2016 STATE OF THE INDUSTRY

The Current State of the Capital Markets

BOYAR MILLER
ATTORNEYS AT LAW

Friends,

There's an adage that the only constant is change and that certainly applies to the capital markets. Keeping up with that change, and hearing expert perspectives on what we can expect in 2017, is the goal of our annual State of the Capital Markets Breakfast Forum.

This ebook is a compilation of some of the key takeaways from the Breakfast Forum. We invite you to review it and pass it along to your business colleagues if you find it helpful. We have also posted the slides from the presentation on our website for future reference.

Sharing information that supports our clients and helps them achieve their business goals is an ongoing commitment of our firm. As a core value, we strive to bring together industry expertise, knowledge of our clients' specific business and our extensive experience in law to achieve practical business solutions for our clients. This is one way we deliver on that promise.

Sincerely,

Chris Hanslik

CHRIS HANSLIK
Firm Chairman

CONTACT

2925 Richmond Avenue, 14th Floor
Houston, Texas 77098

713.850.7766
Visit boyarmiller.com

LEARN MORE ABOUT THE FORUM

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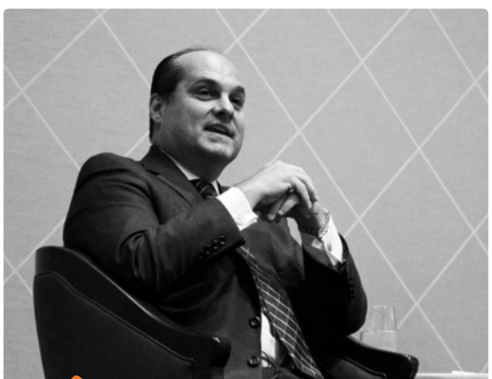
The Breakfast Forum Snapshot

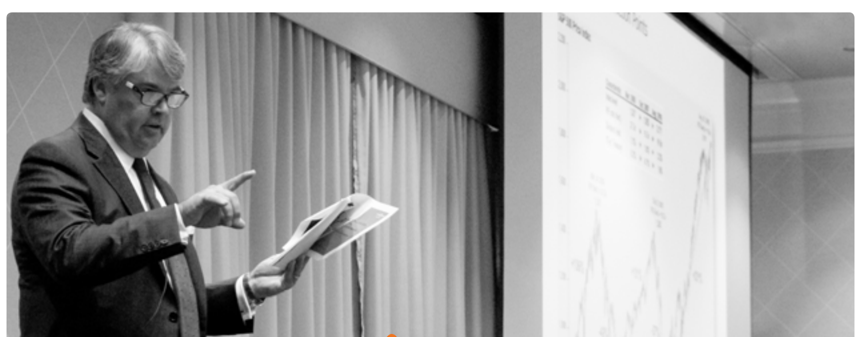


There is a real quality differential going on.

CLIFF ATHERTON

Borrowers: take advantage of current market conditions.

JOHN SARVADI



Your ability to buy shares in the stock market has been reduced.

DREW KANALY

Expert Insights

Equity and the Public Market

DREW KANALY
Chairman, Kanaly Trust

Rolling the dice: Investors grappling with lower interest rates have to take bigger risks if they want to match returns of two decades ago.

KEY TAKEAWAYS

- Public markets are not terribly overpriced, especially when looking historically at inflection points.
- Emerging markets are undervalued compared to historical averages, and have been for quite some time.
- The ability to buy shares in the stock market has been reduced by more than four and a half trillion dollars, yet price earnings multiples are reasonable.
- Allocating to an expected return of 7% in today's markets yields a 17% standard deviation. Probability says that is an unacceptable risk for the average retiree.
- Portfolio construction based upon bonds for moderate risk may not work until interest rates normalize. Modern portfolio theories are on hold for awhile.

ABOUT DREW

Drew is Chairman and President of Kanaly Trust and is responsible for all client and business development firm-wide. He also continues to manage the ongoing investment strategies and personal wealth management programs of several family relationships. He specializes in investment management, charitable trusts and family limited partnerships. Since earning his BBA in Finance from the University of Houston, Drew has attended the American Bankers Association's National Graduate Trust School at Northwestern University, the Texas Bankers Association Regional Trust School at Southern Methodist University and earned a CFTA designation.

Expert Insights

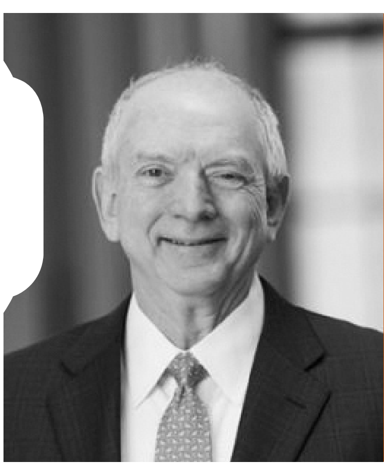
Private Equity and Mergers & Acquisitions

CLIFF ATHERTON
Managing Director, GulfStar Group

Quality differential: There are a handful of good deals that are being chased, and then there are mediocre deals that have a hard time attracting interest.

KEY TAKEAWAYS

- Private equity buyers have significant capital to deploy. The growth of private equity since 1992 has been phenomenal.
- Q2 2016 has been the worst quarter for middle market M&A deals since Q2 2009—only 292 deals were made.
- The private equity machine works off of leverage. Since 2010, multiples in these transactions have increased from three times total debt to almost four times total debt.
- There is about a trillion dollars in dry powder available in the marketplace—that's equity capital that is committed but has not yet been drawn for transactions plus a corresponding amount of debt financing.
- The oil industry has benefited from declining interest rates because it is a capital-intensive business.



ABOUT CLIFF

Cliff Atherton is an investment banker with decades of experience in corporate finance and teaching finance at the graduate level. He joined GulfStar in 1995 and since that time has completed numerous corporate finance assignments for business owners. Most of Cliff's clients are entrepreneur- and family-owned businesses with enterprise values between $25 and $250 million. His transaction experience is split evenly between sales to strategic buyers and recapitalizations with private equity firms.

Expert Insights

Commercial Banking and Senior Debt

JOHN SARVADI
President of Texas Capital Bank

Advice to debt market participants: Raise capital opportunistically, when you can, not when you need it.

KEY TAKEAWAYS

- Interest rates remain low, debt is cheap and investors are chasing yield.
- Stagnant growth in the world economy, particularly in the U.S., is driving such a poor rate environment.
- Absent a dramatic change in the global economy, we can expect a "low for long" environment.
- This recovery is a bit "long in the tooth." Most recoveries don't last this long.
- Abundant non-bank capital is available for financing, replacing bank debt.
- Despite lower growth than past recoveries (2.1%), the current expansion is much longer than previous business cycles.
- Ultimately, greater regulation and cost in the system could lessen availability of credit during future cycles.

ABOUT JOHN

John Sarvadi joined Texas Capital Bank in June 2013 as President of the Bank's Houston Region, with primary responsibility for Houston corporate banking and the bank's national efforts around asset-based lending and branded retail/franchise finance. Prior to joining Texas Capital Bank, John spent 24 years with JPMorgan Chase and predecessor firms, working in and leading teams in the firm's commercial, corporate and investment banking lines of business.

Attorney Insights

Navigating Troubled Waters – The Current State of the Capital Markets

LARRY WILSON
Shareholder, Business Group

CYRUS CHIN
Associate, Business Group

Where is an investor to turn in the current economic climate? Public equity markets are trading around or below historic P/E averages even while yields on sovereign debt is near zero, and sometimes below.

Persistently low oil prices have driven deal flow to the lowest point since 2009 despite plenty of available investment capital. And banks are beset with low-for-long interest rates while they battle increased competition from new and unregulated lenders.

PUBLIC EQUITY AND DEBT

Take a look at stock markets around the world. The S&P 500 Index is trading near its historic high but the index P/E is near the historical average of 16x projected earnings. So what's driving the index to new highs on historic earning multiples?

Maybe it's the net reduction of the number of shares that you can buy since 2004. Stock buybacks, mergers and other transactions have removed $4.5 trillion in stocks from the market. Or maybe it's the dividend yields of over two percent. The picture doesn't get much clearer for emerging markets: they are undervalued and look like a bargain compared to their historic averages but they have been at this level for some time. Either way, the public equity markets do not look overpriced. Couple that with yields on U.S. government bonds that are around 1.6 percent, and yields on the sovereign debt of other creditworthy countries that are sometimes less than zero, and there is a perfect storm for the balanced portfolio.

Conclusion: modern portfolio theories—in which fixed income-yields offset the reasonable risk-weighted return of equity and alternative investments—are going to be on hold for a little while.

PRIVATE EQUITY MARKET

Middle-market M&A deal flow for the first six months of 2016 was at the lowest level since 2009. The perception is that the M&A market has two tiers, with a few transactions getting a lot of investor attention and others having trouble gaining any traction. Valuations have been affected in 2016 but remain healthy.

The other important consideration is the amount of funds available for investment, or dry powder, which is a combination of the undrawn commitments to private equity funds and the leverage that a transaction can support. Private equity has undrawn commitments of more than $500 billion and leverage ratios have been running at about 4.0x EBITDA. So every $1 of equity is matched with a $1 to $1.50 of debt. When you combine the undrawn commitments with the magic of leverage you realize there is somewhere around $1 trillion in dry powder available.

So why aren't there more transactions? As in other years, and in the larger market generally, there is a real difference in the multiples commanded by a $10+ million EBITDA company compared to the multiples that a $5 million EBITDA company will receive. Maybe sellers that see a way to grow their company are holding back a little to capture the benefit of the size premium. And maybe there's just enough uncertainty about the future for private equity funds to wait and see what is going to happen before chasing some transactions.

Conclusion: although there is an abundance of "dry powder" available for investment, as a result of the undrawn investment commitments to private equity and the increase in leverage that can be brought to bear, there simply are not enough transactions of the right size and right quality to put this money to work.

COMMERCIAL LOAN MARKET

When the Federal Reserve raised the interest rate in December 2015, it was the first time in nearly a decade. There are people in the business world that have never seen a rate hike. However, interest rates remain low and there is a prevailing sentiment that they will remain low for awhile.

One of the drivers of the current interest rate environment is stagnant economic growth in the U.S. and other world economies. Almost every recession has been followed by robust growth. Not so with the recession of 2007 – 2009. Although we are currently in the third longest recovery since World War II, we have been limping along because of the anemic U.S. growth rate of 2.1 percent and lingering concerns over Europe and China. Even though we are in a seven-year recovery, there's probably more downside risk in the U.S. economy than upside risk of long-running, robust recovery going forward.

In addition, a new class of investors is putting money into business development companies and other private credit sources that have economic and regulatory flexibility relative to commercial banks. As a result of these alternative lenders, the commercial banking segment has become increasingly more competitive, and borrowers can use that to their advantage.

Conclusion: borrowers should use the current climate as an opportunity to raise debt opportunistically when they can and not when they need it, extend maturity dates, reprice deals, and amend covenants to their advantage. Take up offers from bankers to go to lunch and keep all borrowing options open.

Capital Markets Practice Leaders

BILL BOYAR

Founding Shareholder, Business Group

Represents the various parties involved in the acquisition, disposition, capitalization and financing of national and international businesses. Served as lead counsel for numerous complex, multi-party acquisitions and project financings with significant experience in corporate finance, mergers and acquisitions, private equity and structure finance.

GARY MILLER

Founding Shareholder, Business Group

Represents numerous domestic and offshore-based companies in connection with acquisitions and divestitures, financings, joint ventures and general corporate matters in the United States.

STEVE KESTEN

Chair, Business Group

Represents multiple international energy and energy services clients with outbound expansion (i.e., U.S. companies expanding internationally) and inbound expansion (international companies expanding to the U.S.), including start-up expansion or expansion by acquisition, as well as in connection with financing and merger and divestiture transactions.

GUS BOURGEOIS

Shareholder, Business Group

Represents clients doing business domestically and internationally in connection with mergers and acquisitions, finance and multi-jurisdictional transactions, including negotiation of contracts for sales of goods and services (including master service agreements), technology licensing, joint venture agreements, and employment agreements, with significant experience in assisting foreign businesses in establishing and growing their U.S. operations.

BLAKE D. ROYAL

Shareholder, Business Group

Represents corporations and businesses in corporate transactions, contracts, private equity investments, mergers and acquisitions, corporate restructuring and capital formation strategy and structure.

PHILIP A. DUNLAP

Shareholder, Business Group

Represents clients for corporate and private securities transactions as well as serving as outside general counsel in a variety of matters, including mergers and acquisitions, financing, employment agreements and raising capital through private offerings.

LAWRENCE E. WILSON

Shareholder, Business Group

Represents public and private businesses in acquisitions, divestitures, corporate finance and general corporate matters and provides corporate and commercial counseling – acting as an outside general counsel to various businesses – regarding complex mergers and acquisitions, initial capitalization and growth financing and restructuring transactions.