Aramar
Capital Group, LLC

Middle Market Update

4th Quarter 2015

Fourth Quarter Economic Performance and Future Outlook

Gross Domestic Product

- Real U.S. GDP increased at an annualized rate of 0.7% in Q4 2015, as compared with a 2.0% rise in Q3 2015[1]
  - The slight increase in real GDP was generated by positive contributions from personal consumption expenditures and federal government spending, which were largely offset by negative contributions from private inventory investment, exports, and non-residential fixed investments
  - Likewise, real gross domestic purchases were up 1.1% in Q4, but at a reduced pace from the 2.2% expansion in Q3

Consumer Income and Spending

- Real disposable personal income grew 3.2% in Q4, down from the 3.8% increase in Q3[1]
- Consumer spending was a major contributor to real GDP growth in the fourth quarter[1]
  - Real personal consumption expenditures expanded by 2.2% in Q4, as compared with a 3.0% increase in Q3

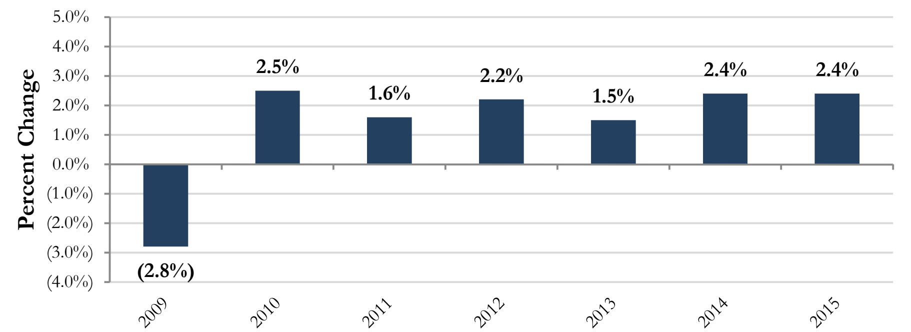
Federal Reserve

- The FOMC raised its federal funds rate by 25 basis points in Q4 2015, the first increase since 2006 and the first federal funds rate event since 2008; further increases during the coming year will depend on the economy and the labor market
- Despite the economic slowdown late in Q4, the Fed found that household spending and business fixed investment have increased moderately, while labor market conditions and the housing sector have improved further[2]

Employment

- In Q4, the unemployment rate was unchanged from Q3 at 4.9%, but the number of unemployed declined by 1.1 million (0.8%) year over year[3]

Annualized Real GDP Growth Since 2009



Source: Bureau of Economic Analysis

- Job gains occurred mainly in retailing, food and drinking services, health care, and manufacturing, more than offsetting drops in private educational services, transportation and warehousing, and mining[3]

U.S. Treasury Securities

- During Q4 and throughout the year , yields on the short-end of the curve increased more than those on the long-end, signaling a flattening of the yield curve[4]

	Q1 2015[5]	Q2 2015[5]	Q3 2015[5]	Q4 2015[5]
5-year Treasury Note	1.49%	1.58%	1.62%	1.66%
10-year Treasury Note	2.06%	2.26%	2.30%	2.29%
30-year Treasury Note	2.69%	3.10%	3.21%	3.21%
10-year Treasury Inflation Protected Security (TIPS)	0.27%	0.30%	0.56%	0.66%

Outlook for 2016

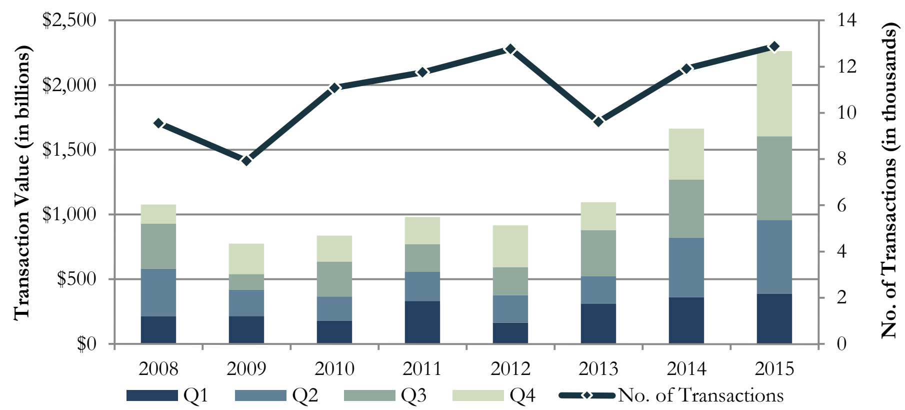
- PWC projects that the real U.S. GDP growth rate will be 2.8% in 2016, leading to the production of roughly 200,000 jobs per month and helping to sustain consumer spending throughout the year[6]
- The Business Roundtable CEO Economic Outlook Survey results indicate that U.S. CEOs expect real GDP to grow 2.4% in 2016[7]

1. *U.S. Bureau of Economic Analysis*
2. *U.S. Federal Reserve*
3. *Bureau of Labor Statistics*
4. *Baird*
5. *U.S. Department of the Treasury*
6. *PWC*
7. *CEO Economic Outlook Survey published by Business Roundtable*

Mergers and Acquisitions and Private Equity

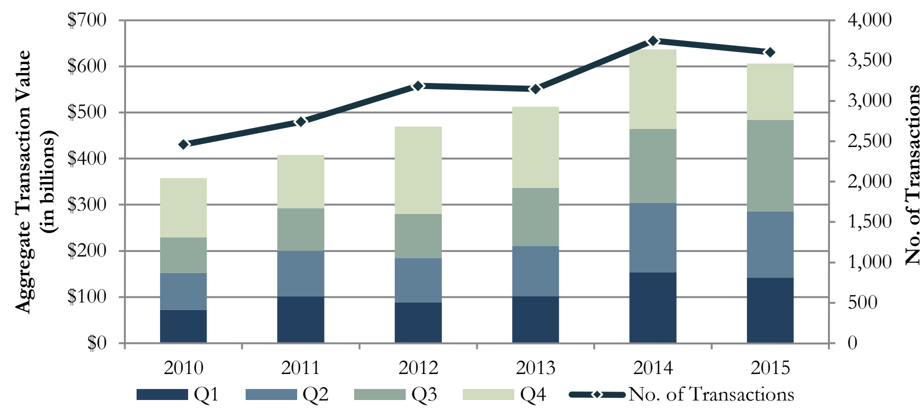
- The aggregate global mergers and acquisitions (M&A) value rose 30.5% to $4.3T, over 16,837 deals in 2015, from $3.3T in 2014[1]
  - Energy, mining, and utilities (EMU) was the leading sector
  - The recent frenetic corporate M&A activity has been spurred largely by sluggish economic demand, leading companies to seek new revenue sources; by historically cheap debt; and by high stock prices
  - In Q4 2015, global M&A activity reached $1.4T, the busiest quarter since 2010
- The U.S. set quarterly and annual records for total deal value in 2015, with $657.8B across 3,099 deals in Q4 and $2,263.4B invested in 12,880 deals over the year[2]
  - Health technology was the most active U.S. sector
- While corporations became even more aggressive buyers, PE firms grew cautious with respect to new platform investments as a result of lofty valuations and global economic uncertainty
  - U.S. PE investments totaled $122.1B in Q4 across 746 deals, down 38.3% and 22.1%, respectively, from Q3[3]
  - U.S. PE firms invested $606.0B in 3,602 deals in 2015, which represented declines of 4.8% and 8.2%, respectively[3]

U.S. M&A Activity



Source: FactSet

U.S. Private Equity Deal Flow



Source: PitchBook

- PE investors consummated 2,894 add-on acquisitions worldwide in 2015, more than double the 1,279 in 2010[3]
- The average enterprise value-to-EBITDA multiple for U.S. buyouts slid from 11.1x in 2014 to 9.1x in 2015, the lowest level since 2012[3,4]
  - However, in the lower middle market (deals between $10M and $250M), the average multiple rose to 6.7x in 2015 from 6.4x in 2014; and multiples for transactions in the $10M to $25M range jumped even further, from 5.4x in 2014 to 5.9x in 2015[5]
- PE funds started in 2003 generated a median return of 1.4 times that of the S&P 500; this public-market-equivalent ratio has declined every year since, hitting 0.9 times in 2010 (the latest one studied due to a four-year minimum holding period), as more capital is chasing more sophisticated sellers[6]
- Shadow capital – when investors co-invest with PE funds or invest directly – was on pace to reach $161B in 2015, which would represent 26% of overall fund-raising, up from just 11% in 2008 and 23% in 2015[7]
- Current PE dry powder is $1.3T, up 23% since the beginning of 2015 and including $147B on hand for three or more years, portending robust activity going forward[3,7]

1. *Mergermarket*
2. *FactSet*
3. *PitchBook*
4. *These multiples reflect prices paid for mainly public companies and do not account for smaller private company transactions (for which there typically are no publicly available data) that tend to change hands at much lower multiples*
5. *GF Data*
6. *Journal of Investment Management*
7. *Triago*

Venture Capital and PIPEs

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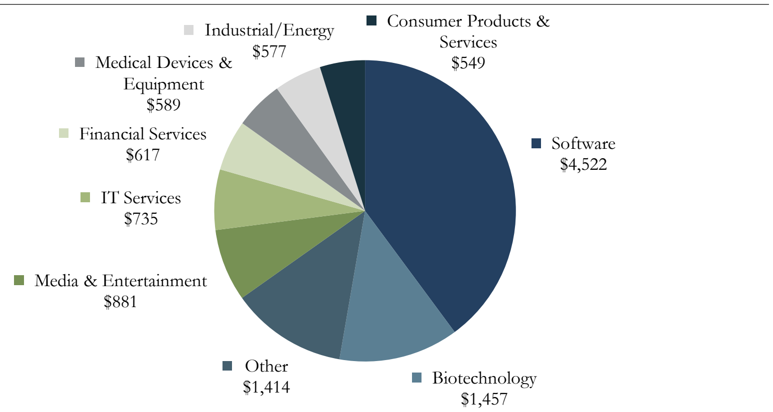
Venture Capital Investing

- In Q4 2015, the venture capital (VC) industry invested $11.3B in 962 deals, a decrease of 31.9% in value and 16.3% in transactions, as compared with $16.6B across 1,149 transactions in Q3 2015[1]
  - — Investors became more cautious due to the uncertain economic outlook, slowdown in China, and softer IPO market
- Despite the relative Q4 weakness, 2015 marked the second highest total in the past 20 years, with $58.8B invested in VC throughout the U.S.[1]
- First-time financings decreased 12.0% from $2.5B in Q3 to $2.2B in Q4, while the number of deals declined 19.9%[1]
- In 2015, there were 77 VC-backed IPOs that raised $9.4B in the U.S., down 34.2% in number of IPOs and 39.5% in dollars raised from 2014, as companies remained private longer[2]
  - — Over half of these IPOs were trading below their offering price at year end, but the outsized performance of some of the stronger stocks led to an average price rise of 5.3% from IPO[3]
- The number of VC-backed M&A deals declined 16.5% to 91 transactions in Q4 from 109 in Q3[2]

PIPE Investing

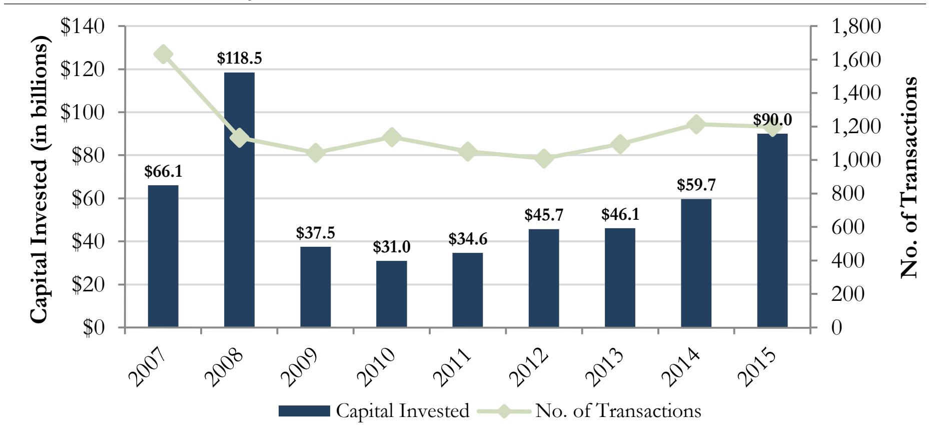
- $17.6B was raised across 308 PIPE transactions that were announced or completed in Q4 2015, down from the $21.7B invested in 282 transactions in Q4 2014[4]
  - — Although the total PIPE deal value was greater in the final quarter of 2014, the transactions were actually more liquid in Q4 2015, with only 30% of deal value stemming from ATM transactions, as compared with 60% in 2014[5]
  - — In Q4 2015, lower-middle-market companies experienced difficulty in receiving ideal terms as a result of market volatility and investor caution
- The most popular deal structure was a common stock offering, which accounted for 42.5% of PIPE transactions in Q4, while ATMs and convertible debt represented 17.9% and 17.5%, respectively[4]
- Energy PIPEs experienced a lapse in Q4 2015, with only $4.8B raised in the PIPE market, a sharp drop from the $13.0B funded in Q4 2014[4]

VC Deals Per Industry – Q4 2015 (in millions)



Source: MoneyTree Report

U.S. PIPE Activity



Source: PrivateRaise/DealFlow

1. *MoneyTree Report by PricewaterhouseCoopers LLC*
2. *NVCA*
3. *Fortune*
4. *PrivateRaise/Dealflow*
5. *ATMs are at-the-market offering facilities, which may not raise capital initially – or ever*

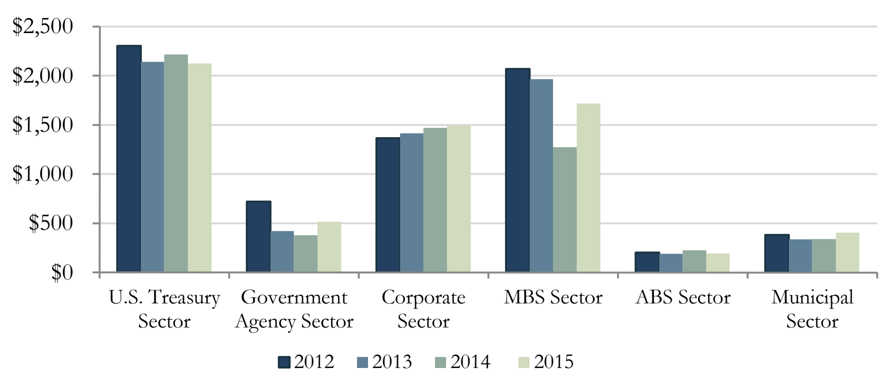
Debt Capital

- The Barclays U.S. Aggregate Bond Index posted a negative 0.6% return in Q4 2015, down from a positive 1.2% return in Q3 2015[1]
  - 2015 resulted in a full-year return of 0.6%, markedly lower than the 6.0% annual return in 2014
- The Barclays U.S. Corporate Bond Index also posted a negative 0.6% return in Q4 2015, reflecting investors' concerns about slow economic growth, the Fed's first rate hike in a decade, and the recent plunge in oil and commodity prices[1]
  - U.S. corporate spreads over similar maturity Treasuries dropped 4 bps from 169 bps in Q3 to 165 bps in Q4
- Total debt issuances decreased 8.4% from $1,576.0B in Q3 to $1,444.2B in Q4[2]
  - The overall decline was driven largely by a 18.9% drop in mortgage-related bond issuances, down to $380.5B in Q4 from $469.5B in Q3
- 2015 marked the first year since 2009 that high-yield bonds and bank loans posted annual losses, and the weakest annual total return the S&P 500 has experienced since 2008, at 1.4%[3]
- The Credit Suisse High-Yield Bond Index posted a loss of 2.6% in Q4 and a loss of 4.9% 2015, the worst annual return since 2008[3]
- The Barclays U.S. Corporate High Yield Index increased 43 bps and ended the month at 9.2%, while remaining extremely volatile[4]
- Prudential predicts a bounce back for fixed income in 2016 thanks to Fed policy actions, positive roll-down returns, and the tightening of the wide spreads currently in the market[1]

Middle-Market Loan Issuances

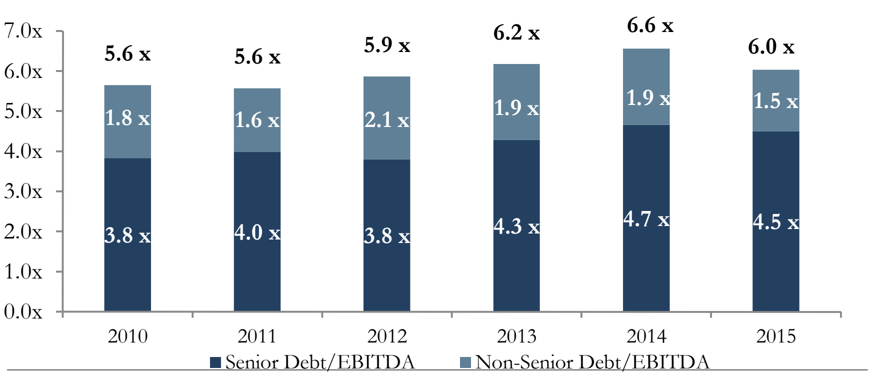
- Bank loans to small businesses were off 16% through Q4, while large company loans were up 37%, as small business owners grew more cautious and banks are focusing on higher-margin lending[5]
  - The dearth of available bank capital for small businesses has opened the door to higher-cost alternatives, as non-bank lenders upped their market share from 10% to 26%[6]
- Total middle-market lending reached $142.0B in 2015, a 30% drop-off from the $202.0B disbursed in 2014[4]
  - Yields reached 7.1% in Q4, up from 6.3% in Q3
- Leverage multiples for broadly syndicated LBO transactions have decreased in 2015, following four years of consecutive growth[4]
  - The average debt-to-EBITDA multiple declined from 6.6x in 2014 to 6.0x in 2015 for middle-market LBOs, but increased from 5.4x to 5.7x for institutional middle-market LBOs[7]

Issuance in the U.S. Bond Market (in billions)



Source: SIFMA

Debt Multiples of Middle-Market LBO Loans



Source: Thomson Reuters LPC

1. *Prudential Financial*
2. *SIFMA*
3. *Guggenheim Partners*
4. *Thomson Reuters LPC*
5. *The FDIC*
6. *The Wall Street Journal*
7. *These multiples mostly reflect prices paid for larger private companies and generally do not account for smaller private company transactions that tend to change hands at much lower multiples and with lower debt ratios*

By CohnReznick Advisory Group

<u>Sealing an M&A Deal: The Importance of Buy-Side and Sell-Side Best Practices</u>

M&A activity in the middle market has reached new highs in recent years. For sellers, to close a transaction at its desired price and terms is priceless. Alarmingly, study after study puts the merger failure rate at between 70% and 90%. As such, it is critical that both buyers and sellers adopt best practices to increase certainty to close the deal.

<u>Adopting Best Practices: Different Agendas, Same Principles</u>

The maturity in the market and the increasing competition for quality businesses make it critical for both buyers and sellers to put their best foot forward in order to increase the chances of closing. There are a number of steps that buyers and sellers can take to increase the certainty of close. Even though the parties are driven by different agendas, when both sides are well organized and adhere to best practices, the odds of success increase.

Buyers should consider ways to differentiate themselves from the competition, and demonstrate their ability to close a deal quickly. For example, they need to demonstrate that they are not just bringing capital to the table, but also value-added from a strategic perspective. To position themselves as the buyer of choice, bidders — especially private equity firms — must bring a laser-like focus to a particular industry or sector, demonstrating that they are able to drive the growth of the target company.

Another way for buyers to differentiate themselves is to eliminate or significantly reduce escrow provisions in the purchase agreement, possibly by replacing them with rep and warranty insurance. This has become increasingly common in today's market. Understanding who bears the costs for the insurance and any exclusions from such insurance is critical.

Acquirers also needs to focus on proper planning, including having financing in place, a well-organized due diligence team, and a well-crafted LOI; otherwise the buyer risks losing deals. The LOI forms the backbone of the transaction terms, so it needs to be as specific as possible with respect to the purchase price, earn-out provisions, working capital target, EBITDA definitions, employment contract provisions, indemnification baskets and caps, and other key deal terms. Buyers and sellers that are able to iron out the most sensitive and contentious issues at the LOI phase will have far greater success at closing the deal. Buyers should encourage transparency throughout the process by developing a trusted relationship with the seller's owners and management team from the outset.

<u>Strong Advisory Teams Help Both Parties Navigate the M&A Minefield</u>

The increased regulatory environment and the complexity of closing a transaction make it essential that both buyers and sellers quickly assemble teams of competent financial, tax, legal, and investment banking professional advisors to help them through all facets of the transaction process. Without proper M&A representation, parties expose themselves to the risk of lack of certainty that the transaction will close in a timely manner and at an acceptable price and terms.

Buyer Advisory Team Considerations

For the buyer, engaging a team of transaction-focused professionals demonstrates serious intentions to the seller, adding certainty and credibility to the ultimate goal of closing the transaction. Financial and valuation advisors will help buyers quickly develop and articulate business and strategic objectives to ensure that the target company is a proper fit strategically and culturally. Such professionals will 1) determine the value of the potential investment to ensure that the buyer's first offer is a credible one and 2) provide important leverage during the negotiation phase of the process. The same can be said for sellers who consult with their own professionals to ensure the offer is reasonable, its terms are market-based, and the buyer is potentially a "good fit."

1. *Tom Zucker, "The Value of Certainty." EdgePoint Capital Investors Website.* http://www.edgepoint.com/article/The-Value-of-Certainty.
2. *Clayton M. Christensen, Richard Alton, Curtis Rising, and Andrew Waldeck, "The Big Idea: The New M&A Playbook." Harvard Business Review.* https://hbr.org/2011/03/the-big-idea-the-new-ma-playbook.

Seller Advisory Team Considerations

For the seller, proper planning, including the allocation of resources and selection of a well-rounded team of advisors, is necessary to respond to all requests during the exclusivity period. The existing relationships a seller has with its professional advisory team may not be appropriate for an M&A transaction. For example, an attorney who provides advice on ongoing corporate matters, such as customer and vendor contracts or employment contracts, may not be experienced with M&A transactions and related tax matters. Therefore, the seller should give consideration to engaging a trained M&A legal team.

Allocating resources to different tasks is helpful; however, the day-to-day business operations have to continue as the priority. An excuse that the financial performance is below budget because the management team has been focusing on the transaction is not one that is widely accepted. Therefore, early planning and understanding of one's own limitations are critical. The transaction process is intense and should not be underestimated. Without proper planning, not only does the process drag, it could have negative consequences as a potential buyer will be looking for any angle to leverage and negotiate the best deal. Where an investment banker is hired to manage the sale process, a timetable should be discussed outlining key deliverables and responsibilities. A thorough review of this should be performed to ensure the time lines are reasonable and are matched with resource availability.

The Importance of Buy-Side and Sell-Side Financial Due Diligence

Buy-side financial due diligence should commence early in the process – preferably prior to the execution of the LOI and commencement of an exclusivity period. This will allow buyers to quickly 1) evaluate the quality of reported earnings; 2) assess the strengths of personnel, processes, and systems; 3) summarize the tax consequences of the proposed transaction; and 4) identify issues to be addressed in the purchase and credit agreements.

Sell-side services such as quality-of-earnings and sell-side assistance have become increasingly popular in recent years. Often, work around the quality of earnings uncovers matters that may impact the overall valuation in both positive and negative ways. For both findings, taking advantage of the situation is key through positioning of the facts in management presentations, confidential information memorandums, and data analysis. Any potentially negative findings can almost always be addressed or rationalized and, in certain situations, delaying the sale process for a period may be in the company's best interests. A recent example of this occurred where unbeknown to the seller, the gross margins for a specific customer and a product segment had been declining. By identifying this upfront, the seller was able to provide a reasonable explanation to prospective buyers and, in this instance, remedy the situation by no longer working with the unprofitable customer, increasing product prices to certain end markets. The seller also was able to proactively seek and obtain better vendor pricing. Hiding issues from buyers is not an option, since they are likely to uncover these situations through their due diligence anyway, which will reflect negatively on the seller and may unravel the transaction altogether.

Transaction Structuring Benefits Both Parties

An integrated team of attorneys and financial and tax professionals will develop a structure that is most advantageous to their client (buyer or seller). Consideration by both parties should be given to the tax ramifications of the transactions, earn-outs, guarantees, debt assumptions, seller financing, employment contracts, carve-outs, hold-backs, and indemnifications.

A common example of a tax-related issue happens where a buyer is seeking a step-up in basis of the underlying assets through a 338(h)(10) or similar election in a stock deal. This may result in significantly higher taxes for the seller, thus negotiating the concept of "being made whole" upfront is important.

Final Thoughts

Anyone who tells buyers and sellers that closing a transaction is easy or simple has not experienced an M&A transaction. Clearly, there are common themes that buyers and sellers should address. If both parties are prepared, it will facilitate the overall process, ensure that agendas are aligned, and lead to favorable outcomes for both parties.

About the Authors

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About CohnReznick

CohnReznick LLP is one of the top accounting, tax, and advisory firms in the United States, combining the resources and technical expertise of a national firm with the hands-on, entrepreneurial approach that today's dynamic business environment demands. Headquartered in New York, NY, and with offices nationwide, CohnReznick serves diverse industries and offers specialized services for middle-market and Fortune 1000 companies, private equity and financial services firms, government contractors and agencies, and not-for-profit organizations. The firm, with origins dating back to 1919, has more than 2,700 employees, including nearly 300 partners, and is a member of Nexia International, a global network of independent accountancy, tax, and business advisors. For more information, visit www.cohnreznick.com.

Differentiation

- Aramar Capital Group, LLC is a boutique investment bank focused on providing merger, acquisition, and strategic private placement services. We are unique among our investment banking peers in that:
  - We focus on middle-market transactions; these transactions are a priority, not a default for when larger deals are dormant;
  - We have significant transactional expertise;
  - We offer senior level attention; and
  - We have a proprietary marketing process that follows a comprehensive approach tailored to each buyer or investor candidate, rather than a typical generic approach utilizing "blast" e-mails, letters, and other contacts.

Services

- Aramar offers a highly focused set of corporate finance services to assist our clients in conceiving, defining, executing, and optimizing their objectives:
  - Mergers and Acquisitions
    - Negotiated Sales of Closely-held Companies
    - Corporate and Private Equity Firm Divestitures
    - Leveraged Buyouts
    - Managed Buyouts
    - Buy-side Advisory
  - Private Equity Placements
  - Private Debt Placements
  - Recapitalizations
  - Fairness Opinions
  - Valuations
  - Financial Advisory

Clientele

- Aramar focuses on providing a superior level of service to "middle-market" clients. Our M&A transactions range in size from approximately $10 million to $200 million. Our strategic private placements range in size from approximately $10 million to $100 million.
- We provide the high quality of service and substantial transactional experience offered by a major national investment bank, but to a clientele that either is too small for, or cannot receive, the proper level of attention from a larger investment bank, or would receive lesser services and capabilities from a business broker, consultant, or smaller investment bank. This encompasses access to Aramar's senior professionals and proprietary marketing process.

Team

- Aramar has assembled a unique team of professionals with a comprehensive and attractive mix of skills and experience. This team has significant investment banking experience, including stints at many other prominent financial services firms.
- Equally important, however, our team has entrepreneurial, managerial, and ownership experience that sets apart Aramar's "principal" perspective from that of most investment banks, where professionals tend to act simply as "agents." As principals, our team members have founded firms, acquired other companies, sold and merged our own companies, and acted as officers and directors of both public and private enterprises. As such, we can relate more closely to our clients and better advise them, at the same time as ensuring senior level investment banking attention.