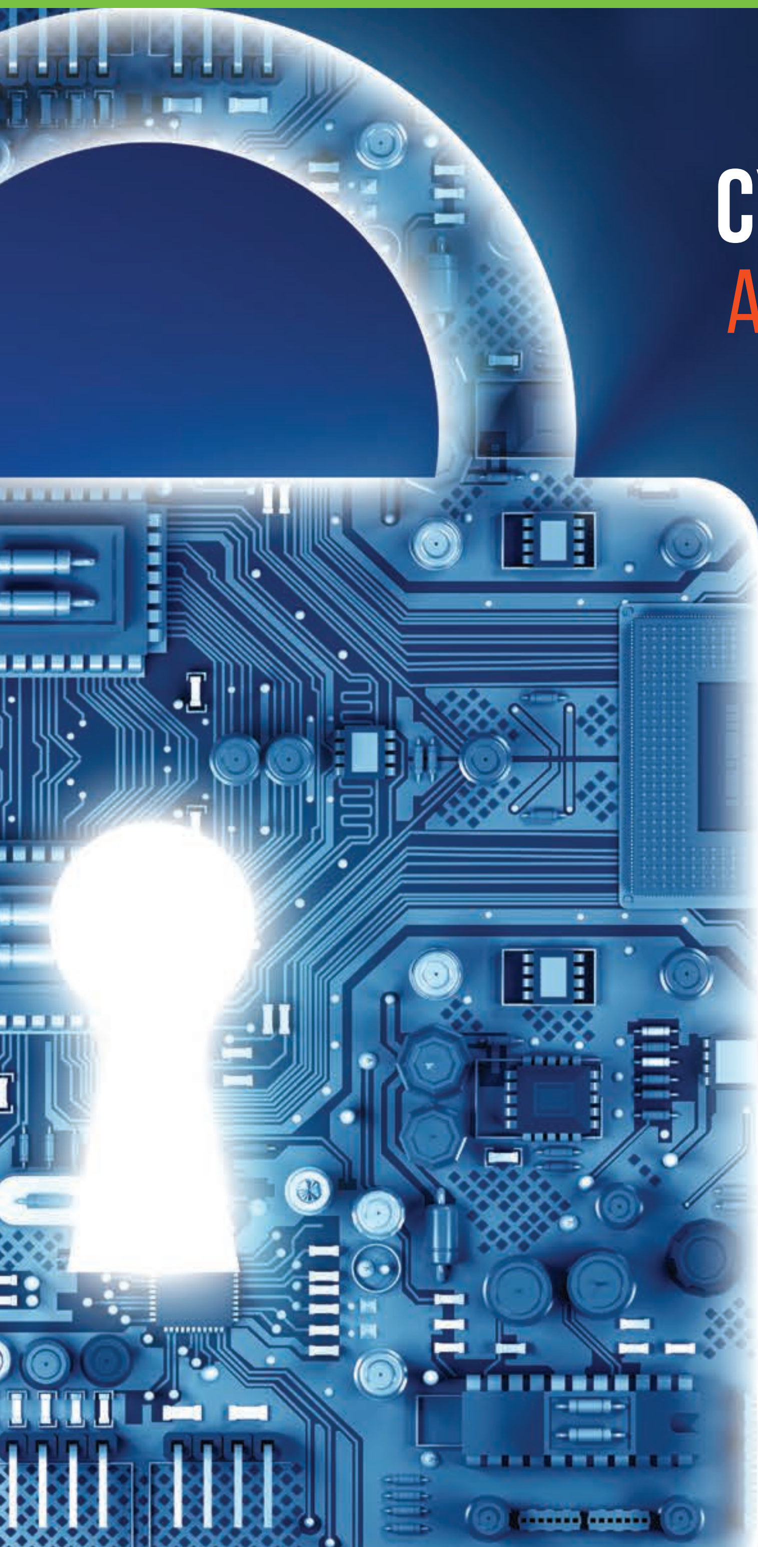
Duane Morris® Buyouts Insider

CONNECTIONS
IN THE MIDDLE MARKET

SUMMER 2015



CYBERSECURITY: ARE YOU AND YOUR STAKEHOLDERS BEING TARGETED?

ALSO INSIDE!

Duane Morris® Buyouts Insider

CONNECTIONS

IN THE MIDDLE MARKET

TABLE OF CONTENTS

Executive Editor, David Toll
(dtoll@buyoutsinsider.com/301-591-1838)

Editorial Advisor, Richard P. Jaffe
(RPJaffe@duanemorris.com/215-979-1935)

Research Editor, Paul Centopani
(pcentopani@buyoutsinsider.com/
301-591-1822)

Editor-in-Chief, Lawrence Aragon

Contributor, Tom Stein

Creative Director, Janet Yuen-Paldino

Junior Graphic Designer, Allison Brown

Sales Director: Robert Raidt
(rraidt@buyoutsinsider.com/301-591-1834)

Sales Associate: Kelley King
(kking@buyoutsinsider.com/301-591-1827)

Publisher: Jim Beecher
(jbeecher@buyoutsinsider.com/
301-591-1851)

A LETTER TO OUR READERS

When Buyouts Insider and Duane Morris embarked on this summer's edition of Connections in the Middle Market, we wanted to provide actionable analysis to middle-market players on two of the burning issues of the day.

- How to protect data from hackers and other malicious forces.
- How to cope with a deal market that most described as fully priced, if not quite in bubble territory.

We also entered the project hoping to address a nagging inconsistency.

By way of background, it is a well-known trait of the deal market that bigger companies, all other things being equal, sell for higher multiples than smaller companies. There are a host of reasons why that is so. Among them, larger companies tend to employ deeper, more experienced management teams, to serve more diversified customer bases, and to boast longer, more consistent track records from which to derive projections about future performance. But that raises a question: What is the most meaningful way to break down the market by size when looking at deal pricing? Few middle-market players seemed to agree. Richard Jaffe, partner and co-head of the private equity practice group at Duane Morris, thought going in that the best ranges might be up to $25 million in enterprise value, $25 million to $100 million, $100 million to $250 million and greater than $250 million. We hoped our research could produce the definitive answer.

Several mid-market investment bankers that we spoke with, including Brian Lucas, a managing director at Harris Williams, did agree that generating $20 million to $25 million in EBITDA was an important break point for companies. Lucas pointed out that "at those levels you start to open yourself up to more sophisticated financial options. There's just more depth to the lending market when you get above $20 million to $25 million of EBITDA." But beyond that we found little consensus. In fact, whereas several investment bankers pointed to EBITDA ranges as being the most telling, others, like Jim Bunn, head of investment banking at Raymond James, pointed to enterprise value ranges.

Leading data providers also remain at odds on the question. In its monthly report produced with data from S&P Capital IQ, investment bank Robert W. Baird & Co presents deal multiples by size for companies with enterprise values of less than $100 million, $100 million to $499 million and $500 million to $1 billion. By contrast, in presenting deal multiples by size on its own, S&P Capital IQ defines the middle market as companies that generate $50 million or less in EBITDA and big companies as generating more than that. Pitchbook in a recent quarterly deal multiple and trends report compared companies with enterprise values of up to $25 million, $25 million to $250 million and $250 million and up.

We'll advance two theories on why the middle market hasn't settled on a single size range.

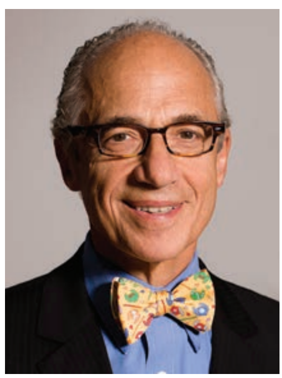
• The first is that, while they move up especially rapidly at discrete break points, deal prices also rise on a continuum by size. As a result, mid-market investment banks and sponsors have been free to cherry-pick transaction size ranges that make the most sense for the size deal that they do. An investment bank that specializes in deals of up to $25 million in enterprise value, for example, might carve up the market far differently than one that specializes in deals of $100 million in enterprise or more.

• A second theory is that the deal multiple-by-size curve changes over time. Robert W. Baird & Co found over a recent 12-month period that, as you'd expect, deals of $500 million to $1 billion command higher multiples than deals of $100 million to $499 million. But in six different years since 2005, including as recently as 2013, the bigger deals actually brought lower multiples—a phenomenon that has Jay Jester, managing director at buy-and-build specialist Audax Group, calling the price difference between small and mid-sized deals the "last great arbitrage" in private equity.

This summer's edition of Connections in the Middle Market marks the first collaboration between Buyouts Insider, publisher of Buyouts Magazine, Venture Capital Journal and peHUB.com, and Duane Morris, a leading international law firm with a thriving practice serving middle market companies and financial sponsors. We hope you find our two feature articles on cybersecurity and deal pricing filled with valuable, actionable information. And we hope you have a fuller appreciation for why we found little consensus on how to break down the market by size when looking at deal prices.

Let us know how well we've succeeded. Please send any comments or suggestions on this edition to dtoll@buyoutsinsider.com or rpjaffe@duanemorris.com.

David Toll
Executive Editor
Buyouts Insider



Richard Jaffe
Partner and Co-head of
Private Equity – U.S.
Duane Morris

Pierfrancesco Carbone
Partner and Co-head of
Private Equity – UK / Europe
Duane Morris

©iStock/aetb

YOUR RISK OF CYBER ATTACK? GREATER THAN YOU THINK

BY TOM STEIN AND DAVID TOLL

Chances are you haven't given cybersecurity as much attention as it deserves. But it is not too late to start catching up. Experts say some of the most important elements of a cybersecurity program include getting senior managers at your firm on board early, doing a thorough assessment of your systems and vulnerabilities, and making sure you run ample fire drills.

Don't think a cyber attack could impact your mid-market shop? That's what The Riverside Company thought—until it happened to them.

A few years ago, two of Riverside's portfolio companies experienced breaches. In one instance, hackers gained access to sensitive customer information and threatened to expose that data if the portfolio company didn't pay a hefty ransom. In another case, hackers infiltrated a portfolio company's computer systems to steal credit card information. Fortunately, in both instances, the companies resolved the issues before any serious damage occurred.

"Both these portfolio companies were less than $20 million in revenue so it was pretty amazing they would get targeted," said Ron Sansom, a managing partner at Riverside. "That's what really woke us up to this problem—that even these companies could get hit."

Cyber breaches are very likely to increase in size and scope, and buyout firms and their portfolios need to be more prepared than ever before, warn experts. "I was at a conference a few months ago where secret service and FBI agents were speaking about the risk to PE firms," said Eric Feldman, chief information officer at Riverside. "They said very soon cyber criminals will stop focusing on the JP Morgans and start concentrating on PE because there is a significant amount of money that moves around in this universe. And it would not take a huge effort to disrupt that and get access to those funds."

Prompted by warnings like these, and by headline-making cyber breaches at companies such as Anthem Blue Cross, Sony and Target, the SEC last year began conducting exams to assess the cybersecurity preparedness of registered broker-dealers and registered investment advisers. It particularly zeroed in on such questions as how well firms identified and assessed risks; how well they protected their information; how quickly they could detect intrusions; and whether they had been hacked before. Among the findings from the 57 broker-dealers and 49 investment advisers examined:

- The vast majority of the firms examined—88 percent of the broker-dealers and 74 percent of the investment advisers—said that they have been victims of cyber attacks either directly or through a vendor. Most attacks involved either malware or fraudulent emails.

- Those firms examined had by and large taken steps to buttress their cyber defenses, with more than 90 percent of broker-dealers and more than 80 percent of investment advisers having "adopted written information security policies," the SEC said. Nearly 90 percent of the broker-dealers examined and well over half of the investment advisers (57 percent) audit their compliance and cybersecurity policies and procedures on a regular basis; and more than 90 percent of broker-dealers and nearly 80 percent of investment advisers also conduct periodic cyber-risk assessments.

> "Both these portfolio companies were less than $20 million in revenue so it was pretty amazing they would get targeted,"
> —Ron Sansom, managing partner, The Riverside Company

- Still, many firms examined don't have strong

Top 11 tips to harden your cyber defenses

Don't be a victim. Follow these 11 recommendations from cybersecurity experts.

1. Get buy-in for a cybersecurity program from senior managers at your firm.
2. Perform a self-assessment to identify any gaps in your defenses.
3. Ensure you have an incident response plan in the event of a breach and practice it in advance
4. Make sure your liaisons at key consultants, IT vendors have excellent communications skills.
5. Develop an enterprise-wide plan of action based on the NIST's cybersecurity framework and ISO standards.
6. Tap your marketing department to help communicate your action plan to employees.
7. Evaluate portfolio companies for cyber risk and ensure they have cybersecurity plans in place.
8. Hire an attorney skilled in cyber security to take advantage of attorney-client privilege in discussing security deficiencies.
9. Back up all key files to avoid lock-out attacks where hackers blackmail you for system access.
10. Make sure suppliers and vendors have adequate defenses, and ensure contracts with third parties spell out your requirements
11. Consider buying a cybersecurity insurance policy.

controls in place related to vendors and business partners, according to the SEC. While 72 percent of broker-dealers include requirements in their contracts related to data security, just 24 percent of investment advisers include such requirements. Just 51 percent of broker-dealers have policies and procedures related to training vendors and business partners on data security, and just 13 percent of investment advisers have such policies and procedures.

The SEC appears set to dramatically expand its sweep of such firms and their security practices. And that has sponsors, both large and small, taking a close look at their internal security systems and processes—and those of their portfolio companies. It is also causing limited partners to ask serious questions about cybersecurity practices as part of their due diligence efforts when evaluating funds.

"I recently filled out a due diligence questionnaire from a potential new investor and it was exclusively focused on cybersecurity," said Riverside's Feldman. "It was 20 questions and it was very specific in nature," such as does the firm follow the NIST (National Institute of Standards and Technology) security framework.

That said, it appears that, while many buyout firms are aware of the issue, only a very small percentage are taking action on cybersecurity, said Daimon Geopfert, national leader of security and privacy services at McGladrey LLP, an assurance, tax and consulting firm focused on the middle market. Private equity firms are getting breached, he said, but they don't necessarily know it. And even when they do, they are not necessarily obligated to tell anyone—giving a "false sense of security" to others in private equity who never find out. "Most PE firms think cybersecurity isn't a big issue for them," he said.

The most common breach Geopfert has seen involves hackers breaking into the bank account of a buyout firm and trying to wire-transfer money out of the account. He has also seen cases where hackers have tried to get information about portfolio companies from the buyout firm, or to gain access to the systems of the portfolio companies via the buyout firm. He said buyout groups in the technology and healthcare sectors have to be especially wary since their portfolio companies deal with a lot of intellectual property, source codes and medical records, which can fetch a premium on the so-called "Dark Web"—an online marketplace for stolen corporate property.

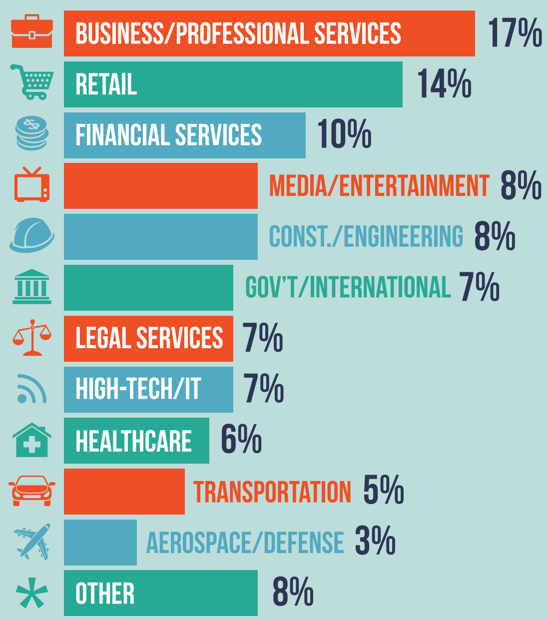
Geopfert said that some buyout shops even suspect that hackers have obtained and leaked information about transactions prior to close. He called such breaches "commonly discussed but impossible to prove."

CYBERSECURITY STEERING COMMITTEE

All it takes is one breach to ruin a firm's reputation and lose LP commitments, said Riverside's Feldman. That's why his firm is investing significant time, money and effort in bolstering its cyber defenses.

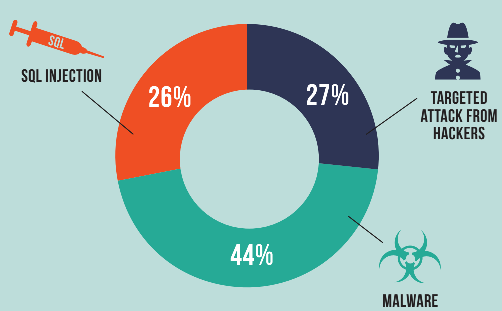
Cybersecurity by the numbers

TOP INDUSTRIES WHERE CYBERSECURITY VENDOR MANDIANT INVESTIGATED ATTACKS LAST YEAR



Source: Mandiant

HOW ARE CORPORATIONS BEING BREACHED?



Source: Ponemon Institute, Post Breach Report, February 2013

One of the first steps it took was to create an internal steering committee, led by Feldman, to better understand the firm's risk posture.

It began by classifying its data into categories of high, medium and low risk. Marketing content designed for public consumption is considered low risk, while the personally identifiable information corresponding to investors qualifies as high risk. The firm then set about understanding where each piece of data resides and who has access to it. It put a series of checks in place to ensure that only approved personnel have access to sensitive data.

Riverside also established an employee education program. This included the creation of an end-user acceptance document outlining how everyone in the firm should be handling data and explaining the various security procedures the firm is taking, such as the archiving of all email and instant messaging communications. The program also features personalized training for each employee. Riverside has even planned to put up posters in its offices informing employees what they should do if they receive suspicious email.

For portfolio companies, the firm created an incidence response initiative called the Riverside Information Security Office (RISO). "When you

ESTIMATE OF CYBERSECURITY COSTS FOR MID-CAP FIRMS

CYBER REQUIREMENT	CYBER REQUIREMENT DESCRIPTION	DURATION	COST
Cyber Readiness Assessment	Vulnerability assessment, compromise assessment and review of the governance and risk framework. Interviews, policy/ configuration reviews with technical testing.	15 Days	$50K
	Assess both what security controls are in place and their operational effectiveness with a gap analysis and a roadmap for improvement based on the specific risk profile.		
Cyber Security Framework Development	Development of a cyber security framework with policies based on ISO or NIST standards.	10 Days	$20K
Cyber Threat Identification & Incident Response	Implementation of third party 24/7 security monitoring (approximately 50 systems) for cyber threats that may impact the corporation. Retain incident response services in the event of malicious activity on the network.	5 Days	$7K monthly
Vulnerability Management Program	Development of program to identify, minimize and manage risk to corporate information from cyber threats. Provide patch management and testing of systems to be secured.	10 Days	$20K
Secure the Supply Chain & Acquisitions	Development of policy/process for securing information/data maintained, stored or managed by suppliers or vendors. Provide a cyber risk assessment strategy for secure acquisition of new companies.	10 Days	$20K
Security Awareness Program	Cyber security awareness program for employees and contractors to include new hires and annual training requirement.	10 Days	$20K
ESTIMATED COSTS			$140K+

Source: Reprinted with permission of Alvarez & Marsal get hacked, you are in shock and don't know what to do or who to turn to," said Sansom. "So the RISO has an 800 number for companies to call and get immediate help." The program provides portfolio companies with a variety of IT and third-party resources to mitigate hacking issues. It also helps companies understand their legal and regulatory obligations in the event of a breach.

April Evans, partner, CFO and chief compliance officer at Monitor Clipper Partners, a mid-market buyout shop with about 20 portfolio companies, said her firm has "always been concerned with cybersecurity in terms of building systems that were difficult to hack into." However, she said the firm has made cybersecurity a "particular focus at present out of an acknowledgment" that the SEC has done the same. The firm recently completed a four-month-long evaluation of IT system risks with the help of its vendors, Coretelligent (which handles email for Monitor Clipper) and Integra (which handles data back-up and related services). That evaluation led Monitor Clipper to take several actions:

• It began manually checking, once a week, in-bound attempts to breach its firewall.

• It plans to put in place a system that requires employees to change their computer password every 90 days or so.

• It plans to encrypt emails.

What information is targeted by hackers?

1. Executive communications, such as e-mail and voice mail
2. Trade secrets and IP
3. Corporate acquisition strategy
4. Employee data, such as social security numbers, dates of birth
5. Information about customers, vendors, partners

Source: Alvarez & Marsal

• It started a search for an online portal service to securely handle confidential communications with LPs, such as the sending of distribution notices.

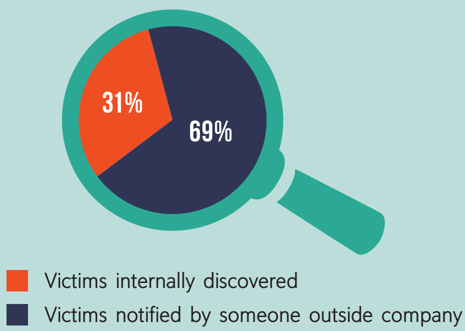
• It started the application process for cybersecurity insurance to cover the costs of re-building or repairing hacked computer systems as well as paying any damages awarded in lawsuits filed by those whose information was compromised. (One of the side benefits of that process is a thorough analysis of security risks conducted by the underwriter during the due diligence process.)

• Finally, it began evaluating the kinds of data it has stored about portfolio companies and the risk of having that data leaked to competitors.

"It takes some time and patience" to get your arms around cybersecurity, said Evans. But she

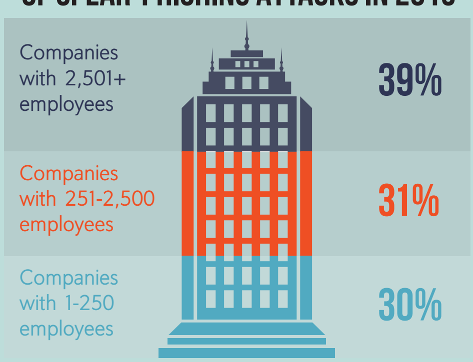
Source: Mandiant

HOW BREACHES WERE DETECTED IN 2014



Source: Mandiant

SMALL BUSINESSES ACCOUNTED FOR 30% OF SPEAR-PHISHING ATTACKS IN 2013



Note: Spear phishing is a phony email that appears to be from a trusted source and seeks access to confidential data.

Source: Symantec

said the effort is worth it “because at the end of the day what my job is about is minimizing the risk from cybersecurity attacks to the firm as a whole in as cost-effective manner as I can.”

70-PAGE RISK ANALYSIS

New Mountain Capital is another mid-market buyout shop that is not taking the cyber threats lightly. “The SEC is concerned about cybersecurity, so anyone who’s registered with the SEC should be concerned about it, too,” said Paula Bosco, managing director and chief compliance officer at New Mountain.

To understand its own exposure, the firm last year hired security vendor (and portfolio company) Stroz Friedberg to perform a risk assessment. Stroz Friedberg was onsite for several months. It conducted interviews with employees at all levels, from the CEO to the receptionist, to determine the types of information people were touching and whether they had access to data a hacker would want.

“Stroz Friedberg logged onto our systems and did penetration testing to see if we could be hacked,” said Bosco. “They looked at it from a people perspective, a system perspective and from a physical perspective.”

In one instance, Stroz Friedberg even conducted a phishing exercise. It created a fake New Mountain website and emailed a link to various recipients asking them to enter certain sensitive information

DuaneMorris®

INNOVATIONS IN GLOBAL PRIVATE EQUITY LAW

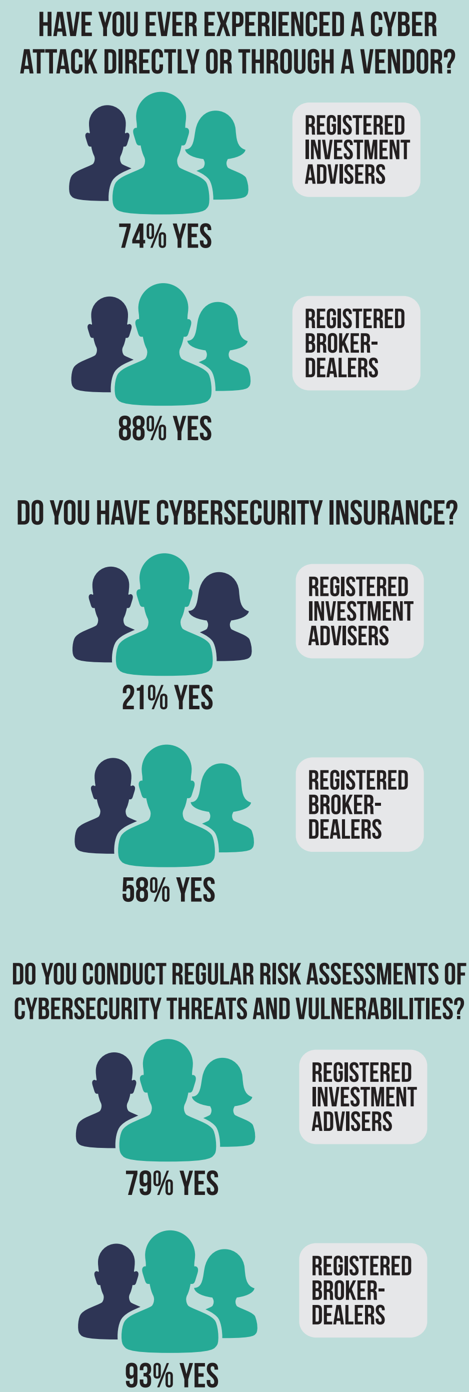
into the site.

Stroz Friedberg recently presented New Mountain with a 70-page report of its findings and recommendations. Bosco said she is going through the report to determine which recommendations to implement. The goal, she said, is to improve the firm's security posture while best complying with the SEC's expectations.

Besides the risk assessment, New Mountain is working with its vendors and portfolio companies to ensure that they are also mitigating their cyber exposure. "We incorporated into our third-party vendor contracts certain clauses that require them to acknowledge that they have data protection policies," said Bosco. "And, to the extent certain key vendors are dealing with sensitive info, we do due diligence on them around the types of network security controls they have internally."

New Mountain also is assessing cyber risk for its portfolio companies. This involves understanding the types of business those companies are in, whether they are at higher risk for cyber attack, and the types of security measures they have in place. For instance, a healthcare company that has regulatory requirements is at greater risk than a company that manufactures cement.

"Going forward, if we deem a company to be high risk, we plan to conduct enhanced due diligence on it prior to acquisition, and where appropriate, would require the company to conduct additional



Source: SEC, based on examinations of 57 registered broker-dealers and 49 registered investment advisers

AT A GLANCE: HOW SPONSORS ARE RESPONDING TO CYBER THREATS				
SPONSOR	WHO'S IN CHARGE OF CYBER-SECURITY?	ANNUAL BUDGET	PROGRAM HIGHLIGHT	HAS FIRM OR PORTFOLIO COMPANIES EXPERIENCED A BREACH?
Monitor Clipper Partners	CFO/COO	An estimated 35 percent to 40 percent of IT budget is devoted cybersecurity	Recently completed risk assessment that led to the manual monitoring of computer logs for breaches every week. Also planned several IT initiatives, including encrypting email and requiring employees to change computer passwords on a regular basis.	No
New Mountain Capital	Chief Compliance Officer	To be determined	Last year hired cybersecurity consultant Stroz Friedberg to perform a risk assessment and recommend ways to improve IT security and ensure compliance with SEC expectations.	No
The Riverside Company	Chief Information Officer	Agrees that cybersecurity cost estimate of $140K+ shown on p.8 is in the ballpark for mid-cap firms	Created the Riverside Information Security Office (RISO), which portfolio companies can call for advice and resources in the event their systems are compromised.	Yes. 2 portfolio companies. In one instance, hackers gained access to sensitive customer information and threatened to expose that data if the portfolio company didn't pay a ransom. In another case, hackers wormed their way into a portfolio company's IT systems and went after credit card information. In both instances, Riverside was able resolve the issue before any serious damage occurred.

Source: Interviews with the firms

risk assessments and monitoring on a post-close basis," said Bosco.

Of course, cybersecurity comes at a price. Companies can expect to spend well into six figures to get started on an initiative, say those who have gone through the process. More specifically, a mid-cap company with, say, 50 servers and computers to protect, can expect to spend at least $130,000 on cybersecurity upfront, and perhaps another $7,000 in ongoing costs per month for 24/7 security monitoring, according to consulting firm Alvarez & Marsal. Evans of Monitor Clipper Partners estimated that her firm devotes 35 to 40 percent of its IT budget to cybersecurity.

But the cost of doing nothing is potentially far greater. "You are going to see something absolutely ridiculous happen, where hackers take over the core system of a buyout firm, resulting in a major theft or highly compromised data," predicted Geopfert of McGladrey LLP.

Bosco, for one, intends to make sure that doesn't happen at New Mountain. "Even if you perceive yourself to be low risk, you still need to invest in security and demonstrate a commitment to protecting confidential information," she said. "That's good for LPs, good for regulators and good for business." ❖


©iStock/erwo1

VALUATIONS REBOUND TO NEAR PRE-CRISIS LEVELS, PUTTING PRESSURE ON SPONSORS

BY DAVID TOLL

Deal prices for companies are approaching nose-bleed levels, thanks in part to a slowly strengthening economy and ample depth in the credit markets. Sponsors always have the option of moving to the sidelines. But that never goes over well with limited partners who signed on for a five or six-year investment period. And so sponsors are cautiously buying up companies, deploying every strategy in the book for ensuring they can still multiply invested capital by two or three times over their holding periods.

Brooks Zug, senior managing director and co-founder of funds-of-funds manager HarbourVest Partners, this spring told an audience of deal-makers about a buyout opportunity some of his associates had recently pitched with a price tag of 23.5x of trailing EBITDA.

Factoring in expected cost-savings, the deal pro forma would be priced at a more reasonable 13x EBITDA. Still, Zug called valuation inflation the biggest change in the buyout market he's witnessed over the last five to 10 years. Very few of the direct buyout deals the firm considered last year, outside of a few located in Brazil, Russia and other "remote places," had price tags under 10x EBITDA, he said.

"It's unlikely we should expect the kind of returns we saw a decade ago," Zug said at the March Buyouts East conference, as reported by Buyouts Insider, producer, along with law firm Duane Morris, of this summer's edition of Connections in the Middle Market. "We'll be lucky if the top-quartile funds have a 15 percent (net) IRR."

A survey of 54 investment bankers, sponsors, lenders and institutional investors by Buyouts Insider and Duane Morris this spring found that close to two-thirds (63 percent) believe M&A prices will hold firm over the next 18 months.

Indeed, bargains in today's M&A market are rare, according to interviews with mid-market investment bankers, sponsors and other industry players.

To cope, sponsors have been pursuing a variety of tactics to reach their objective of beating public equity returns. These include:

- paying up for platform companies but then averaging down their multiples through cheaper add-ons (among proponents: Audax Group; Hammond, Kennedy, Whitney & Co; Huron Capital Partners and The Riverside Company)

- employing full-time deal originators in an effort to keep rival bidders at bay (Hammond, Kennedy, Whitney; Huron Capital; Riverside)

- generating ideas early in the bidding process for cutting costs and super-charging revenue to justify higher bids (Riverside)

- teaming up with C-level executives well in advance of finding target companies (The Edgewater Funds; Frontenac Co; GTCR; Gryphon Investors; Huron Capital)

- and taking regular dividends to generate early returns and reduce equity risk (H.I.G. Capital; Sun Capital Partners)

For now, no relief on pricing is in sight.

"There is substantial liquidity available both from dry powder held by financial sponsors as well as cash on the balance sheets of strategic buyers that's been accumulating for the last half a dozen years," said Paul Smolevitz, managing director and a founding partner at investment bank TM Capital Corp, which advises mainly on transactions with enterprise values of $20 million to $300 million. "Debt is readily available at interest rates that continue to be at historic lows, and the debt multiples at which lenders are willing to finance are back to the kind of historic highs we were seeing in 2007 before the Great Recession."

It has all added up to prices that many investment bankers say also have rebounded to pre-Great Recession levels. Rob Brown, managing director and co-president-North America for Lincoln International, an adviser working mainly with companies generating $10 million to $50 million in EBITDA, said that most of the firm's clients are selling for between 8x and 10x EBITDA. That is easily one to 1.5 points higher than five years ago, he said. Size naturally matters in determining price. Companies generating more than $25 million, because they're attractive to a broader base of bidders, garner higher valuations, although the difference has grown less in a hot market, Brown said.

Brown emphasized that in some industries, such as healthcare, technology and tech-enabled services, companies are selling for multiples above even the lofty range cited above. And, needless to say, countless factors go into determining the value of any one company, including quality of the management team, growth opportunities, the percentage of revenue that is recurring, free cash flow generation, and earnings history, especially if the earnings demonstrated resilience during the last downturn.

ESTIMATED DRY POWDER, U.S. BUYOUT AND MEZZANINE SHOPS

$336 BILLION

Source: Buyouts Insider

ESTIMATED CASH ON BOOKS OF U.S. PUBLIC COMPANIES

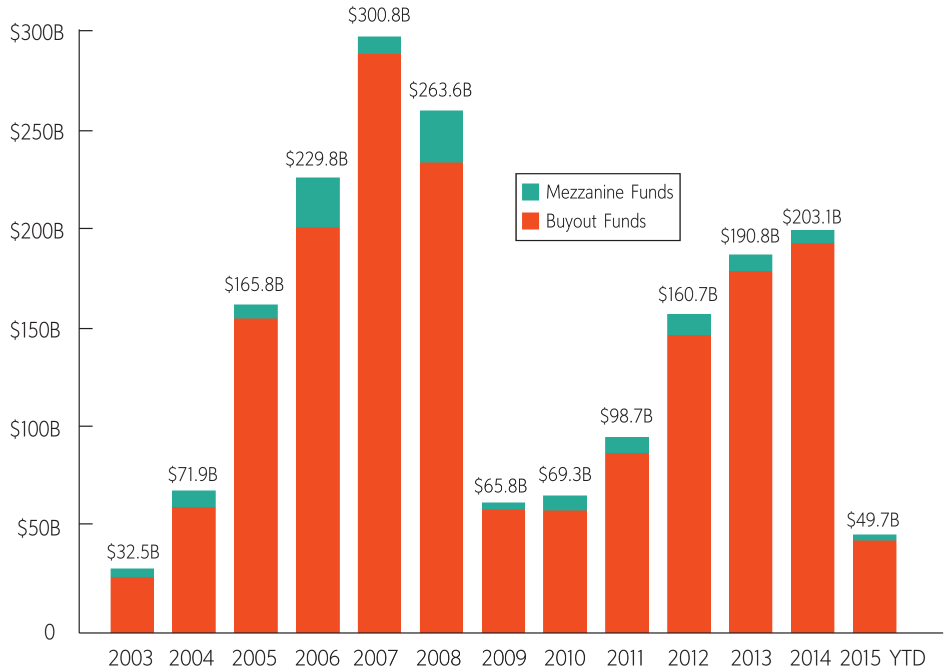
$1.64 TRILLION

Source: Moody's Investors Service, year-end 2013, excluding financial companies

"We are at or pretty close to top market values," said Brown, adding that prices have flattened out since the third quarter of 2014, a function of a similar leveling off in the debt markets. "There's much more downside risk than there is upside opportunity to values right now." Still, Brown predicted that, due to substantial dry powder left to be deployed, and barring an unforeseen "geopolitical event," high prices could last a while.

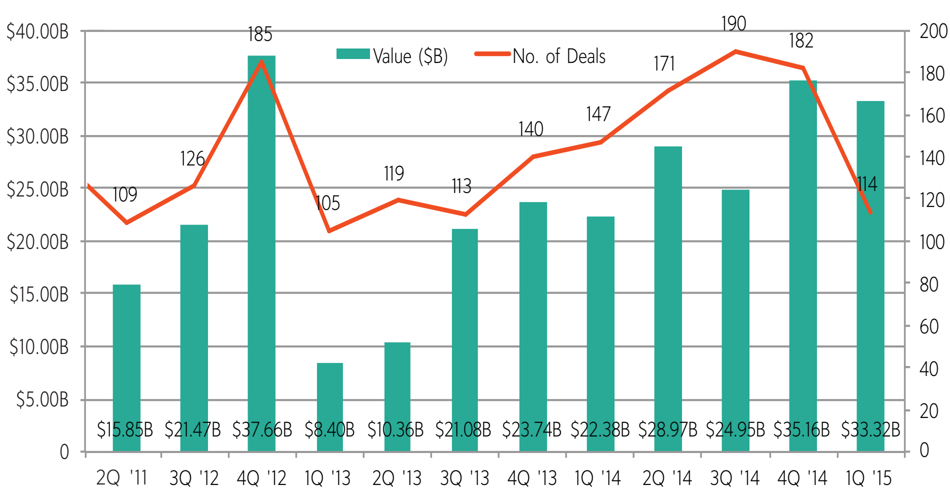
Others agree. A survey of 54 investment bankers, sponsors, lenders and institutional investors by Buyouts Insider and Duane Morris this spring found that close to two-thirds (63 percent) believe M&A prices will hold firm over the next 18 months (see charts, p. 18). Just 24 percent say they will go higher or much higher, while 13 percent say they will go lower.

U.S. BUYOUT AND MEZZANINE FUNDRAISING ($B)



Source: Buyouts Insider. Data is as of Q1

BUYOUT M&A EXITS BY QUARTER



Source: Thomson Reuters. Data is as of Q1

Prices rise in the middle market

U.S. MIDDLE-MARKET ENTERPRISE VALUE TO MEDIAN EBITDA						
EV/ EBITDA	2010	2011	2012	2013	2014	LTM 2015
<$100M	7.0x	8.3x	7.1x	6.8x	8.1x	8.0x
$100M-$499M	10.1x	9.3x	9.1x	9.5x	9.9x	9.2x
$500M-$1B	9.0x	9.9x	8.7x	8.4x	9.9x	10.4x
Middle-Market	8.6x	9.2x	8.1x	8.4x	9.2x	9.0x

Source: S&P Capital IQ and Robert W. Baird & Co., as published in Global M&A Monthly Report; LTM data is through March 31, 2015; republished with permission of Robert W. Baird & Co.

EUROPE MIDDLE-MARKET ENTERPRISE VALUE TO MEDIAN EBITDA						
EV/ EBITDA	2010	2011	2012	2013	2014	LTM 2015
<$100M	6.6x	7.3x	6.8x	6.7x	7.8x	7.9x
$100M-$499M	8.1x	8.7x	9.2x	8.3x	9.3x	8.8x
$500M-$1B	8.9x	9.5x	8.1x	9.4x	9.6x	9.6x
Middle Market	7.5x	8.0x	7.7x	7.5x	8.2x	8.3x

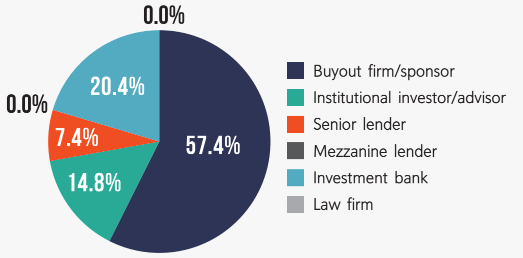
S&P Capital IQ and Robert W. Baird & Co., as published in Global M&A Monthly Report; LTM data is through March 31, 2015; republished with permission of Robert W. Baird & Co.

LINCOLN INTERNATIONAL'S SNAPSHOT VIEW ON LOAN PRICING AND TERMS				
	BORROWERS WITH LESS THAN $15MM EBITDA		BORROWERS WITH AT LEAST $15MM EBITDA	
SECURITY TYPE	PRICING	MULTIPLES	PRICING	MULTIPLES
Asset Based Senior	L + 175 – 275 LIBOR Floor: none	N/A	L + 150 – 250 LIBOR Floor: none	N/A
Cash Flow Senior	L + 475 – 575 LIBOR Floor: 100	2.75x – 3.25x EBITDA	L + 425 – 525 LIBOR Floor: 100	3.00x – 4.00x EBITDA
Senior Stretch	Unlikely	N/A	L + 500 – 600 LIBOR Floor: 100	3.75x – 4.75x EBITDA
Unitranche	L + 750 – 850 LIBOR Floor: 100	4.0x – 5.0x EBITDA	L + 700 – 800 LIBOR Floor: 100	4.00x – 6.00x EBITDA
2nd Lien Loans	Unlikely	4.0x – 5.0x EBITDA	L + 850 – 1000 LIBOR Floor: 100	4.00x – 6.00x EBITDA
Sub Debt	Cash of 11.0% – 13.0% PIK of 1.0% – 2.0% All-in of 12.0% – 14.0%	4.0x – 5.0x EBITDA	Cash of 10.0% – 11.0% PIK of 1.0% – 2.0% All-in of 11.0% – 13.0%	4.00x – 6.00x EBITDA
Equity	N/A	Approximately 35%	N/A	Approximately 30% - 35%

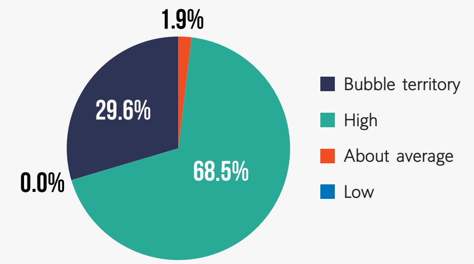
Note: The values presented above are based on prevailing metrics observed by Lincoln International in recent months; however, leverage multiples and pricing are highly dependent on a borrower's credit profile and may be higher or lower than those shown above for certain companies.

Where are deal prices heading?

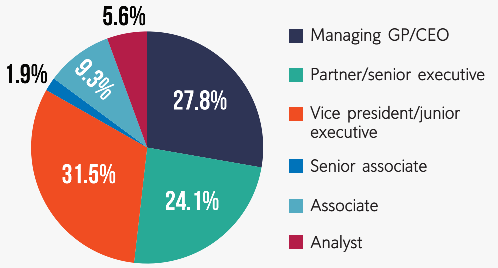
Please pick the term that best describes your firm:



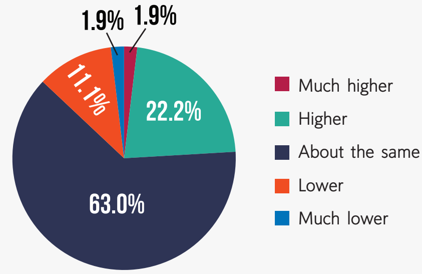
How would you describe deal pricing in the North American middle market right now?



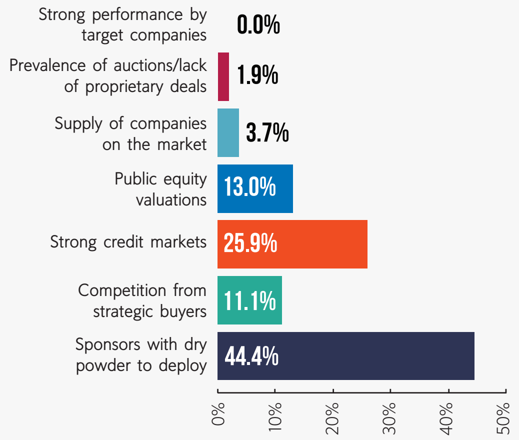
Pick the title that most closely describes your role there:



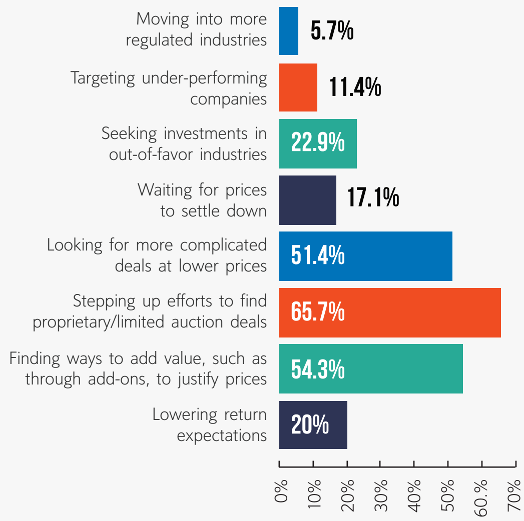
Where do you see prices heading in the North American middle market over the next 18 months?



What is the biggest factor sustaining prices right now?



If you work for a sponsor, in what ways is your firm dealing with high prices? (check all that apply)



Source: Buyouts Insider/Duane Morris survey of 54 professionals

"At least for the next 12 (to 18) months I think we're going to be in a good market," said Brown. "Until the Fed gets serious about raising rates I think that the liquidity we have in the market is going to be there."

PUSHING PRICES HIGHER

A number of factors contribute to today's frothy prices.

The strengthening U.S. economy gives bidders confidence their targets will continue to perform well post-acquisition. Foreign buyers such as Miraca Holdings in Japan and environmental services company ERM in the United Kingdom have grown more acquisitive in the United States. And, especially for financial buyers, the strong M&A and IPO markets provide the prospect of lucrative exits down the road.

But the single biggest reason for price inflation boils down to supply and demand—the limited supply of companies for sale and the seemingly bottomless demand for them by both financial and strategic buyers.

Forty-four percent of respondents to the Buyouts Insider-Duane Morris survey pointed to sponsors with dry powder as the biggest factor sustaining high prices right now. Another 11 percent pointed to competition for deals from strategic buyers. Strong credit markets, in second place, was the choice of 26 percent.

All told U.S. buyout and mezzanine firms have raised $601 billion from the beginning of 2012 through the first quarter of 2015, and, according to Buyouts Insider, at least $336 billion of that is still waiting to be deployed. Add in leverage and you get some $1 trillion in buying power. Meantime, U.S. companies outside of the financial services industry had accumulated $1.64 trillion in cash on their balance sheets by year-end 2013, according to Moody's Investor Service.

Competition for companies with a recent history of earnings growth is particularly intense. Jim Bunn, head of investment banking at Raymond James, said that once they get past a certain size many corporations bump into the "law of large numbers," which makes it harder for them to achieve the kind of growth expected of them by shareholders without doing bigger and bigger deals. "So when they can find companies with strong organic growth they'll pay handsomely," Bunn said. Strategic bidders can also adjust earnings of the target higher in anticipation of cutting costs out of the merged companies—a big reason financial sponsors have been thought to have been at a disadvantage when bidding against them in auctions.

But Bunn said that any gap between what sponsors and strategics can pay has narrowed substantially over time. Sponsors themselves often combine their purchases with other portfolio companies, allowing them to capture the same cost-cutting benefits that strategic bidders achieve. And sponsors also know

How investment bankers view pricing

As a general rule big companies command higher multiples than small companies. The latest statistics from S&P Capital IQ and Robert W. Baird & Co found that in the last 12 months up to March 31 of this year, U.S. companies with enterprise values of less than $100 million sold for a median of 8.0x EBITDA; those with enterprise values between $100 million and $499 million sold for a median of 9.2x EBITDA; and those with enterprise values of $500 million to $1 billion sold for a median of 10.4x EBITDA.

Interviews with investment bankers suggest that multiples rise by size on a continuum, and that the valuation of any one company depends on a host of factors besides size. That said, many see a bump-up in multiples for companies generating $20 million to $25 million in EBITDA, with companies larger than that having demonstrated greater long-term viability while also appealing to a broader array of buyers. The table below outlines how eight investment bankers view pricing by size.

HOW I-BANKERS VIEW DEAL PRICING BY DEAL SIZE

INVESTMENT BANK	INVESTMENT BANKER	FOCUS	WHERE IS PRICING?	HOW DOES PRICING SHIFT BY DEAL SIZE?
Carl Marks	Chuck Boguslasky, managing director	Provides sell-side advisory work for middle-market and lower-middle-market companies generating $5 million to $20 million in EBITDA; often represents owners and entrepreneurs selling companies to financial sponsors or strategic buyers	Has seen slow, steady climb to an average of more than 7x EBITDA	Boguslasky sees a break point for companies generating $10 million in EBITDA, with those larger than that selling for a turn to one and a half turns more than smaller companies
Duff & Phelps	Bob Bartell, head of global investment banking	Takes both buy-side and sell-side assignments involving companies valued at $50 million to $250 million	Sees pricing in the 5x to 10x EBITDA multiple range for 80 percent to 90 percent of deals, and in the 7x to 9x multiple range for two-thirds of deals. However, technology companies can go for 5x to 10x revenue in some cases	Bartell sees differences in multiples for companies with enterprise values of more than $1 billion, $250 million to $1 billion, and below $100 million. He also observes a one to two turn discount for companies generating less than $15 million in EBITDA versus those generating more than $25 million
Harris Williams	Brian Lucas, managing director	Provides sell-side M&A services in the middle market, primarily to companies with enterprise values of $100 million to $2 billion but isn't bound by that range; sponsors are clients on two-thirds of the firm's assignments	Sees pricing back to pre-financial crisis levels of 8x to 12x EBITDA or so on average but prices could be higher or lower depending on sector and individual company dynamics	Lucas sees breakpoints at $20 million to $25 million in EBITDA and $50 million in EBITDA, as buyers gain access to more sophisticated financing options at those points

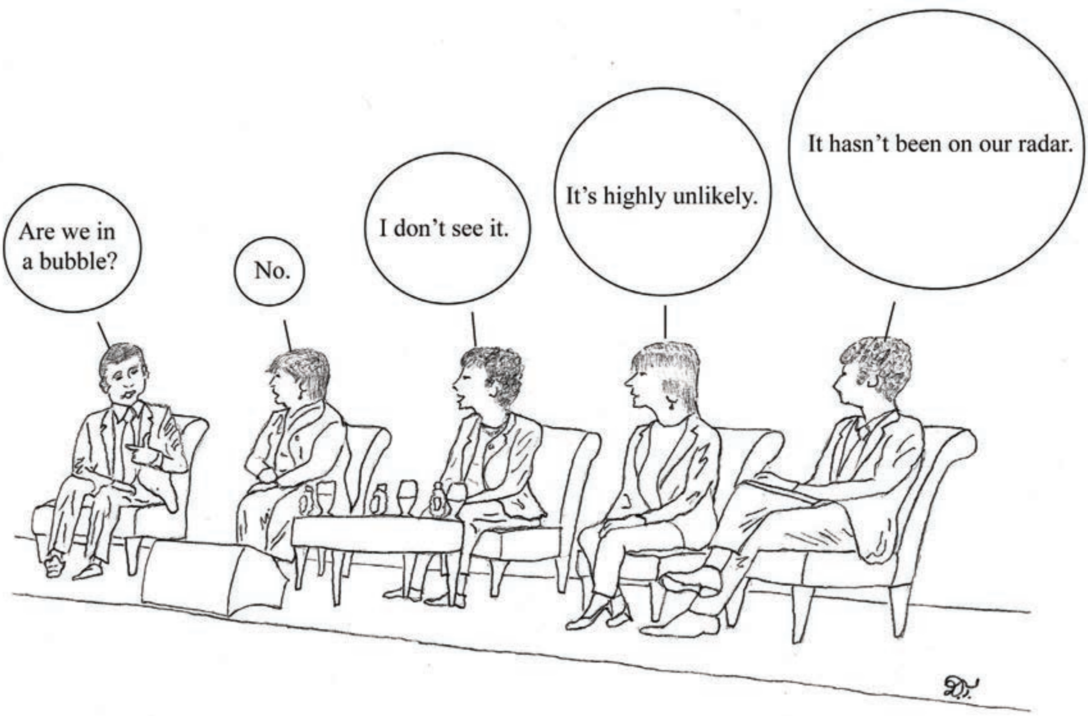
HOW I-BANKERS VIEW DEAL PRICING BY DEAL SIZE

INVESTMENT BANK	INVESTMENT BANKER	FOCUS	WHERE IS PRICING?	HOW DOES PRICING SHIFT BY DEAL SIZE?
Lincoln International	Robert Brown, managing director and co-president-North America	Provides sell-side M&A services to companies generating $10 million to $50 million of EBITDA; sponsors are often clients	Says most of the companies the firm is selling have been going in the 8x-10x range, but many go for more than that	Brown sees a demarcation point for companies that generate $25 million; above that they get higher multiples, but the difference is less than a turn
Petsky Prunier	Sanjay Chadda, partner and managing director	Concentrates on M&A advisory work in media, digital advertising, marketing technology, commerce, information technology, health care and services; usually works with companies under $1 billion in enterprise value	Says traditional media companies are selling for around 10x EBITDA, 3x revenue; software companies 3x to 5x revenue, though up to 8x in some cases; digital advertising firms less than 3x revenue; ad agencies and marketing services companies 7x to 10x EBITDA	Chadda sees a rise in multiples achieved as companies grow above $5 million in EBITDA generated, as well as $10 million, mid-teens and $20 million; competition is more intense for the bigger companies, Chadda explained, and debt less expensive
Raymond James	Jim Bunn, head, investment banking practice	Focuses mainly on sell-side work for companies in the $75 million to $500 million enterprise value range with a sweet spot of $100 million to $300 million	Sees companies that a couple of years ago sold for 8x now selling for 10x EBITDA; companies that sold for 10x are now at 12x-15x	Bunn sees companies in the middle market, with enterprise valuations of $75 million to $750 million selling for higher multiples than companies in the lower middle market of $75 million and below; north of $750 million multiples tend to drop some as the universe of potential bidders shrinks
Stifel Investment Banking	David Lazar, managing director	Advises companies generating EBITDA of $5 million to $20 million	Sees healthy companies go for high-single-digit multiples, up 2 to 2.5 turns from two years ago, but in some industries, such as software-as-a-service, companies can easily go for 4x revenue	Lazar says multiples jump at the $5 million EBITDA level, $10 million level, and $20 to $25 million level, in part because bigger companies can better withstand setbacks; also sees a breakpoint at $40 million to $50 million in EBITDA, as companies gain access to public equity and debt markets
TM Capital Corp	Paul Smolevitz, managing director and a founding partner	Advises on transactions of $20 million to $25 million in enterprise value up to $250 million to $300 million and sometimes higher; half of the firm's work involves financial sponsors	Sees strong companies with values of $100 million in enterprise value garnering double-digit multiples, up from upper-single-digit multiples two to three years ago	Smolevitz sees the main demarcation at $10 million in EBITDA, with companies above that trading for 1 to 2 turns higher

that, all else being equal, fast-growing companies deliver higher returns than slow-growing companies. That is due both to EBITDA expansion and, in some cases, multiple arbitrage opportunities stemming from the typically higher prices commanded by bigger companies. "You have a perfect storm for companies with really strong organic growth prospects," said Bunn.

Of course, strong credit markets have also played a big role in valuation inflation. At the top end of the market, banks face pressure from regulators to limit leverage on deals to no more than 6x EBITDA. But in the middle market, non-bank sources of financing dominate. These include hedge funds, CLOs, private debt funds, and both traded and non-traded business development companies (BDCs), many of them backed by yield-hungry institutional investors eager to take on a modest level of risk to achieve high single-digit rates of return or higher.

And how much leverage is available? According to Lincoln International, which does a booming business in debt advisory work, borrowers generating more than $15 million in EBITDA can borrow 3x to 4x EBITDA in senior cash flow loans, or 4x to 6x EBITDA in a combination of unitranche, second-lien loans and sub debt. The comparable figures for borrowers generating less



than $15 million in EBITDA are 2.75x to 3.25x for senior cash flow loans and 4x to 5x for the combination (see charts, p. 17). In the first quarter, sponsors buying companies generating less than $50 million in EBITDA put in about 43 percent

All told U.S. buyout and mezzanine firms raised $601 billion from the beginning of 2012 through the first quarter of 2015 and, according to Buyouts Insider, at least $336 billion of that is still waiting to be deployed. Add in leverage and you get nearly $1 trillion in buying power.

of the purchase price in equity, according to S&P Capital IQ Leveraged Commentary & Data, with the remaining 57 percent shouldered by creditors.

"Everyone wants to be a middle-market lender," observed Ron Kahn, managing director, Lincoln International, at the late March Buyouts East conference.

Entry price always matters. A recent study by RCP Advisors of more than 1,500 realized lower-middle-market transactions since 2000 found a prominent association between purchase price and return on invested capital. Depending on the industry, you can roughly expect to generate a 2x ROIC instead of a 1.8x ROIC if you pay 6x EBITDA instead of 7x.

SPONSORS DIG DEEP

Sponsors, ever mindful of the return expectations of LPs, have battled high prices in a variety of ways.

As buyers, two-thirds of sponsors that responded to the Buyouts Insider-Duane Morris survey said they have stepped up efforts to find proprietary deals or limited auctions (see chart, p. 18). Other popular tactics (respondents could pick more than one strategy) included finding ways to add value, such as through add-on deals (54 percent), looking for more complex transactions (51 percent), and pursuing investments in out-of-favor industries (23 percent).

Huron Capital, a specialist in buying fundamentally sound businesses not operating to their full potential in one more areas, pursues a number of these strategies, according to Senior Partner Michael Beauregard. The firm has a three-person team dedicated exclusively to deal origination. Two of them call mainly on deal intermediaries, said Beauregard, while a third is responsible for calling directly on business owners. The firm also hosts breakfast roundtables four times a year, rotating them among nine different cities. It invites some 25 local attorneys, accountants, and auditors, who are encouraged to bring with them four to five business owners to the breakfasts. The idea behind both efforts is to get the first call when deal opportunities arise and, by dint of already-established relationships, limit the field of bidders, or at least gain an edge over them.

According to Lincoln International, which does a booming business in debt advisory work, borrowers generating more than $15 million in EBITDA can borrow 3x to 4x EBITDA in senior cash flow loans, or 4x to 6x EBITDA in a combination of unitranche, second-lien loans and sub debt.

Another strategy used by Huron Capital is to partner with CEOs in advance of finding a deal and to conduct extensive market research even before targets come on the market. When attractive targets do appear, the firm pounces, ready to impress sellers and management teams with its expertise and the C-level skills of its executives-in-waiting. The firm has averaged launching three of what it calls "ExecFactors" a year for the past three years, and plans to tackle another three to four in 2015, said Beauregard.

Several of these strategies came together three years ago with the purchase of Bloomer Plastics, a manufacturer of films and plastics based in Bloomer, Wisc. An owner with health problems had been unable to attend to the company, so investments in sales and business development fell and revenues had consequently gone flat. After the owner died about four years ago, his wife hired accounting firm Plante Moran to sell the company. Her desire that the management team have discretion over who to pick worked to Huron Capital's advantage. Earlier the firm had teamed up with Kevin Keneally, previously an executive at Pliant Corp and Amoco Chemical Company, to find opportunities in the films and plastics market. Keneally's chemistry with the management team, which was looking for new leadership and a chance to have equity, turned out to be "essential" to winning the deal, Beauregard said.

Huron Capital set to work, bringing in Keneally as CEO, hiring a COO and tripling the size of the sales team from three to 10 people. The firm made a significant add-on acquisition last November, purchasing Optimum Plastics, maker of a complementary set of products. The deal took revenue at the combined company, which took the name Optimum Plastics, to $100 million. And under Huron Capital's ownership the company, which has EBITDA margins in the high teens, introduced new product lines to better meet demand from its food packaging clients for see-through packages and for ones that take up less shelf space. By year end, Huron Capital expects to do another one or two add-on deals to bring revenue to $150 million, paving the way for an exit in the next two to three years.

Perhaps the most visible way sponsors have responded to high prices has been to become sellers themselves. It has now been more than two years since Leon Black, chairman and CEO of Apollo Global Management, famously said that his firm was "selling everything that's not nailed down." As it turns out, he appeared to have been speaking for a great many firms.

U.S. buyout shops sold an estimated 690 companies with disclosed values of $111 billion last year, according to Thomson Reuters, up from 477 with disclosed values of $63.6 billion the previous year. Sponsors have also been active players in the IPO market, taking 18 companies public in the fourth quarter of 2014 alone. Bob Bartell, head of investment banking at Duff & Phelps, sees sponsors by and large staying disciplined on price—"they know they have to stretch, but they're not going to overpay"—and harvesting where they can. "There's probably more net sellers out there," he said.

Jay Jester, managing director at Audax Group, said that since its founding in 1999 the firm has purchased some 85 platforms, many of them generating in the low teens of EBITDA, and another 370 add-ons. The recent formula, he said, has been to buy platforms for 7x EBITDA or so, work down the average multiple paid to the 6x range through add-ons, then sell the resulting company for 8x to 9x.

Jester said Audax Group is taking advantage of the "last great arbitrage" in private equity. Companies with enterprise values of $100 million to $499 million represent a real sweet spot for strategic buyers, he said, often commanding higher multiples than both smaller and bigger companies. If they are smaller than that then they don't really move the needle for acquirers. If they are bigger than that then they could be career-killing to their proponents if they don't work out.

U.S. buyout shops sold an estimated 690 companies with disclosed values of $111 billion last year, according to Thomson Reuters, up from 477 with disclosed values of $64 billion the previous year.

Combining small companies to reach that $100 million to $499 million range lets Audax Group sell into that "white hot market," said Jester. ❖

Steve Gelsi contributed to this report

ABOUT DUANE MORRIS

With experienced private equity lawyers working in the middle market across our global platform, coupled with experience in key verticals and the deep capabilities of more than 700 lawyers from all major practice areas, Duane Morris creates competitive advantage for participants across the industry. For GPs, we deliver insights that optimize transactional value for both sellers and buyers in control and noncontrol investments and with exit strategies, and support portfolio company growth strategies. For LPs, we review LPA terms and advise on efficient, effective investment strategies, including co-investment and direct investment; alignment of interests; transparency; and governance issues. For business owners, we advise on growth strategies – not only on the mechanics of full or partial exits, but also on crafting wealth-planning approaches designed to positively impact economics for the owner. Given our strategic firmwide focus on private equity, broad experience in major industry sectors and an innovative culture deeply committed to client service, we are regularly called upon to work with company owners, as well as the most sophisticated and demanding players in the private equity marketplace.

DuaneMorris®

INNOVATIONS IN GLOBAL PRIVATE EQUITY LAW

Duane Morris is proud to be an Official Sponsor of Growth® of the Association for Corporate Growth (ACG).

UNITED STATES

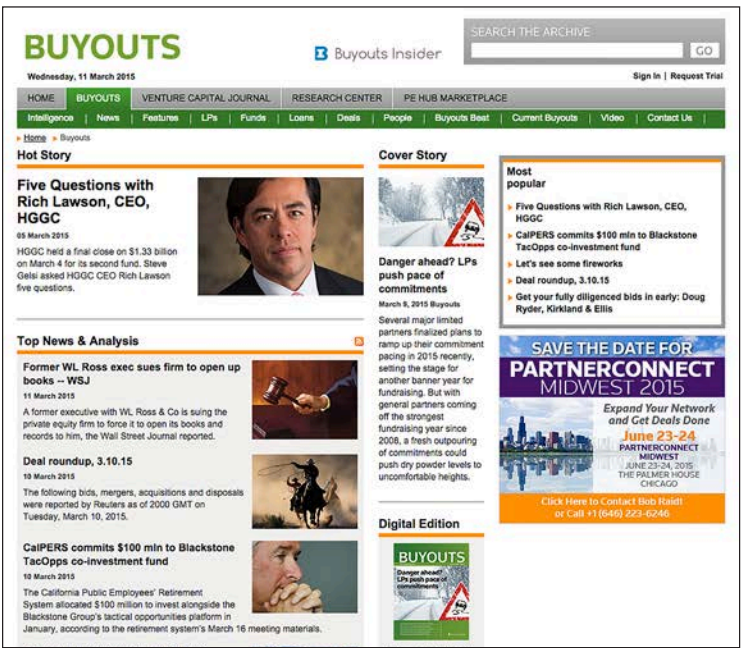
Atlanta
Baltimore
Boca Raton
Boston
Cherry Hill
Chicago
Houston
Lake Tahoe
Las Vegas
Los Angeles
Miami
New York
Newark
Philadelphia
Pittsburgh
San Diego
San Francisco
Silicon Valley
Washington, D.C.
Wilmington

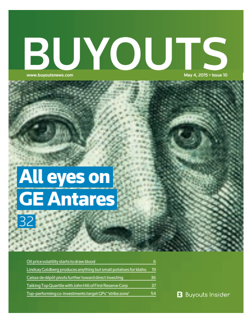
INTERNATIONAL

Hanoi
Ho Chi Minh City
London
Mexico City (alliance)
Myanmar
Oman
Singapore

ABOUT BUYOUTS INSIDER

Buyouts Insider delivers a portfolio of market-leading titles, online services, and senior executive conferences covering private equity and venture capital. The print and online publishing brands of *Buyouts*, *Venture Capital Journal*, and *PE HUB* offer the intelligence professionals need to raise money, find deal opportunities, secure loans to finance deals and benchmark their performance against rival firms. PartnerConnect, the suite of private equity and venture capital conferences, are networking opportunities for fund managers to raise capital for their next fund and source deal flow by hearing from and meeting institutional investors and deal intermediaries. Senior executives involved in private capital have relied on Buyouts Insider products since 1961.





CONTRIBUTOR PROFILES

David Toll, executive editor,

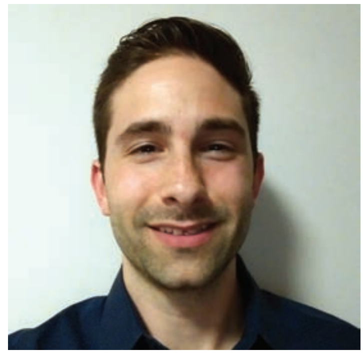
Buyouts Insider

DAVID TOLL is the executive editor of Buyouts Insider, where he oversees the editorial direction of Buyouts Magazine, Venture Capital Journal and the peHUB.com community website. David has been writing about the private equity markets since 1997, and publishes a bi-weekly column in Buyouts Magazine. He is the co-author of several survey-based studies on the private equity and venture capital markets, covering such topics as partnership terms and employee compensation. He is the chief cartoonist at privateequitycartoon.com.

Tom Stein, founder,

Fluent Partners

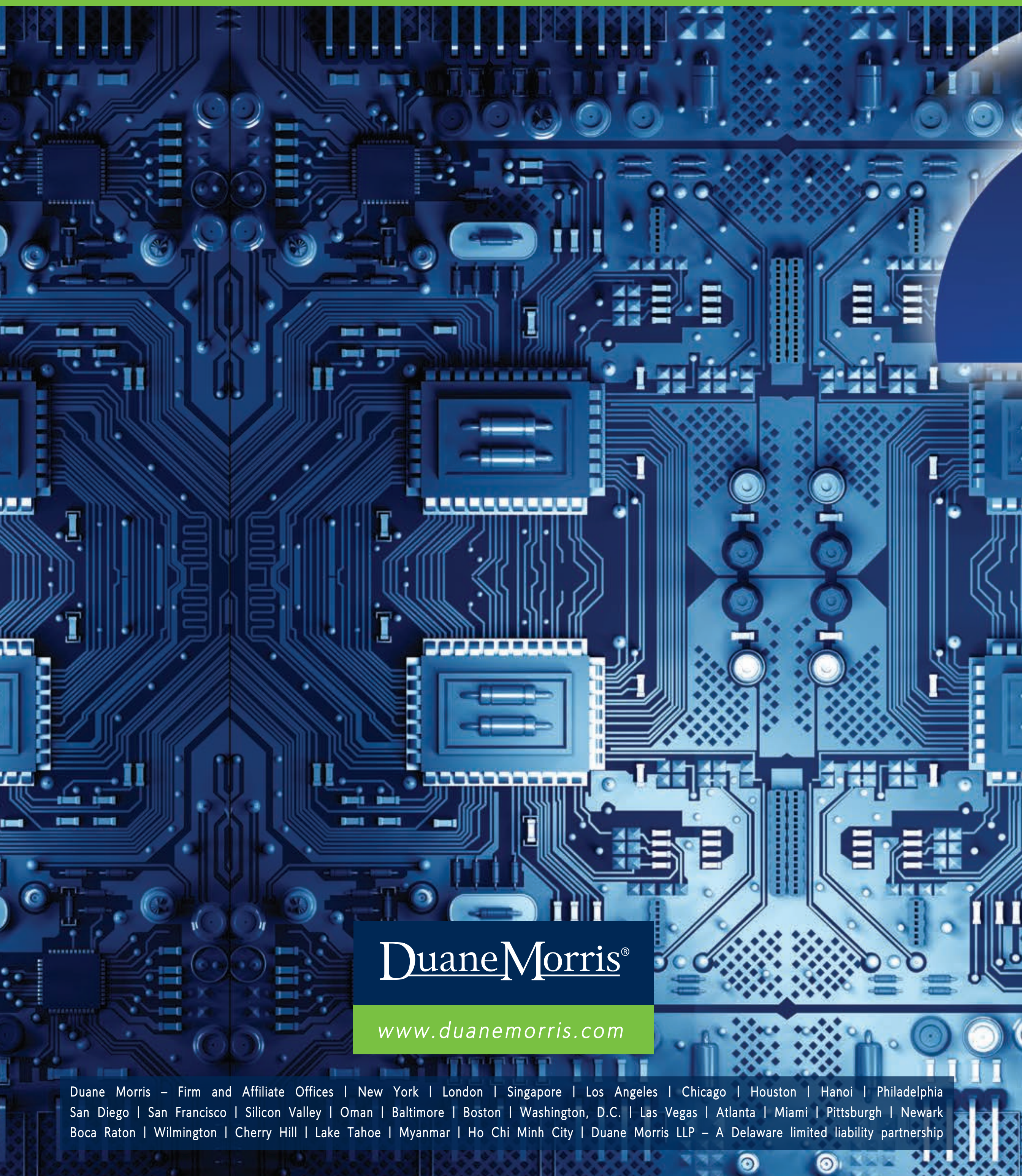
TOM STEIN provides a range of editorial and marketing services to corporate clients, including Yahoo!, Facebook, Sony, Oracle, Saatchi & Saatchi, Marvell, Microsoft and PayPal. His services include contributed articles, newsletters, white papers, website copy, social media content, and speeches. He has contributed to leading business and general interest publications including Buyouts Magazine, Wired Magazine, Forbes, Tennis Magazine, and Venture Capital Journal. Previously, Tom was a senior editor at Red Herring, a magazine where he covered start-ups and venture capital. He also worked as a staff writer at the San Francisco Chronicle, where he covered the tech industry. Additionally, Tom served as a senior editor at InformationWeek and Success Magazine.



Paul Centopani, research editor,

Buyouts Insider

PAUL CENTOPANI is a writer and developer of media and editorial in print, online and presentation formats for Buyouts Insider. His work centers on plumbing the private equity industry for trends and ideas that can be turned into thought-provoking, high-quality content. His stories have been regularly featured in Buyouts Magazine, Venture Capital Journal and the peHUB.com community website. Earlier in his career Paul was a pricing analyst and senior consultant for defense contractor Booz Allen Hamilton. There he managed more than 600 proposals representing nearly $900 million in value.



Duane Morris

www.duanemorris.com

Duane Morris – Firm and Affiliate Offices | New York | London | Singapore | Los Angeles | Chicago | Houston | Hanoi | Philadelphia San Diego | San Francisco | Silicon Valley | Oman | Baltimore | Boston | Washington, D.C. | Las Vegas | Atlanta | Miami | Pittsburgh | Newark Boca Raton | Wilmington | Cherry Hill | Lake Tahoe | Myanmar | Ho Chi Minh City | Duane Morris LLP – A Delaware limited liability partnership