

State of Midmarket M&A

Q1-Q3 2014 Update

The Capstone Strategic Report

November 2014

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Executive Summary

At the end of 2013, Capstone conducted a survey of midmarket company owners and executives, to elicit their insights on mergers and acquisitions. In October of this year, we conducted a follow-up survey. Our objective: to see how the first three quarters of 2014 matched expectations we learned last year, and to indicate any new trends in midmarket M&A.

Key Findings

Growth in M&A: There has been an increase in M&A activity in the midmarket, despite continuing economic uncertainty.

- 60% engaged in M&A or external growth activities in 2014
- 44% are considering M&A activity in last quarter of 2014

Overall Midmarket Growth: Moderate growth continues.

- 68% reported growth in 2014

Opportunities: Companies are very interested in exploring new markets.

- Increased focus on acquisition of new markets (up 11% from 2013)
- A total of 62% of respondents are interested in expanding into new markets.

Challenges: Scarce resources and difficulty in finding companies to acquire.

- Greatest deterrent from M&A activity is lack of time, money, and people.
- 28% of respondents report a lack of suitable companies to purchase.

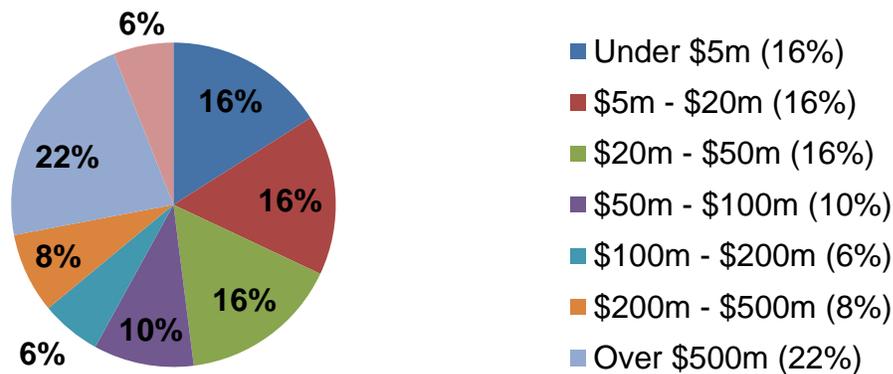
Steady Growth in M&A

Overall, our perception is that the economy will continue to recover, and as it does, more midmarket companies will seize on the opportunities presented by external growth. We define external growth as any strategy that leverages a relationship with another company—such as acquisition, minority ownership, joint venture or strategic alliance. We see more companies recognizing the possibilities for accelerating their growth through these kind of relationships. However, many are still restricting themselves unnecessarily by considering only acquisitions of for-sale companies. In reality, external growth opportunities, including acquisition, are possible with almost any company, for the right equation.

About the Survey

Capstone polled a sample of 50 business leaders in the midmarket, in 25 industries. Businesses ranged in size from \$5m to over \$500m revenues. Our respondents were primarily CEOs and owners, along with other C-level executives.

What is the size of your company in revenues?



Responses may not add up to 100% due to rounding

Industries Represented

Chemical Manufacturing
Construction
Consulting
Consumer Goods
Contract Machining
Education Technology
Electric Utility
Electronics
Facility Services and Management
Financial Services
Government Contracting and Services
Healthcare
Home Improvement

Information Technology
Legal Services
Manufacturing
Nonprofit Sector
Petroleum
Plastics
Pharmacy
Printing and Design
Recycling
Software
Transportation
Warehousing and Distribution

The Growth Picture

We asked our respondents what kind of growth their industry as a whole is experiencing. The overall picture is somewhat flat.

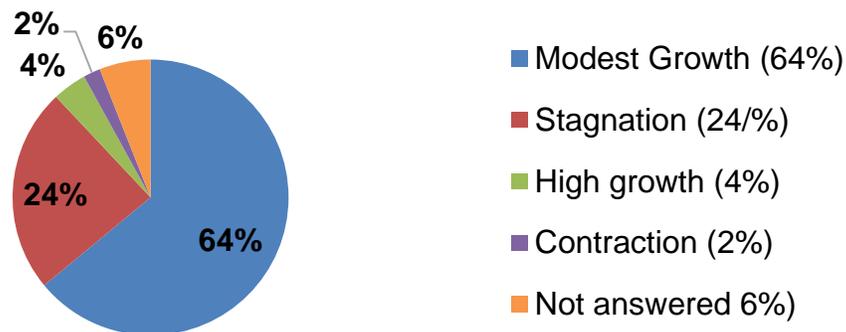
The overwhelming majority (64%) reported “modest growth,” with only 2% reporting contraction—down from 7% in 2013.

The percentage of those reporting high growth dropped by half, from 8% to 4%.

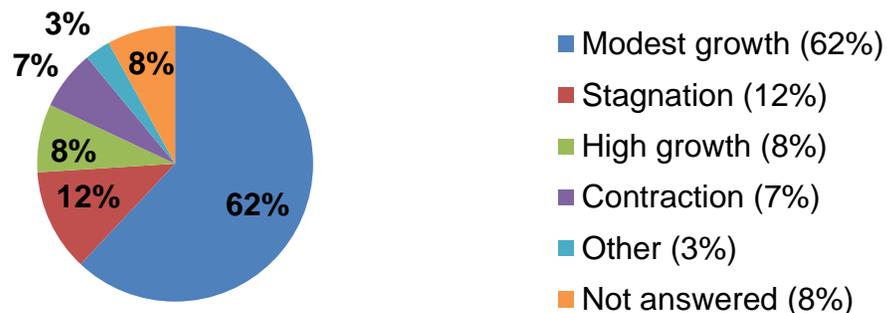
Perhaps most significantly, 24% of respondents reported stagnation in 2014, double the amount reported in the same period last year. This holding pattern may indicate continued anxiety about the economy, the political environment and government regulation.

What kind of growth is your industry as a whole currently seeing?

2014 Data



2013 Data

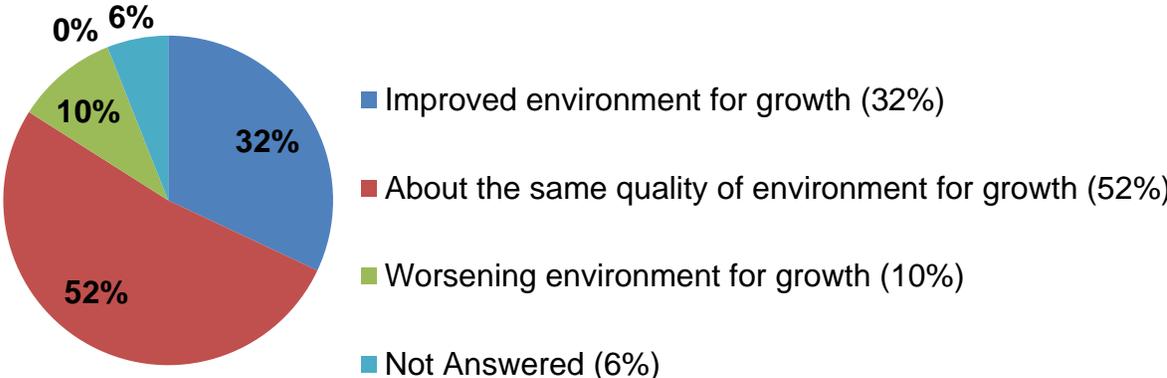


Last year, the survey asked midmarket industry leaders about their predictions for the environment for growth in 2014. 80% expected to see the same or better environment for growth in 2014, while 11% predicted a worsening environment.

Their predictions were largely borne out, according to the most recent survey, with 84% reporting the same or better environment for growth and 10% reporting a worsening environment.

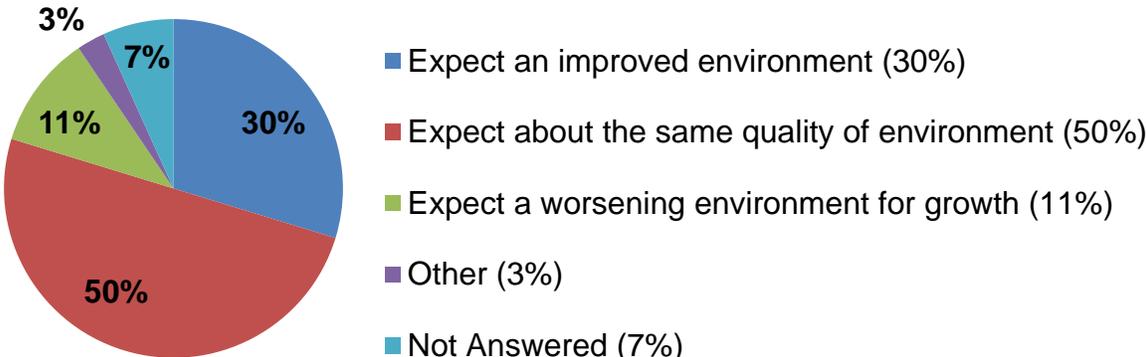
How have you seen the environment for growth in 2014?

2014 Data



How do you see the environment for growth in 2014?

2013 Data



Responses may not add up to 100% due to rounding

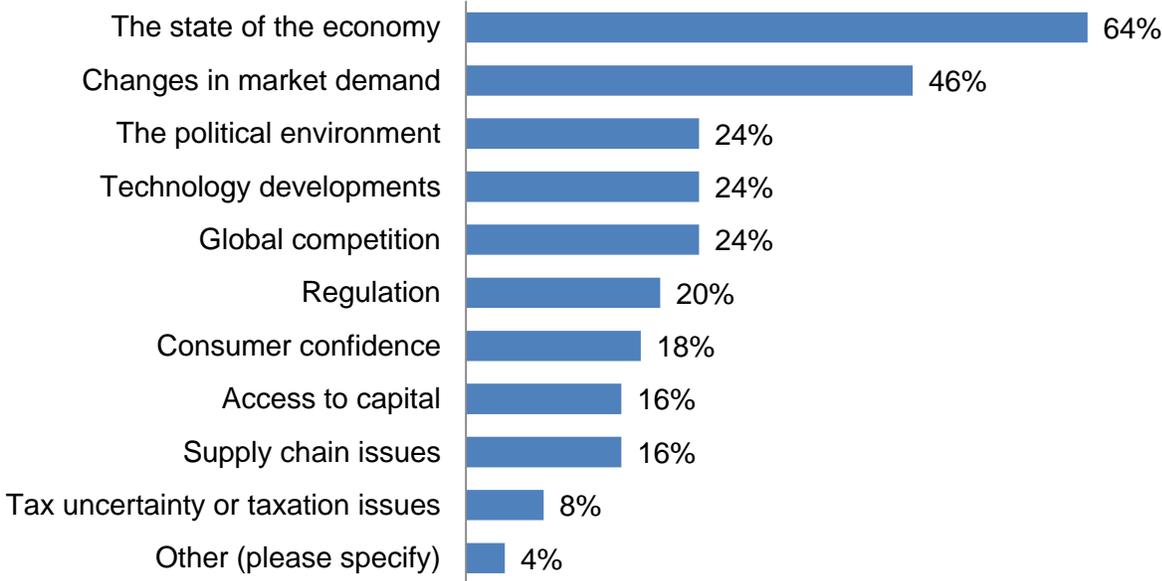
Growth Factors

In our 2013 survey, we asked our respondents their views on the determining factors for growth in the coming year. Their predictions were mostly on point, though there were some surprises.

As expected, the state of the economy topped the 2014 list. Changes in market demand, the political environment, and technology developments continue to be important factors in ongoing growth across all industries.

However, executives reported global competition as an increasingly important concern (up 11% from 2013) while consumer confidence has become less essential (down 8% from 2013). Capital seemed to be more difficult to access (up to 16% from 11%), possibly due to decreased lending, but taxation proved to be less of an issue than industry leaders anticipated (down from 14% to 8%).

In 2014, so far, which factors have impacted growth in your industry?



Multiple responses allowed per respondent

Growth Avenues

We asked about four options for growth, represented in this chart:

Increase sales of existing products to existing markets	Sell existing products to new markets
Sell new products to existing markets	Sell new products to new markets

The relative interest in the four options was very much as before, with the dominant avenue (46%) in the top-left quadrant— doing more of the same. However, we see high interest in both expanding product lines and entering new markets. It is for these avenues that external growth strategies can make the most sense.

What form of growth is most attractive to your company right now?



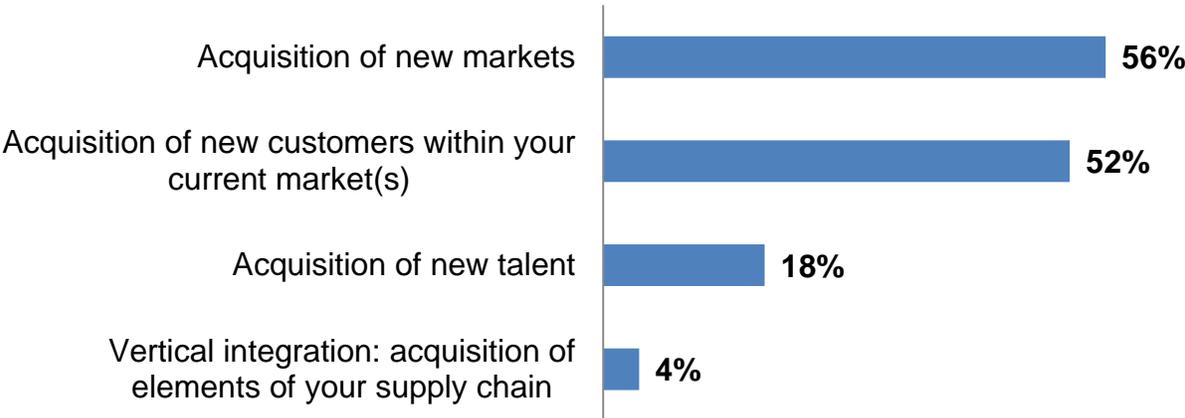
Multiple responses allowed per respondent

Growth Needs

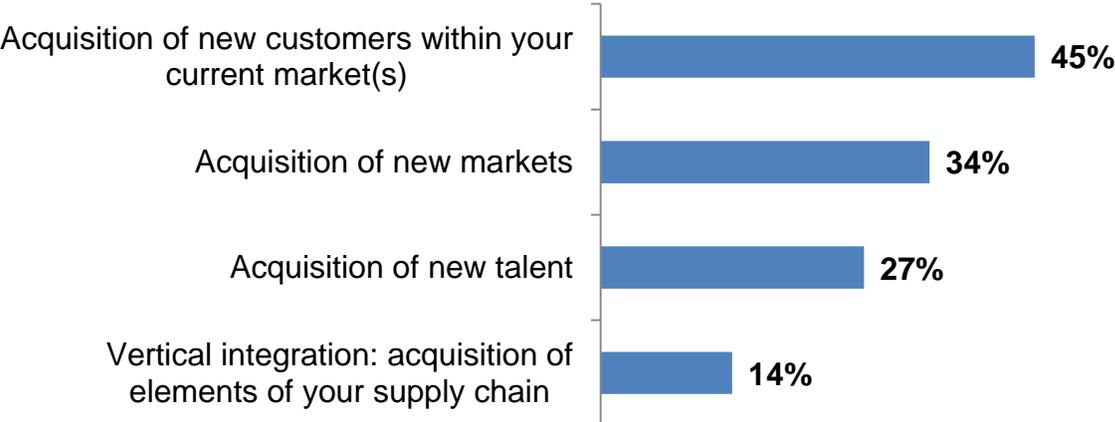
In our 2013 survey, we asked respondents about the growth areas with the most impact on their businesses. Last year, acquisition of new customers in current markets was the area of greatest focus; in 2014, the emphasis has shifted to acquiring new markets. Business owners are also significantly less interested in acquiring new talent and vertical integration (down 9% and 10%, respectively).

Which of these additions to your current business would have the greatest positive impact?

2014 Data



2013 Data

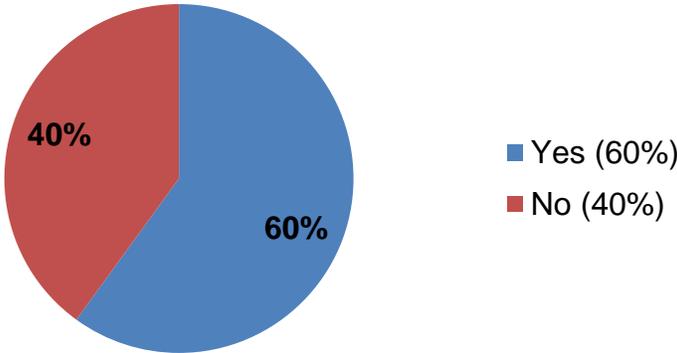


Multiple responses allowed per respondent

M&A Activity: 2014 Year to Date

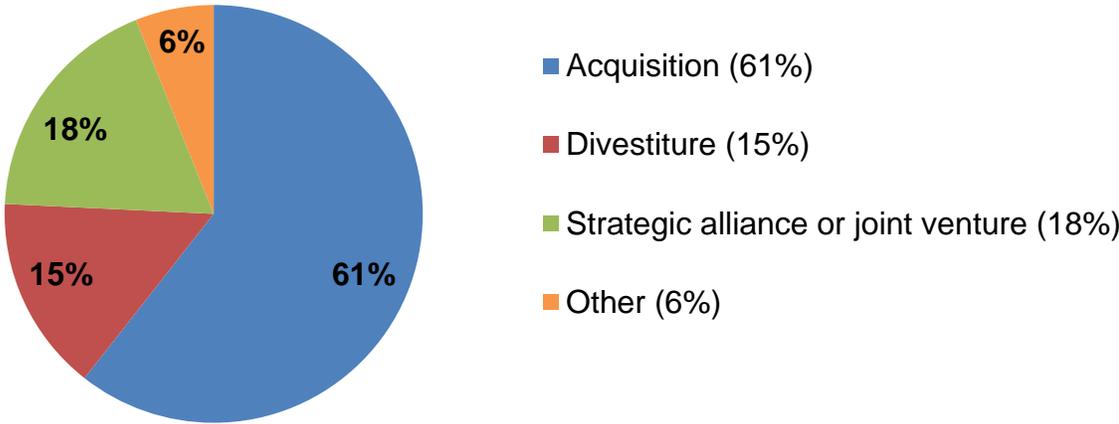
The majority of respondents reported engaging in some form of external growth during the current year, up 14% from last year's numbers.

Has your company engaged in M&A or other external growth activities during 2014?



Of those who engaged in M&A or external growth, the most common activity was again acquisition (61%), with strategic alliance or joint venture and divestiture the second most favored external growth pathways (18% and 15%, respectively).

If your company has engaged in M&A or external growth activities in 2014, what was the activity?

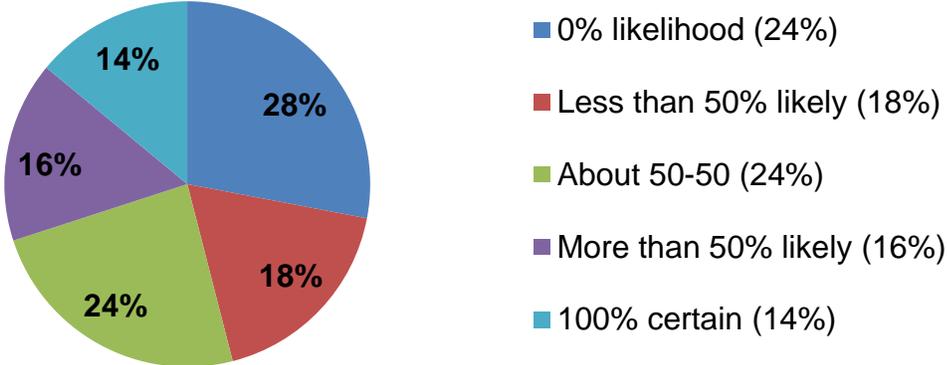


Only includes those who engaged in M&A or external growth
No respondents selected minority ownership acquisition or franchising
Responses may not add up to 100% due to rounding

M&A Activity: Last Quarter 2014

As 2014 draws to a close, midmarket executives predict moderate chances of engaging in M&A activity in the closing months of the year, nearly one quarter predict no chance of M&A activity, while only 14% of respondents claim absolute certainty that M&A activity will take place.

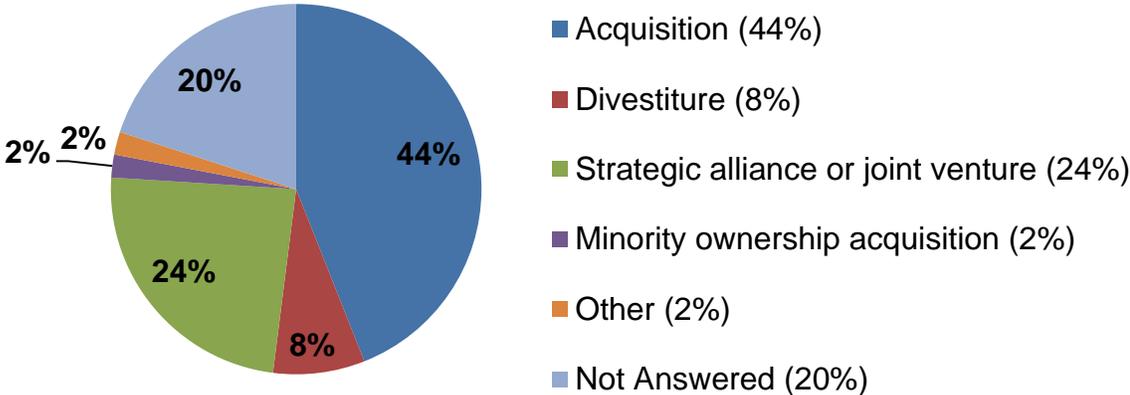
What is the likelihood of your company embarking on M&A activity in the last quarter of 2014?



Responses may not add up to 100% due to rounding

Of the respondents who predicted at least a 50-50 chance of M&A activity in the last quarter, the majority predicted either acquisition (44%) or strategic alliance (24%).

If your company will embark on M&A activity in the last quarter of 2014, which of these is most probable?

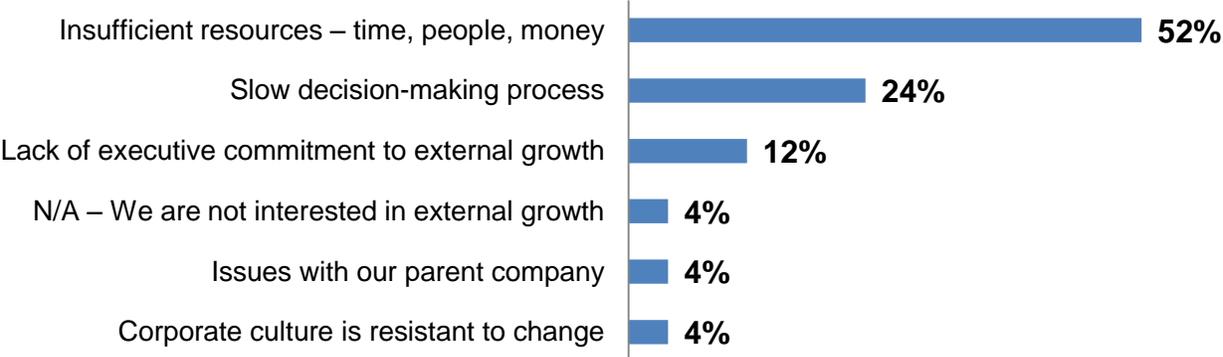


No respondents selected franchising

Deterrents to M&A

We asked our respondents about the barriers they face in pursuing external growth. Overwhelming at 52%, the biggest challenge they face is assembling sufficient resources to execute an effective program. Slow decision-making continues to be a headache—with more reporting this hurdle than in our last survey.

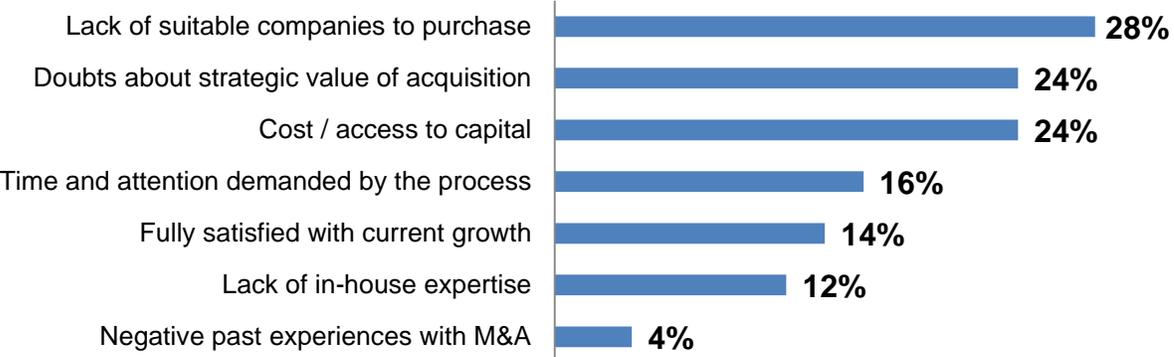
What are the greatest barriers, within your company, to pursuing an effective external growth strategy?



Multiple responses allowed per respondent

We then asked specifically about acquisitions, and what challenges might deter business leaders from making a purchase.

What do you see as the strongest reasons for NOT considering acquisition as a tool for growth?



Multiple responses allowed per respondent

The reasons for not pursuing M&A are very much the same as before, with “lack of suitable companies to purchase” heading the list. From Capstone’s perspective we have to wonder if respondents are only considering companies that currently offered for sale. When options are expand to include not-for-sale companies—the Capstone approach—it is rare to find no suitable targets for acquisition.

Conclusions

Our sample of respondents was relatively small, though it reflects a wide spread of industries. We always check our survey results against the “gut feel” we develop from our day-to-day experience in the field. Our judgment is that the results of the latest survey once again offer reliable insights into the current state of midmarket M&A.

The majority of industry leaders surveyed see the need for continued growth, acquiring new markets, and reaching new customers. Even though a sluggish recovery continues to be a major concern, an increasing number of companies are participating in or considering M&A activity.

Overall, we can look forward to 2015 with guarded optimism. As the economy slowly rebounds, we can expect to witness a continued resurgence of M&A activity among midmarket companies.