SPRING 2018

PRAIRIE

Prairie Middle Market Perspective

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Talk-A-Phone Co.

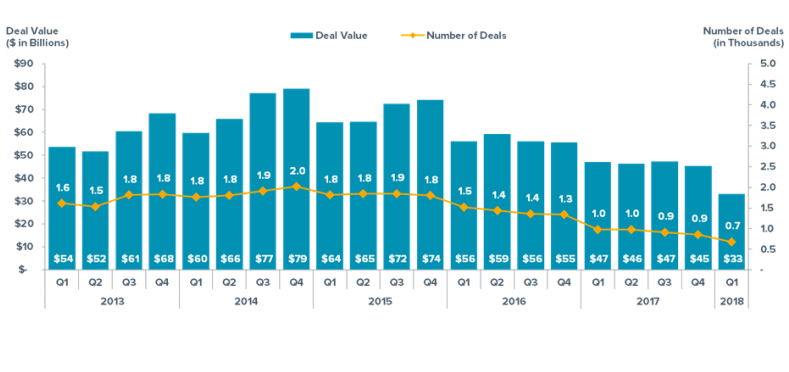
Overall M&A Market Commentary

The deal volume recorded in 1Q18 reflected another quarter of both lower number of deals and deal dollar value. While the quarterly negative trend in M&A activity which began in 2015 continues, the dollar volume of middle market M&A appears to be leveling off which may signal an activity level market bottom. Middle market M&A activity news, like the recent news on the public equity markets and global/national events, is chaotic and subject to hyperbole. The reported information and news analysis may not reflect the actual deal market story. Furthermore, because of the sensitivity to disclosure of private matters, middle market M&A activity detail is hard to gather. As a result, we believe the databases may not capture all relevant deal activity and the actual trends in middle market deal flow may be obscured.

Lower tax rates on repatriated international profits and corporate earnings in 2018 are expected to free up corporate cash flow and increase larger size M&A deal activity. These lower tax rates coupled with the new tax rules allowing the write off of a large portion of the purchase price in the year of acquisition is expected to further stimulate 2018 M&A activity. Like 2017, deal activity on the larger end of the M&A market is expected to lead the way in 2018. Notable large M&A deals already announced in 1Q18 were Comcast Corp.'s offer to acquire Sky Plc for $30 billion, General Dynamics Corp.'s agreement to acquire CSRA, Inc. for $6.8 billion, General Mills, Inc.'s plan to acquire Blue Buffalo Pet Products, Inc. for $7.8 billion and in the retail space, Albertsons Companies, Inc.'s deal to acquire Rite Aid Corp. for an estimated $2.3 billion.

The **continued improvement** in the global economy will help support stronger 2018 deal activity. A Goldman Sachs Economics Research report of late last year, suggested "For the first time since 2010, the world economy is outperforming most predictions, and we expect this strength to continue. Our global GDP forecast for 2018 is 4.0%, up from 3.7% in 2017 and meaningfully above consensus. The strength in global growth is broad-based across most advanced and emerging economies." This same report estimated that the U.S. GDP will grow at 2.5% in 2018. A slightly newer GDP estimate contained in the Conference Board Economic Forecast for the U.S. Economy of March 2018 supported the Goldman Sachs prediction. "2018 has started with a small slowdown in consumption and investment numbers, and our GDP forecast for the first quarter has been revised downward from 3.3 to 2.6 percent." Both of these U.S. 2018 GDP estimates exceed the 2% GDP trend line of the last 8 years.

Total U.S. M&A Deal Volume and Value <$300M Transaction Value
Q1-2013 to Q1-2018



Source: Capital IQ

The distracting 24-hour news cycle covering the current world and U.S. political events might have a negative impact on business and M&A activity. However, there is evidence that business owners continue to be focused on their companies. The NFIB Small Business Optimism Index recorded the 16th consecutive month of historically high readings. "Small businesses have led the economy to what appears to become 12 months of three percent GDP growth," said **NFIB Chief Economist Bill Dunkelberg**. "It is evident that the small business sector has responded positively to the current management in Washington and its economic policies."

These market positives are slightly offset by potential trade policy issues, tech sector volatility induced by Facebook's user data issue, growing global political uncertainty and a myriad of other issues both large and small. Furthermore, increasing volatility in public equity markets, even though the volatility has only returned to more normal levels, has negatively affected market psychology and could cause a drag on 2018 deal volume. Growing business owner confidence, an improving economy, a more business-friendly regulatory environment, and the new tax law reform are all seen as positive influences on 2018 M&A market activity and should outweigh the negative issues.

Although the 1Q18 closed M&A deal data does not yet reflect market improvement, private equity funds, investment bankers and other M&A market participants are reporting increased work in process activity as deals are taking longer to complete. Higher valuations are leading buyers to perform more extensive due diligence which results in extended deal timelines. A normal M&A process, from engagement to closing, a few years ago took from 6 to 12 months. Now, the typical process timeline has extended from 9 to 12 months. This additional lag between deal engagement and transaction closing may be contributing to the lower closed M&A deal data in the early part of this year.

The current M&A market remains a sellers' market. An aging business owner population coupled with abundant capital and the demand of strategic and private equity buyers makes for a fertile M&A environment. The demand for good quality acquisition targets remains largely unsatisfied. We encourage business owners to look at their transition goals and objectives and determine whether a company sale now makes sense for their individual circumstances.

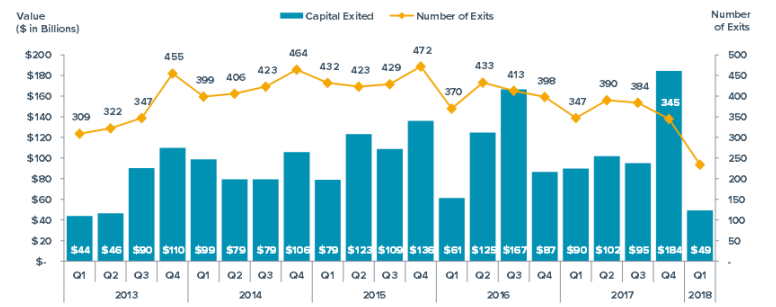
M&A Market Activity

Closed M&A deal activity has experienced a two-year long decline in deal volume starting in the middle of 2015 and continuing through 1Q18. Both dollar volume and number of deals showed declines in 1Q18 and a continuation of the current middle market M&A swoon.

- The $33 billion of middle market deals recorded in 1Q18 reflects a 27% reduction in dollar value from 4Q17. Furthermore, the 1Q18 dollar value of deals was down 30% compared to the 1Q17 levels.
- The number of middle market deals recorded in 1Q18 declined 22% from the number of deals in 4Q17 and was 30% lower than the number of deals closed in 1Q17.
- The average middle market deal size of $47.1 million in 1Q18 was about equal to the average of $47.0 million deal size closed in 1Q17.

PE exit activity showed a similar story in 1Q18. The number of exits in 1Q18 decreased about 32% from the exits recorded in 4Q17 and the capital exited decreased 73% during the same period. The PE exit data seems to indicate that the PE community might have exhausted their saleable portfolio companies due to the spike of capital exited recorded in 4Q17. PEs are normally opportunistic sellers and this group consistently takes advantage of the higher business valuations. It looks like

Private Equity Exits
Q1-2013 to Q1-2018



Source: Pitchbook

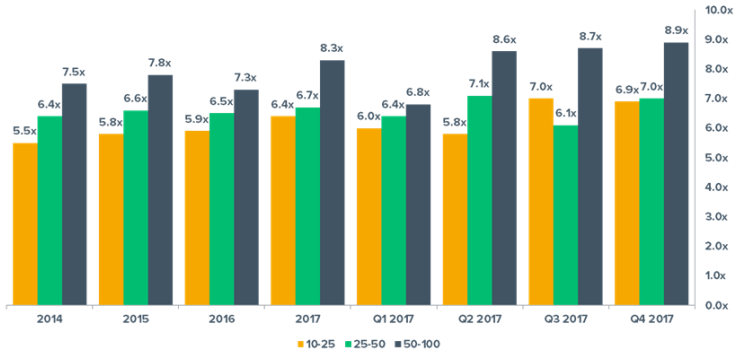
the PEs took advantage of the high market valuations in 4Q17 and "pulled forward" many of their exits into 4Q17 to the detriment of portfolio company sales in 1Q18.

Middle Market Deal Valuations

Middle market M&A valuations remain in elevated territory. The lack of supply of quality sale candidates, improving economic conditions, lower corporate taxes and reduced business regulation are leading to even more aggressive behavior by both strategic and PE buyers. We are seeing growing evidence that valuations may be moving somewhat higher in 2018. While higher interest rates and more companies coming to market in 2018 could lead to valuation multiple declines later this year, improving corporate earnings induced by a stronger economy could still offset the lower multiples and keep the dollar value of M&A deals relatively high. We continue to believe middle market company values are still at or near a market peak and it is an excellent time for sellers to enter the market.

- Sub-$25 million deal valuation multiples moved higher during 2017 reaching near a 6.9x multiple in 4Q17 which is more than one turn higher than the long run multiple average of 5.7x for this size category. Low deal volumes, abundant capital, a good economy and business enthusiasm are all sustaining high valuations.
- Valuations on the large end of the middle market ($50 to $100 million segment) continued to stay at elevated levels in 4Q17 settling at 8.9x, another record high for this size group.
- Valuations in the $25 to $50 million segment moved higher in 4Q17 reaching 7.0x. These volatile multiple trends in these lower end segments are likely due to low deal volumes rather than any sustained trends.
- As we have suggested in our previous reports, properly prepared, solid performing companies are always welcome in the M&A market and will continue to receive strong buyer interest and premium valuations.

TEV*/EBITDA by Deal Size ($ Millions)
2014 to Q4-2017

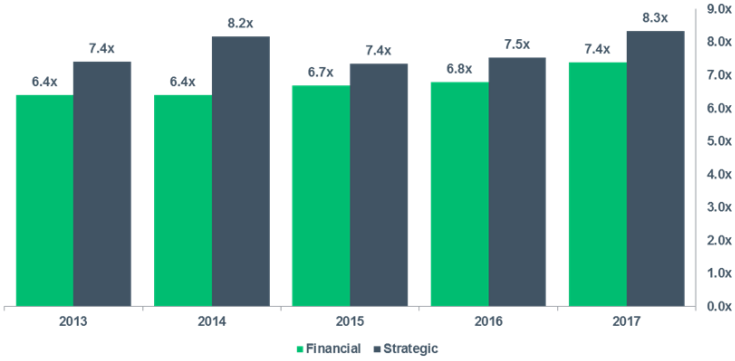


Source: GF Data
**TEV = Total Enterprise Value*

Private Equity versus Strategic Valuations

Better economic conditions, lower tax rates and overall improving business sentiment are leading to more aggressive strategic buyer acquisition behavior in the middle market. Acquisition synergies have resulted in a long term trend of strategic buyers paying approximately 0.75x to 1.0x of EBITDA more than the average PE buyer. Our 2017 data show continued aggressive participation of the strategic buyer in M&A transactions, leading to higher company acquisition offers and increased strategic valuations.

TEV/EBITDA Multiple by Buyer Type ($10-250M of TEV)
2013 to 2017



Source 1: Financial Buyers: GF Data ($10-250M TEV)
Source 2: Strategic Buyers: Capital IQ ($10-250M TEV; Excluding outliers defined as transactions with TEV/EBITDA of less than 3.0x and more than 14.0x)

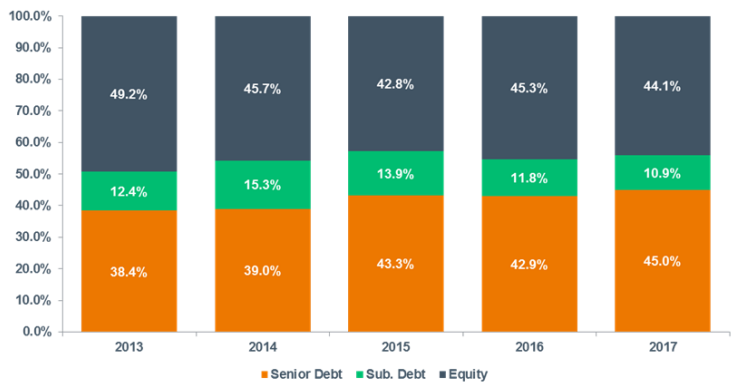
- Strategic buyers continue their aggressive behavior in the middle market deal space. During 2017, our data shows that strategic buyer multiples averaged 8.3x which was about 0.7x higher than the average for the last four years.
- Over the last few years, PE acquisition multiples have gradually moved higher to 7.4x and are now about 0.8x higher than the average PE acquisition multiple of the last four years.
- The increase in valuations indicate that the supply demand imbalance continues in the middle market. Well-prepared, attractive sellers can still take advantage of interest in M&A deals by both strategic buyers and PE funds and achieve reasonably high valuations.
- The data reflect valuation multiples for all size deals. Prairie estimates that for middle market deals below $50 million, valuations are generally 1.0x to 2.0x multiples of EBITDA lower than the levels reflected in the chart above.

Middle Market Leveraged Buy Out Capitalizations

Abundant debt capital and a more upbeat business climate has gradually lead to the acceptance of more leverage in the typical middle market leveraged buyout ("LBO"). The amount of equity capital invested in an LBO has continued to become a declining component of the deal's capital structure. However, even with this reduced equity contribution, LBO transactions remain relatively conservatively structured.

- Growth in the number of lending sources, low interest rates and greater sophistication of borrowers has made the decision on the amount and type of debt capital used an important part of the LBO process. With very high valuations, PEs use debt leverage to offset the negative effects high valuations have on their expected investment returns.
- While borrowing costs are low, more stringent leveraged lending regulatory oversight and a more discerning lending community has kept LBO deal structures in a conservative zone. As such, equity still is in excess of a third of the capital structure. The wide variety of debt sources and the resulting increased demand for new lending opportunities has kept borrowing costs low.
- The mezzanine funds continued to aggressively pursue deal opportunities into 2018. The use of this type of funding in leveraged transactions remains an important part of the LBO capital structure. While interest-only and payment-in-kind structures still dominate the markets, warrants have started to return to the mezzanine return structure, particularly in smaller or more leveraged deal structures. Mezzanine funds continue to pursue equity co-investment opportunities to improve their returns and increase their investment amount in deals.

Equity and Debt Capitalization
2013 to 2017



Source: GF Data

Overall Comment on the Financing Markets

The demand for new loan opportunities is far greater than the supply of companies wishing to borrow money. This demand supply imbalance has created a "borrowers' market" and more competition for the good credits entering the credit markets. Lenders are offering looser loan structures, greater leverage and aggressive pricing to win deals.

Private equity funds and other financial sponsors are taking advantage of this market condition along with pushing aggressive pricing and more borrower-friendly terms on new acquisitions and loan re-financings. The muted M&A volume has helped create this environment and shifted the power from the lenders to the borrowers.

Lower tax rates will provide businesses with more cash flow to make capital equipment purchases and acquisitions. The new 100% bonus depreciation for both new and existing hard-asset capital expenditures in the year made is expected to help capital investment and could enhance loan growth later in 2018. However, the limits on the deductibility of business interest expense will probably offset some of the benefits of the bonus depreciation and limit the amount of debt used by companies. It will likely be later in 2018 before we see the actual effects of the new tax laws.

Even with the Fed's continued interest rate increases, we remain in a low interest rate environment with low borrowing costs for businesses. Credit worthy companies with a need for long-term debt capital are well received in the lending market. The current environment presents companies with an opportunity to borrow at a low interest rate.

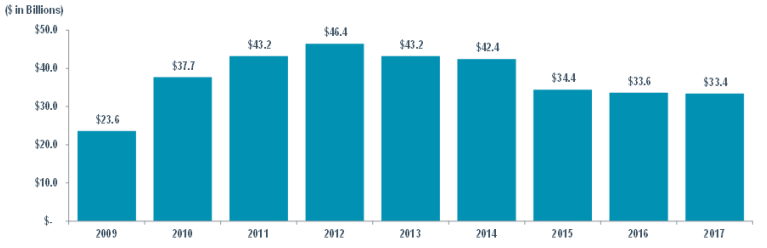
Total U.S. Middle Market Loan Issuance

- New loan issuance for middle market companies in 2017 seems to have stabilized at a lower level even with the issuance of the previous two years. This sustained lower level seems to have halted the slide in loan volume that began in 2012. It is believed that this is a demand side issue because there is an abundant supply of credit available for middle market companies. An improving economy and better business owner sentiment will likely contribute to more loan demand and therefore new loan issuance in 2018.
- The Federal Reserve increased its benchmark interest rate another 25 basis points in March 2018. This was the first 25

basis point increase in 2018 and the sixth 25 basis point increase since the end of the recession. The overnight funds rate target range is currently at 1.50% to 1.75%. Expectations remain for two to three additional increases in 2018 moving closer to a more normalized target range of between 2.00% to 4.00%.

- Bank lenders continue to focus on relationship banking, corporate borrowers' lines of credit and areas where they have a competitive advantage like operating business needs, including payroll and checking accounts. Due to regulatory scrutiny, banks continue to be selective in making new loans and are very selective in new leveraged transactions.
- The non-bank BDC ("Business Development Company") lenders have benefited from rising interest rates and more relaxed regulations. These factors are likely to increase their participation in the middle market leveraged loan market.

Loan Issuance for the Middle Market <$100M
2009 to YTD – 3/17



Source: Thomson Reuters

Interest Rate Environment

- The short-end of the yield curve (Prime and 1 month LIBOR) are 75 and 90 basis points higher respectively, in year-over-year comparisons reflecting the three additional 25 basis point Fed rate hikes orchestrated since the end of 1Q17. The market expects two to three additional Fed rate increases in 2018, which will likely further shift the low end of the curve higher in 2018.
- The yields of the five and 10 year U.S. Treasuries in year-over-year comparisons have not increased as much as the short end of the yield curve. This flattening of the yield curve is a source of concern for some analysts especially when the yield curve inverts. An inverted yield curve is a predictor of recessions. At the end of 1Q18, the spread between the two to 10 year treasury was 45 basis points (compared to 113 basis points at 1Q17), still positively sloping but a statistic to watch in the future.
- The unemployment rate remains at 4.1%. Job growth in the U.S. has been robust and trending higher across many sectors of the economy. The new tax bill's lower corporate taxes and reduced regulation is leading to a more positive market psychology and more investment in capital assets and additional employees. All of these factors are expected to lead to more job growth in 2018.

KEY INTEREST RATES

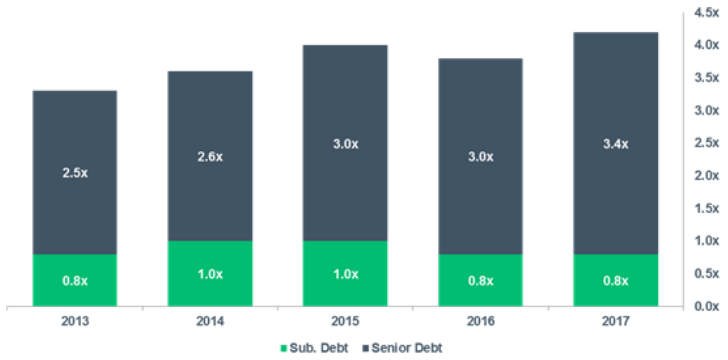
	3/31/2017	3/29/2018	4/16/2018
Prime Rate	4.00%	4.75%	4.75%
Libor - 1 Month	0.98%	1.88%	1.90%
Libor - 3 Month	1.15%	2.31%	2.35%
U.S. Treasury - 2 Year	1.27%	2.27%	2.37%
U.S. Treasury - 5 Year	1.93%	2.56%	2.67%
U.S. Treasury - 10 Year	2.40%	2.74%	2.82%

Source: Capital IQ

Middle Market Debt Multiples

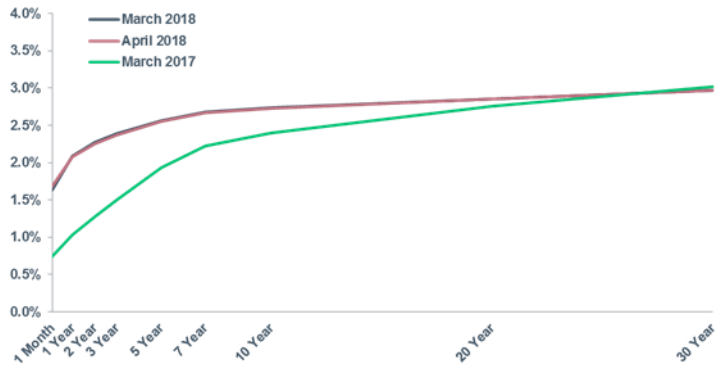
- Deal market debt leverage levels moved higher in 2017. Total leverage reached 4.2x with the senior bank component of the total leverage reaching 3.4x. More aggressive lender behavior, particularly on larger transactions, and improving economic conditions are providing support to deal market participants using debt leverage.
- Mezzanine capital remains an important part of a buyout capital structure. Over the last few years, mezzanine debt has made up between 0.8x to 1.0x EBITDA of a typical leveraged capital structure. This component of the capital structure has remained consistent over the last few years.
- The use of debt leverage helps sustain high middle market M&A valuations. If interest rates rise significantly, the use of senior debt may decline somewhat putting downward pressure on M&A valuations.

Senior Debt and Sub. Debt/EBITDA – TEV of $10-250 Million
2013 to 2017



Source: GF Data

Yield Curves – U.S. Treasuries



Source: Capital IQ

- Bank lenders continue to maintain credit discipline largely to satisfy their regulators. The regulators limit the amount of HLT ("Highly Leveraged Transactions") exposure that a bank can hold. Bank provided senior credit facilities remain at the relatively conservative 3.0x EBITDA senior debt ratio, so the slight increase in the use of senior debt is likely due to more aggressive, unregulated BDC lenders.

Terrel Bressler, Managing Director
312.348.1323, tbressler@prairiecap.com

Financing Pricing

Bank Financing	Upfront Fees	LIBOR Spread
Asset Based Loans	25-50 bps	150-200 bps
Cash Flow Loans		
EBITDA less than $10M:		
Unleveraged Loans	0-50 bps	150-250 bps
Leveraged Loans	75-150 bps	300-425 bps
Cash Flow Loans		
EBITDA more than $10M:		
Unleveraged Loans	0-50 bps	150-250 bps
Leveraged Loans	100-150 bps	350-475 bps

Mezzanine Debt	<$10M EBITDA	> $10M EBITDA
Upfront Fees	2.00%	2.00%
Current Pay Coupon	11.00%-13.00%	10.00%-12.00%
Payment-in-Kind (PIK) Interest	0.00%-3.00%	0.00%-2.00%
All in IRRs	14.00%-17.00%	10.00%-13.00%

Source: Pricing is based on guidance provided by a number of commercial and mezzanine lenders

Note: Warrants and other yield enhancements comprise the incremental return required to meet the all-in internal rate of return ("IRR")

Transaction Highlight

M&A Advisory

TALKAPHONE

was acquired by

CFB CAPITAL FOR BUSINESS

NORTHCREEK MEZZANINE

Advisor to the Seller

About Talk-A-Phone Co.

Founded more than 80 years ago, Talkaphone is the industry's leading designer and manufacturer of security and life safety communication products and solutions for customers all over the world. Talkaphone manufactures emergency communication systems, mass notification systems, area of rescue/refuge systems, and access control systems for educational, corporate, commercial, and government needs.