SPRING 2019

PRAIRIE

Prairie Middle Market Perspective

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Overall M&A Market Commentary

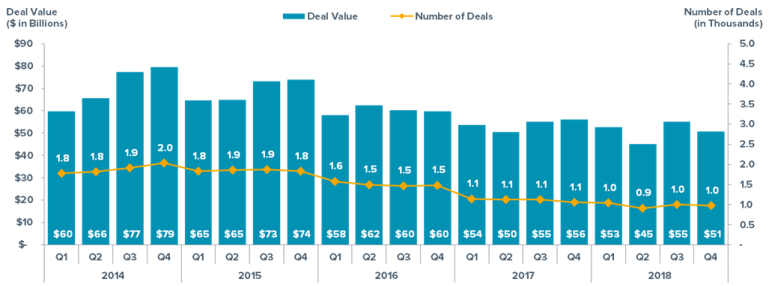
The current U.S. economic expansion continues its run into record length territory in early 2019. After final downward adjustments to 4Q18 GDP, 4Q18 to 4Q17 GDP growth clocked in at 3.1% with total year to year GDP growth at 2.9%. Only a few years ago many economists thought growth rates this robust were no longer possible. In a news conference in late March 2019, Fed Chairman Jerome Powell remarked that the economy "is in a good place" and that "economic fundamentals are still very strong." However, Powell also remarked that the 2019 economy was slowing more than expected due to weakness in consumer spending and business investment. As a result, the Fed reduced its estimate of 2019 GDP growth to 2.1% from the Fed's previous December 2018 forecast of 2.3%. The slowdown in the European and Chinese economies are affecting the U.S. economy and making it difficult to achieve 3% plus GDP growth in 2019. While the Fed has become more conservative in their assessment of the economy, others have more optimism. "The first-quarter was artificially weak and difficult to estimate because of things like the government shutdown, the polar vortex and last year's boost from tax cuts," said Ralf Preusser, rates strategist at Bank of America. "But the labor market is solid and fiscal policy remains supportive. I think there is quite a high chance of a positive GDP surprise, Q2 and Q3 should be above trend."

The labor markets continue to show strength. "The ***economy is at full employment***, hiring plans are strong, and the record-high levels of job openings are positive indicators for economic growth," said NFIB Chief Economist Bill Dunkelberg in the April 4th NFIB monthly job report. "The main concern is the lack of qualified workers. Small businesses' willingness to hire shows that they see an economy that is solid enough to continue investing in labor." The unemployment rate sits at 3.8% with 3.2% wage growth and 832,000 total jobs added so far in 2019.

Trade and tariffs could still be a positive factor in the strength of the economy in 2019. As of mid-April, according to Treasury Secretary Steve Mnuchin, trade negotiations with China are nearing the final stages. If a trade deal can be struck with China, a large component of the market uncertainty is expected to be reduced. A positive outcome with a China trade agreement could lead to stronger growth in the U.S. economy.

Overall, business owners remain optimistic with the economy and the prospect for future growth, but there are potential problems. Trade issues and the slowing European economy may create issues for the strength of the U.S. economy. In the face of this, aging business owners are considering their strategic options leading to more investment banker pitch activity. This increased pitch activity is expected to produce greater middle-market deal flow in late 2019.

Total U.S. M&A Deal Volume and Value <$300M Transaction Value
Q1-2014 to Q4-2018



Source: Capital IQ

The M&A supply demand imbalance continues to favor the sellers in this market. There is strong demand for good quality acquisition targets and M&A market valuations continue to be elevated. We encourage business owners to look at their transition goals and objectives to determine whether a company sale makes sense for their circumstances.

M&A Market Activity

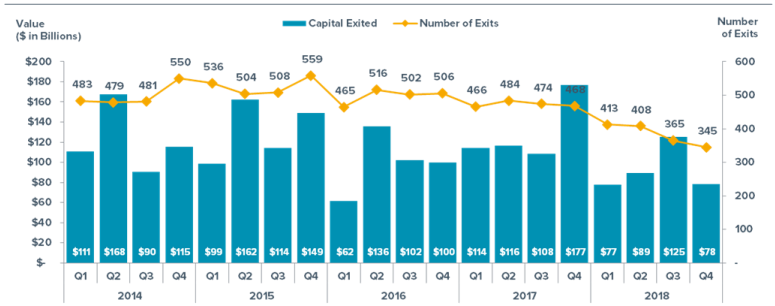
Overall value of closed 2018 middle-market M&A deals decreased slightly from the value closed in 2017 with the number of closed 2018 deals also being lower than the volume in 2017. However, the steady activity observed in each of the four quarters of 2018 seemed to indicate a market bottom in M&A activity. A resilient U.S. economy, a strong March jobs report and 3.2% wage growth have continued consumer confidence and sustained business optimism. This optimism is leading to more interest by business owners in considering a sale and increased pitch activity. Valuations are high, capital is plentiful and demand for quality businesses is strong. We believe action in 2019 is important to avoid missing the open widow of this sellers' market.

In 2017, PE firms took advantage of elevated company valuations and a shortage of quality sale candidates, setting a five-year quarterly high for dollar value of company exits. PE exit activity recorded in 2018 was not impressive. The high level of PE sale activity in 2017 likely pulled deals forward and set the stage for lower PE sale activity in 2018.

Persistently low deal activity and strong buyer demand for acquisitions have sustained M&A valuations at historically high levels. Strategic and PE buyer demand for new deals, the availability of debt capital and the lack of supply of quality companies for sale is expected to continue to support elevated valuations at least through 2019.

- The $51 billion of middle-market deals recorded in 4Q18 reflects a 7% decrease in dollar value from 3Q18, while the full year 2018 dollar value of deals was down 5% compared to levels experienced in full year 2017. The quarter over quarter rate of decline is slowing which reflects the forming of a market bottom in middle-market M&A deal value.
- The number of middle-market closed deals in 4Q18 was flat compared to the number of closed deals in 3Q18. The number of closed deals in full year 2018 was down about 11% from the total closed deal tally in 2017. Deal volume over the last few quarters seemed to reflect the same market bottom in deal volume.
- The average middle-market deal size of $52.3 million in 2018 was up from the average $48.9 million deal size closed in 2017.

Private Equity Exits
Q1-2014 to Q4-2018



Source: Pitchbook

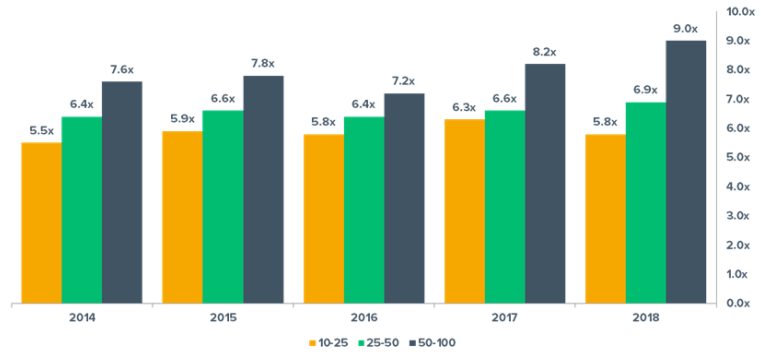
PE exit activity showed a similar picture and a reduction in volume through 4Q18. The number of PE exits in 4Q18 decreased about 6% from 3Q18 and the capital exited decreased 38% during the same period. Full year 2018 showed a 28% decline in the amount of capital exited from 2017 while the number of exits declined by 19%. 2018 was not a standout year for PE sales.

Middle Market Deal Valuations

Middle-market valuations reached record territory in 2018. Relatively low new deal volume coupled with abundant capital and a strong economy have sustained higher middle-market M&A valuations for several years. Even the increased stock market volatility in 4Q18 had little negative effect on market psyche and on middle-market M&A valuations. These high valuations provide evidence we are still in a strong seller's market. We believe middle -market company values have been near the market peak for a long time with increasing risk to the downside. Sellers should review their options and consider entering the M&A market before the opportunity is gone.

- Sub-$25 million deal valuation multiples moved slightly lower in 2018 declining to a 5.8x multiple which is near the long run multiple average for this size category.
- Valuations on the large end of the middle-market ($50 to $100 million segment) reached a high point at 9.0x, well above the last four years. More strategic buyer activity in this size range has likely supported this high valuation level.
- Valuations in the $25 to $50 million segment moved higher as well in 2018 reaching a five year high as well. Larger middle market companies are aggressively pursued in this market.
- Preparation is key to high valuations. 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 2018



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

Private Equity versus Strategic Valuations

Strategic buyers continue to lead in valuations in middle-market M&A. Strong economic conditions, lower corporate taxes and earnings growth objectives have led to aggressive strategic buyer behavior. Historically strategic buyers have been paying just short of 1.0x of EBITDA more than the average PE buyer. Our data show aggressive participation of the strategic buyer in 2018 M&A transactions has led to 1.4x EBITDA higher deal offer than PEs in 2018.

- Strategic buyers continue to be a significant factor in middle-market M&A. In 2018, strategic buyers reached a record high 8.6x multiple which is above the 5 year average.
- Over the last couple of years, PE acquisition multiples have remained in a stable range above 7.0x. We believe PE multiples are moving higher coincident to the strategic multiples.
- The trend in increasing valuations indicates 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.
- 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 below.

TEV/EBITDA Multiple by Buyer Type ($10-250M of TEV)
2014 to 2018

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)

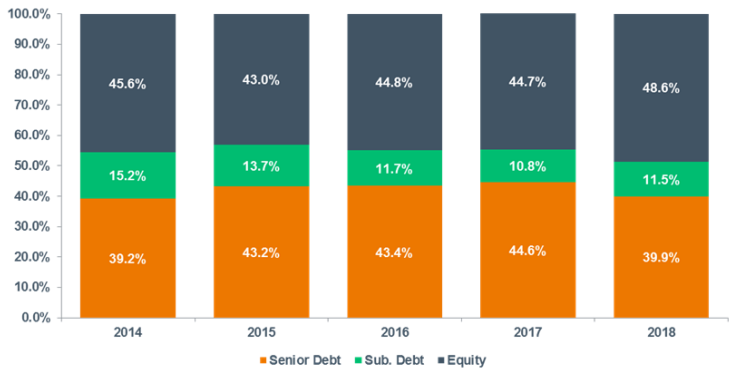
Middle Market Leveraged Buy Out Capitalizations

Lower levels of debt and more conservative capital structures are becoming prevalent in the middle-market leveraged buyout ("LBO") market. Even with abundant debt capital and aggressive lenders, in 2018 the average equity component of an LBO

transaction rose to over 48% of the capitalization. The data show a trend to more conservative capital structures, perhaps reflecting concerns over potentially higher interest rates and/or an expectation for an economic slowdown later in 2019 or early 2020.

- Debt capital is readily available across the middle-market. Commercial banks, asset-based lenders, business development corporations ("BDC") and mezzanine lenders all stand ready to support acquisitions and growth financing situations.
- The wide variety of non-bank debt sources and increased competition among banks for new lending opportunities has kept borrowing costs low. Increased lender competition has led to more borrower-friendly terms and a borrower's market.
- Mezzanine funds continued to aggressively pursue deal opportunities into 2019. The use of this type of financing in leveraged transactions remains an important part of the LBO capital structure. Interest only and payment in kind structures still dominate the markets. Mezzanine funds continue to pursue equity co-investment opportunities to improve their returns and increase their investment amount in deals.

Equity and Debt Capitalization
2014 to 2018



Source: GF Data

Overall Comment on the Financing Markets

There continues to be an abundance of debt and mezzanine capital for M&A deals and corporate growth. Banks, non-bank lenders, mezzanine funds and private equity investors all have investable funds and they are anxious to put the money to work. The economy measured by GDP, while slowing, continues to perform above trend with this above trend performance expected through at least 2019. According to the New York Fed's Yield Curve as a leading indicator (updated March 11, 2019) model puts the probability of a recession in the 12 months ahead at 24.6%. While not directly affecting the economy, the stock market volatility of 4Q18 has subsided. The public equity markets have returned to an upward trend with a new market high possible in 2Q19. Business optimism continues its positive trends.

Middle-market loan volume has remained relatively flat from 2015 through 2017. Breaking the trend, 2018 middle-market loan volume declined approximately 8.5% in 2018. While lenders and borrowers have become a little more conservative in 2018, lenders remain anxious to make new loans for M&A transactions or business growth. The lack of middle-market loan growth is a demand driven problem. According to the February 2019 NFIB Small Business Optimism Index, only 27% of small business owners plan capital expenditures in 2019. Business increases in capital expenditures, continued economic growth and a trade deal with China could once again lead to more borrowing in 2019.

The yield curve shifted during 2018, with one-month Libor, the extreme short end of the curve now being slightly higher than the five-year treasury yield. Normally an inversion of the yield curve would signal a recession in 18 months, but with only a slight inversion, low inflation, a strong labor market and expected continued above trend economic growth, any recession will likely be a little further off. The Fed interest rate normalization program was put on hold in late 2018 signaling that it is unlikely there will be any rate increases in 2019.

We remain in a low interest rate environment with favorable business borrowing costs. Low interest rates coupled with borrower friendly terms makes this a borrower's market. Credit worthy companies still have an opportunity to structure loans with favorable terms and are welcome in the lending market.

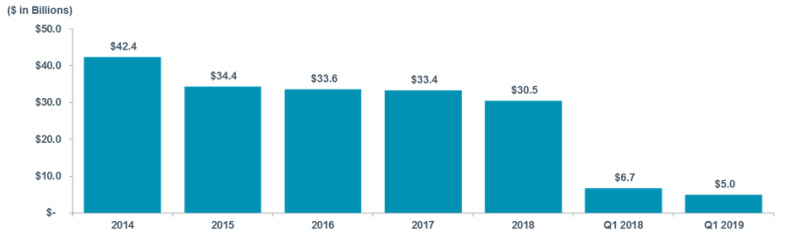
Total U.S. Middle Market Loan Issuance

- New bank loan issuance for middle-market companies was anemic during 2018 dropping about 8.5% from previous years. Even while the 2018 economy was booming, middle-market companies did not see reasons to take on debt. First quarter data for 2019 seems to indicate that 2019 could be another down year in middle-market bank lending.
- The Fed has increased rates nine times since it began its normalization tightening cycle in December 2015. The

overnight funds rate target range is currently at 2.25% to 2.50%. Citing concerns over the global economy the Fed has decided to delay any further rate increases in 2019.

- 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.
- While significant concerns about a recession have subsided, U.S. borrowers and lenders have become more conservative in the use of debt because of concerns with the global economy and trade and the potential effect on their business.

Loan Issuance for the Middle Market <$100M
2014 to YTD Q1-2019



Source: Thomson Reuters

Interest Rate Environment

- The short end of the yield curve (Prime and one-month LIBOR) in a year-over-year comparison reflects the three additional 25 basis point Fed rate hikes orchestrated in the last three quarters of calendar year 2018. Prime was up 75 basis points and one-month LIBOR was up 61 basis points. The Fed signaled that concerns with the strength of the global economy would cause them to cease additional rate increases.
- The yield curve has changed shape since last year and now is slightly inverted at the five-year treasury. An inverted yield curve is a source of concern for analysts because it is considered by some to be a predictor of a future recession. At the end of March 2019, the interest rates on the long end of the curve were about 33 basis points lower than last year while the rates on the short end of the curve were higher than the rates of last year. The short end of the curve is now higher than the long end.
- Lower corporate taxes and reduced regulation are leading to a dramatically improved labor market. The March jobs report had better job creation than expected and the wage growth continued at a strong 3.2% growth rate. There are more available jobs than there are unemployed which is good for economic growth. Even with a slightly inverted yield curve there appears to be no recession on the horizon.

KEY INTEREST RATES

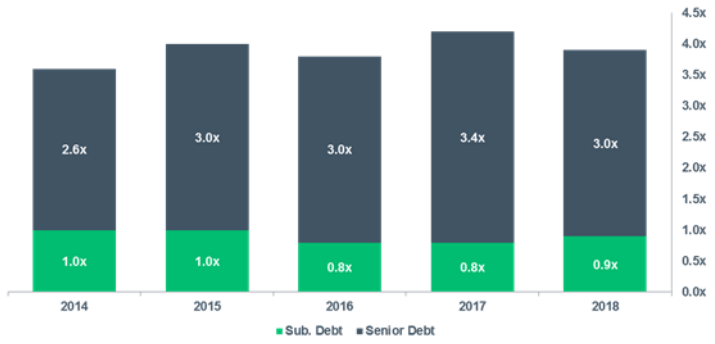
	3/29/2018	3/29/2019	4/15/2019
Prime Rate	4.75%	5.50%	5.50%
Libor - 1 Month	1.88%	2.49%	2.48%
Libor - 3 Month	2.31%	2.60%	2.60%
U.S. Treasury - 2 Year	2.27%	2.27%	2.40%
U.S. Treasury - 5 Year	2.56%	2.23%	2.37%
U.S. Treasury - 10 Year	2.74%	2.41%	2.55%

Source: Capital IQ

Middle Market Debt Multiples

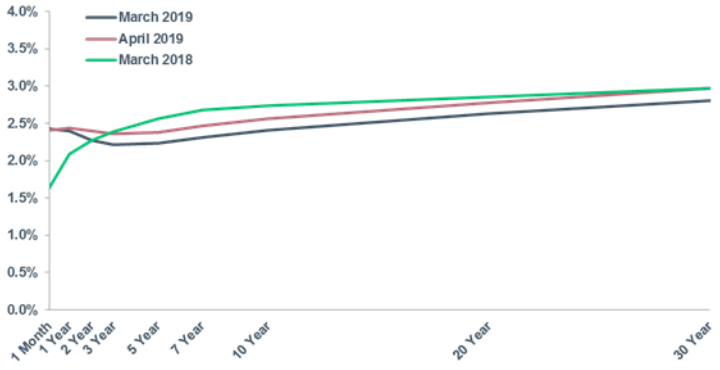
- Deal market total debt leverage has moved to 3.9x in 2018 with the senior bank component of the total leverage declining to 3.0x. Tariff issues, political uncertainty and more volatile markets are making borrowers and lenders more cautious in structuring new loans
- Mezzanine capital still plays an important role in a leveraged capital structure. Over the last few years, mezzanine debt has represented a little less than 1.0x EBITDA which has remained consistent.
- The use of debt leverage, even when it is declining slightly helps sustain high middle-market M&A valuations. If interest rates rise significantly, the use of senior debt may decline further putting downward pressure on M&A valuations.
- 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 at the relatively conservative 3.0x EBITDA senior debt ratio. During 2018 BDC lenders have also become more conservative in their lending practices contributing further to the decline in debt multiples

Senior Debt and Sub. Debt/EBITDA – TEV of $10-250 Million 2014 to YTD 2018



Source: GF Data

Yield Curves – U.S. Treasuries



Source: Capital IQ

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")

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Transaction Highlight

M&A Advisory

THE LIFEGUARD STORE

was acquired by

Kiefer

Adolph Kiefer & Associates

Advisor to the Seller

About The Lifeguard Store

Headquartered in Bloomington, IL and founded in 1990, The Lifeguard Store is the largest supplier of lifeguard equipment, aquatic safety products, and lifeguard swimwear in the U.S. The Company is also a leading outfitter of swimwear, swim gear, and equipment to the competitive swim team market. The Lifeguard Store offers the top brands in the market including Speedo, TYR, Adidas, Dolfin and Nike as well as its own Rise Aquatics private label line.

The Lifeguard Store has been acquired by Adolph Kiefer & Associates.