

# *Middle Market Update*

**Q4 2018**



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### Federal Reserve and Inflation

- The Federal Open Market Committee (FOMC) views recent economic activity as positive, as evidenced by the continued strengthening of the labor market and rising economic activity, including gains in job activity and household spending<sup>1</sup>
  - During its December 2018 meeting, the FOMC decided to increase the target for the federal funds rate by 25 basis points from 2.25% to 2.50%
- The committee expects that the near-term economic outlook will remain favorable, fueled by sustained expansion of economic activity, stable inflation, and strong labor markets<sup>1</sup>
- The U.S. Consumer Price Index (CPI) increased by 1.9% in 2018, the first time since 2015 that the inflation rate has fallen below 2.0%<sup>2</sup>
  - The decrease in the inflation rate was primarily driven by the 25% drop in oil prices in Q4 2018<sup>3</sup>

### Employment

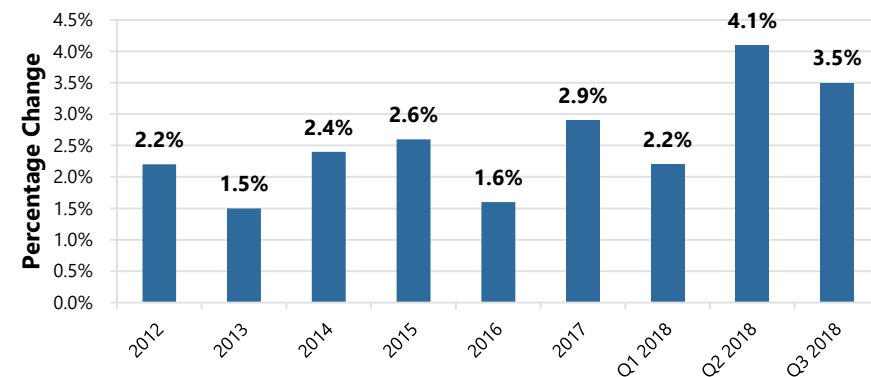
- The U.S. unemployment rate increased to 3.9% at the end of Q4 2018, as compared with 3.7% at the end of Q3 2018, with the number of unemployed persons at 6.3 million<sup>2</sup>
  - The increase was owed in part to more people entering the labor force and an increase in the number of people voluntarily leaving their jobs in search of new employment
- U.S. employers added 2.6 million jobs to their payrolls in 2018, the 99<sup>th</sup> consecutive month of payroll growth<sup>3</sup>
- The average U.S. employee hourly earnings rose by 3.2% in 2018, posting its largest full-year gain in the past decade<sup>2</sup>
  - Tightening labor markets due to labor shortages continue to provide upward pressure on wages, as companies find it difficult to hire and retain quality workers<sup>3</sup>

### U.S. Treasury Securities

- The 10-year U.S. Treasury Note yield increased from an average of 2.92% in Q3 2018 to an average of 3.04% in Q4 2018<sup>4</sup>

	Q1 2018	Q2 2018	Q3 2018	Q4 2018 <sup>4,5</sup>
5-year Treasury Note	2.56%	2.79%	2.81%	2.88%
10-year Treasury Note	2.74%	2.95%	2.92%	3.04%
30-year Treasury Note	2.97%	3.16%	3.06%	3.27%
10-year Treasury (Inflation Protected)	0.69%	0.79%	0.81%	1.06%

### Real GDP Growth Since 2012 (annualized)<sup>10</sup>



Source: U.S. Bureau of Economic Analysis

### Outlook for 2019

- Leading CEOs surveyed by Business Roundtable project that the U.S. GDP will grow by 2.7% in 2019, a slight decrease of 0.1% from the previous quarter's forecast<sup>6</sup>
  - Q4 2018 marks the third consecutive quarter in which CEOs' expectations for GDP growth fell and were primarily due to concerns over trade disputes, trade barriers, and increasing labor costs
- The Congressional Budget Office forecasts a budget deficit of \$897 billion for fiscal year 2019, up sharply from the \$779.0 billion deficit incurred in fiscal year 2018<sup>7</sup>
  - The U.S. federal budget deficit has ballooned in large part due to an aging population and the rising cost of health care, which contributed significantly to the growth in spending for major benefit programs
- U.S. consumer confidence index fell to 120.2 in January, down 17.7 points since October, the largest three-month decline since 2011<sup>8</sup>
- Global economic growth is expected to slow in 2019 due to tightening global financing conditions and elevating trade tensions, which have added significant stress to the financial markets<sup>9</sup>

1. U.S. Federal Reserve

2. Bureau of Labor Statistics

3. The Wall Street Journal

4. U.S. Department of Treasury

5. Federal Reserve Economic Data

6. Business Roundtable

7. Congressional Budget Office

8. The Conference Board

9. World Bank Group

10. Q4 2018 GDP data are unavailable due to the recent government shutdown

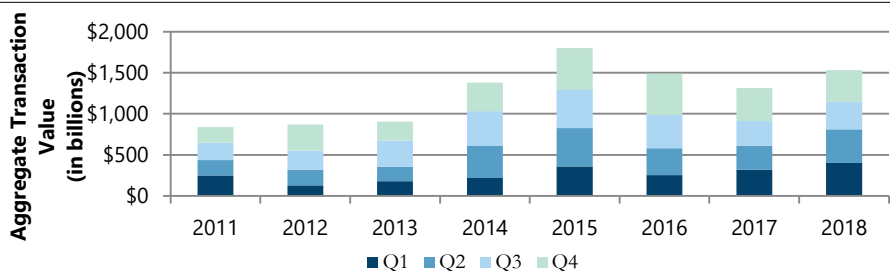
# Bryant Park Capital

## Mergers and Acquisitions and Private Equity



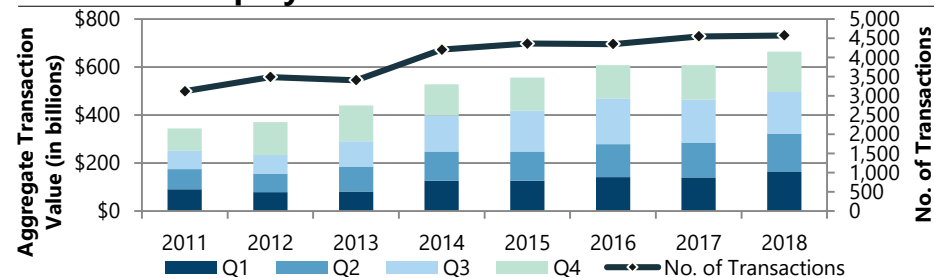
- Global mergers and acquisitions (M&A) activity reached \$3.5T during the full year 2018, climbing to the second-highest level since the financial crisis; Q4 deal value reached \$708.3B, the lowest Q4 figure since 2013<sup>1</sup>
  - Q4 experienced a decline in M&A size and volume, as strategic acquirers are navigating through uncertainty driven by disruptive events, such as the trade war, falling asset prices, and the longest U.S. government shutdown in history<sup>1</sup>
  - While macroeconomic factors are playing an important role in how businesses are considering strategic initiatives, only slightly more than one-third of CEOs around the world are concerned about capital availability<sup>2</sup>
- U.S. M&A value reached \$1.9T across 13,243 transactions in 2018, increases of 15.6% and 8.0%, respectively, as compared to 2017<sup>1</sup>
  - In 2018, the average deal size increased by 27.4% to \$1.3B, specifically driven by growth in the number of transactions above \$1B<sup>1</sup>
  - Despite uncertainty over global trade agreements and tariffs, domestic policy could accelerate deal-making, as the majority of corporate investors believe that a portion of capital saved from tax reform will be used to facilitate transactions and expect to close more deals in 2019<sup>3</sup>
- The median North American and European M&A EV/EBITDA multiple has reached the highest level in more than a decade, increasing from 9.4x in 2017 to 9.6x in 2018<sup>4</sup>
  - The surge in the transaction multiple was driven primarily by low-cost financing and heightened competition, as many publicly-traded companies have shifted their focus from organic growth to growth via acquisition
- Cross-border M&A activity experienced an accelerated slowdown this year, as inbound M&A in North America fell by 20% in both deal size and volume, as compared to 2017<sup>4</sup>
  - Cross-border deals were hit by a wave of protectionism that dissuades foreign companies, especially Chinese, from acquiring U.S.-based assets

### U.S. M&A Activity



Source: Mergermarket and FactSet

### U.S. Private Equity Deal Flow



Source: PitchBook

- Despite the U.S. public markets providing the worst returns in a decade, private market valuations remain relatively stable; multiples remain elevated and leverage is making a rebound, with median debt percentages in buyouts reaching 54.0%, the highest since 2015<sup>4</sup>
- U.S. middle-market PE firms completed 2,971 buyouts worth \$427.9B in 2018, as compared with \$372.7B in 2017<sup>4</sup>
  - The increase in the value of buyouts was due to high PE dry powder (\$427B)<sup>6</sup>, ample debt capital available, and an increasing number of add-on acquisitions (2,326)<sup>2</sup> to capitalize on synergies with strategic platform investments
  - Even though 2018 set records for deal count and value, the median deal size for 2018 was \$175M, 1.6% below that of full-year 2017
- U.S. middle-market PE firms raised \$109.5B across 130 funds in 2018, down from \$115.9B across 166 funds in 2017<sup>4</sup>
  - The average U.S. buyout fund size increased to \$929.0M during 2018, eclipsing \$900.0M for the second time since 2011, when the average was \$901.3M
- For PE-led transactions between \$10.0M and \$250.0M, the median EV/EBITDA multiple was 7.3x during the most recent period for which data are available, flat in comparison to the previous quarter<sup>5</sup>
  - With growing economic risks, U.S. companies have increased their repatriation of cash from overseas funds to boost add-on and strategic acquisitions in order to mitigate the impact from slowing organic growth, rising interest rates, and trade tariffs<sup>6</sup>
  - The growing number of strategic buyers have saturated the market and made it harder for U.S. PE firms to compete, causing dry powder to accumulate to a total of \$427B in 2018<sup>6</sup>
- U.S. PE-backed company exit activity remained busy throughout 2018, totaling 1,049 exits valued at \$365.4B<sup>4</sup>
  - The 2018 median PE-backed IPO value was \$670.9M, 76.4% greater than the median exit value of \$330.0M across all exit types, spurred by public investor demand
  - Secondary buyouts accounted for 54.0% of middle-market exit volume and 31.4% of middle-market exit value in 2018

1. Mergermarket  
2. PWC  
3. Deloitte

4. PitchBook  
5. GF Data  
6. American Investment Council

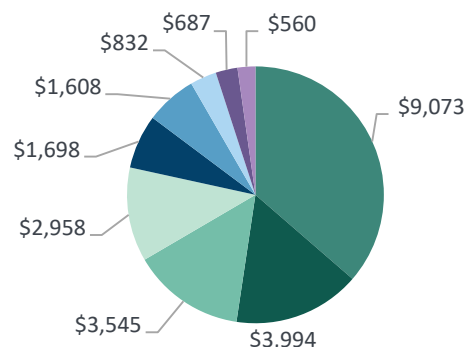


## Venture Capital Investing

- In 2018, transactions for U.S. venture capital (VC)-backed companies totaled 5,536 valued at \$99.5B, a decrease in volume of approximately 4.9% but an increase in value of 30.2%, as compared with 2017<sup>1</sup>
  - The venture capital markets saw a sharp decrease in angel and seed deal volume, as more capital pursued larger late-stage investments, with 61.9% of total capital invested stemming from deals sized \$50 million or larger<sup>2</sup>
  - Partially due to the increasing deal sizes and valuations and improving VC returns, VC fundraising had a record year in 2018 with \$55.5 billion raised, the fifth consecutive year that at least \$34 billion was raised<sup>2</sup>
  - Mega-round investment (capital raise rounds of \$100.0M or more) activity for U.S.-based companies notched a record high 198 deals in 2018, doubling 2017 deal count activity<sup>2</sup>
- U.S. corporate VC participation continued to trend upward to close out 2018, with \$66.8B invested over 1,443 deals, an increase in deal value of 83.2% from 2017<sup>2</sup>
  - The elevated corporate VC investment can be attributed in part to the continued popularity of utilizing investments in startups as a less costly alternative to R&D and corporate innovation
  - Corporate tax cuts have boosted corporate coffers, leading to more outsized financings and the participation of previously capital-constrained corporations
- Despite a third consecutive decline in annual deal volume, global VC surpassed \$250 billion for the first time this decade, with \$63.9 billion in Q4 2018 deal value, up 22.9% from Q3 2018<sup>3</sup>
  - In 2018, the U.S. accounted for 53 new unicorns (private companies with valuations over \$1 billion), more than doubling the 26 new unicorns seen in Asia and over five times more than the 10 new unicorns recorded in Europe

## U.S. VC Deal Value per Industry (in millions) – Q4 2018

- Internet
- Healthcare
- Mobile & Telecommunications
- Software (non-internet/mobile)
- Industrial
- Other
- Electronics
- Computer Hardware & Services
- Leisure

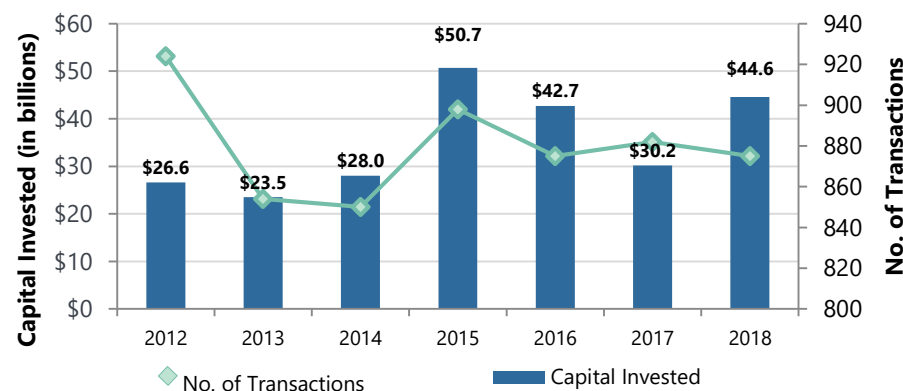


Source: MoneyTree Report

## PIPE Investing

- There were 875 U.S. private-investment-in-public-equity (PIPE) deals that closed in 2018, a 44% year-over-year increase in total capital raised compared with the same period in 2017<sup>4</sup>
  - Biotech continued to be the most robust deal driver, with more than 130 transactions that generated over \$8.0B; many of the deals involved less than a \$5.0M raise
  - Cannabis companies continue to drive the PIPE market in Canada

## U.S. PIPE Activity



Source: Placement Tracker

## Corporate Earnings

- The S&P 500 ended 2018 down 6.6%, with stocks falling 9.6% in December alone, the biggest year-end loss since 1931<sup>5</sup>
  - The December decline came as a result of Federal Reserve rate hikes and the U.S. / China trade war causing economic growth concerns
- S&P 500 company earnings for Q4 2018 are on pace to grow 13.3% year-over-year, which would mark the first quarter of below 20% earnings growth since Q4 2017<sup>6</sup>
  - Of the 66% of companies that have reported earnings during Q4 2018, 62% have had a positive EPS surprise, on par with the five-year average

1. PricewaterhouseCoopers  
2. PitchBook  
3. KPMG

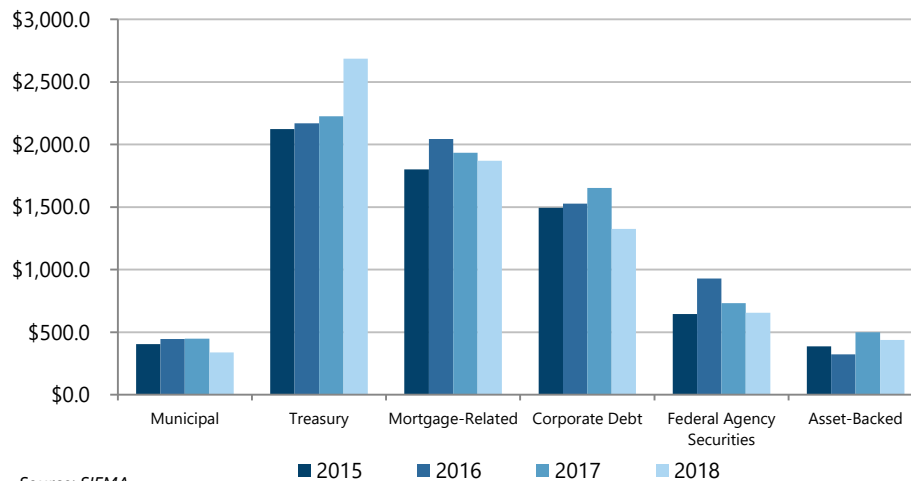
4. Placement Tracker  
5. CNBC  
6. FactSet



### Debt Capital

- The Barclays U.S. Aggregate Bond Index recorded a 1.64% gain during Q4 2018, an increase from the 0.02% gain in Q3 2018<sup>1</sup>
  - Concerns about the impact of tightening economic conditions on corporate earnings growth and equity performance have led investors to rebalance their portfolios into the less riskier fixed income markets
- The Barclays Investment Grade U.S. Corporate Bond Index generated a loss of 0.18% in Q4 2018, following a 0.97% gain in Q3 2018<sup>1</sup>
  - New corporate debt issuances eased in Q4 2018, due in part to a decline in debt issued to fund M&As and share buybacks given market uncertainty, lower business confidence, and new tax rules that incentivize companies to hold less debt on their balance sheets
  - Despite the decrease in activity from foreign purchasers, investor demand for new issuances remained strong, with most deals being 2.0x to 5.0x oversubscribed
  - U.S. corporate debt has reached 46% of gross domestic product, the highest on record due to ultra-low interest rates, with non-banks holding more than \$500B of loans to mid-size companies, up from about \$300B in 2012<sup>2,3</sup>
- Total U.S. bond issuances were \$1,715.1B in Q4 2018, a 6.72% decrease from the Q3 2018 level of \$1,838.7B, and a 8.31% year-over-year decrease from the Q4 2017 level of \$1,870.5B<sup>4</sup>
  - U.S. bond issuances across the mortgage debt, corporate debt, and asset-backed securities debt markets decreased from Q3 2018 to Q4 2018
  - The largest contributing factor to this decrease was the shrinking of corporate debt and mortgage debt bond issuances, whose volume dropped 34.3% and 25.6%, respectively, to a total of \$110.7B and \$137.7B, respectively<sup>5</sup>

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



Source: SIFMA

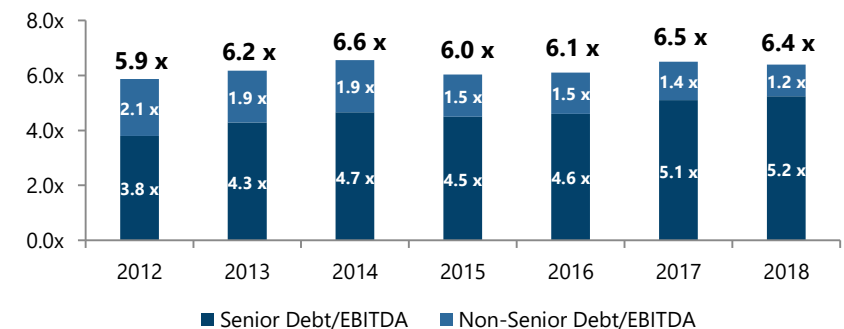
### Middle-Market Lending

- Total U.S. middle-market lending in year end 2018 was \$183.0B, up 7.0% compared with year end 2017<sup>5</sup>
  - Growing uncertainty regarding issues such as economic growth, trade policies, interest rates, and the overall political landscape have pushed lenders to focus more on credit quality and driven away many retail investors<sup>6</sup>
  - The increase in 2018 loan issuances was primarily driven by an 11.0% increase in large middle-market lending (deal sizes ranging from \$100M to \$500M), which made up around 83.0% of middle-market volume for the year
  - The average issuance yield increased to 6.5% for large corporate loans and 7.7% for middle-market loans in Q4 2018 due to an uptick in the three-month LIBOR combined with steeper original issue discounts (OIDs)
  - There have been a total of \$21.7B of institutional loan defaults in 2018, as compared with \$26.0B in 2017
    - The trailing 12-month default rate dropped to 1.75% from 2.40% a year ago, with only one institutional leveraged loan default in Q4 2018
- Corporate borrowings now sit at 92% of output globally and 47% in the U.S., both record highs, with junk-rated debt accounting for 11% of all corporate debt, up from 2% in the early 2000s<sup>7</sup>
- At the end of Q4 2018, 27% of first-lien loans were backed by companies without junior debt, the highest amount since 2007<sup>8</sup>

### IPO Market

- The U.S. IPO market saw 205 IPOs raising a total of \$52.8B in 2018, increases of 14% and 31%, respectively, compared to 2017<sup>9</sup>
  - Momentum in the IPO markets has been driven by positive post-IPO price performance, which keeps investors engaged and draws more issuers to the market
  - Even though the IPO pipeline has limited visibility due to confidentiality filings, significant IPO activity is expected to occur in 2019, but may be pushed back as a result of the lengthy government shutdown and volatile markets

### Debt Multiples of Middle-Market LBO Loans



Source: Thomson Reuters LPC

1. Prudential  
 2. Federal Reserve  
 3. Ares Management LP  
 4. SIFMA  
 5. Thomson Reuters LPC  
 6. William Blair  
 7. The Wall Street Journal  
 8. S&P Global Intelligence  
 9. Ernst & Young



**By Rishi Jain, Managing Director & Anthony Horvat, Managing Director, Accordion**

Last Spring, Justify joined the elite group of Triple Crown winners. But, as anyone who's ever bet the ponies knows, they can't all be Justifys. Sometimes you get a winner and sometimes, for reasons that aren't quite clear to anyone, you get an underperformer.

It's a concept with which most fund sponsors and other acquirers may be intimately familiar. You bet on the investment because you foresee its potential and understand the path it needs to take in order to achieve it. Sometimes you get a mudder – an investment that thrives under institutional or corporate ownership, meeting, if not exceeding, expectations. And sometimes you get a stuck-in-the-mudder – a portfolio company whose progression has stalled or gone sideways.

But, don't shoot the horse just yet. The first step is to acknowledge its existence in your portfolio. The second step is to understand the many parties that have a stake in its success: Yes, the fund sponsor or parent company, but also the management team and the lenders. And, the third step is to diagnose the problem and rehabilitate the investment.

### Recognizing the Problem

In its broadest definition, a 'stuck-in-the-mudder' is a portfolio company where there is significant underperformance relative to expectations (specifically cash or EBITDA) and there are enough performance surprises to suggest management is not fully in control of the business.

That said, every investment or acquisition is unique and no catchall definition will ever be comprehensive enough to capture the complex tapestry of characteristics that, when combined, lead to underperformance. And so, aside from the most obvious indicators of trouble (negative EBITDA coupled with a lack of liquidity), there are subtler markers that can (and should) flag where an investment might be stuck in muddy terrain. They tend to come in three varieties:

1. **The financial markers:** Here we see a lack of financial predictability, coupled with frequent budgeting and forecasting errors or missed targets. Margins may lag behind expectations. Capital investments may not be producing the expected efficiencies. The biggest flag, of course, generally is that the cash generated by the company is not meeting expectations, particularly as related to the debt structure. The company is not throwing off sufficient EBITDA or cash to satisfy its stakeholders, and is potentially running the risk of covenant default. Or, maybe the company hasn't yet run out of cash, but liquidity trends are a concern with no clear line-of-sight solution available.
2. **The management markers:** Here we see issues with management's closeness to the business, often in the form of a significant disconnect between what

management said would happen and what the actual, tangible results are. As is often the case in this scenario, the team may lack an acute understanding of the drivers contributing to the underperformance. Sometimes that lack of understanding can be traced back to plans that are not tracked and/or lack measurable key performance indicators (KPIs). And sometimes, it's not a lack of understanding as much as it is a lack of acknowledgement of the underperformance. But management markers can also manifest in important non-financial flags. Product quality concerns, customer service issues, and employee unrest are all signs of shortfalls attributable to underperforming management.

3. **The market-standing markers:** Here we speak of underperformance relative to the company's industry or competition. Market markers are particularly problematic when the investment is based on a platform purchase with subsequent add-on acquisitions. If the outcome of serial acquisition has not been greater than the sum of its parts, that could suggest a 'stuck' scenario in which capital was mis-deployed or integration plans were poorly executed.

### Rehabbing the Problem

So, your horse is stuck. The question becomes: how do you correct to get in racing shape?

The easy answer is that you have to find and release the trapped cash and EBITDA potential in the company – unlock the promise first noted during due diligence and at the time of the initial investment. The more difficult part is finding an effective way to do that. Here we suggest six potential strategies:

1. **Must be the money:** Start with the cash flow. Where does it come from? Where does it go? Building a detailed liquidity forecast is critical for all businesses and particularly critical to getting to the root of underperformance. A 13-week cash flow projection can be useful even absent significant liquidity problems (and should be mandated where those liquidity issues exist). Once you understand where the money is coming from and where it's going, you will have enhanced visibility into the economics of the business.
2. **Know thy customer:** Because, they're not all created equal. It is critical to assess who the customers are and their relative importance to the business. Which customers are helping profitability, and are there some that are not? In tangible terms, implementing a detailed SKU profitability analysis of customers and products can illuminate quite a bit about where the business is making money and where the business may be trading dollars (or worse). With this enhanced visibility, higher value customers can then be catered to, while lower value customers may ultimately prove a hindrance to profitability. (And yes, you're allowed to fire them in such cases.) Target the 'low-profit' portion of the product portfolio for improvement. Linking this knowledge to the sales function can generate significant performance improvement quickly.



- 3. Let the sunshine in:** Often hidden costs develop across an organization related to the creation and deployment of products and services. Product margins are meaningful measures but, in many companies, those margins do not account for the totality of product costs. Implementing a zero-based budgeting process can help uncover those hidden costs. Matching those costs to their related functions will then help establish the effectiveness of those costs on behalf of the customer.
- 4. The big spender scenario:** Know it. Avoid it. Conduct a deep-dive spending analysis to determine how revenue is related to expenses. In too many companies, particularly in underperforming ones, the spend on SG&A activities is misaligned to revenues. Identify, analyze, and track spending trends to find where resources are not being applied to quality revenue-producing activities. If needed, cut them out, scale them back, or redeploy them to more value-producing activity.
- 5. Who's the boss:** Too often, that answer is not clear. Companies undergoing change need well-communicated lines of organizational responsibility coupled with strategic leadership. When the model is either not clear, or simply not adhered to, it can create confusion that makes progress hard to measure and almost impossible to track. Establishing a proactive, timely communication process matched with visibility tools to identify priorities and review progress-of-action plans, can help achieve improved performance cadence.
- 6. Define success:** What are we trying to do? What does the transition from 'stuck' to 'success' look like? Course corrections come complete with a huge list of 'to dos.' Businesses that successfully undergo change understand the difference between the want to dos and the need to dos. To effectively change the trajectory of an underperforming business, management should prioritize the need list and build tactical programs around it. For example, if the goal is Q1 profitability, how do we achieve that across organization and by department? How many new sales leads do we need to convert? How much inventory do we need to think about buying? How does the weekly invoicing plan compare to the operations plan? This requires a granular understanding of the business – the sum of the learnings from the list above. If, after all the aforementioned analysis, the root causes of underperformance are clearly understood, then implementing corrective initiatives will also require changes in measurement methods. Building and tracking the right KPI measurement tools to monitor those initiatives is critical.

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And off to the races we go...

### **About Accordion and its authors:**

Accordion is a financial consulting and technology firm that is a go-to partner in the private equity community. It focuses on the Office of the CFO and works alongside fund sponsor management teams to support initiatives across their respective companies' entire finance function.

**Rishi Jain** is the Head of Western Region and a Managing Director at Accordion.

**Anthony Horvat** is a Managing Director at Accordion.



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## Selected Transactions

<p>\$250,000,000</p>  <p>has merged with</p>  <p>and secured equity and debt financing affiliates of <b>LL Funds, LLC</b></p> <p>EXCLUSIVE FINANCIAL ADVISER</p>	<p>\$150,000,000</p>  <p><b>Senior Secured Credit Facility</b></p> <p>EXCLUSIVE FINANCIAL ADVISER</p>	<p>\$31,000,000</p>  <p>has been acquired by</p>  <p>EXCLUSIVE FINANCIAL ADVISER</p>	<p>\$95,600,000</p>  <p>has been acquired by</p>  <p>EXCLUSIVE FINANCIAL ADVISER</p>	<p>\$240,000,000</p>  <p>has sold a majority stake in the company through a leveraged buyout transaction to</p>  <p>EXCLUSIVE FINANCIAL ADVISER</p>
<p>\$50,000,000</p>  <p><b>Term-Out Facility</b></p> <p>EXCLUSIVE FINANCIAL ADVISER</p>	<p>Up to \$50,000,000</p>  <p><b>Senior Credit Facility</b></p> <p>EXCLUSIVE FINANCIAL ADVISER</p>	<p>\$20,000,000</p>  <p><b>Mezzanine Debt</b></p> <p>CO-ADVISER</p>	<p>Amount Not Disclosed</p>  <p>has merged with</p>  <p>to form</p>  <p>EXCLUSIVE FINANCIAL ADVISER</p>	<p>\$30,000,000</p>  <p><b>Credit Facility</b></p> <p>EXCLUSIVE FINANCIAL ADVISER</p>
<p>\$60,000,000</p>  <p><b>Senior Secured Credit Facility</b></p> <p>EXCLUSIVE FINANCIAL ADVISER</p>	<p>Amount Not Disclosed</p>  <p>Private Placement of Preferred Stock with</p>  <p>EXCLUSIVE FINANCIAL ADVISER</p>	<p>Amount Not Disclosed</p>  <p>FRANKFORD CANDY &amp; CHOCOLATE CO., INC. has sold its business operations and real estate to</p>  <p>FRANKFORD CANDY LLC a company formed by Management and a Strategic Partner</p> <p>EXCLUSIVE FINANCIAL ADVISER</p>	<p>Amount Not Disclosed</p>  <p>has acquired the assets of</p> <p>Chamber Performance Services a division of</p>  <p>EXCLUSIVE FINANCIAL ADVISER</p>	<p>\$150,000,000</p>  <p><b>\$100,000,000 Senior Secured Credit Facility \$50,000,000 Additional Commitment</b></p> <p>EXCLUSIVE FINANCIAL ADVISER</p>
<p>\$200,000,000</p>  <p><b>Senior and Junior Secured Credit Facilities</b></p> <p>EXCLUSIVE FINANCIAL ADVISER</p>	<p>\$185,000,000</p>  <p>has merged with</p> <p>INFINITY CROSS BORDER ACQUISITION CO. (NASDAQ: INXBU)</p> <p>EXCLUSIVE FINANCIAL ADVISER</p>	<p>\$20,000,000</p>  <p><b>Mezzanine Debt</b></p> <p>CO-ADVISER</p>	<p>\$140,000,000</p>  <p>has acquired</p>  <p>MISSISSIPPI HUB LLC</p> <p>EXCLUSIVE FINANCIAL ADVISER</p>	<p>\$278,000,000</p>  <p>has been acquired by</p>  <p>EXCLUSIVE FINANCIAL ADVISER</p>

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