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THE B2B PRICE & PROFIT EXPERTS

B2B Dealmaking Dynamics

A review of key trends in PE dealmaking across the B2B landscape

Data provided by PitchBook

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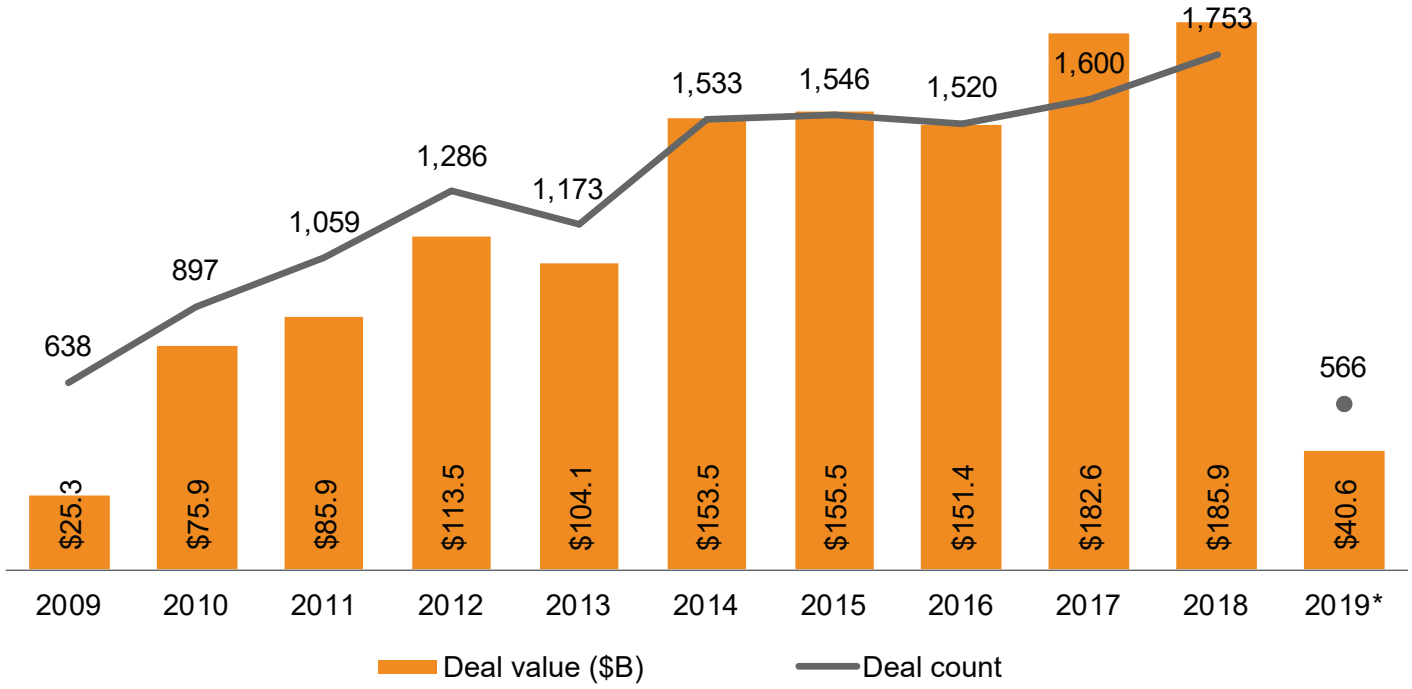
Dealmaking

US PE B2B deal activity

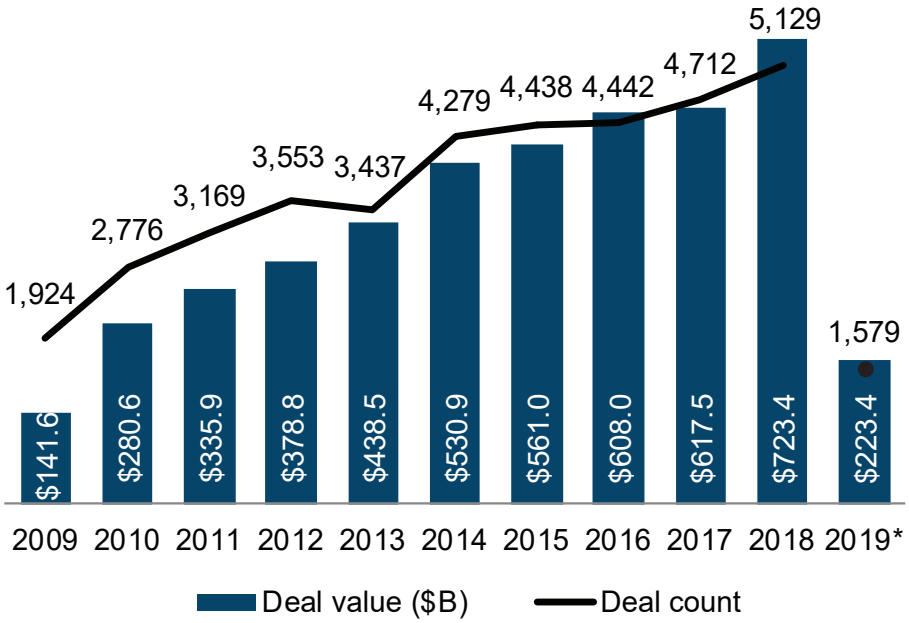


Source: PitchBook
*As of June 7, 2019

The volume of private equity (PE) dealmaking in the US has never been higher. More than 5,000 transactions were struck in 2018 for a mammoth total of $723.4 billion in value. Although 2007's gargantuan tally of $769.3 billion still exceeds that total, around 3,500 deals were closed that year—a far cry from the heights notched in 2018.

The pace in 2019 is so far still intense if not quite as frenetic, with $223.4 billion closed across nearly 1,600 transactions through early June. Multiple factors, from the cyclical to the macro, could be driving this mild deceleration after such intensity. Financial markets have been bullish for roughly a decade, leading participants and industry observers to question how sustainable overall pricing levels and behavior is in the event of an economic downturn. Private markets are not insulated from similar concerns, with much discussion as of late among PE fund managers as to how to manage

US PE deal activity



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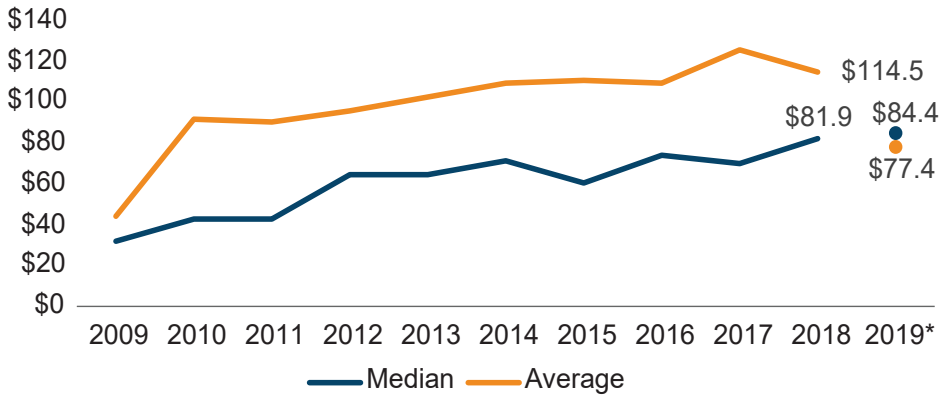
their portfolio exposure to supply chain shocks in the event of more stringent tariffs, for example. Yet at the same time, many PE firms still find themselves with plenty of capital to dispense—PE capital overhang is closing in on a record $800 billion—and mandates to do so. Consequently, even as the pace of dealmaking has cooled somewhat, the median buyout deal size has stayed near all-time highs, driven by elevated demand for worthwhile targets.

These trends only intensify within B2B, historically the most popular and optimal playing field for PE firms. After decades of consolidation in key markets, many enterprise incumbents have embarked on transformation of core business lines driven by technology adoption, while newer niches are opening up (e.g. distribution and processing centers leveraging new logistics systems to execute on last-mile delivery). This has compelled prospective PE acquirers to ensure their playbooks can take technical evolution and adaptation into account, on top of traditional, bread-and-butter operational improvements. Competition on those traits only further underlines the process of vying on pure price alone. But all of that is post-acquisition; prior to even striking the deal, PE firms have had to attune their processes to a higher pitch of sophistication.

As PE investors assess the types of prices they'll have to pay, they are eager to either line up add-ons for their original, larger platform buyout—thereby justifying higher entry multiples—or map out more sustainable and swifter routes to growth throughout the projected holding period. However, much of this diligence and planning must occur on fast-paced, competitive timelines during auctions or in discovery. Outsourcing to third parties for additional verification or expedited execution is a more frequent occurrence. All in all, this concurrent evolution in response to market trends is culminating in a grander reshaping, maturing and indeed sophisticating of PE playbooks, especially as financial sponsorship penetrates deeper into the US middle market.

Median and average US PE B2B buyout sizes ($M)



Source: PitchBook
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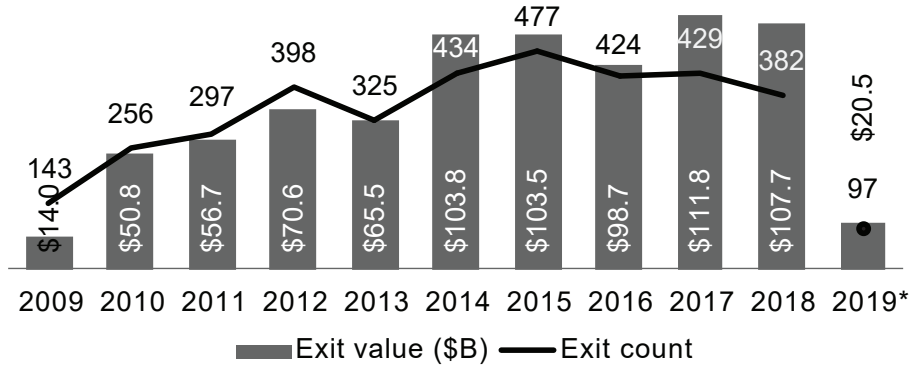
US PE B2B exit activity



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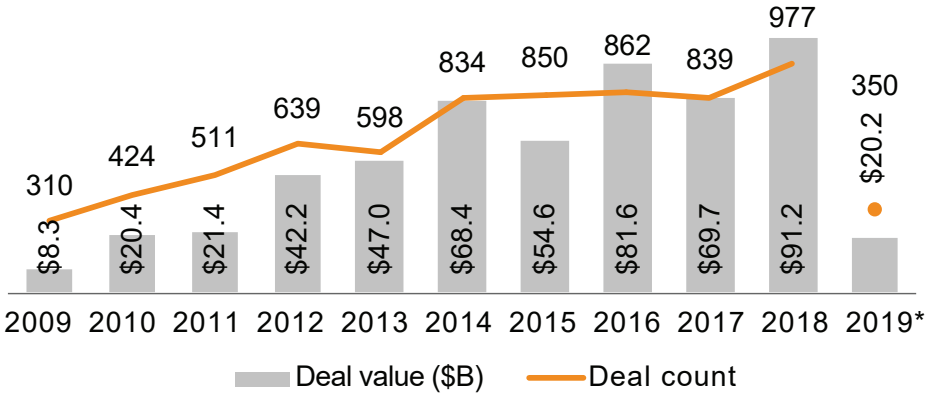
US PE B2B add-on activity



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Q&A: Navigating B2B dealmaking dynamics

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Andy partners with PE firms, their portfolio companies and other advisors to add significant value to the M&A process by identifying EV creation opportunities and risks in an accelerated timeframe. His team's sole mission is, through Quality of Pricing℠, to support buy-side and sell-side due diligence and post-acquisition value creation.

Can you give a broad overview of PE dealmaking in the B2B market?

Andy: Many factors remain the same; it's still a highly competitive market with elevated valuations. On the buy side, PE firms are diving deeper into their diligence processes to assess risks and understand growth opportunities in target companies. On the sell side, companies are looking to capitalize on current market dynamics. PitchBook has observed a prevalence of secondary buyouts (SBOs) as of late. Much of the underlying dynamics around SBOs certainly drive the need for further diligence. Significantly more data in data rooms is creating options for target companies and the PE firms looking to analyze them, but there's limited ability to quickly absorb, validate and analyze data to identify value creation opportunities. One area worth noting is the level of EBITDA adjustments. The buy-side analysis of those adjustments—how to really think of them on a proforma basis and, ultimately, how to value and potentially underwrite them—should be a priority. Additionally, the creation of such adjustments on the sell side, pertaining to those areas where companies think they should be getting credit that may not be showing up on a financial statement, should be examined closely. INSIGHT2PROFIT's Quality of Pricing℠ (QofP℠) elevates both the buy- and sell-side diligence processes by identifying enterprise value (EV) creation opportunities and risks in unparalleled levels of depth and speed.

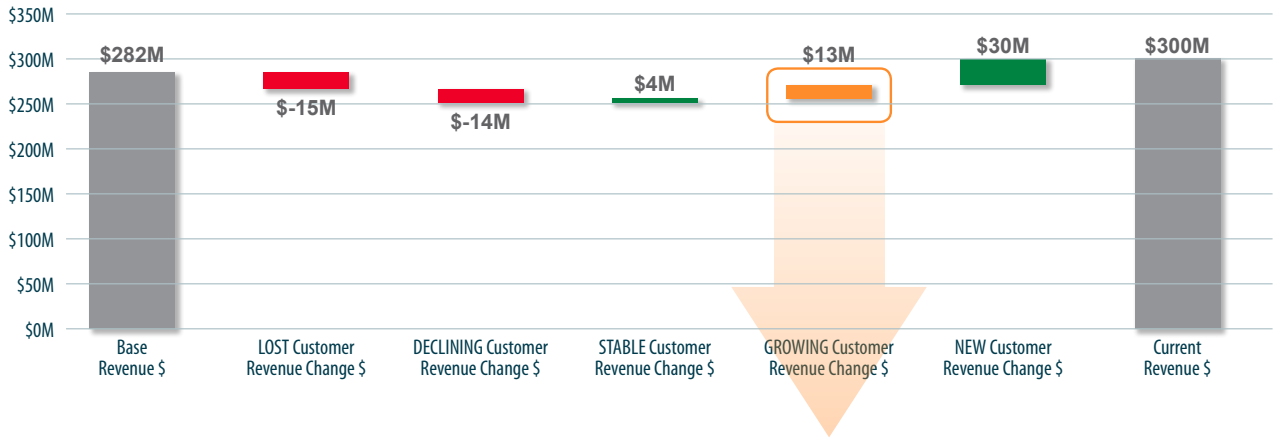
I wanted to follow up on your take on the rate and level of EBITDA adjustments. What are your thoughts around their incidence and justifiability?

Andy: Our point of view on EBITDA adjustments is going to focus on commercial elements, not purchasing synergies or other cost-out types of elements. Our perspective is focused around value creation relative to pricing, reduction in customer churn, understanding business mix and pocket margin. We certainly see the incidence of those types of adjustments increasing. I think where they are most effective and get qualified by Quality of Earnings (QofE) is where they can actually be demonstrated in a financial statement over a period of time—for example, price increases that have yielded margin improvement in specific segments of the business. To the extent that any EBITDA adjustments can be validated in financial statements, then additional proforma initiatives have more validity, and a portion of the current and future price improvement realization is more likely to be underwritten by an acquiring company or a PE firm.

Diving in a little bit deeper, is there anything you would consider that people would need prioritized in the current market? As you work with your clients, what would you say they need to prioritize the most?

Andy: As companies consider going to market, and they're talking with their advisors such as investment banks, accounting firms or lawyers, the key question is how they're going to prioritize the time they have before they start the transaction process. They want to be able to showcase their business journey, and show a potential acquiring sponsor their commercial improvement in revenue and margin terms. Additional points those companies should be emphasizing include a clear view to future opportunities and the organizational ability and capacity to execute on any incremental opportunity. They don't want to show they've gotten everything, but they do want to show they've made improvements. For example, we recently worked with a $400 million manufacturer of industrial equipment and components on a QofP initiative. As it was going to market, we worked with the investment bank, and later the QofE provider, to show the margin improvement initiatives and the progress, including the financial EBITDA impact of commercial changes related to pricing optimization, salesforce effectiveness and reduction in profit leaks. Further, this QofP initiative laid out a multi-year roadmap of incremental margin improvement initiatives across divisions, beyond the initial scope, for an acquiring sponsor to consider as part of its value-creation plan.

QofP℠ Opportunity Assessment — Business Mix Analytics



Drill Down: *Where Does the Growth Come From?*

Product Mix Category	Current Revenue $	Revenue Change $	Revenue Change %	Current Margin $	Margin Change $	Base Margin %	Current Margin %
Volume Growth Same Products	$68,181,818	$6,198,347	10%	$25,568,182	$2,634,298	37.0%	37.5%
Wallet Share Growth	$5,000,000	$5,000,000	**100%**	$2,125,000	$2,125,000	0.0%	**42.5%**
New Products	$1,818,182	$1,818,182	**100%**	$806,818	$806,818	0.0%	**44.4%**
Growing Customer Segment	$75,000,000	$13,016,529	21%	$28,500,000	$5,566,116	37.0%	38.0%

Source: INSIGHT2PROFIT

What would you say are their biggest and most frequent hurdles that they have not yet addressed?

Andy: As companies look at a transaction, they have many constraints. Two major factors are time and organizational capacity; they want to get to market now as they hear about elevated valuations and how "frothy" the market is. They need to decide what initiatives (e.g. pricing, ERP implementation, IT projects) would result in the highest ROI—tangible or intangible in that period—and have the least customer and organizational disruption. We encourage companies to explore implementing a risk-adjusted pricing initiative pre-transaction to deliver margin growth and increase valuation. In a sell-side QofP assessment, we analyze the business and collaborate with company executives and their advisors to quantify the margin improvement opportunity and prioritize actions that can be taken to yield near-term impact—the assessment typically takes two to three weeks with us doing the heavy lifting to minimize organizational disruption.

Are any of those connected to broader macro factors?

Andy: Several macro factors may be driving some of this. First, PE buyers want to understand the impact of any significant cost variable. Take tariffs, for example—what are the implications, and should the target company implement surcharges, pass on price increases or absorb cost increase? Or freight-cost inflation due to the scarcity of commercial drivers. Other examples include different raw materials or certain types of metals or fluctuations in petroleum prices. Companies definitely need further visibility into what those major factors may be and how they should plan for them, both in their investment thesis and value-creation plans when they're looking at different performance scenarios. We work closely with our clients to develop strategies and model tactics for how to navigate sectorial and macroeconomic factors affecting costs and market demand. Then, given current valuations, the transition from diligence to the 100-day plan to value creation is condensed. As such, due-diligence playbooks are becoming more robust and in alignment with the value-creation playbooks the various PE buyers have, so they're able to accelerate the time to value. So, on the sell side, companies are trying to tee up for a buyer to accelerate that same time horizon to show a revenue growth bridge.

How are PE buyers handling increased levels of competition?

Andy: Given the number of SBOs, a lot of "lower-hanging fruit" has been picked by the initial financial sponsor(s). Now, PE firms need to be more specific as to how

they will create value within businesses. Clarity in what they will do helps speed the time to close, which differentiates buyers in the eyes of sellers. Another differentiator—maybe not in the seller's eyes but certainly in the diligence process—is the ability to swiftly leverage the significant influx of data now present in data rooms. In this era of Big Data and ample data rooms, PE firms may be working with transactional data that comes from 10 divisions of a company from five systems all in different formats. Data rooms now contain elements as granular as freight files, rebates, promotions, etc. From there, PE buyers have access to multiple types of diligence and can determine which are necessary. There's also an increase in PE firms turning to third-party advisors for specialization and depth and speed of analysis. Our QofP allows our PE clients to efficiently leverage the contents of the data room to eliminate unknowns and quickly provide granular visibility into business dynamics such as customer and product mix shifts, profit leaks and price optimization opportunities. Our proprietary data-analytics platform and data-engineering capabilities enable our QofP offering to differentiate our PE clients' due-diligence processes.

How actionable and good is that proliferation of data, however?

Andy: As you look at buy-and-build strategies, which you hear a lot about these days, the quality of data becomes particularly important. From a sell-side perspective, a company that is setting itself up as a platform for further add-ons should demonstrate clear direction, customer segmentation, product segmentation and other market positioning such as channels, geography, and level of competition. Further, the company's data should align to that same commercial strategy. As an acquiring company looks at the target, it can see a level of clarity and a shorter, easier time to scaling that platform and adding on. While lack of commercial structure and sophistication is not a deal breaker, it certainly extends the period of time an acquiring company would spend to drive value. A clear strategy and intentional approach to positioning will capture a higher valuation. The hierarchy and integrity of a company's data are good indicators of its strength in commercial foundation and its approach to markets. Data cleanliness is certainly not consistent across the businesses we see. It may not even be consistent within the businesses—i.e. some divisions are much better than others, because they've grown through acquisition, have disparate ERP and CRM systems—and that's where we add value in being able to validate, normalize and ensure clean, aggregated data so we can do a wide range of in-depth analyses and help our clients provide more visibility into what's really driving the target business.

Have you seen newer PE entrants into B2B?

Andy: We've seen larger players that didn't historically participate in the true middle market and maybe a bit of the lower middle market. Also, many new funds are spinning out of PE firms that have historically been in the B2B space and are now competing against their legacy PE firms. These new PE firms are raising funds quickly and are keen to deploy that capital with equal speed. That's certainly been good for us, because it brings more players and, thereby, more interest in QofP as PE firms look to differentiate their diligence toolkit with new tools and expertise.

What else should participants know about the current market?

Andy: There are a couple things. On the buy side, based upon the growth and acceleration of data availability in data rooms, the ability to quickly aggregate, validate and analyze becomes more and more important. This level of data analytics is a key differentiator that gives an acquiring PE firm perspective into what's really going on in a business they'd not otherwise get in a two to three week timeframe. They can see there's revenue growth but may not understand if it's coming from new or existing customers. If they are existing customers, are they buying more of the same products, are they buying new products, or are they just buying in new locations? What's really driving that? Is churn or loss specific to certain geographies or certain salespeople? Our clients are becoming more and more keen to unpack those mix shifts, customer trends, and growth factors. They want to understand not just that there's a number there, but the underlying drivers. As illustrated in the Business Mix Analytics chart on the previous page, our QofP provides a level of depth that gets to the dynamics truly having an impact on business performance several layers below where our clients can get on their own. Ultimately, PE firms want to remove unknowns and know what risks exist and what the size of the prize is.

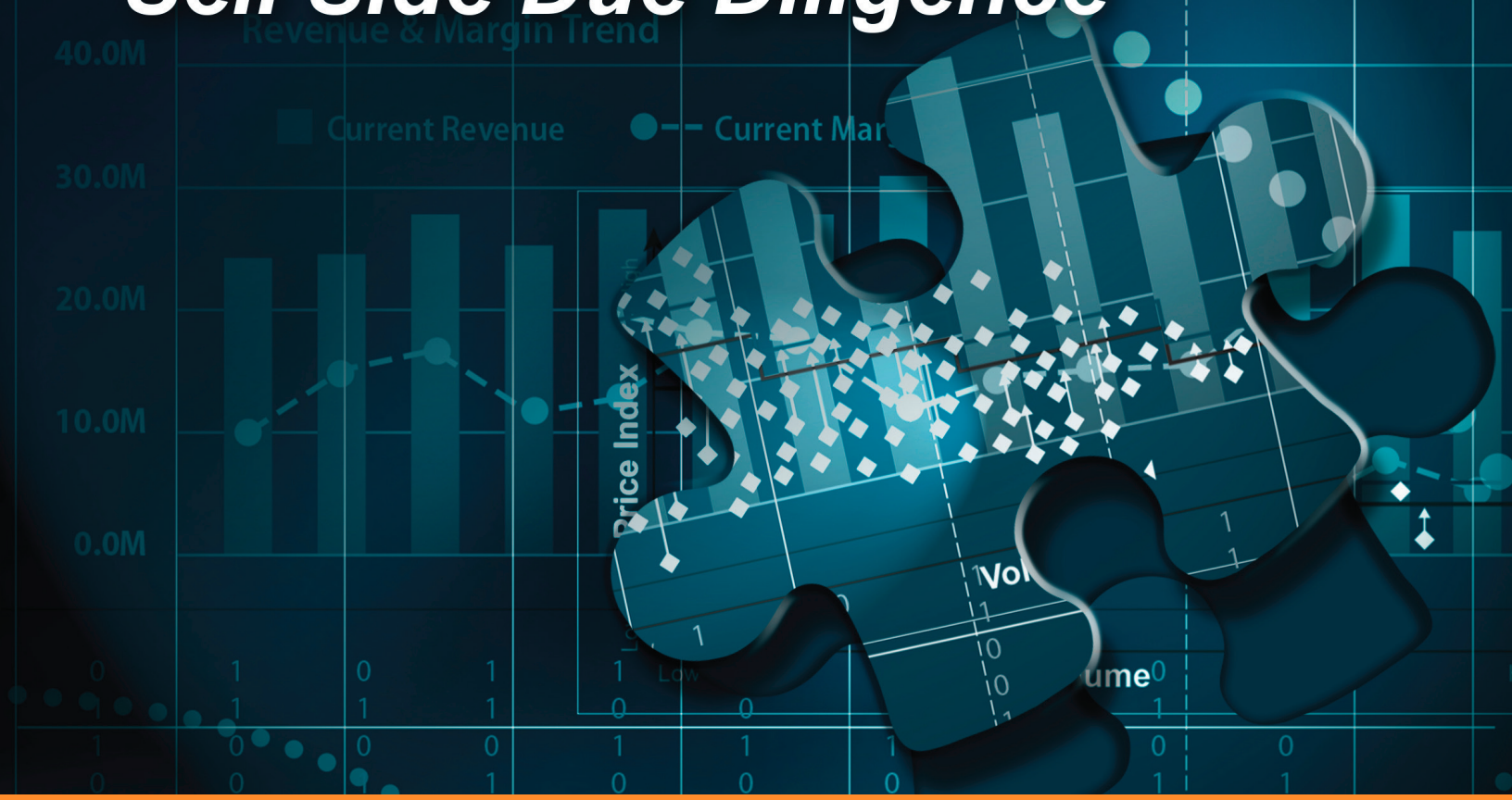
Any specific examples, in closing?

Andy: Our first example is a PE-sponsored field service organization that also sells products. As the company has looked at doing add-ons, we've helped with confirming and adjusting its assumptions around commercial synergies and similar products and services for cross-selling opportunities; looking at overlaps of customers; and, lastly, understanding the change management factors as it integrates new businesses onto the platform—in terms of data integration and segmentation, training on cross-selling, and price-optimization opportunities.

Another example, on the sell side, is a specialty distributor. About a year out from its transaction, the distributor looked at doing a QofP assessment to identify where it could get margin lift and build momentum pre-transaction. We identified meaningful potential margin improvement in about half its business, took a price increase into a portion of its market segment and saw results in its financial statements within the first quarter of implementation, reflected in its CIM and management presentation. We also collaborated with the client to develop a roadmap of future opportunities—e.g. segmentation, cross-selling and developing a quoting tool—to put in the CIM. The roadmap ultimately informed the acquiring PE firm's value-creation plan, enabling the transition from diligence into the 100-day execution plan.

QoP Elevates QoE

Quality of Pricing is the Missing Piece to Buy and Sell Side Due Diligence



Learn more at *www.insight2profit.com/qualityofpricing*

Quality of Pricing℠ (QoP℠)

A unique service dedicated to identifying margin improvement opportunities that gives you the competitive edge you need throughout the transaction process.

INSIGHT2PROFIT is the go-to partner for private equity firms and investment banks. From due diligence to portfolio value creation to exit strategy, we bring our pricing expertise, data analytics, and proprietary technology to create competitive advantages and margin improvement throughout the investment lifecycle.

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