QUARTER 4 2016

RSM QUARTERLY SPOTLIGHT

BUSINESS PRODUCTS AND SERVICES

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PERSPECTIVES ON THE REAL ECONOMY

By Joe Brusuelas, RSM Chief Economist

The upset presidential election victory of Donald J. Trump and the Republican hold of the House of Representatives and the Senate signal major changes ahead in both the federal government's approach to growth and the Federal Reserve's approach to monetary policy. Most evident will be a return of supply-side tax cuts, large operating fiscal deficits, and a move back toward more traditional monetary policies that, over time, should lead to higher short- and long-term interest rates.

Below we outline our views on the implications of a Trump presidency for economic growth and trade, in particular, with other issues considered at greater length online.

Economic growth

We anticipate that the Trump administration will attempt to achieve the economic equivalence of a strategic breakout with respect to the pace of economic growth. It will also seek significant reform of Dodd-Frank, which would be a boost for Wall Street, and move to inject private competition into the health care system. Because the GOP does not have veto-proof majority, the reform of regulation governing finance and health care will be quite challenging and difficult to obtain.

While there will likely be a faster pace of growth in the near term, uncertainty about the role and status of the United States in the global economy may combine to create longer-term issues that, ironically, act as a drag on growth.

Trade

In our estimation, the Trans-Pacific Partnership (TPP) represents a once-in-a-lifetime opportunity for the middle market to be given preference in a multilateral trade treaty. It would not be any surprise if the TPP quickly becomes the last major policy debate of the outgoing Obama administration. Given the outcome of the election, the upcoming lame-duck session of Congress represents likely the last opportunity for a number of years to pass multilateral trade policies that decisively favor the middle market.

It is here where the greatest risks lie. It is quite clear that Trump intends to slow down the pace of economic integration between the U.S. and its trade partners. More than half of all U.S. trade is with its North American partners, and is an important source of growth in the economy. To the extent that Trump either intends to, or can, renegotiate portions of NAFTA will define what appears to be neomercantilist policies that the new administration may adopt.

Because of the relative lack of substantial policy preferences set out by the Trump campaign, at the current time, it's difficult to quantify the overall economic impact from what policies do emerge. It is safe to say that it is best to avoid starting trade wars, which are always popular at the outset but end up harming everyone over the long term.

For consideration of the implications of a Trump presidency on taxes, infrastructure, central bank policy and interest rates, click here.

OTHER RESOURCES

The Real Economy

A monthly publication to help the middle market anticipate and address the unique issues and challenges facing their businesses and the industries in which they operate. We also release a Global Edition on a semi-annual basis that addresses issues affecting business on a global scale. Read more.

B2B AT A GLANCE

Stagnancy in the forecast

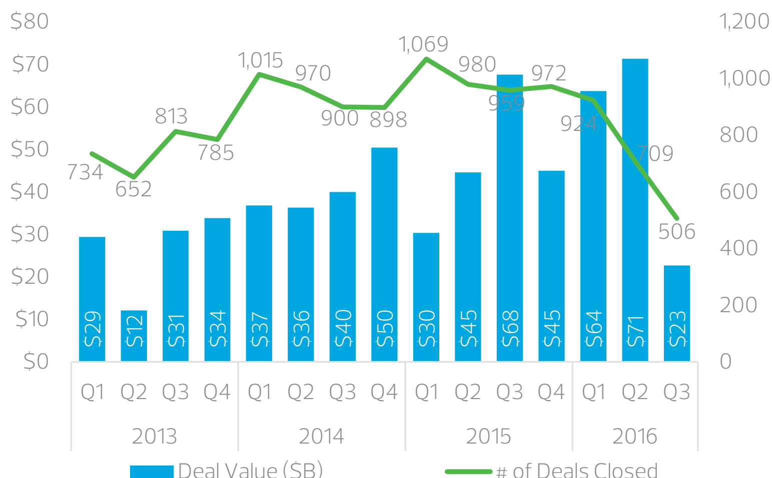
As an industry that moves in close proximity with the global economy, the outlook for the business products and services (B2B) industry remains steady. The world has seen a plethora of political and economic changes that have certainly stoked uncertainty, and while for some industries, such as health care, those changes can introduce a more dramatic shift in how businesses operate, the B2B space continues to see the same underlying factors drive it.

"For the most part, steady as she goes," is how Joe Brusuelas, chief economist at RSM US LLP, sees the global economy. According to Brusuelas, GDP is poised to continue growing at a 1 to 2 percent pace, and while unemployment has remained low, the United States has continued to hire at nearly double the rate that would fill business needs, and that figure is expected to stabilize towards approximately 80,000 per month soon. In terms of inflation, the expectation is to reach near 2 percent, yet that has long been the goal and price levels have also remained constant. The above economic indicators paint a new-normal of slow growth and while the outlook isn't completely negative for the B2B sector, management teams are certainly moving forward with caution.

According to RSM US LLP's middle-market business index (MMBI), hiring, revenue and earnings statistics came in relatively unchanged last quarter relative to the second quarter of the year, and when looking at B2B companies, the same can be said. "Wages will continue to rise," states Mark Gaines, a partner in RSM US LLP's business products and services group practice. "The big question is whether or not revenues can rise to offset the increase in wages," he continues. With inflation set to remain low, Gaines expects that companies will face problems increasing top-lines and as a result, many businesses will see squeezes on their margins and operating results. According to Brusuelas, however, there is a silver lining to the wage increase we've continued to see in B2B. In anticipation, many firms have moved early to increase pay for lower-waged workers, which should theoretically help form a more positive outlook for spending as we move into the holiday season, yet as that trend will help boost the general economy, B2B businesses may not benefit to the same extent that consumer companies and retailers should.

One item we've long maintained has been the ability of U.S. middle-market businesses to remain sheltered to an extent from foreign policy and currency shocks. While that framework continues to hold, tepid domestic growth, coupled with the uncertain policy risks associated with the most-recent U.S. presidential election have dampened both M&A activity and business investment plans. "Businesses are cautious today about capital investment and people investment," states Michael Fanelli, a partner with RSM US LLP's transaction advisory services practice. Further, the most-recent MMBI measure also corroborated this, seeing a noticeable increase in the percentage of respondents that reported they expect to see a significant decrease in capex investments over the next six months; a trend that for many larger firms ($50 million to $1 billion in revenues), will in large part be achieved via hiring and compensation cuts.

B2B M&A deal flow by quarter



Source: PitchBook

Moving forward, organic revenue growth will likely remain stagnant. While foreign shocks haven't posed an outsized threat on the revenues of domestic B2B companies, the continued uncertainty around foreign policy and currency volatility makes it difficult for business who might be looking to expand their reach abroad. Gaines points to a need for companies to thoroughly examine the sources of their revenues today. Finding new domestic channels to sell into will certainly help businesses outperform the global economic growth rate the industry is linked to, yet managing cost structures and vendor prices, in addition to simply relying on any headcount or capex freezes will help noticeably boost margins and overall performance. Lastly, back-end technology can also be a significant driver of cost savings, yet cybersecurity has recently become a heightened concern for management teams, especially across many B2B information and data providers. The costs associated with recouping the damages from any cyberattack would be material for many middle-market businesses and thus, working such expenses into capex budgets should also be thoroughly considered in an effort to mitigate future expenses.

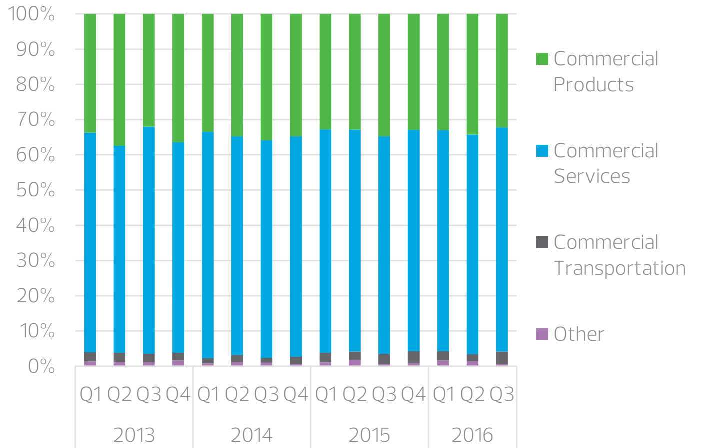
M&A DEAL FLOW

Quality remains an issue

Through the third quarter of the year, just shy of $158 billion was invested across 2,139 completed M&A transactions, reflecting a solid 10.7 percent increase in total transaction value over the same period last year, yet a rather pronounced 29 percent decline in deal volume. With a common strategic acquirer profile that today encompasses ample cash to put to work and stagnating top- and bottom-line growth, there has been a series of blockbuster transactions that have skewed capital invested figures up as corporations look to acquire immediate growth, yet across the entire market, activity thus far into 2016 has not come in at the levels we saw over the previous two years. On a quarterly basis, both transaction value and volume plunged in Q3; $23 billion was invested across 506 completed deals last quarter, amounting to quarter-over-quarter declines of 68 percent and 29 percent, respectively. Taken into account major global events such as BREXIT or the surprising U.S. presidential election, dealmakers have understandably exercised a bit of patience. "People are being very cautious," states Fanelli. "They hear the pundits saying that a recession may be looming. We're in an election cycle, and people have no idea what's going to happen post-election and so, on the corporate-to-corporate side, people are being cautious and just working on their core business operations," he explains.

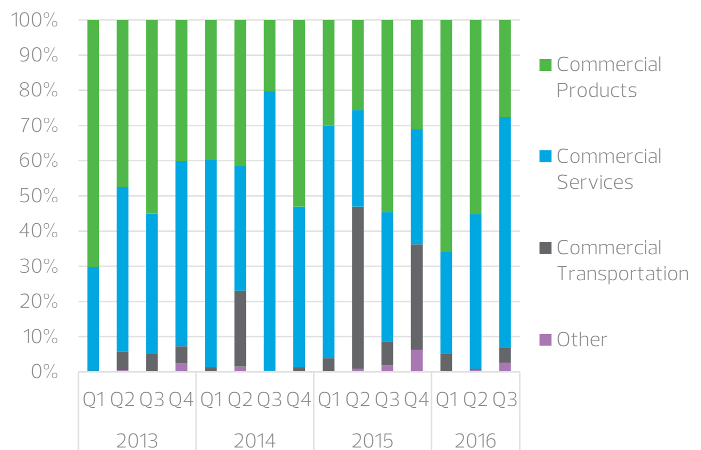
Regardless of fallen activity, valuations have continued to remain extremely strong. The median valuation-to-EBITDA multiple for B2B transactions three quarters into 2016 sits at 10.5x, more than a whole turn higher than what we saw in 2015. One caveat, however, has been the percentage of debt being utilized. The median debt percentage used by M&A dealmakers in 2016 came in at just 46 percent, a rather notable decline relative to the 60 percent figure we saw last year. With the quantity of active buyers continuing to outnumber sellers in the current market, multiples appear set to stagnate at their inflated state, yet the considerable drop in debt percentages speaks to a more conservative transaction structure being utilized. Should performance fluctuate for any number of reasons in the near future, carrying a conservative debt load will certainly help companies manage interest payments accordingly.

M&A transactions (count) by sector



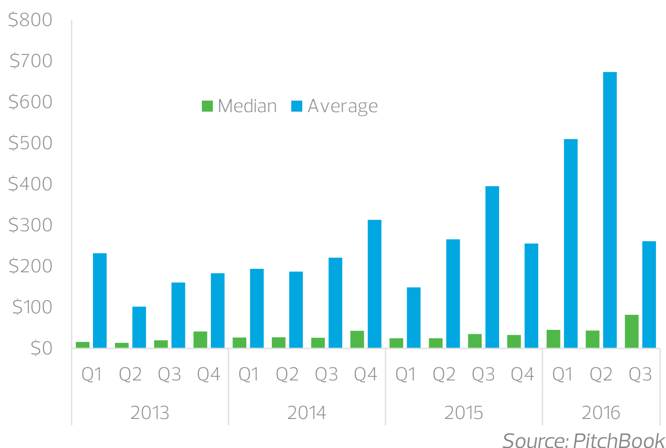
Source: PitchBook

M&A transactions ($B) by sector



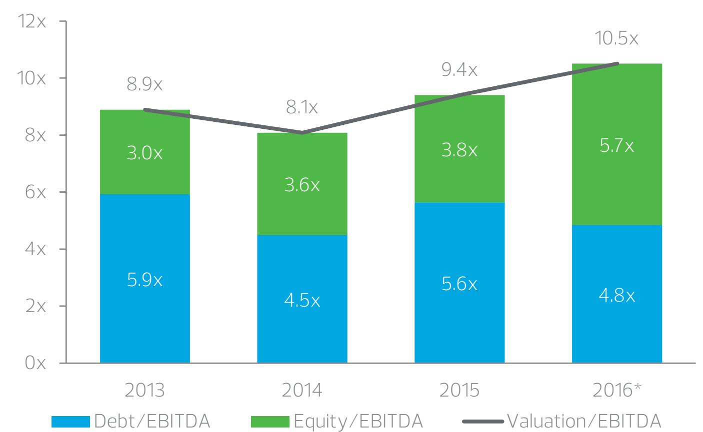
Source: PitchBook

Average and median M&A deal size ($M)



Source: PitchBook

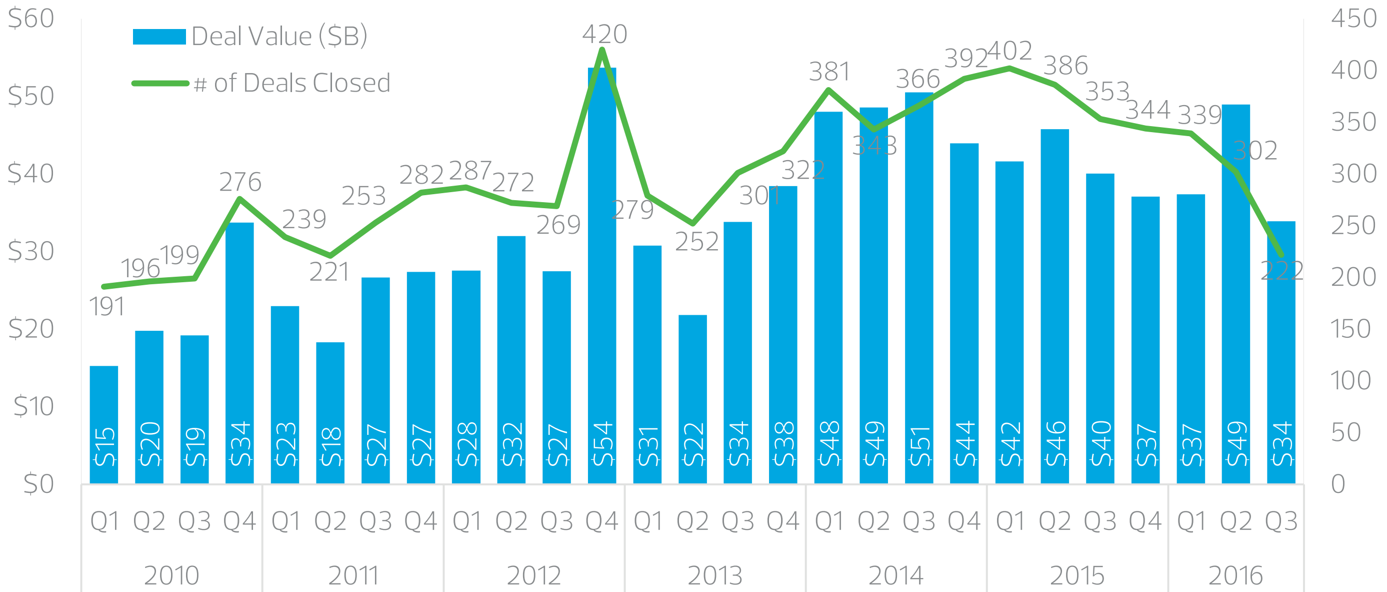
Deal multiples



*Source: PitchBook. *As of 9/30/16*

PRIVATE EQUITY DEAL FLOW

B2B private equity deal flow by quarter



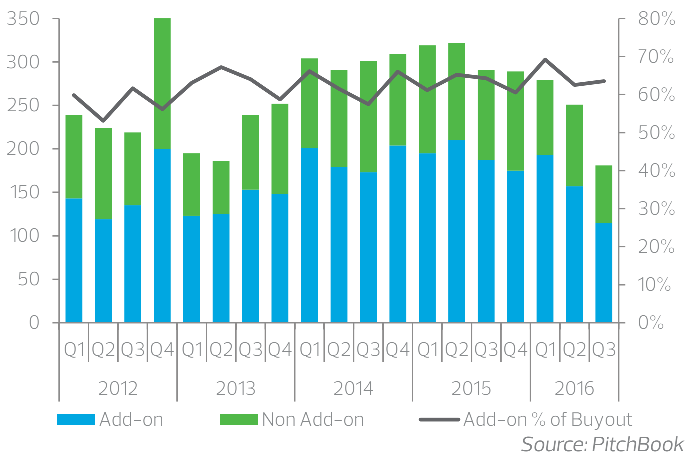
Source: PitchBook. Note: Deal values are extrapolated.

Demonstrating value to compete

B2B private equity (PE) activity continues to decline, recording 222 completed transactions in the third quarter of 2016 for a combined value of $33.9 billion. Even if tallies are revised upward once final data is aggregated, those figures represent a decline of 15.4 percent in value and 37.1 percent in activity. As suggested by the relatively robust deal value total even as activity declines, prices remain high; hence the continued prevalence of add-ons with PE buyers leveraging down their EBITDA multiples as part of their add-on acquisition strategy on top of typical operational EBITDA margin enhancement.

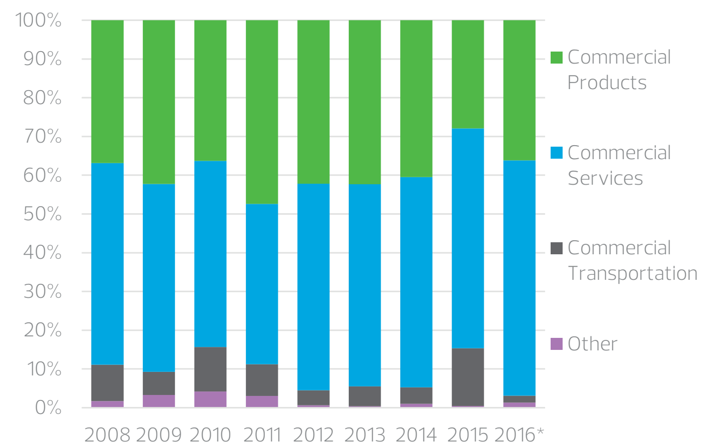
"There are not enough quality middle-market businesses out there in the marketplace for the level of capital that is looking to be invested," says Fanelli. "So they are trying to show that they can bring something else to the table other than financial backing." According to Fanelli, examples of PE firms demonstrating value-add include bringing in new C-level executives, new selling or distribution channels, newer vendors, and volume purchasing discounts. PE firms currently hunting for deals are engaging in those and other strategies in order to secure better opportunities, all the while assessing whether the market has permanently changed or not. "The PE firms that are thinking this may be the new normal and they can guide down their return levels are the ones paying high multiples and still cutting deals," says Milton Marcotte, practice leader at RSM US LLP's transaction advisory services. "Many think this isn't a new normal and accordingly are not getting many deals done."

B2B add-on activity



Source: PitchBook

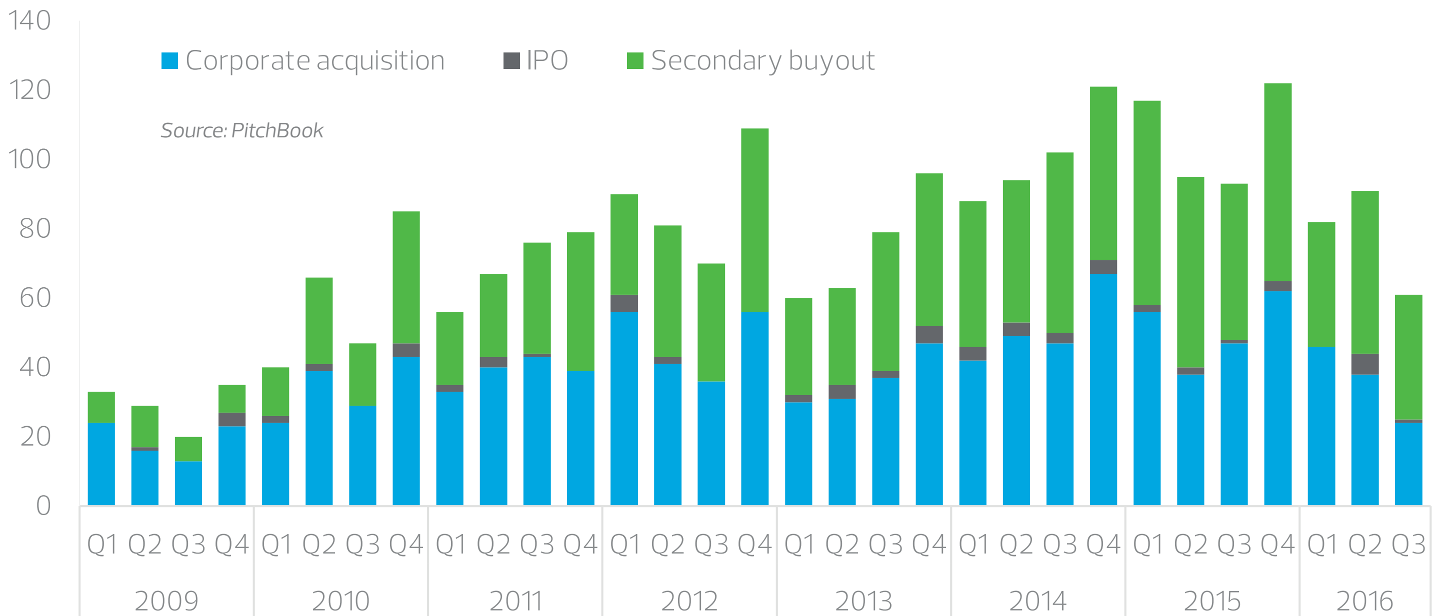
B2B private equity deals ($) by sector



*Source: PitchBook. *As of 9/30/16*

PRIVATE EQUITY EXIT ACTIVITY

B2B private equity exits by quarter



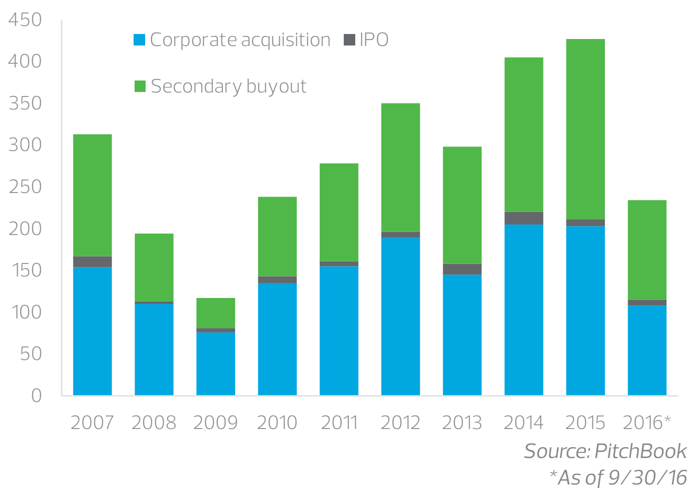
Waiting for the opportune moment

The primary narrative from 2014 through 2015 was that PE sellers were clearly taking advantage of an exit market rife with opportunities. "Many deals closed last year that were from pre-recession investments," says Fanelli. "Even post-recession investments that were held for only two to three years were sold because their owners knew they'd be able to realize the returns they were seeking."

However, that exiting cycle has slowly wound down over the past several quarters, with the third quarter of 2016 recording the fewest completed PE-backed sales since the comparable period in 2013.

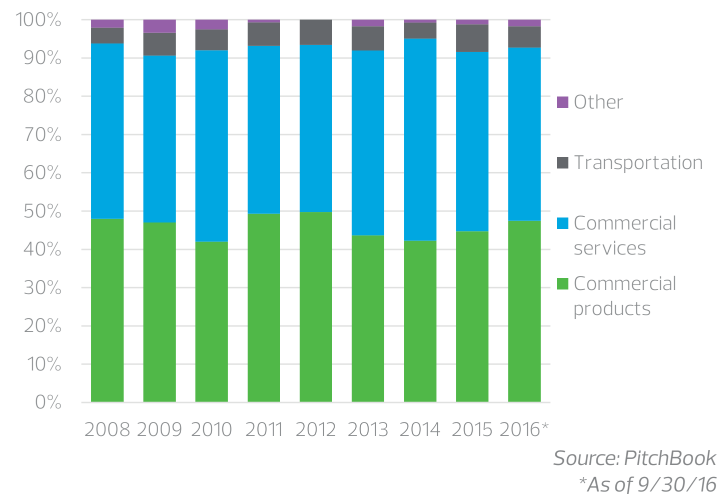
"We are getting to the stage where PE firms have a couple of assets they might be willing to sell," Fanelli states, "but really only for the right price and buyer. So they are not running broad processes yet." Fanelli says that interest definitely remains intact, but PE firms are not willing to simply stretch their asking prices in the current market, as whatever uncertainties there are in the overall exit and economic cycles are not yet serious enough to justify selling too early. "They are willing to keep investing in improvements to the business," says Fanelli. "They think there's more room to grow even in this uncertain environment." Accordingly, this current downturn in selling should not be overinterpreted as a sign of forthcoming trouble but more the natural slowing of a highly active cycle and timing on the part of owners for optimal exit conditions.

B2B private equity exits (count) by year



Source: PitchBook
*As of 9/30/16

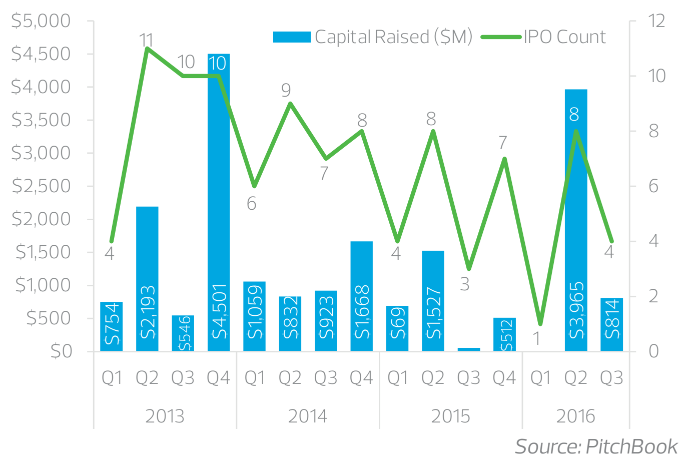
B2B private equity exits (count) by sector



Source: PitchBook
*As of 9/30/16

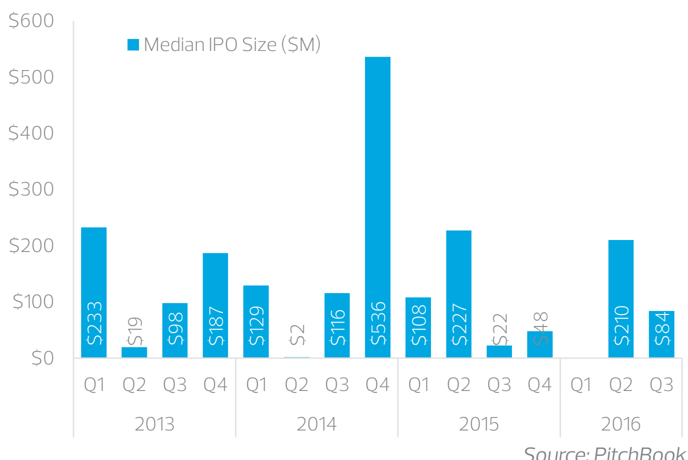
IPO ACTIVITY

IPOs in the B2B industry



Source: PitchBook

Median IPO size ($M)

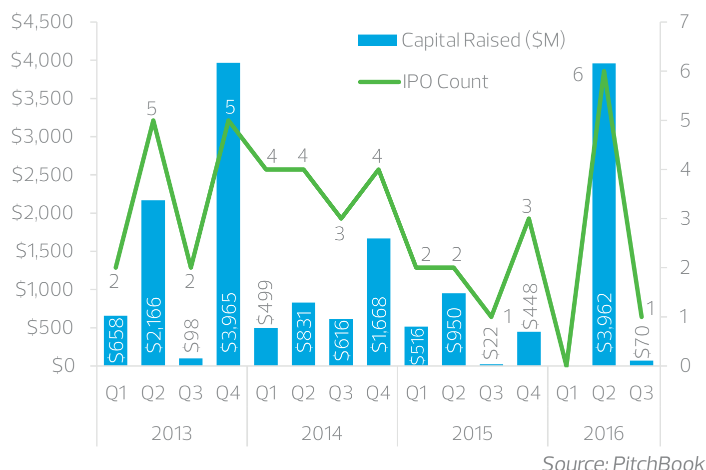


Source: PitchBook

Set for a slow year overall

"There's seldom a time when PE firms are doing as many deals as they'd like," says Fanelli. "It's an even more popular asset class now, so there is that much more capital available." Furthermore, as PE managers continue to raise successive funds, they often scale up in size, which can result in average equity investment sizes moving up as well, enabling PE buyers to stay competitive in even a high-priced environment. Consequently, as corporate M&A has declined in tandem with PE activity, the latter has remained relatively more resilient. "Top-line revenue growth has been slow," says Fanelli, "People are cautious about capital and talent investment, and even if there is plenty of cash on corporate balance sheets to be able to invest in mergers for synergy or growth, many are staying cautious and working on core business operations." But PE firms have mandates to meet, and though they won't keep cutting checks just to fulfill those mandates, they are likely to source more widely and keep making deals even during an overall lull in M&A in order to keep putting capital to work if they can justify how much they may have to spend.

PE-backed IPOs



Source: PitchBook

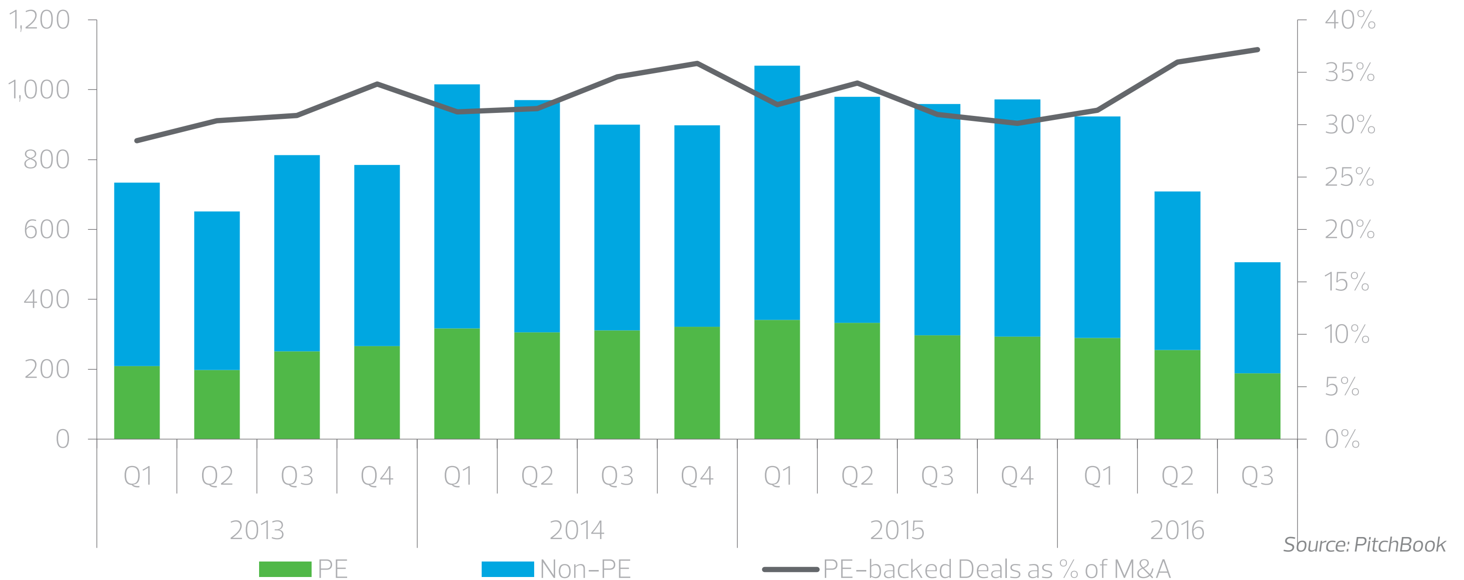
B2B IPO PIPELINE

Company name	Sponsor(s)	Sector	Amount ($M)
PSAV	Olympus Partners, Goldman Sachs Alternative Investments, FS Investment II	Media & Information Services	$177.4
REV Group	American Industrial Partners	Road	$100
JELD-WEN	Onex	Building Products	$100

Source: PitchBook

PUBLIC-TO-PRIVATE ACTIVITY

Private equity as % of overall M&A activity

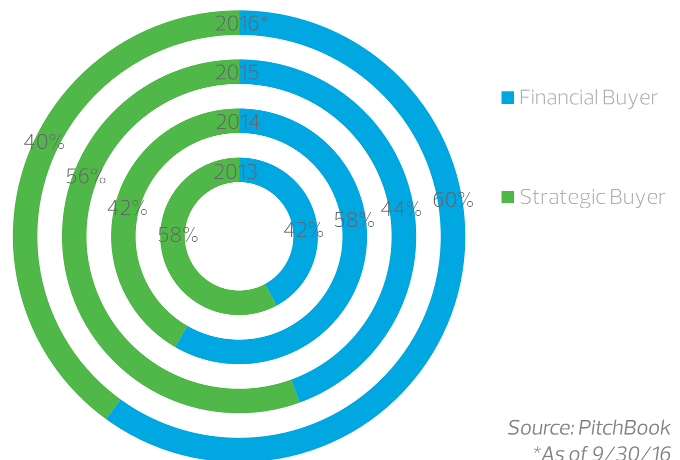


Source: PitchBook

PE remains relatively more active

"There's seldom a time when PE firms are doing as many deals as they'd like," says Fanelli. "It's an even more popular asset class now, so there is that much more capital available." Furthermore, as PE managers continue to raise successive funds, they often scale up in size, which can result in average equity investment sizes moving up as well, enabling PE buyers to stay competitive in even a high-priced environment. Consequently, as corporate M&A has declined in tandem with PE activity, the latter has remained relatively more resilient. "Top-line revenue growth has been slow," says Fanelli, "People are cautious about capital and talent investment, and even if there is plenty of cash on corporate balance sheets to be able to invest in mergers for synergy or growth, many are staying cautious and working on core business operations." But PE firms have mandates to meet and though they won't keep cutting checks just to fulfill those mandates, they are likelier to source more widely and keep making deals even during an overall lull in M&A in order to keep putting capital to work if they can justify how much they may have to spend.

Public-to-private deals (#) by acquirer type



Source: PitchBook
*As of 9/30/16

SELECT B2B Q3 2016 M&A/PE TRANSACTIONS

Company name	Buyer	Sector	Amount ($M)
Epiq Systems	Document Technologies	Legal Services	$1,000
Multi Fineline Electronix	Suzhou Dongshan Precision Manufacturing	Electrical Equipment	$610
Wyle	KBR	Government	$600
Electro Rent	Platinum Equity	Commercial Services	$382.2

Source: PitchBook

INSIGHTS YOU CAN USE

New debt-equity regulations provide favorable treatment to many private equity investments

In April 2016, the Treasury proposed broad and controversial debt-equity regulations designed to limit erosion of the United States corporate tax base. The final and temporary regulations issued Oct. 13, 2016, significantly improve upon the proposed regulations and place the focus squarely on certain areas in which the Treasury and the Internal Revenue Service (IRS) have viewed issuance of related party debt as inappropriate or abusive.

Under new regulations many related party debts issued by US C corporations could be characterized as equity, thereby eliminating the tax shield provided by interest deduction on the recharacterized debt. In general, the regulations apply only to debt issued by US C corporations, so most debt issued by flow through portfolio investments would be exempt from equity recharacterization.

In addition, only debt issued to another corporation (and certain controlled partnerships) is subject to characterization, so debt issued to a private equity (PE) fund or related entity that is a partnership for tax purposes is also exempt. Another PE-favorable position exempts debt issued amongst commonly controlled US corporations where the common control is held through a partnership or other non-corporate entity.

As a result, a large number of small and midsized portfolio investments will be exempt from the rules, which is a favorable outcome. However, where the portfolio investment is a multinational group with multiple corporate entities and related party debt, the new regulations are likely to require consideration.

As always, the regulations include a number of exceptions to every rule, so consult your tax advisor to determine if and how the new rules will impact your investments.

Read more on the new debt-equity regulations and how they may impact your investments.

Top accounting due diligence observations for business and professional services

1. Revenue recognition, especially related to target companies that derive the majority of revenue from large or lengthy projects, including project estimation, deferred revenue and customer deposits. Also, sales of bundled service packages that include multiple element arrangements. Important to differentiate whether these arrangements include software as a service, common in certain consulting businesses recently, such as Salesforce.com or other customer relationship management (CRM) systems, to determine if SOP 97-2 guidance is applicable, or alternatively, if they simply fall under a subscription revenue model, and would fall under ASU 2009-13. Important to be able to determine if a value can be assigned to any of the individual services provided to clients or software.
2. Partner and owner compensation (historical versus future and valuation or cash requirements of the business), including types of compensation, such as salary versus dividends.
3. W-2 vs. 1099 employee function and reporting.
4. Employee utilization analysis and net realization by employee.
5. Employee turnover and ability to hire and retain qualified professionals. Treatment of severance and establishing "normal business" levels of severance payments when company operates a semi variable staffing model.

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The value of RSM's middle-market leadership

Focusing on the middle market, RSM US provides integrated transaction advisory, tax, assurance and consulting services. Our work with 500 middle-market technology companies gives us a deep understanding of the key trends impacting the industry. In addition, we have performed due diligence on more than 1,700 deals in the past five years, over 200 of which were technology transactions. This in-depth knowledge provides our private equity and strategic buyer clients with industry-specific due diligence considerations.

The following list shows a detailed breakdown of the PitchBook industry codes for the B2B industry.

1. BUSINESS PRODUCTS AND SERVICES (B2B)

1.1 Commercial products

1.2 Commercial services

1.3 Transportation

1.4 Other business products and services

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