Overall M&A Market Commentary

At 115 months and counting, the current U.S. economic expansion is in record territory. After eight years of fed policy induced stock market tranquility, stock market volatility returned in 2018 with a vengeance. Even with more market volatility and a growing number of potential economic concerns, there are still no clear signs of an imminent recession. While there is speculation as to when the recovery will end, it looks like the great economic expansion of 2009 will continue well into 2019. GDP growth continues its pace above trend with 3Q18 GDP a strong 3.4% following the extraordinary 2Q18 measure of 4.2%. If estimates of 4Q18 GDP hit the low 2% range as anticipated, annual 2018 GDP will have topped 3% for the first time since 2005. The GDP results in 2018 could be a tough act to follow. Most analysts are calling for 2019 GDP growth between 2.0% to 2.5%, still above the trend of 2%. According to Chicago Fed President, Charles L. Evans in a January 2019 speech, “Solid economic fundamentals lead me – and most other forecasters – to expect another good year in 2019...” Evans continued, “The vibrant labor market and corresponding increases in household income were key factors behind strong consumer spending; the 2017 personal income tax cuts also contributed. In addition, business investment was strong last year, boosted in part by a variety of changes to the tax code.”

As the Chicago Fed President indicated, the U.S. jobs market is strong and improving. The record December 2018 jobs report put an exclamation point on the current economic environment. With 2.6 million jobs created in 2018 and wage growth climbing to 3.2%, the working public will have more disposable income to consume goods and services, which should extend the recovery well into 2019.

Trade and tariffs have been another source of economic concern. The current trade skirmish with China remains unsettled and is a major source of business and economic uncertainty. According to an article by Pew Research Center in March 2018, “Since the turn of the 21st century, U.S. average tariff rates have consistently been at or near their lowest levels in the nation’s history; today they’re also among the lowest in the world.” According to Pew Research, before the tariff increase, the average U.S. tariff was 1.61%, the European Union average tariff was 1.60% and China was 3.54%. Obviously moving China closer to the average tariffs of other nations is a worthy goal, but the execution of that strategy is where the debate lies. At least the task has been started and talks are ongoing. According to Investor’s Business Daily on January 10th, “The coming trade deal could keep the China trade war at a low boil, even as the two economic and geopolitical rivals aim to coexist to avoid serious near-term disruption to the global economy.” Both the U.S. and China have
reasons to reach some sort of accommodation, so there is continued optimism that an agreement will be made.

Overall, we have a strong U.S. economy with many reasons for continued business optimism. However, the growing number of uncertainties related to trade, global economic growth and global political risk are starting to be a drag on the economy. In the face of this, aging business owners must still consider their options to sell their businesses. With a strong economy and growing uncertainty, more owners are deciding to sell, leading to greater middle-market deal flow in late 2018. We believe this trend will continue into 2019.

The M&A supply demand imbalance continues to favor the sellers in this market. The demand for good quality acquisition targets remains high and M&A market valuations continue to be elevated. We encourage business owners to look at their transition goals and objectives to determine whether a company sale makes sense for their circumstances.

M&A Market Activity

Closed middle-market M&A deal dollar value in 3Q18 edged upward slightly from a low point recorded in 2Q18, while the number of deals stabilized and was flat between these quarters. Increased stock market volatility in late 2018 has caused some consternation in the business community. However, a remarkably strong U.S. economy, a record number of December jobs and escalating wage growth have sustained consumer confidence and business optimism nationwide. Continuing concerns with the global trade wars and general political uncertainty seem to be weighing heavily on middle-market business owners with growing numbers beginning to consider their strategic options, including a company sale. Valuations are high, capital is plentiful and demand for quality businesses is strong. Action in 2019 is important to avoid missing the open window of this sellers’ market.

In 2017, PE firms took advantage of elevated company valuations and a shortage of quality sale candidates, setting a five-year quarterly high for dollar value of company exits in 4Q17. This high level of activity likely pulled deals forward and set the stage for lower PE sale activity in 2018. While PE sales started slowly in 2018, there seems to be an escalating volume of activity that will show up in late 2018 and early 2019.

Persistently low deal activity and strong buyer demand for acquisitions have sustained M&A valuations at historically high levels. Strategic and PE buyer demand for new deals, the availability of debt capital and the lack of supply of quality companies for sale is expected to continue to support elevated valuations at least through early 2019.

- The $50 billion of middle-market deals recorded in 3Q18 reflects a 16% increase in dollar value from 2Q18, while the YTD18 (3 quarters) dollar value of deals was down 9% compared to levels experienced in YTD17. This may reflect the forming of a market bottom in middle-market M&A deal value.
- The number of middle-market closed deals in 3Q18 was flat compared to the number of closed deals in 2Q18. The number of closed deals in YTD18 (3 quarters) was down about 15% from the total closed deal tally in YTD17. Deal volume seemed to reflect the same market bottom noted above.
- The average middle-market deal size of $51.4 million in YTD18 was up from the average $47.9 million deal size closed in YTD17.

PE exit activity showed a different picture and a reduction in volume through 3Q18. The number of PE exits in 3Q18 decreased about 21% from 2Q18 and the capital exited decreased 3% during the same period. The PE community may have exhausted their supply of ready sale candidates in the spike of PE sales recorded in late 2017.
Middle Market Deal Valuations

Aggressive strategic and PE buyer behavior coupled with abundant capital and a strong economy have sustained higher middle-market M&A valuations for several years. While news of increased stock market volatility has dominated the media, the stock market has little effect on middle-market M&A. According to the NFIB December Small Business Optimism Index, business owner optimism remains strong with only demand for workers cited as a significant constraint. We are still in a strong seller’s market. We believe middle-market company values are at or near the market peak with increasing risk to the downside. It would be an excellent time for sellers to review their options and consider entering the M&A market.

- Sub-$25 million deal valuation multiples moved slightly lower in 3Q18 declining to a 5.8x multiple which is near the long run multiple average for this size category.
- Valuations on the large end of the middle-market ($50 to $100 million segment) dropped from last quarter’s record high but continued to stay at elevated levels in 3Q18. More strategic buyer activity in this size range has likely supported these high valuations.
- Valuations in the $25 to $50 million segment moved slightly higher in 3Q18. Volatility in quarterly data has likely skewed this segment’s valuation higher during the quarter.
- As we have suggested in our previous reports, properly prepared, solid performing companies are always welcome in the M&A market and will continue to receive strong buyer interest and premium valuations.

Private Equity versus Strategic Valuations

Strategic buyers continue to be active in middle-market M&A. Ongoing strong economic conditions, lower taxes and the need for earnings growth have induced aggressive strategic buyer behavior. Recently, strategic buyers have been paying at least 1.0x of EBITDA more than the average PE buyer. Our data shows aggressive participation of the strategic buyer in M&A transactions, leading to higher deal offers and increased strategic valuations.

- Strategic buyers continue to be a significant factor in middle-market M&A. Although there was a slight pull back in the 3Q18 strategic multiple to 8.5x from 9.3x in 2Q18, our data reflects that the average YTD18 strategic buyer multiple remains higher than the annual averages for the last four years.
- Over the last couple of years, PE acquisition multiples have remained in a stable range around 7.0x. We believe PE multiples are moving higher coincident to the strategic multiples even though the interim 2018 data shows slightly lower PE valuations.
- The trend in increasing valuations indicates that the supply demand imbalance continues in the middle-market. Well-prepared, attractive sellers can still take advantage of interest in M&A deals by both strategic buyers and PE funds and achieve reasonably high valuations.
- Prairie estimates that for middle-market deals below $50 million, valuations are generally 1.0x to 2.0x multiples of EBITDA lower than the levels reflected in the chart below.

Source: QF Data

* TEV = Total Enterprise Value

Source 1: Financial Buyers: GF Data ($10-250M TEV)
Source 2: Strategic Buyers: Capital IQ ($10-250M TEV; Excluding outliers defined as transactions with TEV/EBITDA of less than 3.0x or greater than 18.0x)
Middle Market Leveraged Buy Out Capitalizations

Abundant debt capital and more aggressive lenders have led to more debt availability for middle-market leveraged buyout ("LBO") transactions. However, the actual amount of debt used in an LBO is the buyer’s decision. While prior to 2018 we saw the use of more debt and a corresponding reduction in equity. That trend seems to have reversed. The quarterly data show a trend to more conservative capital structures, perhaps reflecting concerns over potentially higher interest rates and/or an expectation for an economic slowdown.

- Sophisticated borrowers and the PEs make greater use of the Business Development Corporation ("BDC") lenders, where acceptable leverage levels are somewhat higher. According to the GF Data November 2018 leverage report, total leverage employed in BDC capital structures is now also becoming more conservative.

- The wide variety of non-bank debt sources and increased competition among banks for new lending opportunities has kept borrowing costs low. Increased bank competition has led to more borrower-friendly terms and a borrower’s market. Continued lending regulatory oversight and a discerning lending community has kept LBO deal structures in a conservative zone. As such, equity still is in excess of a third of the capital structure.

- Mezzanine funds continued to aggressively pursue deal opportunities in 2018. The use of this type of financing in leveraged transactions remains an important part of the LBO capital structure. Interest only and payment in kind structures still dominate the markets, but mezzanine funds continue to pursue equity co-investment opportunities to improve their returns and increase their investment amount in deals.

Overall Comment on the Financing Markets

Capital for M&A deals and corporate growth continues to be relatively plentiful. Banks, non-bank lenders, mezzanine funds and private equity investors all have capital they wish to invest. The economy continues to perform and many of the leading economic indicators, while beginning to signal caution, are not yet suggesting a recession in 2019. While not directly tied to the economy, the recent increased stock market volatility may begin to have a negative impact on business owner and consumer sentiment. The stellar December 2018 jobs report has helped settle many business owners’ nerves and has “reset” attitudes. Stock market gains in early 2019 have made up some of the decline in late 2018.

After remaining relatively flat between 2015 through 2017, middle-market loan volume declined approximately 9% in 2018. The lack of middle-market loan growth is a demand driven problem. Lenders are anxious to make new loans for M&A transactions or business growth but borrowers are hard to find. BDCs have been a factor in the M&A market for years, many times providing aggressive structures and pricing in acquisition transactions. However recently, with the increased stock market volatility and uncertainty, the BDCs have pulled back and are offering terms similar to the banks.

Across the yield curve, interest rates have increased approximately 100 basis points since the end of 2017. The Fed interest rate normalization program is nearing completion with two additional 25 basis point increases anticipated in 2019. Even with the recent upward shift in the yield curve, we remain in a low interest rate environment with favorable business borrowing costs. Low interest rates coupled with borrower friendly terms makes this a borrower’s market. Credit worthy companies still have an opportunity to structure loans with favorable terms and are welcome in the lending market.

Total U.S. Middle Market Loan Issuance

- New bank loan issuance for middle-market companies continued to be anemic during 2018. Even while the 2018 economy was booming, middle-market companies did not see reasons to take on debt. According to Thomson Reuters, middle-market loan issuance was down about 9% in 2018. In light of the weaker demand, according to the Fed’s October 2018 Senior Loan Officer Opinion Survey, many banks “have eased their standards and terms for commercial & industrial loans” and “narrowed rate spreads on C&I loans for firms of all sizes.”

- The Fed has increased rates nine times since it began its normalization tightening cycle in December 2015. The overnight
funds rate target range is currently at 2.25% to 2.50%. Expectations are for two additional 25 basis point rate increases in 2019.

- Bank lenders continue to focus on relationship banking, corporate borrowers’ lines of credit and areas where they have a competitive advantage like operating business needs, including payroll and checking accounts. Due to regulatory scrutiny, banks continue to be selective in making new loans and are very selective in new leveraged transactions.

- With growing concerns about a recession, the non-bank BDC lenders are currently less of a factor in middle-market lending. Out of 52 BDCs that are currently publicly traded, only eight are currently trading above their Net Asset Value, reflecting investor concerns of their exposure to more recession sensitive middle market loans.

Interest Rate Environment

- The short end of the yield curve (Prime and 1-month LIBOR) are about 100 basis points higher in year-over-year comparisons reflecting the four additional 25 basis point Fed rate hikes orchestrated in calendar year 2018. The hot labor market, potential tariff issues and emerging inflation concerns could affect the Fed’s future interest rate decisions. Currently the Fed has signaled they will have at least two additional 25 basis point increases to take the Fed funds rate up to the 3.00% level.

- The slope of the yield curve continues to flatten. This flattening yield curve is a source of concern for analysts, especially when the long-end of the yield curve inverts (long rates move below short rates) which is considered a predictor of a future recession. At the end of 2017, the spread between the two and the 10 year treasuries was about 51 basis points whereas at the end of 2018 this spread was 21 basis points (further narrowing to 19 basis points in mid-January 2019). The yield curve is still positively sloped but should be watched closely in the future.

- Lower corporate taxes and reduced regulation are leading to a dramatically improved labor market. According to the Wall Street Journal, “the very strong December jobs report showed the benefit of new capital investment spurred by tax reform and deregulation.” While the unemployment rate increased slightly to 3.9%, the rise was largely due to more workers reentering the workforce as evidenced by an increase in the labor participation rate. Wage growth in 2018 was pegged at 3.2%, the fastest rate since before the 2008 financial panic.

**Middle Market Debt Multiples**

- Deal market total debt leverage has moved below 4.0x in 2018 with the senior bank component of the total leverage declining slightly to 3.1x in 3Q18. Tariff issues, political uncertainty and more volatile markets are making lenders more cautious in structuring new loans. However, continued strong economic conditions and a resolution of the tariff situation might lead to more aggressive lender behavior in 2019.

- Mezzanine capital still plays an important role in a leveraged capital structure. Over the last few years, mezzanine debt has represented a little less than 1.0x EBITDA which has remained consistent.

- The use of debt leverage helps sustain high middle-market M&A valuations. If interest rates rise significantly, the use of senior debt may decline somewhat putting downward pressure on M&A valuations.

- Bank lenders continue to maintain credit discipline largely to satisfy their regulators. The regulators limit the amount of HLT (“Highly Leveraged Transactions”) exposure that a bank can hold at the relatively conservative 3.0x EBITDA senior debt ratio. Our assessment is that the BDC lenders have also recently become more conservative in their lending practices.
About Prairie Capital Advisors

Prairie offers investment banking, ESOP advisory and valuation services to support the growth and ownership transition strategies of middle-market companies. Headquartered in Oakbrook Terrace, Illinois, the company is a leading advisor to closely-held companies nationwide.

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About Sternberg Lighting

Headquartered in Roselle, Illinois and founded in 1923, Sternberg Lighting has maintained its position as a leader in the architectural and decorative street lighting industry. With its unique combination of technological innovation and design, the Company serves diverse end-markets including municipal, education and commercial customers.

Sternberg Lighting has been acquired by Lumenpulse Group.

About Prairie Capital Advisors

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