SUMMER 2021

PRAIRIE

Prairie Middle Market Perspective

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Overall M&A Market Commentary

The pandemic business and economic recovery continues in full swing. The resilience of the U.S. business environment is truly quite remarkable, and the strength of the recovery was unexpected by most economists. However, the rapid increase in business activity has strained the manufacturing supply chain and created delays and shortages across the economy as raw materials supplies and labor availability became limiting factors to temper even stronger growth. In addition, inflation is a growing concern as shortages and the high government spending levels lead to a significant rise in the price of goods and services.

The success of the vaccine rollout is the largest contributor to the ***full-throttle economy***. According to the Center for Disease Control and Prevention ("CDC"), as of July 1, 2021, 54.6% of the U.S. population has had at least one dose of vaccine. When combined with the portion of the population with "earned immunity" (those who had the infection), the part of the population that is protected from serious illness is quite large. The CDC indicates that the number of citizens hospitalized and the number of daily deaths are now at the lowest levels since March 2020. Further, early studies indicate that the vaccines in use are highly effective against the new strains of the virus, including the Delta variant. As a result, it is believed that any autumn virus surge will be limited and will only affect the remaining unvaccinated population. The rapid vaccine development, aided by Operation Warp Speed, and the quick move to manufacturing and rollout of the doses was truly a remarkable pandemic event.

The success of the vaccine, the lifting of restrictions on citizens and businesses and the massive government stimulus has contributed to the surge in economic growth. The final revision of annualized real Q1 GDP growth was 6.4%, fueled by personal consumption and business investment. The largest drag on 1Q GDP growth was inventory, as supply issues caused businesses to sell from inventory rather than produce new goods. These inventories will eventually need to be replenished, which will contribute future economic activity and even higher GDP growth.

The U.S manufacturing sector continues to show strength as well. The ISM Manufacturing Index was 60.6 in June, which marked the fifth consecutive month that the index was above 60. Values above 50 show growth, with values above 55 signifying strong growth. The manufacturing sector performance is impressive given the negative impacts of labor shortages, rising costs of raw materials and transportation issues.

The massive government stimulus, combined with high individual savings rates during the pandemic, has resulted in a vast resource ready to fuel the economy. Record savings balances, reduced pandemic restrictions on individuals and improving job prospects coupled with wage growth are collectively improving the consumer psyche. The Conference Board's June survey of consumer sentiment reached 127.3, well above the pre-pandemic three-year average of 122. Because the consumer drives almost 70% of the U.S. economy, these factors are expected to continue the strong economic recovery from the pandemic.

Due to the extended period that private company M&A market data is collected, there is a one-quarter lag in our information. As a result, the market commentary reflected below is limited to the data through 1Q21. The 2Q21 data will be reviewed in the next quarter newsletter.

Total U.S. M&A Deal Volume and Value <$300M Transaction Value
2016 to Q1 2021

Source: Capital IQ

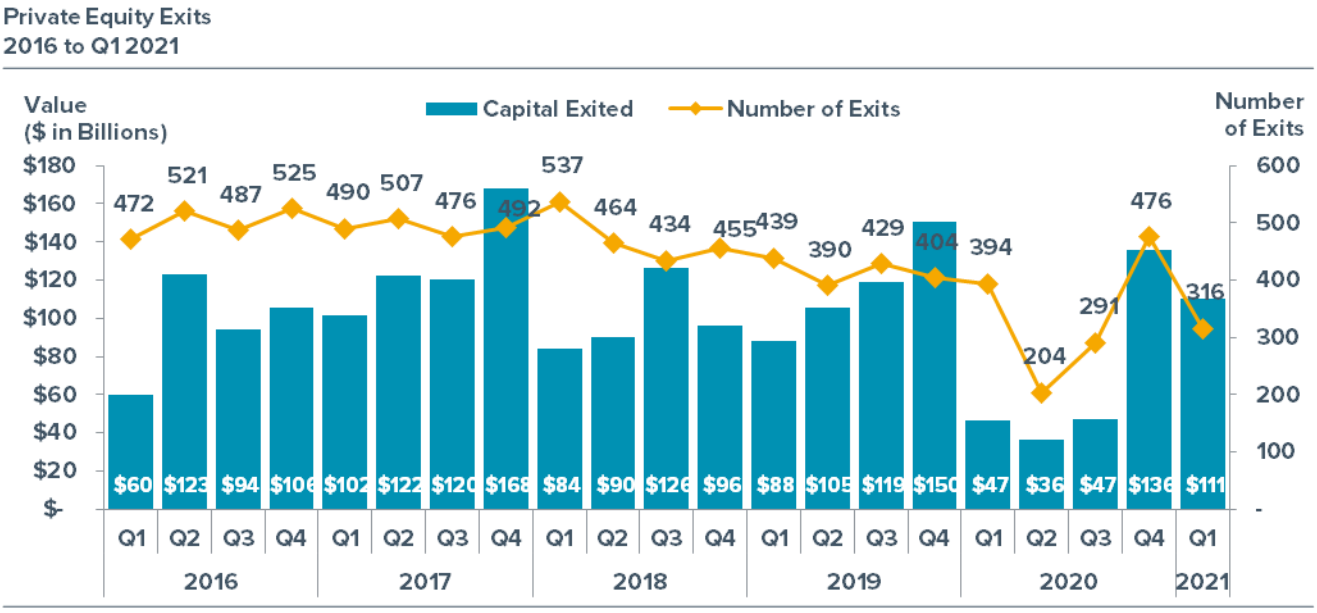
M&A Market Activity

M&A dollar and deal volume in 1Q21 slowed from the strong deal flow experienced in late 2020. Typically, the first quarter in a year is lower than other quarters because of the large number of closings in the previous 4th quarter. The rapid recovery from the pandemic lockdown has led to a robust economy and a strong deal environment, which is not completely reflected in the 1Q21 data. The demand for new M&A transactions is very strong, with a scarcity of supply being the primary issue. This sets up a perfect opportunity for sellers today. The deal community is seeing strong early-transaction phase activity, with deal market processing capacity being stretched. As a result, it is expected that closed transaction activity will likely pick up later in 2021.

- $43 billion of middle-market deals were recorded in 1Q21, down 28.3% from the value in 4Q20 and, in year-over-year comparisons, 1Q21 deal value was down 27.1% compared to the mostly pre-pandemic 1Q20.
- The number of middle-market deals closed in 1Q21 decreased 18.2% compared to the number of deals closed in 4Q20. Like deal value, in year-over-year comparisons, the number of deals in 1Q21 was down 25.0% from the pre-pandemic 1Q20.
- The average middle-market deal size of $47.8 million in 1Q21 was about 2.8% smaller than the average $49.2 million deal size closed in 1Q20.

Similar to the overall M&A market, Private Equity ("PE") exit activity slowed in 1Q21. The number of PE exits in 1Q21 decreased 33.6% from the number of exits in 4Q20, while the capital exited decreased 18.4% during the same period.

This supply shortage of deals, along with higher valuations, has enticed the PE funds to sell their portfolio companies to take advantage of the current market. While PE exit activity slowed in 1Q21, this is expected to reverse later in 2021. Moving into 2021, there continues to be strong demand for good-quality companies that far exceeds the current supply of such assets. The shortage of quality companies available for sale has caused a rapid return to the pre-pandemic sellers' market with higher sale valuations. We believe that sellers with strong-performing businesses will have an opportunity in 2021 to drive better deal terms, including higher sale valuations.



Source: Pitchbook

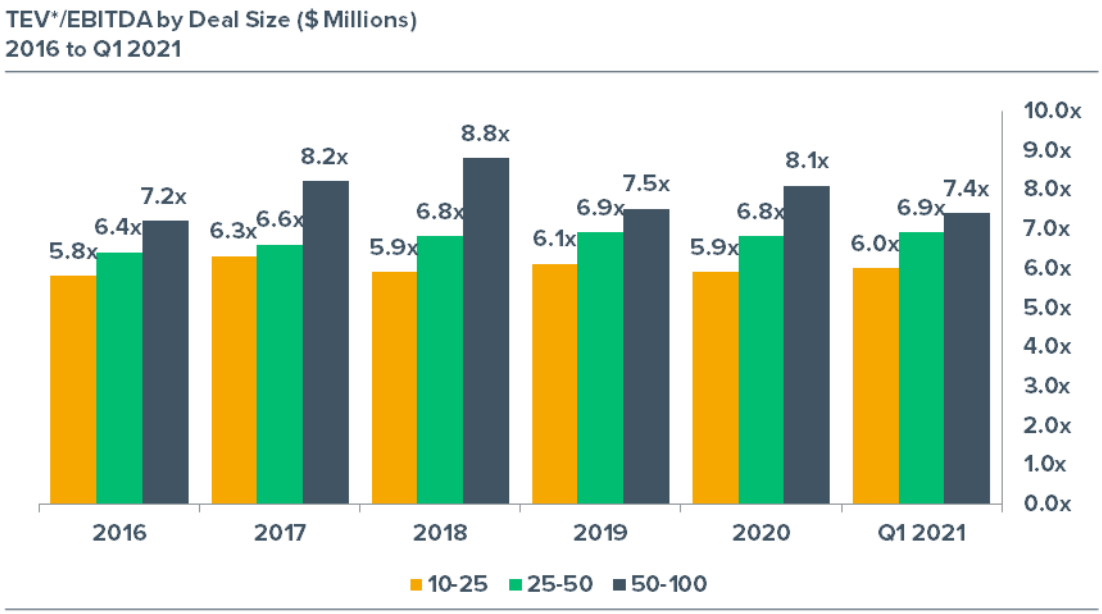
Middle Market Deal Valuations

The supply-demand imbalance continues in the M&A market and is becoming even more pronounced in 2021. M&A valuations were trending higher in 2019 and into early 2020 before the pandemic. The large number and variety of buyers created abundant competition and gave rise to a strong sellers' market. Moving into 2021, the more than $3 trillion in undeployed PE funds, the large cash balances on strategic buyers' balance sheets, the available debt capital and the Special Purpose Acquisition Corporations ("SPACs") all created substantial demand for new M&A deals. This surging demand for M&A transactions may limit the future valuation declines.

The capital available for new deals and the large amounts of post-pandemic government stimulus have led to record stock market levels and a resurgence of the M&A market. Until the supply of new deals increases significantly, we will continue to see valuations at these elevated levels. However, sellers must be well-prepared and ready for a rigorous deal process. The time and effort invested up front in preparing for a sale will ensure that sellers receive strong interest and attractive valuations in this robust M&A sellers' market.

Quarterly data tends to be more volatile than annual data, so we suggest focusing on trends rather than actual values in the quarterly data. The 1Q21 data shows a continuation of the valuation trends observed in the pre-pandemic period of 2019.

- 1Q20 deal valuation multiples for the sub-$25 million category came in at 6.0x, on par with the long-run average for this size category. Smaller deals are easier to digest and finance, which helps support valuations in a narrow range.
- Larger middle-market valuations ($50 to $100 million segment) in 1Q21 moved to 7.4x, below the long-run average of 8.0x for this segment. Quarterly data is more volatile, so this may be a temporary valuation decline.
- Valuations in the $25 to $50 million segment also moved higher to 6.9x, which is slightly higher than the average of this size segment for the last few years.



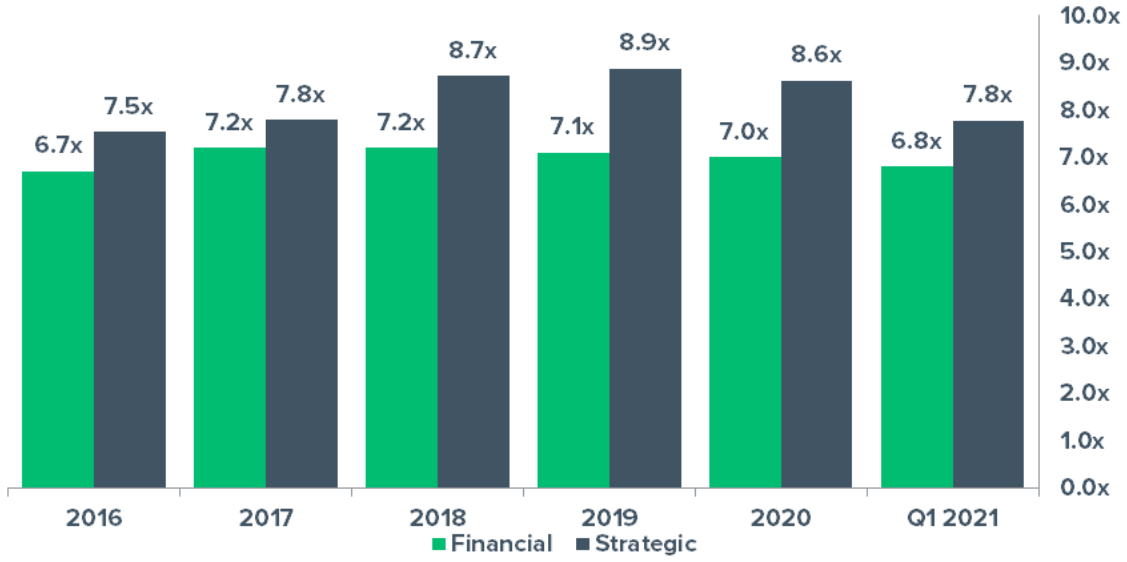
Source: GF Data
**TEV = Total Enterprise Value*

Private Equity versus Strategic Valuations

Strategic buyers are very active in the M&A market during the late stages of the pandemic. Synergistic cost savings, access to new customers and other revenue enhancements enable strategic buyers to pay more than the typical financial buyer. The 2020 data show that the strategic community was willing to pay a significant premium even during the pandemic for their acquisitions at the same levels before the pandemic.

- As usual, strategic buyers are active participants in middle-market M&A. In 1Q21, strategic buyers, on average, paid more than PEs. While quarterly data is volatile, strategic buyers still pay a premium for deals.
- Over the last five years, EBITDA multiples paid by PE buyers have remained in a range above 7.0x.
- The long-run valuation data suggest that strategic buyers are paying a premium of at least 1.0x when compared to PE firms in the M&A market.
- Prairie estimates that for middle-market deals below $50 million, valuations are generally one to two multiples of EBITDA lower than the levels reflected in the chart below.

TEV/EBITDA Multiple by Buyer Type ($10-250M of TEV)
2016 to Q1 2021



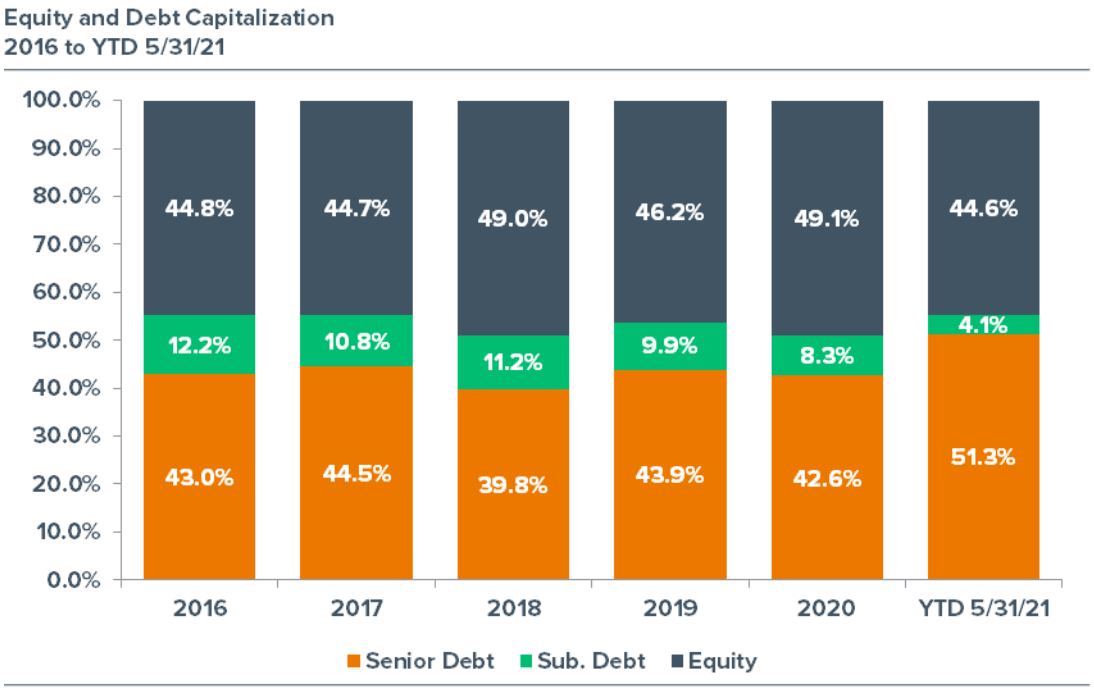
Source 1: Financial Buyers: GF Data ($10-250M TEV)
Source 2: Strategic Buyers: Capital IQ ($10-250M TEV; Excluding outliers defined as transactions with TEV/EBITDA of less than 3.0x and more than 14.0x)

Middle Market Leveraged Buy Out Capitalizations

In 2020, debt capital was available, but the amount of total leverage (the combination of senior and subordinated debt) in a typical acquisition capital structure trended lower. The pandemic caused lenders to be more cautious, which led to conservative capitalizations, with equity representing almost half of a typical leveraged buyout ("LBO") capital structure.

- Commercial banks, asset-based lenders, business development corporations ("BDCs") and mezzanine lenders continue to be anxious to support acquisitions and growth financing situations.
- There is strong availability for borrowing in the current market, but generally on more conservative terms than in 2019. Deals are seeing less financial leverage, higher debt pricing and more lender-friendly terms, reflecting the perceived business risks in the current environment. While the 2Q21 data shows the use of increased leverage, we believe this is an anomaly in the data, and the amount of leverage will trend lower in late 2021.
- BDCs are becoming a bigger factor in the deal market and are being more aggressive in pursuing new lending opportunities. The reemergence of the BDCs has begun to force more aggressive deal structures and better loan pricing for borrowers.

Although the data does not reflect it, mezzanine funds have increased their activity in leveraged transactions in 2021. This capital has a high interest rate that can stress a company's cash flows. Interest-only and payment-in-kind ("PIK") structures still dominate the markets, but in the current environment, the use of equity co-investment structures may increase to match mezzanine returns with the deal risk profile.



Source: GF Data

Overall Comment on the Financing Markets

The U.S. economy in 2021 continues to show surprising resilience and a dramatic rebound from the pandemic shutdown. Pent-up consumer demand and abundant levels of consumer savings accumulated during the pandemic, coupled with massive government stimulus programs, has resulted in a hot economy. The rapid pace of the recovery surprised many businesses, and many companies were slow to ramp up their production. This slow start caused shortages of raw materials and component parts, as many sectors of the economy bid at the same time for the goods and services that were available. These circumstances were made worse by labor shortages, induced partially by the generous unemployment offered through the pandemic recovery programs. Labor was in short supply pre-pandemic, and it appears as though labor will be in short supply post-pandemic as well.

Inflation has started to increase, which is leading to concerns by many market participants. The Fed remains dedicated to keeping overall financial conditions accommodative, including low interest rates. After the June 15th meeting, the Federal Open Markets Committee ("FOMC") statement suggests that they remain committed to promoting "maximum employment and price stability." While noting that inflation has risen, the FOMC still attributes this largely to "transitory factors" and states again that it will "maintain an accommodative stance of monetary policy" as long as "inflation averages 2 percent over time and longer-term inflation expectations remain well anchored at 2 percent." Further, the FOMC statement acknowledges that inflation is "on track to moderately exceed 2 percent for some time." Clearly, this is an area to monitor.

The U.S. equity and debt capital markets are strong and have set record highs in the last quarter. While volatility has increased, the markets have generally trended higher due to improving economic conditions and strong corporate earnings.

Bank lending is also slowly improving in the first half of 2021, as bankers became more comfortable with their ability to assess the business risks of the pandemic on borrowers. However, like the M&A market's demand for new deals, the demand by lenders for new credit opportunities currently outstrips the lending opportunities available.

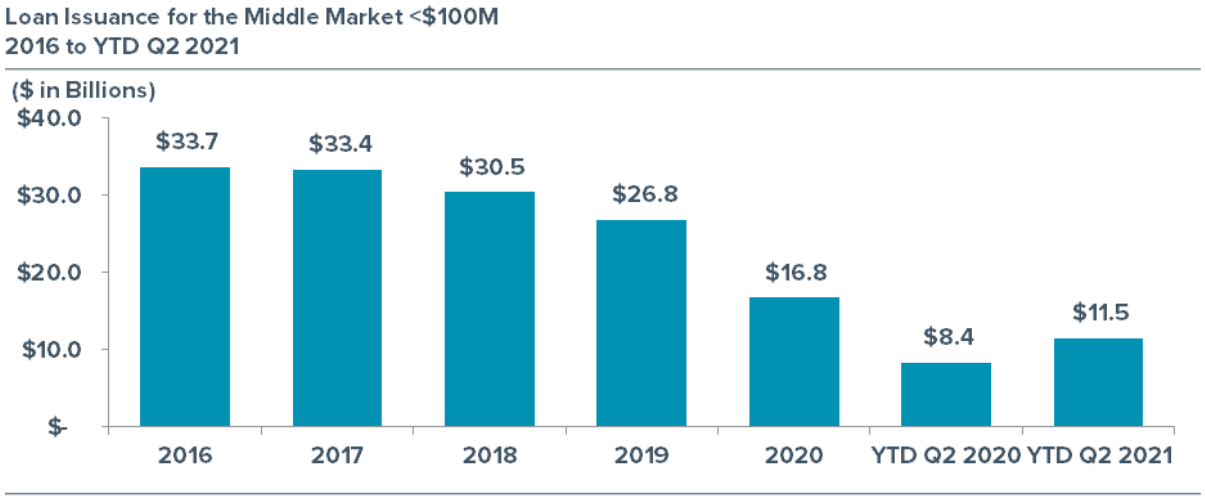
Even with the increased interest in new loan activity, acquisition capital structures remain conservative, with equity making up half of the typical capital structure. The credit markets' need for borrower financial flexibility to accommodate unexpected pandemic and economic issues has reduced the amount of leverage in new deal structures. While lenders are still in control and demanding more lender-friendly loan terms, increased competition is starting to change the issuer-lender negotiating dynamic in 2021.

Overall, equity and debt capital markets are healthy and providing access to financing for all credit-worthy issuers. While debt capital is readily available, acquirers will have to be prepared for a longer financing process and potentially more conservative and expensive capital structures.

Total U.S. Middle Market Loan Issuance

- New bank loan issuance for middle-market companies in 2020 was 37% lower than the $26.8 billion issued in 2019. The downward trend in new commercial and industrial ("C&I") loan issuance already observed over the last few years was further exacerbated by the pandemic-driven economic slowdown. This decline in lending activity is primarily driven by a lack of demand rather than a bank willingness to lend. New loan issuance through 2Q21 has picked up slightly as the rapidly improving economy and M&A market activity escalate.
- At the beginning of the pandemic, the Fed pledged to take any steps necessary to support banks and maintain sufficient liquidity in the banking system. Banks had abundant liquidity for loans, but the pandemic-induced economic shutdown and the stalled M&A market negatively impacted loan demand. These trends have reversed, and it appears as though loan issuance has begun to improve.

Up until the pandemic, bank lenders continued to focus on relationship banking, corporate borrowers' lines of credit and areas where they have a competitive advantage, such as operating business needs (including payroll and checking accounts). Due to regulatory scrutiny and the pandemic, banks are cautious in making new loans and are very selective in new leveraged transactions, leaving that market segment to the BDCs.



Source: Thomson Reuters

Interest Rate Environment

- The Fed has pledged to continue to support the financial markets, which has kept short-term interest rates very low. The short-end of the yield curve (one-month and three-month LIBOR) is 1.65 to 1.75 basis points lower than pre-pandemic levels, reflecting the effort to keep rates low and stimulate the economy. Obviously, this seems to have worked.
- The slope of the yield curve at the end of 2020 and continuing into 2Q21 is significantly upward-sloping and reflects increasing inflation expectations. The 2-year to 10-year Treasury differential was 34 basis points at the end of 2019, 80 basis points at the end of 2020 and 122 as of June 30, 2021. The increasing inflation expectations are due to increasing asset prices driven by low interest rates and the record levels of government spending through borrowing.
- The pandemic-related federal Paycheck Protection Program ("PPP") and Main Street lending programs, along with the very low interest rate environment, provide credit-worthy companies the opportunity to borrow at favorable interest rates and lock in attractive long-term fixed rate financings.

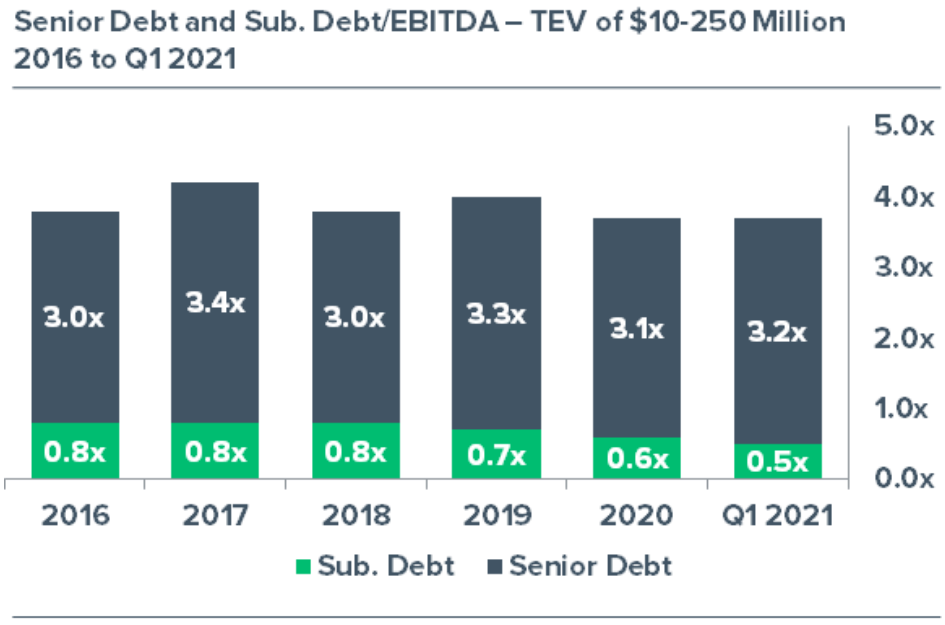
Financial Indicators

	6/30/2020	6/30/2021	7/14/2021
Interest Rates			
Prime Rate	3.25%	3.25%	3.25%
Libor - 1 Month	0.16%	0.10%	0.09%
Libor - 3 Month	0.30%	0.15%	0.13%
U.S. Treasury - 2 Year	0.16%	0.25%	0.26%
U.S. Treasury - 5 Year	0.29%	0.87%	0.85%
U.S. Treasury - 10 Year	0.66%	1.45%	1.42%
Stock Market			
Dow Jones Industrial	25,813	34,503	34,893
S&P 500	3,100	4,297	4,374
NASDAQ	10,059	14,504	14,677
Commodities			
Gold ($ per troy ounce)	1,801	1,772	1,810
Oil ($ per barrel - WTI)	39	73	75

Source: Capital IQ

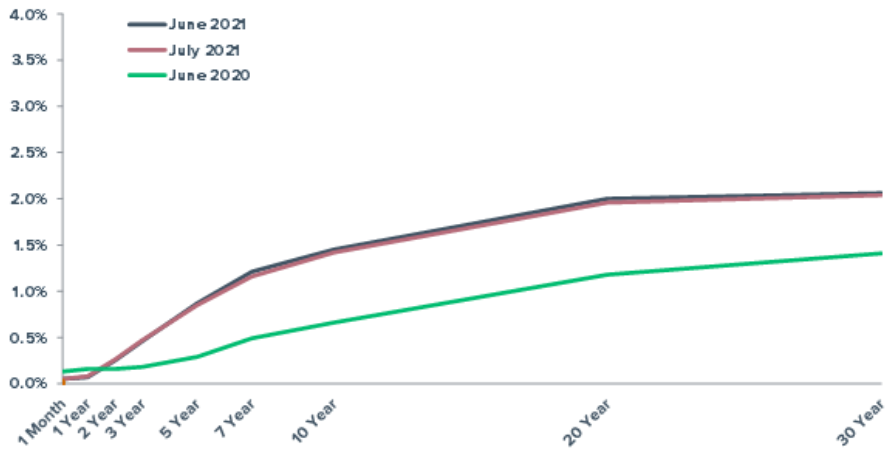
Middle Market Debt Multiples

- Average total debt leverage in middle-market deals declined to 3.7x in 2020, down from the 4.0x average in 2019. This continued into 1Q21, where total leverage stayed at 3.7x. The pandemic business uncertainty has caused more conservative lending behavior in 2020 and into 2021.
- Mezzanine capital played an important role in a leveraged
- capital structure in the pandemic environment. While mezzanine is more expensive capital than senior debt, its return structure matches the risk profile of companies operating in the pandemic better than a similar amount of equity.
- Over the past five years (2015-2019), mezzanine debt averaged about 0.8x EBITDA in the typical capital structure. In 2019, banks and BDC lenders started to disintermediate the mezzanine capital as they searched for new lending opportunities. So far, in 2021, even with a conservative bank lending environment and increased mezzanine fund pitching activity, mezzanine capital continues to become a slightly smaller component of the typical capital structure.
- The use of debt capital helps sustain high middle-market M&A valuations. We believe a more conservative lending environment may somewhat temper the upward trend in valuations.
- Regulators enforce credit discipline in the banking community. These regulators limit the amount of Highly Leveraged Transaction ("HLT") exposure that a bank can hold, which has resulted in conservative bank senior leverage levels.



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 (Now Subject to 1% LIBOR Floor)		
EBITDA less than $10M		
Unleveraged Loans	0-50 bps	200-300 bps
Leveraged Loans	75-150 bps	350-475 bps
Cash Flow Loans (Now Subject to 1% LIBOR Floor)		
EBITDA more than $10M:		
Unleveraged Loans	0-50 bps	200-300 bps
Leveraged Loans	100-150 bps	400-525 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

About Crafts Technology

With a history dating back to 1860, Crafts Technology strives to deliver the most advanced systems and tooling that continually enhance the utilization & performance of industrial equipment. Headquartered in Elk Grove Village, Illinois, Crafts offers decades of experience in developing products that demand super-hard materials in order to achieve maximum wear life, corrosion resistance and optimal performance for each application. The Company is dedicated to quality, innovation and solutions that translate to the success of its clients.

Crafts Technology was acquired by Hyperion Materials & Technologies, a portfolio company of KKR .

Terrel Bressler, Managing Director

312.348.1323, tbressler@prairiecap.com

About Prairie Capital Advisors

Prairie offers investment banking, ESOP advisory, valuation advisory and financial reporting valuations to support the growth and ownership transition strategies of middle-market companies. Headquartered in Oakbrook Terrace, Illinois, the company is a leading advisor to closely-held companies nationwide.