Q1 2022 EDITION

Pursant
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DEAL insider

M&A and Strategic Transaction Insights

THE INVESTMENT BANK THAT ALSO BUILDS THE VALUE OF YOUR BUSINESS

Q1 2022 Highlights:

- Middle market M&A activity continued at healthy levels, albeit lower than in Q1 2021
- Valuation multiples held strong in the face of recent interest rate increases
- Some banks began to pull back, but Buyers' desire to borrow for M&A is not softening

Pursant's Thoughts on the Near Future

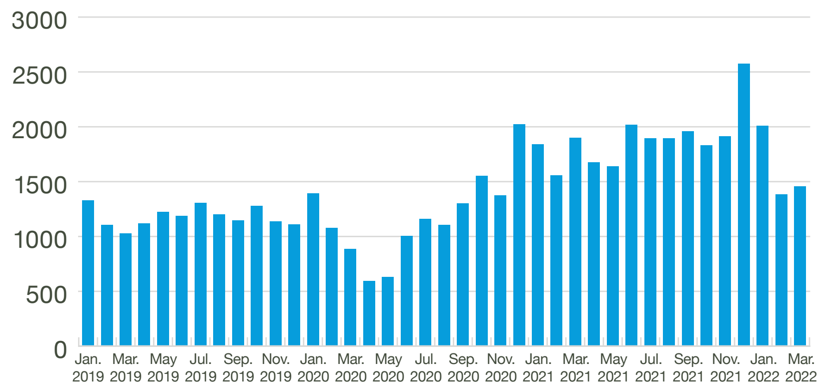
- Supply chain issues, staffing shortages, higher interest rates and inflation could continue to weigh on the macropicture, but not enough to derail M&A
- Fed rate increases are expected at every 2022 Fed meeting, but not raising rates to a level that compresses multiples
- We'll continue to see a healthy balance of Sellers and Buyers in the middle market

Q1 2022 Middle Market M&A Activity Markedly Lower Than in 2021

Chart 1 shows a noticeable drop in M&A activity in Q1 2022 when compared to the same period in 2021. At face value, this decline could be viewed as concerning; however, the reality is that M&A activity has returned to a more "normal" level after the massive surge in 2021 activity. Virtually all sectors have seen a decline in activity when compared to the same period in 2021, but activity is still higher than pre-Pandemic levels. We continue to see the healthiest levels of M&A activity for transactions valued between $25M and $250M (the lower middle market), followed by transactions valued at $250M+. Transactions less than $10M are still showing activity below the norm.

Chart #1

2019-2022 US M&A Activity



Source: Factset®

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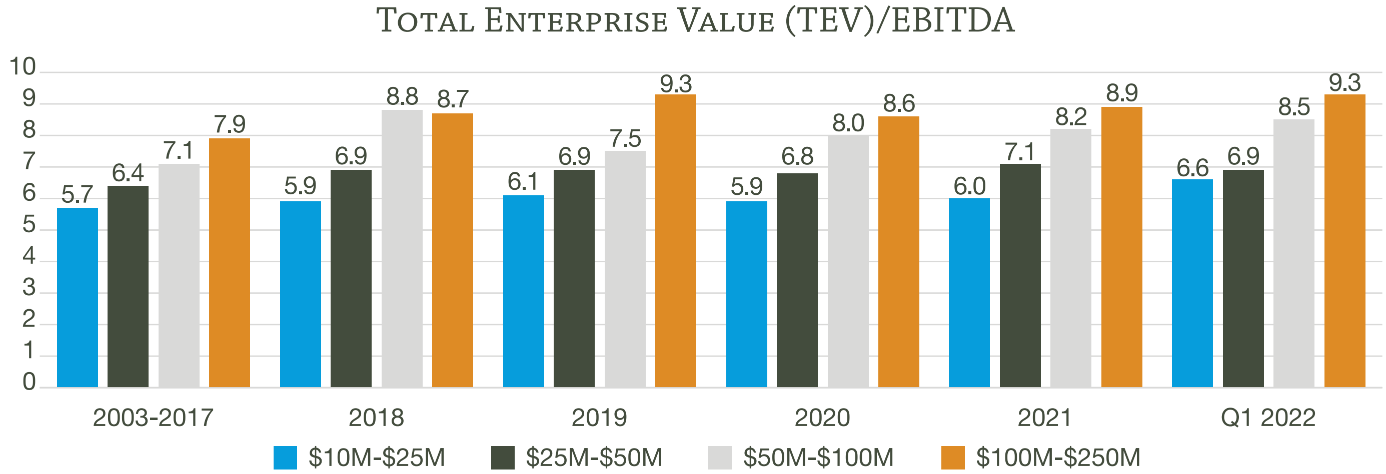
The Pursant Deal Insider is a quarterly publication offering analysis of the marketplace and climate for middle market mergers, acquisitions and strategic transactions. Our emphasis is on transactions with a total enterprise value of less than $250M. Our goal is to arm business owners and other parties with insight to help prepare for such transactions in order to optimize transaction outcomes.

Chart 2 shows that lower middle market valuations for Q1 2022 averaged 7.3x, matching the multiple for full year 2021, but down slightly from the 7.5x average recorded in Q3 and Q4 of 2021. While valuations held steady, a host of complicating factors has arisen—including Russia's war in Ukraine, a surge in commodities prices, interest rate increases and ongoing supply-chain issues—that are likely to impact the deal environment over the next few quarters.

While the total number of deals reported YTD is down, an unusually high percentage of deals occurred in Q1 2022 that met the standards for "above-average" financial performance underlying the calculation of a "quality premium." In Chart 2, the selling businesses designated as "above-average" based on TTM EBITDA margin and revenue growth represents two-thirds of the total deal volume in Q1. This reinforces the belief that a subset of businesses remains that would have traded, if not for the challenging conditions of the past two years. With these businesses remaining on the sidelines, volume is lower and overall multiple averages are dominated by the more desirable and more highly valued businesses that do trade.

We define "above average" financial performers as businesses with TTM EBITDA margins and revenue growth rates both above 10%, or one above 12% and the other metric at least 8%. Outliers on the high side are also excluded.

Chart #2



Source: GF Data®

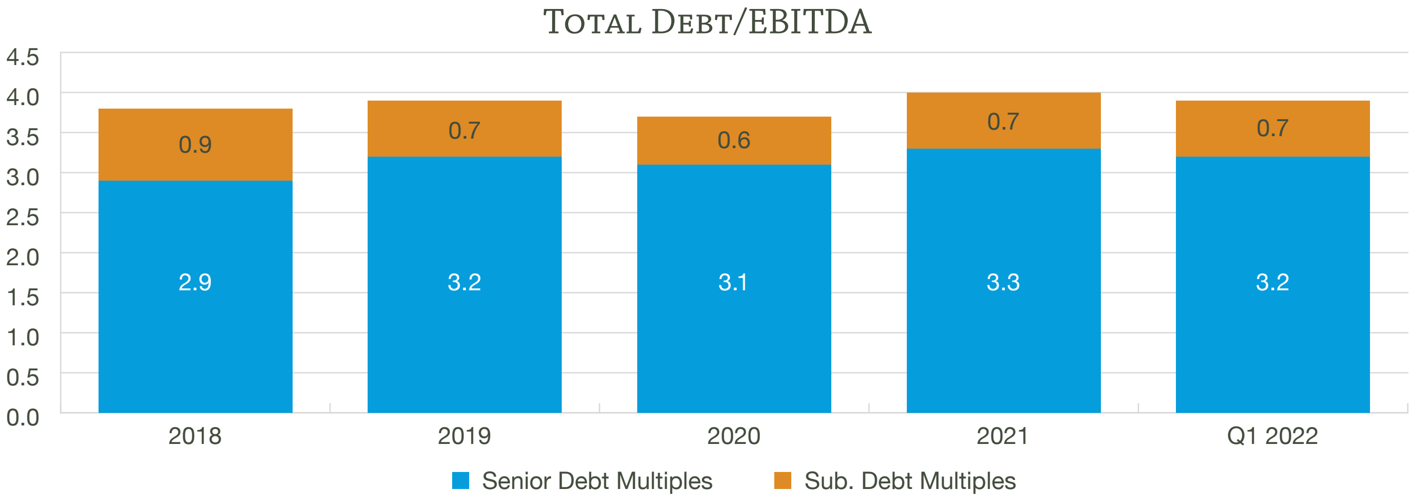
EBITDA Defined *– For most middle-market businesses, valuation is typically expressed in the form of a multiple of EBITDA (earnings before interest, taxes, depreciation and amortization)—a measurement of a company's ability to generate cash flow. EBITDA figures also serve as a barometer of the company's health and performance. Multiples of EBITDA vary greatly depending on a company's risk profile, the markets in which it operates and the likelihood of continued returns.*

M&A Borrowing Appetite Remains High—Chart 3 shows us that debt utilization within a deal remains at pre-COVID levels YTD. Overall, total debt averaged 3.9x YTD, with senior debt accounting for 3.2x and subordinated debt running at .7x. ***Average senior debt pricing for Q1 2022 was 4.3%—a drop of approximately 0.3 percentage points from Q4 2021. In the meantime, average sub-debt jumped by 50 basis points to 11.4%***.

As it relates to loan volume, rising rates have prompted some banks to start reining in lending. The data shows that during Q1 2022, an equal number of banks have tightened and loosened their lending standards. That's a stark reversal from last year, when nearly all banks were tripping over themselves to get money out the door. We expect more banks to tighten lending by the end of the Q2.

The relevance of monitoring debt utilization in M&A is that Buyers—financial Buyers in particular—virtually always utilize debt to fund acquisitions; the more Buyers are able to borrow and the lower the rate, the higher multiples tend to be.

Chart #3



Source: GF Data®

It's Not Only About Purchase Price

In all M&A transactions, purchase price overshadows all other aspects of the deal; however, deals are often derailed by parties' failure to agree on other key detail terms, which can have a meaningful impact on the overall risk profile and attractiveness of the deal. A hallmark of the extended Seller's market in the past decade has been declining caps on indemnification against breaches of general reps and warranties. The data shows that not all companies are afforded similar terms, even if they are the same size deal in the same industry. Businesses are rewarded in valuation and have lower caps when they offer above-average financials and are part of deals where Rep. and Warranty Insurance (RWI) are used.

Aside from earnouts and working capital, the following are five of the most heavily negotiated key economic deal terms:

- **Indemnification Cap**—This refers to the general indemnification provided by the Seller to the Buyer against breaches of reps and warranties. This does not include carveouts for specific issues or items. For example, parties often agree that the general cap will not apply in the event of fraud. As we see from the table to the right, as a general rule, the bigger the deal, the lower the percentage. Additionally, these percentages can vary greatly from industry to industry. For example, Healthcare Services averages 22% while Business Services is just 11%. The percentages represented here are reflective of predominantly transactions where RWI was used. In cases where RWI was not used these caps can nearly double.

TEV	Percentage of Purchase Price
10M – 25M	16.1%
25M – 50M	15.9%
50M – 100M	9.3%
100M – 250M	7.5%

Source: GF Data®

- **Survival Period**—This refers to the period after closing during which a Buyer may assert a breach of the reps and warranties against the Seller. Again, this does not include carveouts. For example, exposure on tax, environmental, and ERISA issues often exceeds the general survival period. While we see bigger gaps in amounts based on deal size, the survival periods are very similar, averaging 20 months regardless of deal size.

TEV	Months After Closing
10M – 25M	19.9
25M – 50M	20.6
50M – 100M	20.5
100M – 250M	18.6

Source: GF Data®

- **Indemnification Basket**—This refers to the amount that damages or losses must exceed before a Seller is liable for any indemnification payments. The additional negotiation point here is whether or not the Seller is responsible for all damages or losses going back to dollar one when the threshold is reached.

TEV	Percentage of Purchase Price
10M – 25M	1.1%
25M – 50M	0.9%
50M – 100M	0.7%
100M – 250M	0.6%

Source: GF Data®

- **Escrow/Holdback**—This refers to transaction consideration placed in escrow by the Buyer, subject to events or conditions expected to occur post-closing. For example, the parties may agree to a working capital adjustment based on financial statements that will not be available until after the end of the fiscal period. This does not include earnouts or other payments payable to the Seller post-closing contingent on the selling company's performance for a certain period post-closing. As with Indemnification Cap percentages, the larger the deal the lower the percentage. Of note, the percentages represented here are reflective of predominantly transactions where RWI was used. Absent this insurance, average percentages are markedly higher, nearing 10% of purchase price according to SRS Acquiom's recent deal term study.

TEV	Percentage of Purchase Price
10M – 25M	6.7%
25M – 50M	3.6%
50M – 100M	2.1%
100M – 250M	1.3%

Source: GF Data®

- **Escrow/Holdback Period**—This refers to the period of time during which the last of funds placed in escrow or held back are scheduled to be released. Customary Escrow/Holdback periods are very similar to those of Indemnification Cap periods—they average 15 months regardless of deal size.

TEV	Months After Closing
10M – 25M	16.2
25M – 50M	15.6
50M – 100M	13.0
100M – 250M	15.5

Source: GF Data®

The US Macroeconomic Picture for Q1 2022 and its Impact on M&A

GDP Growth Rate Disappoints in Q1—According to the US Bureau of Economic Analysis, the US economy contracted an annualized 1.4% in the first three months of 2022, following 6.9% growth in Q4 2021, primarily due to a record trade deficit and a decline in inventory investment. Exports dropped 5.9% (from 22.4% in Q4), while imports were up at 17.7% (from 17.9% in Q4). Additionally, gross private domestic investment growth slowed sharply (2.3% vs 36.7%) and government spending declined further (-2.7% vs -2.6%). On the flip side, consumer spending (2.7% vs 2.5%) and fixed investment (7.3% vs 2.7%), particularly nonresidential, contributed positively to GDP.

Highest Inflation in More Than 40 Years—The annual inflation rate in the US accelerated to 8.5% at the end of Q1—the highest since December 1981. Energy prices increased 32%--namely gasoline (48%) and fuel oil (70.1%)—as Russia's invasion of Ukraine pushed crude oil prices higher. Also, food prices jumped 8.8%, the most since May 1981. Inflation accelerated for shelter (5% vs 4.7% in February) and new vehicles (12.5% vs 12.4%), but eased for used cars and trucks (35.3% vs 41.2%). Excluding volatile energy and food categories, the CPI rose 6.5%--the most in 40 years but slightly below forecasts of 6.6%. Many analysts expect that March 2022 would mark the peak in inflation, although a number of factors are likely to further weigh on the CPI, including the war in Ukraine being far from over, the persistence of supply chain bottlenecks and elevated consumer demand.

Business Confidence—The ISM Manufacturing PMI for the US fell to 57.1 at the end of Q1 from 58.7 in Q4 2021, pointing to the slowest growth in factory activity since September 2020. A slowdown was seen in new orders and production and a backlog of orders and price pressures intensified due to instability in global energy markets. A PMI reading under 50 represents a contraction, and a reading at 50 indicates no change. The further the number is from 50, the greater the level of change. Timothy Fiore, Chair of the ISM Manufacturing Business Survey Committee, commented on the state of manufacturing: "The US manufacturing sector remains in a demand-driven, supply chain-constrained environment. Progress was made to solve the labor shortage problems at all tiers of the supply chain, which will result in improved factory throughput and supplier deliveries. Panel sentiment remained strongly optimistic regarding demand."

Fed Lending Rate—The Fed raised the target for the Fed funds rate by a quarter-point to 0.25%-0.5% during its March 2022 meeting, in line with market expectations. It was the first increase in borrowing costs since 2018. In addition, policymakers expect to begin reducing holdings of Treasury securities, agency debt and agency mortgage-backed securities in the coming months. As of the writing of this newsletter, the Fed has implemented further rate increases, taking the current rate to 0.75%-1% at its May meeting.

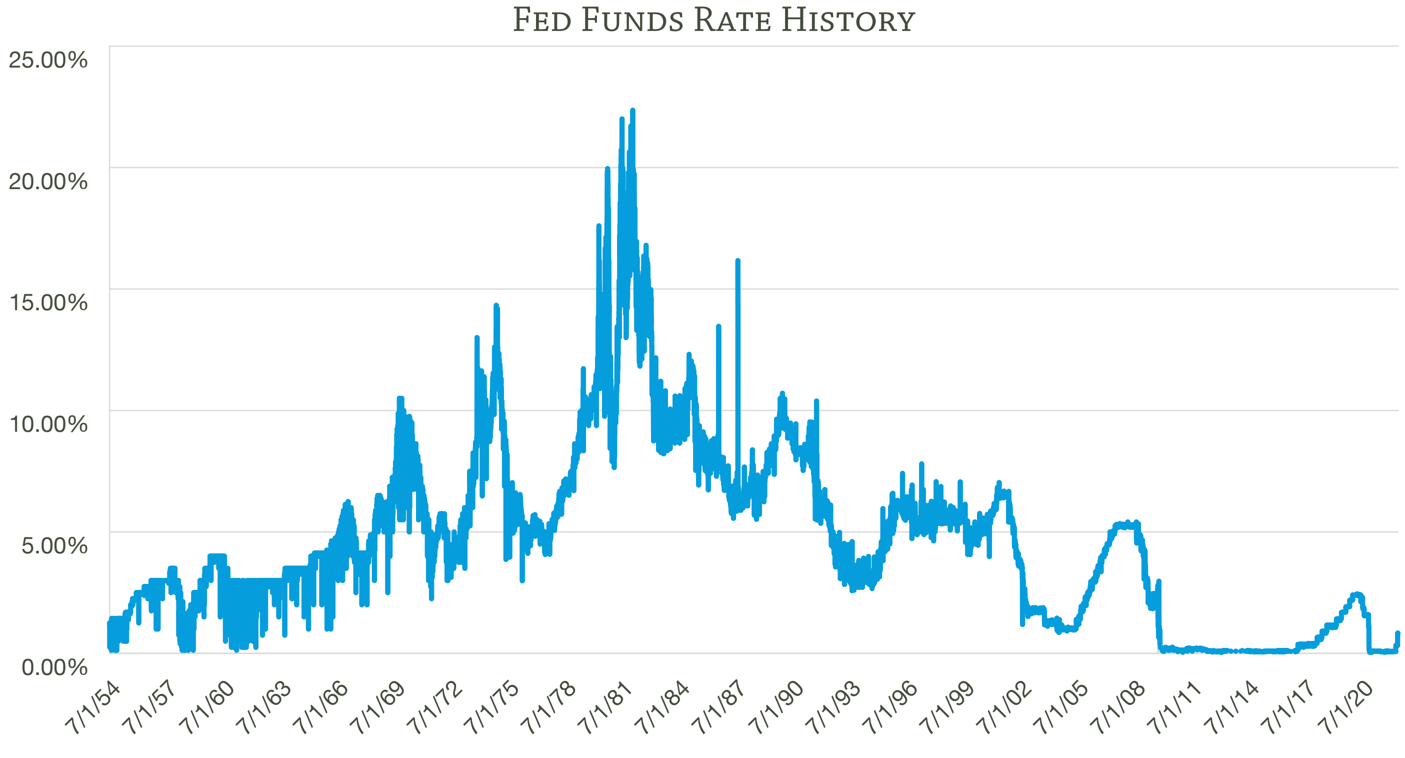
Pursant watches these macroeconomic indicators because the direction and performance of the greater economy gives us an indication of whether the Middle Market business transfer cycle is heading toward a favorable or less favorable phase.

More on the Fed Funds Rate and its Impact on M&A

As of late and for the first time in over a decade, we are fielding the question of "will the increase in the cost of capital lower valuations?" The short answer is: eventually, yes, but not quite yet and not a lot. If we look back over the last 20 years (see Chart #4), we can see how even if the Fed hits its current projected 2%-3% base rate target this year, it is still very low compared to what we saw in 2006 and 2007 (very strong M&A years) and nowhere near what we saw in 1981, when the measure was more than 20%! Even then, M&A marched on.

There is no question that the cost of capital has an impact on how much debt can be utilized to fund an acquisition and that as that cost of capital rises, it will put downward pressure on valuations. That said, we are not yet at levels where we are expecting meaningful multiple compression—especially for middle market deals.

Chart #4



Source: Macrotrends®

Quality of Earnings—What Buyers and Sellers Need to Know

If you are party to an M&A transaction, regardless of your role, you can expect to hear the term quality of earnings ("QoE"). Determining QoE is one of the most common and vital exercises performed in any M&A transaction. When performed by a Buyer, it is referred to as a buy-side QoE. When performed by a Seller, it is referred to as a sell-side QoE. The work, analysis and content of buy-side and sell-side QoEs are very similar, with the difference being the party commissioning the work. A QoE exercise evaluates and determines the sustainability of a business' earnings and cash flow generation capabilities.

The purpose of a QoE is to understand the sustainability of a company's future earnings—specifically EBITDA, which is not a term recognized by GAAP or evaluated as part of an audit. The scope of a QoE is tailored to address items of specific interest or concern, with a focus on understanding a business' story, operating trends, metrics and KPIs – all to ensure an appropriate EBITDA.

Many business owners assume that an audit is the same as or a replacement for a QoE; however, a QoE is very different than an audit. An audit is more rigid, follows a standard scope, and is performed only by certified public accountants and governed by specific accounting standards. ***An audit is very balance sheet oriented, focused on historical informatio***n and ensures that financial statements conform to generally accepted accounting principles (more commonly referred to as GAAP). While a QoE is often performed by a certified public accountant, it is not required. It can be performed by a financially competent person/organization with a strong accounting/financial and business acumen.

Buy-Side QoE

A buy-side QoE is a best practice for the most astute Buyers—a standard part of their pre-acquisition due diligence. It is generally the first exercise that follows the signing of a letter-of-intent. Buyers usually incur the cost to engage a third party to perform the QoE. A buy-side QoE requires significant input, information and support from the Seller and typically takes about a month for the Buyer's third-party service provider to complete.

The party performing the QoE is tasked with confirming the EBITDA presented by the Seller and oftentimes includes identifying adjustments to arrive at a normalized and appropriate EBITDA. Adjustments can relate to one-time sources of income (e.g. PPP forgiveness), non-recurring expenses (e.g. owner personal costs), out-of-period charges (e.g. bonus payments recorded in one period related to performance in a previous accounting period) or even a change in accounting policy that impacts the financials but does not reflect a change in the cash flow generation of the business. It is important to note that adjustments identified during the QoE do not indicate that financials are erroneous—they can be proper from an accounting standpoint, but some forms of financial presentation muddy the waters when assessing the sustainability of earnings and EBITDA.

As part of the process of identifying adjustments to EBITDA, QoE also provides key business insights and highlights key performance trends. Through the QoE, a Buyer should gain a deep understanding of the business and its operations: key customer relationships and trends, key vendor relationship and trends, margins, significant and/or unusual accounting policies/practices, related party transactions, concentration considerations (e.g. customer, vendor), backlog and pipeline considerations and headcount/employee statistics.

Sell-Side QoE

Think of a sell-side QoE as akin to taking a stress test in advance of running a marathon to ensure that your body can handle it. A sell-side QoE is performed by a third party and designed to help the Seller understand the business from the perspective of a potential Buyer. Sell-side QoEs are commissioned by Sellers and done in advance of a Seller engaging with a Buyer. A Seller will make this investment for the purpose of uncovering and getting ahead of potential issues/concerns that a Buyer will likely raise during diligence. Similar to a buy-side QoE, a sell-side QoE requires significant input, information and support from the Seller and typically takes about a month to complete.

If issues or adjustments are identified as part of the sell-side QoE, Sellers can take remedial actions to eliminate or mitigate issues so that they are non-issues by the time a potential Buyer performs its due diligence. ***The return on investment for a sell-side QoE is an accelerated due diligence process with better credibility throughout, which collectively should increase (or at least preserve) the initial agreed-upon valuation.***

During the sale process, Sellers typically will provide a Buyer with the sell-side QoE, but Buyers will still engage a third party to perform a buy-side QoE. Having the sell-side QoE will help make the buy-side QoE exercise more efficient.

When entering into a strategic transaction, whether you're a Buyer or Seller, it's important to arm yourself with as many tools as possible to allow you to maximize value (if a Seller) and manage risk (if a Buyer.) The QoE is an effective tool that helps to accomplish both.

Pursant’s Expectations for the Near Future

At the time of the writing of this newsletter, Pursant is involved in nearly 20 M&A engagements and a robust pipeline of inbound inquiries about new engagements, which gives us good visibility into market trends. Our feeling is that the back half of 2022 will largely mirror the front half of the year.

M&A in early 2022 has continued full speed ahead in the face of supply chain issues, the Russia/Ukraine war, soaring inflation and interest rate increases. The expectation is that supply chain issues will resolve, the rate of inflation will come down and interest rate increases will not dampen M&A activity. Although when the Russia/Ukraine conflict will end remains unknown, considering the strength of consumer and corporate balance sheets, the macropicture looks to be very favorable to M&A.

As it relates specifically to the lower middle market business owner sentiment, we continue to see a high sense of urgency from Baby Boomers to exit their businesses before taxes increase in a meaningful way and a major recession rears its head. Transacting in 2022 increases the chances of taking advantage of the most favorable market conditions.

Both strategic and financial Buyers most likely will continue to express a high demand and willingness to pay a premium for better businesses. Corporate balance sheets continue to be flush with cash and Private Equity dry powder continues to be at extraordinarily high levels. The available supply of Sellers and abundant availability of well capitalized Buyers make this a great time to explore a strategic transaction.

Our Investment Banking practice helps business owners make a profitable exit from the company they have built or launch and manage acquisition initiatives that will take their business to the next level.

Our Financial Consulting practice delivers the strategy, skills and brainpower needed, in the form of advisory or interim financial professionals, to support and augment finance teams with needs often related to strategic transactions.

Our Management Consulting practice provides customized solutions designed to re-shape conventional thinking about growing enterprise value.

We use a deep immersion process, our expansive networks and experience as owner/operators, dealmakers and sector experts to effectively deliver on these critical initiatives for which most companies do not have the time, manpower or expertise.

To learn more about how Pursant can help you, email info@pursant.com or visit www.Pursant.com.

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