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# Middle Market Update

4<sup>th</sup> Quarter 2017

# Fourth Quarter Economic Performance and Future Outlook



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## Gross Domestic Product

- The real U.S. GDP increased by an annualized rate of 2.6% in Q4 2017, down from the 3.2% rate in Q3 2017, primarily due to<sup>1</sup>:
  - Positive contributions from personal consumption expenditures, exports, residential and non-residential fixed investments, and government spending, partly offset by
  - Negative contributions from private inventory investment and increases in imports

## Consumer Income, Savings, and Spending

- Real disposable personal income grew by 1.1% in Q4 2017, an improvement over the 0.5% growth in Q3 2017<sup>1</sup>
- The personal savings rate, expressed as a percentage of disposable income, was 2.6% in Q4 2017, down from 3.3% in Q3 2017 and 5.6% in Q4 2016<sup>1</sup>
  - Driving this shift is the upward trend in consumer spending, which can be seen in the personal consumption expenditures index that rose at a compound annual growth rate of 2.6% over the 2016-2017 period

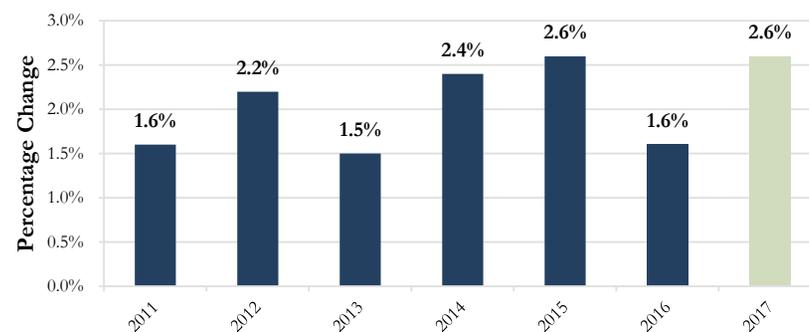
## Federal Reserve

- The Federal Open Market Committee (FOMC) views recent economic activity as positive, as evidenced by a strengthened labor market and rising economic activity, including gains in employment, household spending, and business fixed investment<sup>2</sup>
  - During its December 2017 meeting, the FOMC decided to increase the target for the federal funds rate by 25 basis points to 1.50%
- The committee expects that the near-term economic outlook will remain favorable, fueled by expanding economic activity and strong labor markets<sup>2</sup>

## Employment

- The U.S. unemployment rate dropped to 4.1% to end the year, leaving the total number of unemployed at 6.7 million, as compared with 4.7% and 7.5 million, respectively, at the end of 2016<sup>3</sup>
  - The U.S. economy added 148,000 new jobs in December, with notable employment increases in the construction, food services, health care, and manufacturing sectors
- Real average hourly earnings improved by 0.4% from Q4 2016 to Q4 2017<sup>3</sup>
  - This rate of improvement is significantly lower than last quarter's year-over-year jump of 2.9%, which was the highest annual increase in over eight years

## Real GDP Growth Since 2011 (annualized)<sup>1</sup>



U.S. Bureau of Economic Analysis

## U.S. Treasury Securities

- The 10-year U.S. Treasury Note yield widened slightly from 2.29% at the end of Q3 2017 to 2.40% at the end of Q4 2017<sup>4</sup>
  - The yield curve flattened further with a 51-basis-point spread between the 2- and 10-year securities at the end of 2017

	Q1 2017	Q2 2017	Q3 2017	Q4 2017 <sup>5</sup>
5-year Treasury Note	2.01%	1.86%	1.85%	2.10%
10-year Treasury Note	2.52%	2.32%	2.29%	2.40%
30-year Treasury Note	3.27%	3.12%	3.00%	2.97%
10-year Treasury Inflation Protected Security	0.44%	0.44%	0.45%	0.50%

Source: U.S. Department of Treasury

## Outlook for 2018

- Leading CEOs surveyed by Business Roundtable projected that U.S. GDP will grow by 2.5% in 2018, an uptick of 0.4% from the previous quarter's forecast<sup>5</sup>
  - Business leaders are confident in the economy and are planning to increase capital expenditures as long as cost pressures continue to decrease with reduced regulation from the Trump administration
- PricewaterhouseCoopers predicts that the global economy will grow by almost 4%, the fastest rate since 2011<sup>6</sup>

1. U.S. Bureau of Economic Analysis  
 2. U.S. Federal Reserve  
 3. Bureau of Labor Statistics  
 4. U.S. Department of Treasury

5. Business Roundtable  
 6. PricewaterhouseCoopers

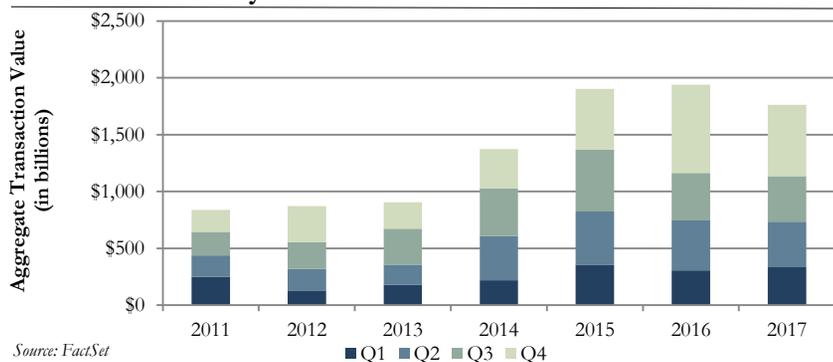
# Mergers and Acquisitions and Private Equity



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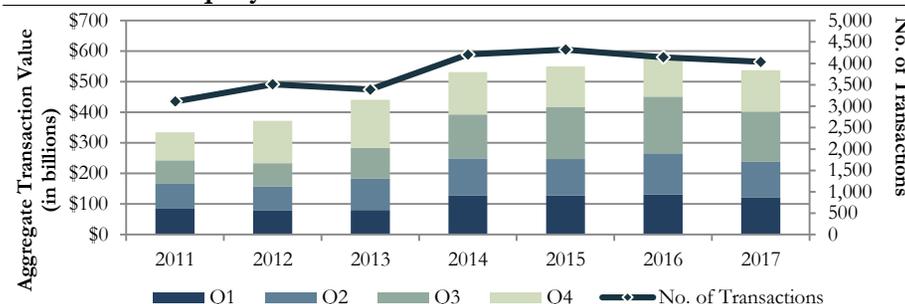
- Global mergers and acquisitions (M&A) activity reached \$3.2T across 18,433 deals in 2017, falling just short of the \$3.3T spent on 18,592 transactions in 2016<sup>1</sup>
  - 2017 is the fourth consecutive year global M&A has remained above \$3.0T
  - December 2017 had the two largest announced M&A transactions of the year: CVS Health Corp.'s \$67.8B acquisition of Aetna, Inc. and The Walt Disney Company's \$68.4B acquisition of Twenty-First Century Fox, Inc.
- U.S. M&A volume totaled \$1.3T in 2017 across 5,326 deals, slightly below the \$1.5T expended on 5,325 transactions in 2016<sup>1</sup>
  - The U.S. market share of global M&A activity was 40.2% in 2017, the lowest level since 2013 when it was 40.5%<sup>1</sup>
  - The decline in M&A deal value was spurred by tax legislation and interest rate uncertainty and came despite positive economic signals, such as steady corporate earnings growth, manufacturing improvements, and positive CEO sentiment<sup>2</sup>
  - The median EV/EBITDA multiple for U.S. M&A transactions was 10.3x in 2017, marginally higher than the 10.2x multiple in 2016<sup>2,3</sup>
  - Increased M&A deal activity is expected in 2018, in part due to new tax legislation that should bring in \$300B to \$400B of cash from overseas, which will expand corporate balance sheets and foster national growth<sup>2</sup>
- Cross-border inbound activity in the U.S. fell by 18.4% to \$278.4B in 2017, while outbound volume rose by 14.9% to \$363.6B<sup>1</sup>
  - Seven of the ten highest-valued deals were cross-border, the largest of which was British American Tobacco's \$59.0B acquisition of Reynolds America

## U.S. M&A Activity



Source: FactSet

## U.S. Private Equity Deal Flow



Source: PitchBook

- Overall U.S. private equity (PE) deal value was \$538.2B across 4,035 deals in 2017<sup>2</sup>
  - After a booming Q3 2017 with 1,007 closed transactions, Q4 2017 deal activity declined by 19.6% in spite of rising dry powder among U.S. PE funds which reached \$565.9B at the end of 2017 (\$1.0T globally)<sup>2,4</sup>
  - This was due in large part to dealmaker concerns about the high-priced environment and the existence of fewer quality targets<sup>2</sup>
- U.S. middle-market PE investments totaled 2,306 completed deals worth \$324.1B in 2017, a 14.0% increase year-over-year from 2016<sup>2</sup>
  - Driving this surge in activity was (i) the shift towards the upper middle market, which experienced 46% greater deal flow and 62% higher deal value, (ii) larger PE firms seeking to find better values that are more prevalent in the middle market, and (iii) a desire for (more economic) add-on acquisitions for existing portfolio companies
- Middle-market PE firms raised \$121.9B in 2017, marking the fourth consecutive year with over \$120.0B raised, a threshold that prior to 2014 had not been met since 2008<sup>2</sup>
  - There is a shift among LP's towards larger commitments to fewer PE funds, partially due to increasingly competitive fee structures from larger funds to attract new capital
- Median middle-market EV/EBITDA multiples reached 8.1x in Q4 2017, setting a record high<sup>5</sup>
- U.S. PE exits reversed the downward trend that began in 2015, with \$89.8B across 934 exits in 2017, a 10.5% increase in exit value from 2016<sup>2</sup>
  - Secondary buyouts comprised 51% of total exit volume in 2017, the highest percentage on record; this trend likely will continue as PE firms, flush with new capital, struggle to find deal flow

1. Mergermarket  
 2. PitchBook  
 3. These multiples reflect prices paid for mainly public companies and do not account for smaller private company transactions (for which there typically are no publicly available data) that tend to change hands at much lower multiples  
 4. Preqin

# Venture Capital, PIPEs, and Corporate Earnings

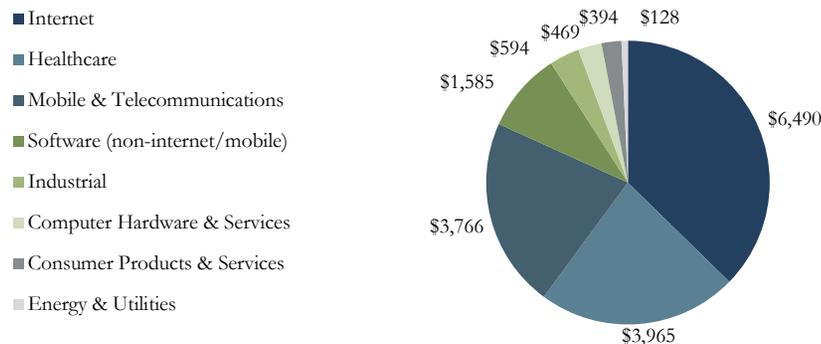


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## Venture Capital Investing

- In 2017, there was \$71.9B invested in U.S. venture capital (VC)-backed businesses, the second highest amount this century<sup>1</sup>
  - While dollars invested neared peaks in 2017, the deal count was 5,052, which was 10.2% lower than the 5,623 deals in 2016 and the lowest amount since 2012
  - Behind the uptick in VC investments is the record influx of new funds to VC firms
- Strong VC funding activity and higher per-deal investment levels were driven by a year-long boost in mega-round (MR) funding, defined as capital raises of over \$100M<sup>1</sup>
  - In Q4 2017, 33 MR fund investments occurred, bringing the total for 2017 to 109 and resulting in the most active MR investment year in history; in Q4 2016, there were only 11 MR investments
- Corporate VC investors contributed 44% of all 2017 deal value<sup>2</sup>, highlighting the growing role corporate backers have within the VC universe and their desire to identify new technologies and platforms to gain a competitive edge
  - Corporate VC investors participated in 1,268 financings worth a record \$37B
  - The number of financings grew by 15% in 2017, as compared with 3% in 2016
- While the number of VC exits in 2017 continued the downward trend that began in 2016, average exit deal values have grown<sup>2</sup>
  - There was \$51B in exit value across 770 liquidity events, equating to a year-over-year decline of 10% in exit volume, but only a 3.6% decline in exit value

## U.S. VC Deal Value Per Industry (in millions) – Q4 2017



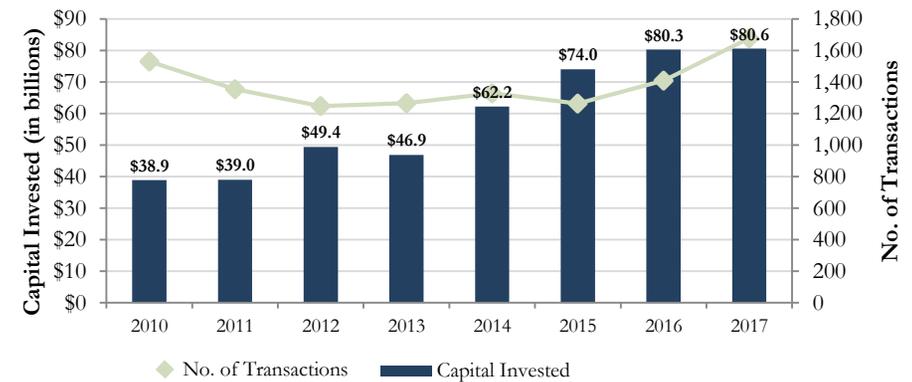
Source: MoneyTree Report

1. PricewaterhouseCoopers
2. PitchBook
3. The Deal
4. FactSet

## PIPE Investing

- Q4 2017 was a highly active quarter in the private-investment-in-public-equity (PIPE) market with over \$20B raised, bringing the year end total to approximately \$80B<sup>3</sup>
- There were more PIPE transactions in Q4 2017 than in almost every quarter since the 2007 global financial crisis<sup>3</sup>

## U.S. PIPE Activity



Source: DealFlow Report

## Corporate Earnings

- U.S. corporate earnings are on pace to grow by 15.2% in Q4 2017, which would mark the highest increase by reporting S&P 500 companies since Q3 2011<sup>4</sup>
  - Of the 80% of S&P 500 companies that have reported earnings thus far, 75% have beaten their consensus earnings per share (EPS) estimates
- During 2017, the market has been rewarding positive earnings surprises and punishing negative surprises less than has occurred historically<sup>4</sup>
  - On average, Q4 2017 positive earnings reports resulted in a price decrease of 0.4%, while during the previous five years the average price increased by 1.2%

# Debt Capital and IPO Markets



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## Debt Capital

- The Barclays U.S. Aggregate Bond Index recorded a 0.39% positive return during Q4 2017, a decrease from the 0.85% return in Q3 2017<sup>1</sup>
  - U.S. corporate bonds closed the year on a positive note, supported by tailwinds from the new U.S. tax reform act, ongoing investor demand, robust earnings, and positive global economic growth
- The Barclays Investment Grade U.S. Corporate Bond Index generated a positive return of 1.17% in Q4 2017, below the 1.34% return in Q3 2017<sup>1</sup>
  - Despite the Federal Reserve's well-telegraphed plan to raise short term rates, current accommodative global monetary policies still support U.S. corporate bond buying
  - The repatriation of up to \$2T of offshore profits should lead to reduced issuances from multinational companies, while limiting the deductibility of interest expense should have little effect on the investment-grade market, but may steer companies to favor equity financing over borrowing on the margin
- Total U.S. bond issuances reached \$1,838.8B in Q4 2017, a 6.6% increase from the Q3 2017 level of \$1,725.4B and an 8.1% escalation from the Q4 2016 level of \$1,701.6B<sup>2</sup>
  - The largest contributing factor to the increase in U.S. bond issuances in Q4 2017 relative to Q3 2017 was the sharp rise in U.S. Treasury and municipal issuances, which grew 15.4% and 68.1%, respectively; total U.S. Treasury and municipal issuances in Q4 2017 were \$535.5B and \$154.8B, respectively
  - U.S. corporate bond issuances in Q4 2017 fell relative to Q3 2017, driven by a decrease in investment-grade debt of 24.5% and an increase in high-yield debt of 16.1%; total investment-grade and high-yield issuances in Q4 2017 were \$255.5B and \$68.1B, respectively

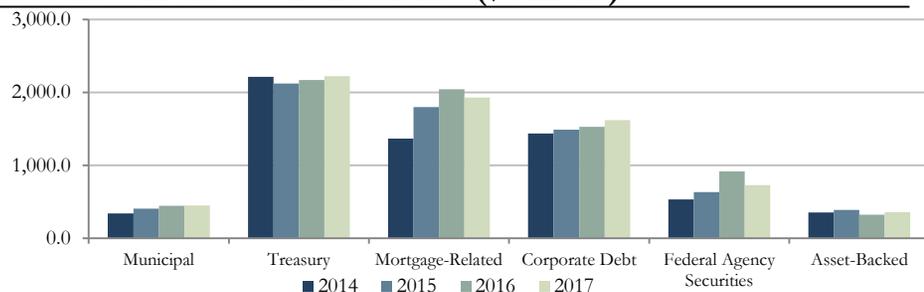
## Middle-Market Lending

- Total U.S. middle-market lending in Q4 2017 was \$44B, bringing the year-to-date total to \$170B, 23% above the 2016 issuance level<sup>3</sup>
  - The increase was most pronounced in the larger segment of the middle market (\$100M to \$500M), accounting for 80% of 2017 total volume
  - Average yields on newly issued loans diverged in Q4 2017, with large corporate credit yields tightening to 4.85%, while middle-market yields increased to 6.06%
- The average debt-to-EBITDA level for broadly syndicated LBO transactions stayed constant at 6.5x in Q4 2017 relative to Q3 2017<sup>3</sup>
  - The debt-to-EBITDA ratio for institutional middle-market LBOs dropped to 5.9x in Q4 2017, down from 6.2x in Q3 2017
- U.S. leveraged loan volume in 2017 increased 60% relative to 2016, totaling \$1.4T, above the 2013 high of \$1.1T, while U.S. loans issued to fund LBOs reached \$126B, a year-over-year increase of 44%<sup>3</sup>

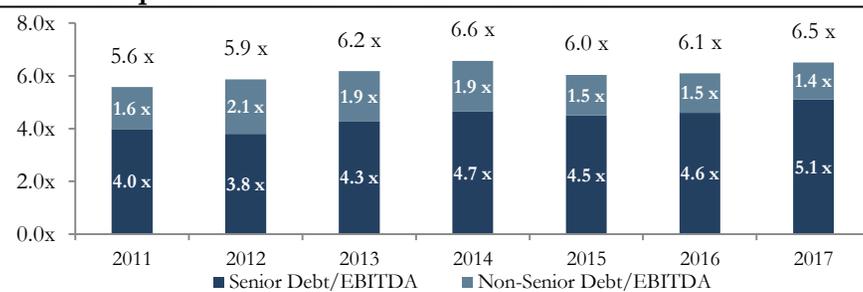
## IPO Market

- Globally, 1,624 companies went public in 2017, raising \$188.8B, the most active year since 2007, though still well below the pre-financial crisis years<sup>4</sup>
  - 57.6% of the IPOs and 38.8% of proceeds came from the Asia-Pacific region
  - There were 174 IPOs in the U.S. in 2017, raising \$39.5B, which was an increase of 85.4% in terms of proceeds and 55.4% in terms of volume compared with 2016

## Issuances in the U.S. Bond Market (\$ billions)



## Debt Multiples of Middle-Market LBO Loans



Source: SIFMA

Source: Thomson Reuters LPC

1. Prudential  
2. SIFMA  
3. Thomson Reuters LPC



## Will Cryptocurrency Become Mainstream?

*By Priya Sinha Cloutier, Esq., Co-Founder, Cloutier Ortega Law*

### What is Cryptocurrency?

Cryptocurrency is a digital monetary unit linked to a globally decentralized payment system and is generally purchased by transferring fiat currency (*i.e.*, currency that is government-certified as legal tender and not backed by a physical commodity) through an exchange or an individual. Cryptocurrency utilizes blockchain technology, which enables functions such as currency issuance and transaction processing and verification to be carried out by a distributed network; and is created digitally through a “mining” process that requires powerful computers to solve complex algorithms. Transfers are processed between users over the network without needing a central processing unit. The payor uses the unique address of the recipient to transfer a set amount of cryptocurrency to the recipient.

Cryptocurrency has been in the news the last several months as its value has risen and fallen in a sinusoidal fashion. Although, when thinking about cryptocurrency, Bitcoin most often comes to mind, it is not the only cryptocurrency on the market. Below are some of the newest players:



Collectively, these players have raised \$1.4 billion in 2017 in Initial Coin Offerings (“ICOs”).

In 2017, the SEC started providing guidance for ICOs stating that “the token [offering] constituted an investment contract and therefore was a security under our federal securities laws.” The SEC even noted that attempts to characterize cryptocurrency as tokens were insufficient to avoid registrations requirements: “simply calling something a ‘currency’ or a currency-based product does not mean that it is not a security.”

Cryptocurrency is not the only application of blockchain technology. According to International Data Corp. Distribution, corporate spending on blockchain technology software is expected to more than double in 2018 to \$2.1 billion. Some examples of how blockchain technology is being used include:

- ChroniCled (<https://chronicled.com/>) manages versioning control and signatures of contracts by using automation and digital signatures to create a unique digital identity for physical items and digital documents alike. Some features allow for better supply chain control and management and anti-fraud opportunities to protect brand integrity around the world.
- Storji (<https://storj.io/>) enables users to store digital objects more securely and efficiently in the cloud with greater security, uptime, and faster delivery. Most online storage requires your data to live in a central server, which sends out your web assets on demand when visitors click a link to your page. Storj is doing work that will silently speed up and improve the web.
- BitCongress (<https://www.bitcongress.org/>) is working on creating a platform that uses blockchain technology to replace and/or enhance the current voting methods. The company employs a token-based system to control a voting system ensuring a one-person, one-“unchangeable” vote.

### Advantages of Cryptocurrency.

Those who champion cryptos (as they are called) argue that the main advantage of digital currency is that it cannot be manipulated as easily as fiat currency because of its decentralized and unregulated status. Further, cryptocurrency’s properties would remove the need to use intermediaries in everyday transactions. This could increase transparency, cut costs for businesses and ultimately help consumers.



## Will Cryptocurrency Become Mainstream?

However, this advantage may be short lived. Government agencies are starting to take note of digital currencies, especially when they are used for fundraising efforts. As discussed above, the SEC has issued guidance on ICOs. China has banned any foreign coin exchanges and appears to be heading towards banning all cryptocurrency because of “financial risks.”

### Disadvantages of Cryptocurrency

Unlike fiat currency, which is backed by the full faith and credit of its government, there is nothing to independently back the value of cryptocurrency. Further, the issuance of fiat currency is a highly centralized activity supervised by a nation’s central bank. While the bank regulates the amount of currency issued in accordance with its monetary policy objectives, there is theoretically no upper limit to the amount of such currency issuance. In the United States, and most developed countries, fiat currency deposits are insured against bank failures by a government body.

Cryptocurrency has no such support mechanisms. Its value is wholly dependent on what investors are willing to pay for it at a point in time. Additionally, if a cryptocurrency or cryptocurrency exchange “fails” or is “hacked,” there is no obvious recourse to get the cryptocurrency back, or even exchanged for fiat currency. An investment is simply lost in cyberspace.

### Can Cryptocurrency Go Mainstream?

The number of merchants that accept cryptocurrencies has increased in certain parts of the world; they are, however, still very much in the minority. Consumers who wish to use cryptocurrency for day-to-day purchases most often exchange it into fiat currency. In several commercial locations in Seattle, Washington, there are strategically located “automatic teller machines” that allow a user to withdraw fiat currency in exchange for cryptocurrency.

Any cryptocurrency that becomes mainstream will have to satisfy the many criteria that fiat currency does and more. On the technical side, cryptocurrency will need to be mathematically complex to avoid fraud or hackers, but easy for consumers to understand and use. The regulatory side is more difficult, with the underlying value of cryptocurrency playing tug-of-war with the regulatory needs of ordinary folks.

On the one hand, to maintain its presumed benefits, cryptocurrency will have to remain decentralized and preserve user anonymity. On the other hand, governmental oversight will be required to provide adequate consumer safeguards and protection. Governmental agencies will also want to regulate cryptocurrencies to confirm that they do not become a conduit for tax evasion, money laundering, and other nefarious activities. With all this being said, there may yet emerge a cryptocurrency that falls somewhere in between the digital currencies of today and fiat currencies.

### ***About the Author***

*Priya Sinha Cloutier, Esq. focuses her practice on helping start-ups and emerging companies build their intellectual property. She also has extensive experience in the procurement and enforcement of domestic and international patents, trademarks, and copyrights. Her industry experience includes consumer goods, aerospace, hybrid and electrical engines/motors, architecture and construction, medical devices, agriculture (including cannabis), food, and energy systems.*

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## Selected Transactions

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\$250,000,000



has merged with



and secured equity and debt financing from affiliates of

**LL Funds, LLC**

Exclusive Financial Advisor

\$150,000,000



Senior Secured Credit Facility

Exclusive Financial Advisor

\$31,000,000



has been acquired by



Exclusive Financial Advisor

\$95,600,000



(NASDAQ: USHS)

has been acquired by



(NYSE: HD)

Exclusive Financial Advisor

\$240,000,000



has sold a majority stake in the company through a leveraged buyout transaction to



Exclusive Financial Advisor

\$75,000,000



Term-Out Facility

Exclusive Financial Advisor

Up to \$50,000,000



Senior Credit Facility

Exclusive Financial Advisor

\$20,000,000



Mezzanine Debt

Co-Advisor

MDAligne

has merged with



to form



Exclusive Financial Advisor

\$30,000,000



Credit Facility

Exclusive Financial Advisor

\$60,000,000



Senior Secured Credit Facility

Exclusive Financial Advisor

123 LUMP \$UM HOLDINGS

Private Placement of Preferred Stock with

**GCP Capital Partners**

Exclusive Financial Advisor



FRANKFORD CANDY & CHOCOLATE CO., INC.

has sold its business operations and real estate to



FRANKFORD CANDY LLC

a company formed by Management and a Strategic Partner

Exclusive Financial Advisor

QUANTUM CLEAN

has acquired the assets of

Chamber Performance Services

a division of



(NASDAQ: AMAT)

Exclusive Financial Advisor

\$150,000,000



\$100,000,000 Senior Secured Credit Facility  
\$50,000,000 Additional Commitment

Exclusive Financial Advisor

\$200,000,000



(NYSE: ENT and TSX: ENT.UN)

Senior and Junior Secured Credit Facilities

Exclusive Financial Advisor

\$185,000,000



has merged with

INFINITY CROSS BORDER ACQUISITION CO.

(NASDAQ: INXBU)

Exclusive Financial Advisor

APPLIED NATURAL GAS FEELS, INC. (OTC:BB.AGAS)

Senior Secured Revolving Credit Facility

Exclusive Financial Advisor

\$140,000,000



(NASDAQ NMS: ENS)

has managed by affiliates of



have acquired

MISSISSIPPI HUB LLC

Exclusive Financial Advisor

\$278,000,000



(AMEX: DMX)

has been acquired by



Exclusive Financial Advisor

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