The M&A Redshift

Heritage Quarterly Newsletter – 1Q 2016

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HIGHLIGHTS (Quarterly Focus: Mergers & Acquisitions)

- We have observed that recent M&A cycles exhibit a more gradual progression to peak (vs a dramatic upward spike) and have softer landings post peak than in decades past.
- 2015 saw the value of M&A deals increase disproportionately more than the number of deals indicating more aggressive valuations.
- Strategic buyers upped their game in 2015, indicating confidence in the economy and higher expected returns through M&A transactions versus organic growth.
- The consensus for 2016 is that M&A activity will continue to grow, although political and economic instability continues to loom on the horizon.
- Last quarter we judged the credit cycle to be about two-thirds of the way to its apex, and believe the M&A cycle (which is a correlated cycle) to be even further along.

Following on from our 4Q 2015 newsletter "Take Me Out to the Credit Ballgame", we elected to continue the discussion on cycles, this time in the M&A markets. It is no secret that the US M&A market is strong, and M&A activity has eclipsed prior pre-recession peak levels—many in our industry speculate that M&A and fundraising activity may possibly be at peak. Our belief is that M&A activity is farther along the cycle than the credit growth and is beginning to show signs symptomatic of a "top".

$107 billion

AB InBev agreed to buy SABMiller in November 2015 to combine the world's two biggest brewers.

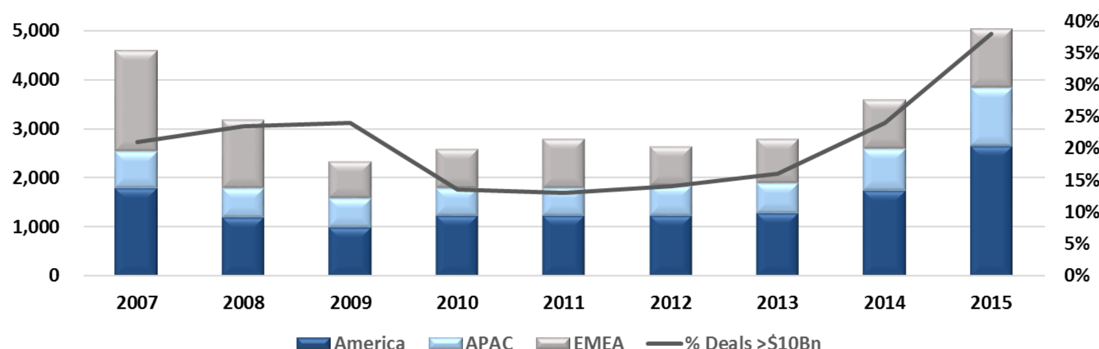
INTRODUCTION

2015 was a plentiful year for M&A in terms of total dollar volume as well as transaction size. Based on year to date data, there is nothing to suggest 2016 will experience a contraction. We have not seen signs that indicate we are at the top of a credit bubble (typically consecutive quarters of double digit commercial credit expansion). **However, we do appreciate that though correlated, credit cycles and M&A cycles do not perfectly sync up with each other**. We believe the M&A cycle is farther along than the credit cycle (which we assessed to be somewhere around the 6th inning). Anecdotally, when there is no fear of a bubble, no growing voice of concern, then the beat tends to go on. There is no fear when you are having fun, so to speak.

$55 billion

KraftHeinz

The biggest PE deal in 2015 backed by 3G Capital and Berkshire Hathaway to form the third-biggest F&B company in North America



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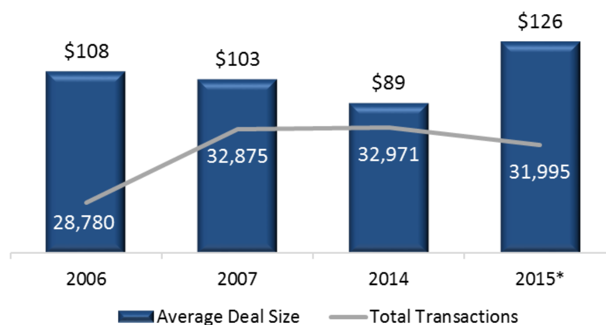
<u>DILUTION IN RETURNS</u>

Cheap money has the dual effect of i) lowering cost of capital for buyers that can access it and ii) lowering yields on risk-free or low-risk assets, so the need to reach for yield in riskier assets is heightened.

The increased demand for heightened yields, particularly from players that have access to ample sources of capital, naturally leads to a dilution in returns. Deploying capital at attractive rates is a challenge worldwide, often more pronounced abroad than it is here in the US. Low yields in many parts of the world are driving additional cross-border capital deployment, as investors seek out returns no longer achievable in local markets. Strategic buyers are looking for ways to augment income outside of organic growth, as domestic demand has contracted in parts of Europe, Asia, and the developing world. Financial buyers simply need to seek jurisdictions where return on invested capital is greater than capital spent in their home countries. Further, many financial players (e.g. pension funds and mutual funds) tend to seek returns that are only attractive on a relative basis (relative to home country) instead of seeking returns on an absolute basis. So while a 4% return doesn't appear attractive to either of us, it's higher than what some international investors could achieve domestically. The combination of these factors fuel demand from international buyers: financial, strategic, and quasi-strategic (international corporations which are state-owned or receive considerable financial backing from the state).

Deal value increased significantly more than deal volume, driving multiples and average deal sizes to new heights.

Subsequently, the acquisition market has become a very crowded space. The graph below demonstrates this price squeeze as the total deal value has increased in significantly greater proportion than deal volume compared to the last top in 2006 – 2007. The average deal size in 2015 of $126 million represents a **20%** increase over 2007, and a 17% increase compared to 2006. Meanwhile, EV/EBITDA multiples have pushed up from 7x to 10x, and EV/revenue multiples from 1.0 to 1.2x as compared to 2006 period. This means valuation is anywhere from **20-50%** higher than last peak. By definition, if valuation multiples are increasing by the same or higher magnitude than deal sizes, then aggressive bidding is the responsible culprit behind large deals, not an increase in underlying cash flows (i.e. true value creation).



*2015 year to November, annualized

Multiple	2006	2015
EV/EBITDA [1]	7X	10X
EV/Revenue [2]	1.0X	1.2X

1) Global EV/EBITDA multiple for all markets.
2) Global EV/Revenue multiple for middle market transactions.

Data shows that North America and China are the main contributors to this increase in deal value, growing deal value by 57% and 359% respectively.

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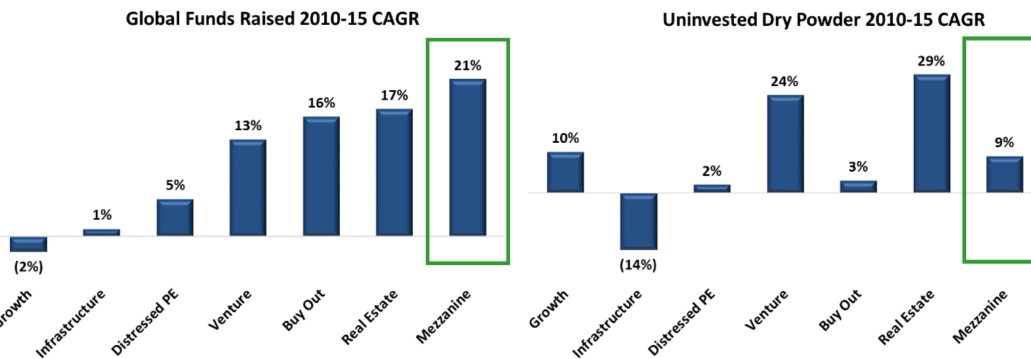
EMERGENCE OF ALTERNATIVE FINANCING

We cannot complete a discussion of the M&A markets and buyout activity without reviewing how debt has played a role. Debt is readily available and cheap like never before, ***but only for those who can access it***. There is a cohort of corporations and consumers out there that have discovered they are "unbankable" and have struggled to tap cheap credit from banks and similar financing sources—they would disagree with our statement. Corporations and consumers are unbankable for a variety of reasons: they have not been in business long enough, there is not enough liquid assets on the balance sheet, weak or nonexistent cash flow generation, or they are simply trying to borrow too much debt. The common thread of all of this is the bank believes the prospective borrower is unlikely to pay the full loan back according to their rigid assessments of underwriting risk.

This has led to the emergence of alternative financing. Hedge funds, credit funds, ABL lenders, P2P (peer to peer) platforms, business development corporations, and mezzanine funds have emerged to service this gap in financing. In addition to the senior and secured space, they play in the subordinated, unsecured, and specialty financing space. This class of investors will lend to "riskier" companies, but for additional yield – yields that are equity like in some cases. This has the unintended consequence of introducing additional risk into the system because the cost of debt servicing is higher; and that cost of debt servicing is being borne by generally smaller and less financially-stable companies. Ironically, the Fed's intent of placing more capital into the coffers of small and mid-size companies a la increased liquidity in the banking system is not working in the way it was intended to.

The M&A space has been crowded by new lenders, cross border capital and the need for strategic buyers to augment income.



What is clear from the charts above is that mezzanine capital raised has grown far quicker than all of its peers, at a compounded annual growth rate of 21% between 2010-2015 (in 2014-15, growth was 118%). Further still, uninvested dry powder in the mezzanine space over the same period has shown relatively low growth, compared to other asset classes–most of the mezzanine capital raised is being deployed. This growth in mezzanine debt activity is much higher than the rate of corporate credit growth in the broader economy, which has been in the mid to high single digits. Though regulation might be weighing heavily on traditional lenders, these mezzanine and non-traditional players are more than filling any gap in the ability to close deals. In other words, debt has played a disproportionately larger role in the M&A arena than it has in the overall US economy. It has done so through branches of alternative financing as we've outlined. Traditional banking channels are of course still open, but usually for the higher-quality and easily bankable entities. Given this phenomenon, as well as some illustrative statistics we discuss below, **we believe the M&A cycle is farther along the cycle and closer to peak than the credit cycle is.**

$8 billion

Goldman Sachs

Goldman Sachs raises $8 billion for GS Mezzanine Partners VI, making it the largest mezzanine fund ever raised

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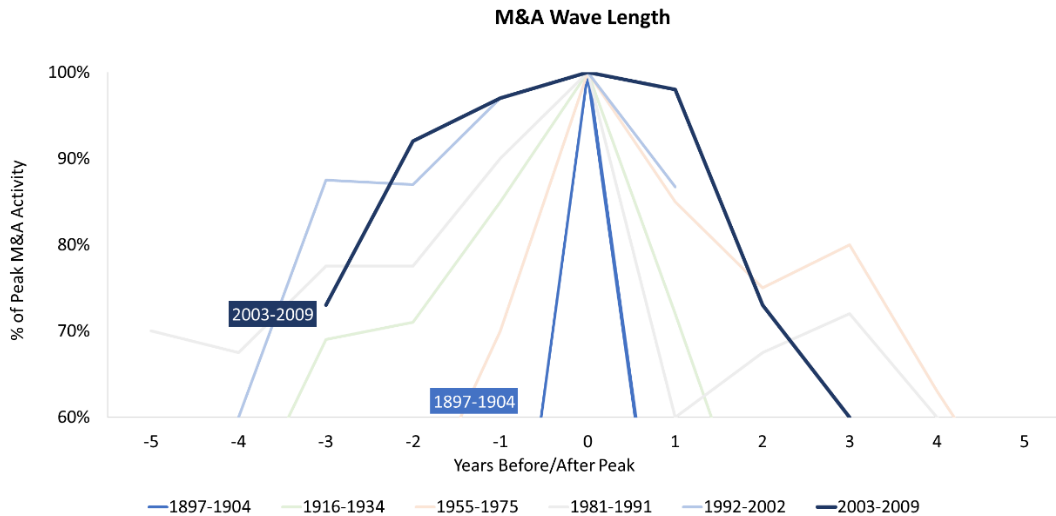
HISTORICAL CONTEXT

Whilst there are many factors affecting M&A cycles, it is becoming clear that current growth rates cannot be maintained indefinitely. It is human nature to keep pushing until the bubble bursts, and we expect the medium term M&A market to demonstrate exactly that.



An interesting tidbit to close on. We examined the duration of M&A cycles from 1900 to 2015. We saw that the "approach" to each peak becomes smoother over time, with the cycle from 2003-2009 crossing the 90%-of-peak-value threshold a full 2 years before the actual peak occurred. Back in the 1897-1904 cycle, activity had not hit 60% of its apex point as recently as a year prior. Of course, every cycle is different with its own set of unique drivers, parameters and considerations, and it could be argued that the vastly bigger economy of today is inherently more stable than the turn of the 20th century. This fundamentally leads to a smoother progression towards the zenith, and a shallower recession thereafter. A number of factors could be driving this apparent "redshift" in M&A cycles; but certainly, the data suggests that over the long term, we can expect a softer landing than in previous cycles, making the "peak just that little bit harder to see.

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Data from 1900 to 2015 indicates M&A cycles are generally becoming 'smoother' over time.

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