Overall M&A Market Comment
The looming fiscal cliff, the growing mountain of federal debt and the avalanche of new regulations: this sounds more like a geography lesson than a list of major M&A market influencers. Despite a small uptick in US GDP growth to 2.7% in Q3, the languishing US economy continues to weigh heavily on the M&A market only exacerbated by the uncertainties surrounding government economic policy in 2013 and beyond. The one bright spot is the expected resurgence, albeit temporary, in M&A activity in Q4 as owners, investors and dealmakers race to conclude transactions before the January 1, 2013 deadline for expected radical changes in the investment environment.

The modest improvement in Q3 GDP growth to 2.7% sends a mixed message as it is largely a result of inventory building (as opposed to actual sales) and a 9.5% increase in federal government spending (including a 12.9% increase in defense outlays after 3 successive quarters of decreases). As shown on the chart to the right, the average quarterly GNP growth thus far in 2012 has been 2%, barely enough to hold even, let alone to achieve the vitality of pre-recession levels.

The impact of the political uncertainty emanating from Washington DC on M&A markets has been profound. The fiscal cliff, if not resolved this year, will result in a dramatic increase of tax rates for all Americans and an equally dramatic reduction in federal government spending which has been a substantial economic crutch for the economy over the last four years. According to the Congressional Budget Office, 2013 GDP growth will fall to just 0.5% under the current law if not amended. In addition, this potential slowing of the US economy will have a ripple effect around the world hitting the already depressed European economy and the softening Chinese economy. Finally, the results of the 2012 election also have heightened concerns about the regulatory outlook as new healthcare, financial services and EPA rules and requirements have been reaffirmed and likely will be expanded in 2013 and beyond.

The macro impact of this environment on the M&A community has been to raise concerns about future growth, available returns and overall predictability and the aforementioned rush to consummate transactions (both M&A and recaps) in 2012.

M&A Market Activity
As the perceived likelihood of resolving these issues has decreased, M&A volume has also declined. Not only has the value of transactions declined quarter to quarter, but also well below 2011 levels.

- As shown on the Capital IQ data chart to the right, overall United States M&A transaction deal volume declined 3% from 2012 Q2 to Q3 and dollar value fell more precipitously by 28%.
- Overall deal volume relative to Q3 2011 was also down nearly 8%. PitchBook data, as shown on the next page, shows private equity volume and value down 20% and 25% respectively, from Q3 YTD 2011 to Q3 YTD 2012.
- According to PitchBook, smaller add-on deals now constitute 50% of all PE transactions, up from 44% in 2007, which partially explains the relative decline in deal value vs. number of deals.
M&A Market Activity continued from page 1

- Fortune 500 companies still have nearly $2.0 trillion in cash and private equity firms have $430 billion in uninvested capital (“the overhang”) still providing pressure to acquire assets.
- The economic and regulatory environment uncertainty has focused the attention of buyers, strategic and PE alike, on higher quality assets, for which they are willing to pay higher multiples than a year ago (more later).

Middle Market Deal Valuations

- As depicted in the data to the right, middle market private equity deal valuations as measured by EV/EBITDA multiples have remained stable throughout 2012 and are similar to that seen in 2011 and better than the 2003-2007 pre-recession period (although not as good as the singular year of 2007).
- The spread of multiples among the different sized deals, from $25 million to $250 million, has also remained consistent at about 2x.
- Nonetheless, as noted above, as PE buyers seek out accretive, yet smaller, add-on acquisitions, there has been some increase in the multiples for smaller deals.
- As predicted in our earlier market reports this year, the shortage of “good” deals and many buyers for those deals has supported higher multiples despite the overall uncertainty in the market. This trend may falter in 2013 as expected returns will decline if the government issues are not settled quickly.

Private Equity versus Strategic Valuations

- Looking at the broader M&A market reported by Capital IQ, including private equity and strategic buyers, the trend for modestly expanding valuations is seen with average EV/EBITDA multiples growing 0.5x from 2011 to 2012.
- Also apparent from the data is the continuation of the trend of PE buyers stepping up with higher multiples than strategic buyers. That trend, which started again in 2011 (after reversing earlier in 2008), is now quite strong with PE buyers paying more by over 0.5x, 8.9x vs. 8.3x. Historically, with the exception of the frothy 2008/2009 years, strategic buyers have been willing and able to pay more as they typically can assign synergies to the valuation not available to the financial buyer. However, since 2011, PE funds have been under pressure to invest the funds raised in the mid-2000’s or run the risk of having to return that capital to the limited partners. This has caused the PE buyers to be more aggressive in their bidding.
- The data reflects all transactions less than $300 million and, as seen above, smaller lower middle market deals (less than $50 million) would likely trade at multiples 2.0x to 2.5x lower than that depicted to the right.

Private Equity Transactions

[Graph showing capital invested and deals closed over time]

Source: PitchBook

Total Enterprise Value / EBITDA by Deal Size 2007 - 3Q 2012

[Graph showing enterprise value to EBITDA multiples by deal size]

Source: GF Data

EV / EBITDA Multiple by Buyer Type

[Graph showing EV / EBITDA multiples by buyer type]

Source: Capital IQ

Note: Includes only non-financial institution deals under $300 million, excluding outliers defined as deals with EV/EBITDA of less than 3.0x and more than 14.0x.
Middle Market Private Equity Capitalizations

- Equity continues to represent about 50% of the average capital structure in 2012 on private equity transactions as it has generally since 2010.
- What we continue to see is a significant divergence in the makeup of the debt component of the structure depending on size. Given the average transaction size, the senior portion can range from 1.5x for $25 million deals to 3.0x to 3.5x for deals larger than $100 million.
- As a result, subordinate debt continues to be a big portion for smaller deals and seller notes continue to be the principle form of that debt often representing 1x to 2x of the capital structure for those transactions.

Overall Comment on the Financing Markets

There continues to be plenty of debt financing available from lenders. The slowdown of M&A transactions and the decline of growth have reduced the demand for money and banks are anxious to lend money to qualified borrowers.

Interest Rate Environment

- Three-month LIBOR and one-month LIBOR have been stable for several quarters with little change expected over the next several quarters.
- The yield curve below shows the overall interest rate environment at historic lows as a result of the turmoil in the EU, the weak U.S. economy and continued quantitative easing from the US Fed.
- The yield on the 10-year U.S. Treasury note reached record lows of 1.40% earlier this summer. It has now crept up to 1.72%, still near that historical low. The 10-year Treasury note rate is a driver of many long term debt products including home mortgages, which therefore also continue to be near historical lows. Qualifying for those mortgages remains a challenge for many borrowers despite some recent recovery in the US housing sector.
Senior Bank Debt and Mezzanine Debt Pricing

### Senior Bank Debt

<table>
<thead>
<tr>
<th>BANK FINANCING</th>
<th>LIBOR Spread</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset Based Loans</td>
<td>0% - 100 bps</td>
</tr>
<tr>
<td>Cash Flow: EBITDA Less than $10m</td>
<td>1.0% - 1.5%</td>
</tr>
<tr>
<td>Cash Flow: EBITDA More than $10m</td>
<td>1.0% - 1.5%</td>
</tr>
</tbody>
</table>

Source: Sikich senior bank pricing is based on guidance provided by a number of commercial lenders.

### Mezzanine Debt

#### EBITDA LEVELS

<table>
<thead>
<tr>
<th>Upfront Fees</th>
<th>Below $10 Million</th>
<th>Above $10 Million</th>
</tr>
</thead>
<tbody>
<tr>
<td>LiBOR spread</td>
<td>2.0%</td>
<td>2.0%</td>
</tr>
<tr>
<td>Current Pay Coupon</td>
<td>11.0% - 13.0%</td>
<td>11.0% - 13.0%</td>
</tr>
<tr>
<td>Payment-in-Kind (PIK) Interest</td>
<td>2.0% - 3.0%</td>
<td>1.0% - 3.0%</td>
</tr>
<tr>
<td>All-In IRR</td>
<td>16.0% - 19.0%</td>
<td>13.0% - 16.0%</td>
</tr>
</tbody>
</table>

Note: Warrants and other yield enhancements comprise the incremental return required to meet the All-In IRR.

Source: Sikich analysis is based on guidance by mezzanine funds.

### Market Outlook – 2013

As noted at the beginning of this report, the outlook for the M&A market in 2013 is very dependent on what occurs in Washington DC. If the fiscal cliff is averted and a compromise is reached that reassures investors, then 2013 looks to be a very robust year for middle market M&A. There continues to be a growing list of “aging portfolio companies” owned by PE firms, estimated at over 4,000 by PitchBook, which will provide an increasing source of deals as funds look to monetize these mature investments. Non-PE owners have also been waiting on the sidelines looking for a return to pre-2009 performance but they, too, are facing increasing pressure to sell as succession and estate planning issues become more important.

However, if our representatives in Washington cannot come to an agreement and we do fall off the cliff with all the consequences that have been forecast, this will cause a further hunkering down mentality among sellers and buyers alike. Almost as harmful would be “kicking the can down the road” as it will result in continued uncertainty. Either way, a lack of resolution early in 2013 will not be good news for the M&A industry.

Our best wishes to our readers for a happy holiday season and a more certain and prosperous New Year.

### Sikich Investment Banking

Sikich Investment Banking is the corporate finance and advisory practice of Sikich LLP, a multi-disciplinary professional services firm with more than 400 employees in eight offices located in Illinois, Indiana, Missouri, and Colorado. Through Sikich Corporate Finance LLC, a broker-dealer registered with the Securities and Exchange Commission and a member of FINRA and SIPC, we offer our financial advisory services throughout the US and abroad.

Sikich provides middle market financial advisory services to corporations, investors, private equity groups and entrepreneurs in the U.S. and abroad. Each client is unique and has different needs and goals. By understanding and respecting each client individually, we are able to deliver the best results on every assignment.

Furthermore, Sikich investment bankers remain available to our clients after the transaction closes. We foster long-term relationships, not one-time engagements.

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