

“ a firm belief in the entrepreneurial spirit ”

CLEARY GULL

MARKET MONITOR

M&A AND FINANCING UPDATE



4th QUARTER 2016

Modestly Higher Interest Rates Not Expected to Impact M&A in 2017

The Federal Open Market Committee (“Fed”) finally increased the Federal Funds rate by 25 basis points on December 13th. The increase was highly anticipated and there seems to be a further consensus among economic experts that there will be two or three more increases in 2017 and 2018. To keep inflation in check, some believe the Fed will most likely continue to increase the rate 25 to 50 basis points per meeting until the Fed Funds rate reaches 2.5%.

Cleary Gull does not expect modest increases in rates to have a material impact on M&A volume or valuation in 2017. In theory, higher rates can adversely affect valuations several ways: they reduce cash flow available to repay debt or reinvest in operations, they increase the costs of all layers of capital, and they reflect higher inflation that correlates to higher

present value discount rates. In practice, however, our experience has been that M&A activity is more sensitive to debt availability than interest rates. For the time being at least, debt availability to finance leveraged buyouts is at historically high or even increasing levels.

Senior and Subordinated Debt Availability Expands

According to GF Data[®], average senior debt/EBITDA multiples for \$10 to \$250 million enterprise value private equity-backed buyouts increased to 3.2x through Q3 2016, 0.5x higher than the average during H1 2016 and all of 2015. The Q3 2016 average senior debt/EBITDA multiples were the highest since the Great Recession.

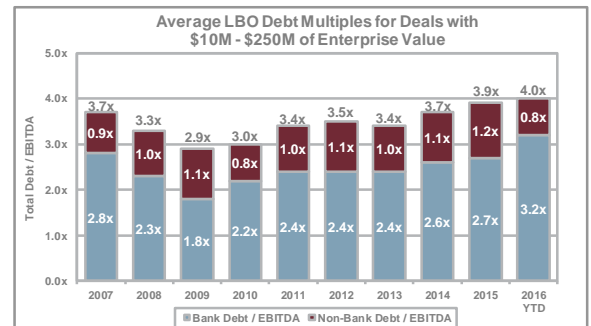
The subordinated debt market remains strong as well, with total debt/EBITDA through Q3 2016 increasing slightly to 4.0x EBITDA.

KEY INTEREST RATES

	12/21/2016	12/31/2015	12/31/2014
1-Month T-Bill	0.48%	0.14%	0.03%
2-Year UST	1.25%	1.06%	0.67%
5-Year UST	2.06%	1.76%	1.65%
30-Year UST	3.15%	3.01%	2.75%
EUR/USD	\$0.959	\$0.921	\$0.826
1-Month Libor	0.75%	0.43%	0.17%
Federal Funds	0.50%	0.50%	0.25%
Prime rate	3.75%	3.50%	3.25%
WTI Crude Oil	\$54.19	\$38.17	\$53.27

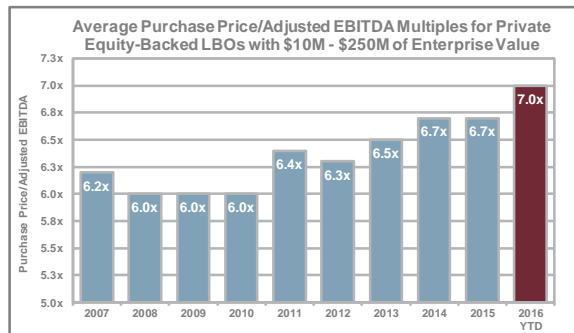
Source: Capital IQ

SENIOR DEBT AND TOTAL LEVERAGE



Source: GF Data[®]

PURCHASE PRICES REMAIN STRONG



Source: GF Data®

Purchase Prices Reach a New Peak

Purchase price multiples for \$10 to \$250 million LBO transactions reported to GF Data® through the first three quarters of 2016 were the highest since GF Data® began collecting this information in 2003. With an abundance of capital chasing fewer quality deals, the average purchase price multiple for these LBOs reached 7.0x EBITDA, 0.3x higher than the previous peak achieved in 2014 and 2015. In addition to the continued supply/demand imbalance for transactions in the \$10 to \$250 million range, the historically high valuation multiples can be partially attributed to the abundant availability of debt to finance them.

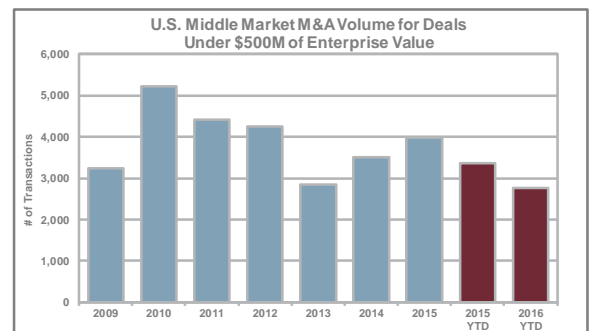
A late August article in *Forbes* attributed the 2016 slowdown in activity to low economic growth, the prospect of U.S. interest rate hikes, and the uncertainty over the outcome of the presidential election. While we believe the sluggishness of the economy in certain sectors has negatively impacted deal volume in 2016, we did not experience sellers delaying transactions this year because of fears over rising interest rates or the presidential election.

Now that the elections and the first interest rate increase are behind us, comments from private equity funds, lenders, and corporations suggest that deal volume increased in late 2016 and may continue to increase in 2017.

Deal Volume Remains Tepid

Middle market deal volume continued to decelerate through October 2016. According to Robert W. Baird, the total number of U.S. transactions declined 17.7% through early Q4 2016 compared to the same period in 2015.

M&A DEAL VOLUME



Source: Robert W. Baird & Co.

Tax Reform is on the Horizon

The Trump Administration (“Trump”) and the U.S. House of Representatives’ Committee on Ways and Means (“House”) are aligned on making tax reform a priority in 2017. Trump and the House believe that a simplified tax code and lower tax rates will fuel job creation, wage increases, and economic growth.

In its Tax Reform Blueprint (“Tax Plan”), the House stated that eliminating the tax penalty on American businesses will make “Made in America” products and services price competitive again in the global economy.

In addition to helping U.S. products and services to be competitive, lower taxes should have a positive impact on U.S. business valuations and shareholder returns. The authors of the Tax Plan believe that American business owners will reinvest the extra profits to hire workers, purchase equipment, and pursue acquisitions that would increase the value of their companies.

Is the End Near for the Carried Interest Loophole?

A tax increase that both Trump and the House support is the elimination of the so-called “carried interest tax loophole.” Today, the profits interests that private equity and hedge funds receive as compensation for putting together deals are taxed as capital gains instead of ordinary income.

If taxes increase on carried interests, it could have a near term effect on M&A activity. Will private equity firms be unfazed? Or, will they follow the behavior of business owners in 2012 who accelerated the sale of their companies in advance of the tax increases on January 1st of the following year? Historically, tax increases have not been retroactive. Accordingly, if carried interest is part of the 2017 tax reform, a future effective date could cause some private equity owners to accelerate sales of their portfolio companies.

TAX RATES

Tax	Highest Margin Tax Rate	
	Trump Proposal	Current
U.S. Corporate	15.0%	38.9%
Personal	33.0%	39.6%
Capital Gains	20.0%	23.8%
Carried Interest	33.0%	23.8%

Source: IRS and Trump Pence 2016

FIRM OVERVIEW

Cleary Gull Inc. is an employee-owned financial services firm providing high-quality financial services to private equity funds, entrepreneurs, and middle market companies. “A Firm Belief in the Entrepreneurial Spirit” is our core ideology and the foundation for all of our client engagements.

Cleary Gull’s investment bankers help clients throughout the U.S. achieve their financial and business goals with advice on exclusive sales, mergers, acquisitions, raising debt and equity in private capital markets and other transactions, working through complex financial, legal, tax, accounting and other technical issues.

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CONTACT

The Cleary Gull Investment Banking team has completed more than 120 transactions since 1995, representing over \$6 billion in transaction value.

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