Mid-Year Financial Market Review

M&A Outlook and Economic Report Card

July 2018

GLEASON
ADVISORS

Gleason Advisors Perspectives

Coming off a record first half in 2018, M&A looks set to continue its pace through the year – though warning signs have started flashing

The M&A market had a huge first half of 2018, with total announced deal value reaching a record of $2.5 trillion – a 61% increase over the first half of 2017. While overall value is up this year, deal volume slowed again, dropping nearly 4% in the first half of 2018. The story here is the increase in blockbuster deals between corporate heavyweights. One of the most active sectors has been media & telecom. The industry has seen a major shake up with the approval of the $85.4 billion merger between AT&T and Time Warner. Also in this space, Disney has outbid Comcast for 21st Century Fox ($71.3 billion cash and stock). Once complete, Dealogic and Moody's project that these deals will create companies that owe a combined $350 billion. Clearly the debt markets are still alive and well and looking for deals. The Healthcare industry has also seen its share of mega deals, with CVS/Aetna ($68 billion cash and stock) and Cigna/Express Scripts ($54 billion cash and stock). Both of these transactions will be funded in large part with debt. While on a smaller scale than these deals, Amazon announced that they would be acquiring online pharmacy PillPack for $1 billion. Despite the relatively small size, the deal has potential to be more disruptive to the pharma industry than blockbuster deals by the industry incumbents, whose shares tumbled following Amazon's announcement.

While these blockbuster deals have been the primary driver behind the increase total transaction value, the middle market has continued to see deals close at premium valuations. The private equity industry continues to be a major driver of activity in the market. Firms have continued to raise significant capital that has yet to be deployed (over $1 trillion of "dry powder"), providing on-going demand for deals. Contrary to the overall M&A market, the private equity market saw increasing deal volume (up 2%), while deal value decreased (down 6%) compared to 1H 2017. Debt has also been an increasingly significant driver of middle market deal activity. LBO leverage multiples continue to increase, going from 5.3x at the end of 2017 to 5.9x in Q1 of this year. In addition to easy debt, corporates are currently sitting on record amounts of cash, which has ballooned to $2.5 trillion. Further bolstering corporate coffers is the Tax Cuts and Jobs Act of 2017. In addition to lower corporate rates, companies also stand to benefit from bonus depreciation and a more favorable territorial taxing system on foreign earnings. Private equity and Strategic buyers with abundant capital and incentives to invest has resulted in persistently high valuations across industries and company sizes. We expect this trend to continue and private market M&A valuations to remain elevated throughout the remainder of 2018.

When we think about where financial markets are headed beyond 2018, we feel that it is important to assess the underlying performance of the economy and its primary participants (consumers and corporates) and policy makers (U.S. Government and the Fed). We take a deeper look at each of these groups, their current landscape and where their markets are heading. On the following pages we provide a high-level discussion and report card for each group. We think there are few issues in the near term (tariffs / trade wars) that pose a threat to an otherwise strong economy. We also seeing more caution signals appearing across the economy, with a flattening yield curve and increasing leverage for both consumers & corporates. While the tax cuts have provided a jolt to the economy, the CBO projects that these lower rates will lead to increased deficits and reduce flexibility for fiscal stimulus in the coming years. As the current bull market approaches the decade mark, we see an increasing likelihood for a downturn in the global economy. However, we think the market fundamentals for corporates and level of dry powder at private equity firms will likely limit the impact on the M&A market and prevent a protracted downturn.

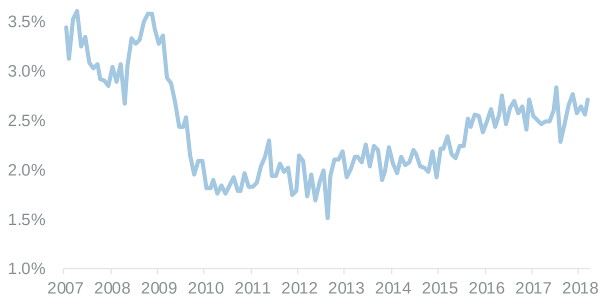
Financial Report Card of the U.S. Economy

B

Consumer & household report card

Indicator and Commentary	Grade

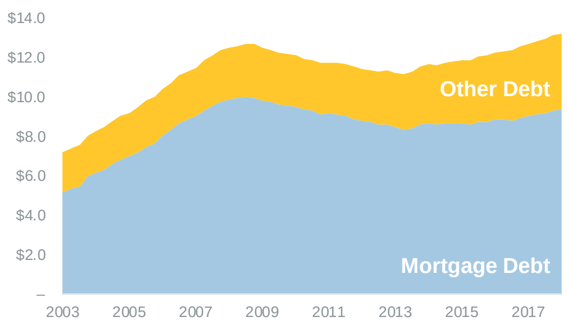
Average Hourly Wages



- The unemployment rate continues to improve, today sitting below 4.0%, which represents the lowest level since 2000
- Despite the strong economy and low unemployment rate, wages have seen lackluster growth during the recovery, confounding many economists given the low unemployment rate. Some theories on this stagnation include (i) the unemployment rate is not reflecting the true slack in the labor markets, (ii) a changing workforce demographic of older workers to younger workers, and lastly (iii) the advent of the Uber-economy of flexible work schedule may be holding down wages for the formal economy

Grade: B

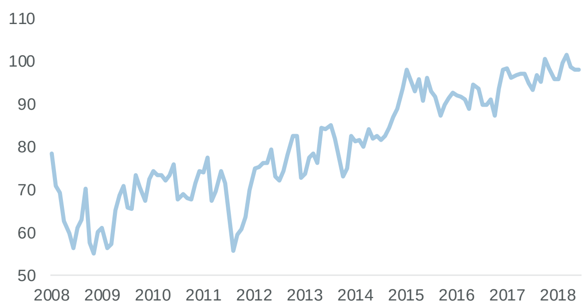
Consumer Debt



- Consumer Debt, (ex mortgages and other home loans), rose 5.5% during 2017, the highest amount since the Federal Reserve Bank of New York began tracking the data in 1999
  - This rising debt environment reflects consumers comfort in borrowing but also banks willingness to lend
- Student loan debt, now the second highest consumer debt category after mortgage debt, has reached $1.52 trillion and has a 10.7% delinquency rate, which has remained persistently high since the Great Recession
- Mortgage debt barely edged up in 2017 and remains well off the crisis-era highs as a percent of U.S. economic output

Grade: C

Consumer Sentiment



- Consumer sentiment has continued its upward trend since recent lows in 2011; driven higher by improving job market and economic conditions
- Consumers expect unemployment to edge lower and wages to improve
- However, ~1 in 4 respondents to the University of Michigan's June survey cited the impact of tariffs on their outlook, with the vast majority of those believing that slower growth and inflation are likely outcomes
- Economist are split on whether Consumer Sentiment is a leading or lagging indicator, but we view their optimism as positive

Grade: A

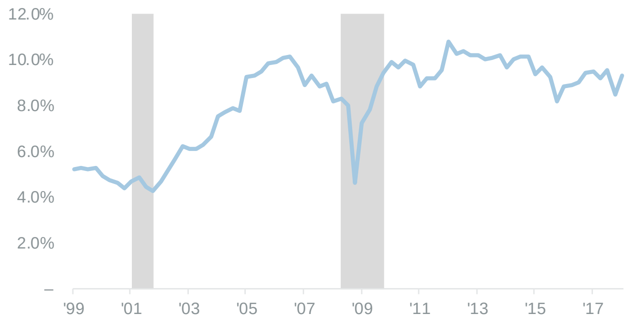
Financial Report Card of the U.S. Economy

B+

U.S. corporate financial report card

Indicator and Commentary | **Grade**

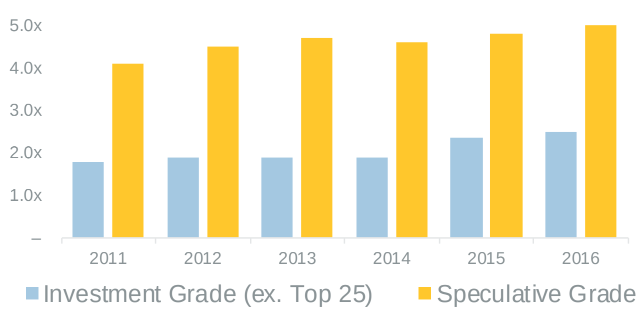
Corporate Profit Margins



- Corporate earnings posted a 16% increase in Q1 2018, the largest increase since Q1 2011, supported by the Tax Cuts and Jobs Act of 2017, which boosted profits through reduced corporate taxation
    - It could take several quarters for clear trends to emerge from the tax-associated noise as the law created incentives to shift earnings and expenses between periods, among other effects
- Profit margins have been somewhat strained since 2012, as some executives have cited increased pressure on margins from rising costs for labor, raw materials and transportation as a result of generally strong economic conditions

Grade: B

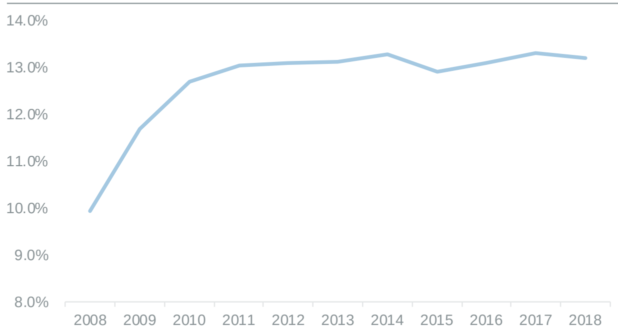
Net Debt to EBITDA Ratio



- Corporate debt (excluding financial institutions) has reached $11 trillion globally, and the median leverage at investment grade corporates has jumped 30% since pre-crises levels in 2007
- Demand for corporate loans has shown no sign of slowing, even amid increased volatility. A major contributor to loan market is collateralized loan obligations (CLOs), which have raised $66 billion year-to-date and account for nearly 60% of the leveraged loan market
- At these record debt levels, refinance risk is increasingly a concern in a rising interest rate environment and in later stages of the economic cycle

Grade: B

U.S. Banks Tier-1 Capital Ratio



- U.S. banks have put in significant effort to be compliant with Basel III, a set of regulations imposed in late-2009 that require banks to maintain proper leverage ratios and minimum capital requirements
- Basel III states that U.S. banks must have a minimum 10.5% tier-1 capital ratio, and most U.S. banks far exceed this figure
- Now that most are compliant, we expect firms to increase payment to shareholders through increases in dividends and share repurchases

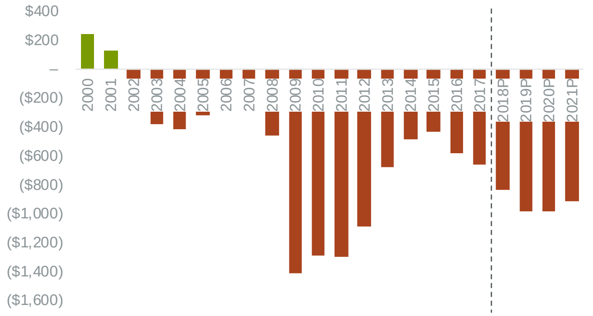
Grade: A

Financial Report Card of the U.S. Economy

Government report card

Indicator and Commentary	Grade

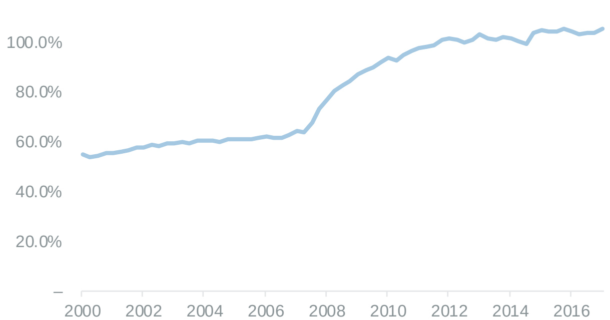
Deficit / Surplus



- The U.S. budget deficit for fiscal year 2018 is expected reach $804 billion, and is projected to surpass $1 trillion by 2020
- The deficit that the CBO now estimates for 2018 is $242 billion larger than its previous projection for the year, driven by lower collections of individual and corporate income taxes as a result of the 2017 tax act
- Through 2027, the CBO now projects a cumulative deficit that is $1.6 trillion larger than the $10.1 trillion that the agency anticipated in June 2017. Projected revenues are lower by $1.1 trillion, while projected outlays are higher by $0.5 trillion

Grade: C

Debt / GDP



- The debt to GDP ratio is expected to continue its upward trend, reaching 107% by the end of 2018
- According to the IMF, the U.S. is the only developed country that is currently increasing federal deficits and its debt-to-GDP ratio
- Increasing government borrowing via tax cuts and omnibus spending bills, while not taking action on entitlement spending during a period of favorable economic conditions is unprecedented in the U.S.
- The current debt/GDP ratio does not pose any immediate threats, but the trend does create concerns amid future recessions

Grade: C

Foreign Trade

- President Trump first announced plans to impose tariffs in March of this year, initially targeting Chinese steel and aluminum
- The trade wars have expanded to include agriculture and other industrial sectors from traditional allies, including Europe and Canada
- Tariff impacts have begun to hit companies, as news of job cuts (Mid Continent Nail Corp.) and moving production overseas (Harley Davidson) have been well covered. What remains to be seen is when and how significantly the impacts are felt by corporates and consumers

Grade: TBD

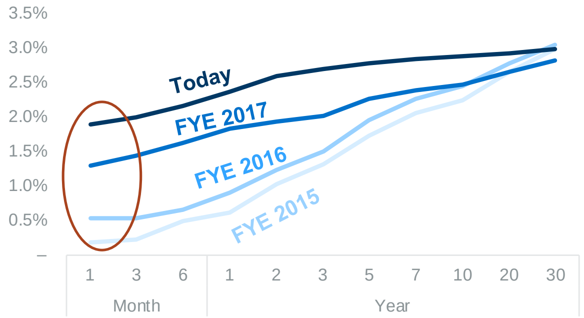
Financial Report Card of the U.S. Economy

Federal Reserve report card

B

Indicator and Commentary | Grade

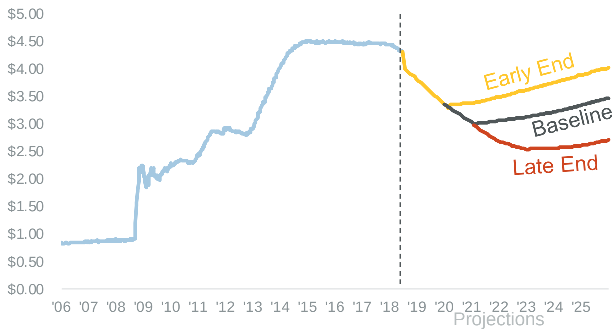
Interest Rate Policy & Yield Curve



- Jerome Powell, the new Federal Reserve Chairman, began his oversight in February 2018
- In June, the Federal Reserve raised the Fed Funds Rate to a target range of 1.75-2.00%
- The yield curve flattened during 2018, as the gap between 2-yr and 10-yr U.S. Treasuries is roughly 0.34%. It last saw these levels in 2007
  - o Higher short-term rates make adjustable-rate loans more expensive & lower long-term rates eat into the profitability of banks, which tends to lead to lending restraint & often why analysts consider a flat yield curve a recession indicator

Grade: C

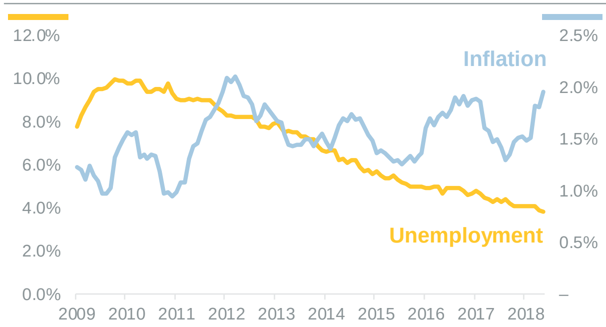
Deleveraging the Fed Balance Sheet



- From the start of quantitative easing to its conclusion in Oct '14, the Fed balance sheet increased from less than $900bn to around $4.3T (around $2.5T in Treasuries and $1.8T in mortgage-related securities)
  - o The Fed's asset purchases were controversial when it undertook them. They were meant to drive down long-term interest rates and drive up asset prices
- In Oct '17, the Fed stopped reinvesting all of its proceeds from maturing assets and started a contraction of the balance sheet
  - o The Fed has managed to put the program in reverse without creating much turbulence in markets, but the pace and magnitude of further B/S reduction has yet to be seen in the market

Grade: B

Dual Mandate



- The Fed's mandate includes two primary goals (i) foster maximum employment and (i) maintain price stability. As indicated by the chart at the left, the policies of the Fed over the past decade have contributed to the sustained recovery of the U.S. economy
- Inflation, as measured by Personal Consumption Expenditures (ex-food and energy) has fallen slightly under the targeted 2.0% rate
- Unemployment has consistently decreased during the post-Financial Crisis recovery. At 4.0%, it appears that we are approaching full employment

Grade: A

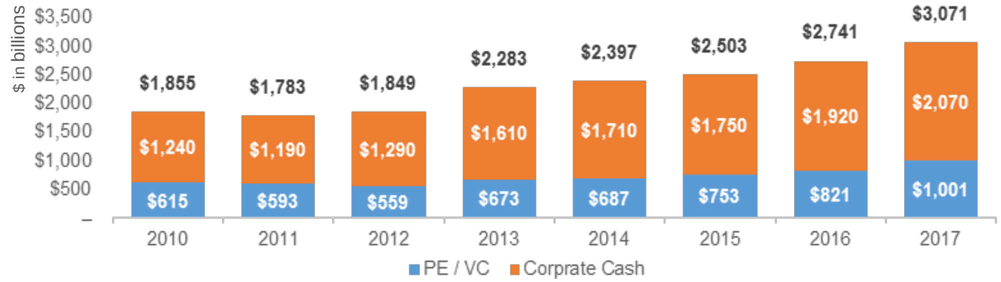
Current M&A Environment

Cause

PE / VC Dry Powder & Corporate Cash [1]

– Over $2 trillion of cash is on U.S. corporations balance sheets and private investment firms are waiting to deploy $1 trillion of capital, for a record $3.0 trillion combined

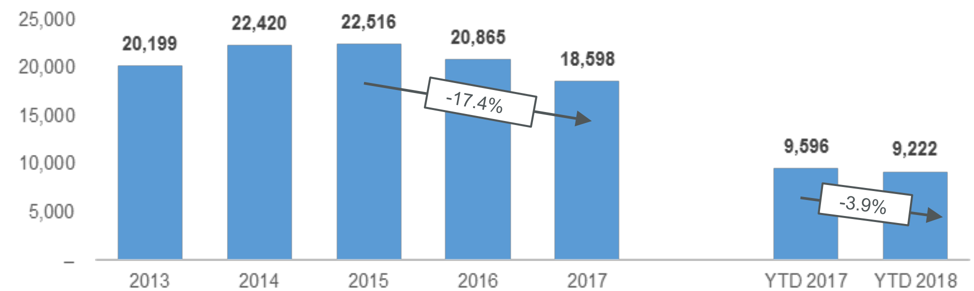
– Record amounts of dry powder – with nearly 15% coming from funds with vintages prior to 2014 – chasing decreasing deal volume may lead to a compression of returns for PE/VC



North American M&A Transaction Volume [2]

– Overall, deal volume has exhibited a decreasing trend after peaking in 2015. From this high water mark, deal volume was down more than 17% through the end of 2017

– This trend has continued into 2018, as both Q1 and Q2 saw deal volume decrease by nearly 4% from 2017 levels

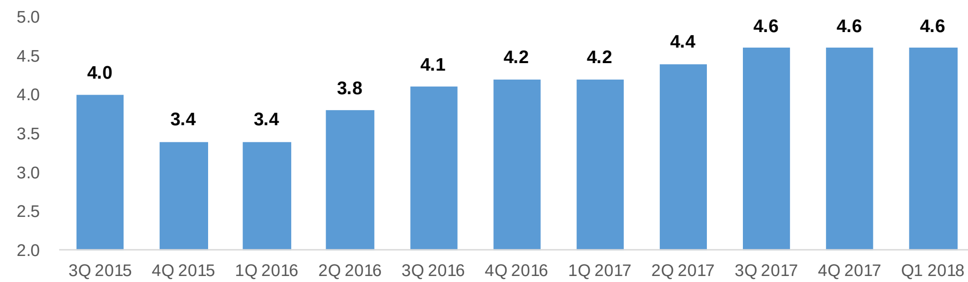


Leveraged Lending Environment (1-5 Scale) [3]

– William Blair's 1Q lender survey reported lenders providing looser terms, more leverage, and lower pricing in the latest quarter

– Lenders reported total leverage of 5.9x for middle market leveraged financing packages over the observed period

– 96% of lenders expect the next year to continue to be more borrower friendly than lender friendly



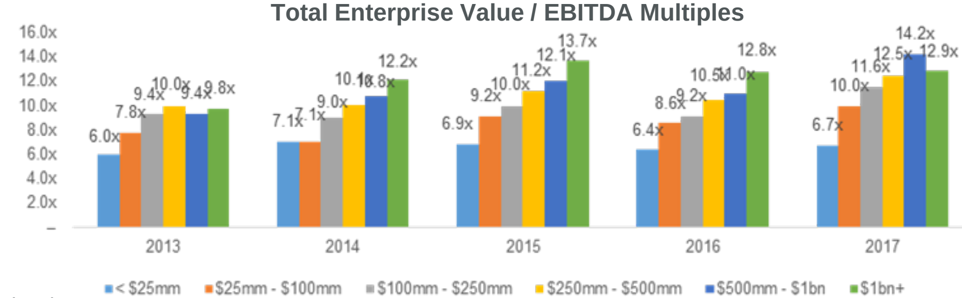
Effect

M&A Transaction Multiples [4]

– The aggressive lending environment and well capitalized acquirers have both contributed to the increase in valuation multiples since 2013

– Acquirers are placing a premium on size, however we see acquirers moving down market which should pressure multiples higher in the lower middle market

Total Enterprise Value / EBITDA Multiples



Footnotes

1. S&P Global Ratings, Preqin
2. S&P Capital IQ
3. William Blair
4. S&P Capital IQ (excludes empty values)

Gleason Advisors 2018 Expectations

	JANUARY 2018 PREDICTION		Actual YTD Results
Item	**2018 Trend**	**Commentary**	
GDP		We believe Tax Reform will lead to consumer and business confidence that will spur spending and investment and drive economic expansion. Our expectation is 3.0%+ for the year, barring weather, political or other unforeseen events.	+2.3% thru 1Q 2018
Short-Term Interest Rates		The new Fed will continue rate hikes to keep pace with economic growth. We expect short-term rates in the 2.0-2.5% range by the end of 2018.	1.75 – 2.00% as of 6/14
Long-Term Interest Rates		Irrespective of the increase in short term rates, we expect long term yields to stay relatively unchanged, resulting in a flattening of the yield curve. We expect the 20-Year Treasury Rate to finish the year at no greater than 3.0%.	20-yr 2.87% as of 7/13
U.S. Stock Market		We don't expect the U.S. stock market to see gains similar to 2017. We believe the Nasdaq will lead the major indices at a 10% increase. Increasing rates, and an exogenous event will cause investors to have pause on valuation.	+11.4% Nasdaq thru 7/17
M&A Market		The large amount of dry powder will counteract the limited availability of investment opportunities. Valuation multiples will remain high but M&A transaction volume will continue to decline. Venture Capital outperforms M&A.	(3.9%) thru 2Q 2018
Capital Expenditures		The new tax plan has a strong incentivize for corporates to invest in capex. That said, we believe corporates will use their cash coffers with a balance between share buybacks & capital investment.	+39% capex +$800bn - est ytd 2018
International Tensions		2018 will have the same players continue to put stability at risk. North Korea threatening with its nuclear arsenal, uprisings in Iran, and the stance of Russia & China will create on-going, but manageable challenges in 2018.	n/a
Disruptive Technology		Artificial intelligence and blockchain technology have become household terms and will continue to see greater adoption and use cases in 2018.	n/a

GLEASON ADVISORS

Gleason Advisors Service Offering

Gleason Advisors provides strategic & financial advisory services to middle market companies through the following offerings

Investment Banking*

Sell-Side

- Run the marketing process for the sale of a business
- Approximate financial criteria
  - Revenue: $5 - $150 million
  - EBITDA: $2 – $10 million
- Industry Agnostic

Buy-Side

- Investment thesis origination
- Prospective target outreach
- Arrange acquisition financing
- No size criteria for target

Capital Raise

- Growth Equity
- Venture Capital
- Business plan development

Strategic Consulting

Business Valuation

- Auction value expectations, along with textbook valuations (DCF, precedent transactions, etc.)
- Intellectual Property valuations
- 409A Valuations
- Estate and Gift Valuations

Strategic Financial Advisory

- Financial modeling
- Unit level product economics and detailed customer analysis
- Debt capacity and lending covenant analysis
- Exit planning strategy and timeline
- Profit improvement strategy
- Cap table management

Restructuring

Out-of-Court Services

- Operational assessments
- Refinancings, asset sales, capital infusions
- Liquidity management
- Valuation (liquidation, asset sale, auction)
- Litigation support and expert testimony

Bankruptcy

- Run §363 sales
- Court appointed trustee / receiver
- Prepackaged Chapter 11 plans
- Arrange DIP financing

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