies gives us a deep understanding of the key trends impacting the industry. In addition, we have performed due diligence on more than 1,900 deals, over 200 of which were business and professional services transactions. This in-depth knowledge provides our private equity and strategic buyer clients with industry-specific due diligence considerations.
Business Products and Services (B2B)

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<td>1.3</td>
<td>Transportation</td>
</tr>
<tr>
<td>1.4</td>
<td>Other business products and services</td>
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The following list shows a detailed breakdown of the PitchBook industry codes for the B2B industry.
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