Q1 2024 EDITION

Pursant
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DEAL insider

M&A and Strategic Transaction Insights

Q1 2024 Highlights:

- Despite the Fed's higher for longer interest rates, healthy M&A activity persists
- Valuation multiples were impacted by higher rates—especially for larger deals
- The popularity of private debt grew as the means to fund M&A initiatives

Pursant's Thoughts on the Near Future

- Borrowing rates should decline as well-capitalized, optimistic banks compete more aggressively for deals
- A more "neutral" M&A market, not disproportionately favoring Buyers or Sellers
- The middle market is likely to remain nimble, with the ability to adapt to challenges

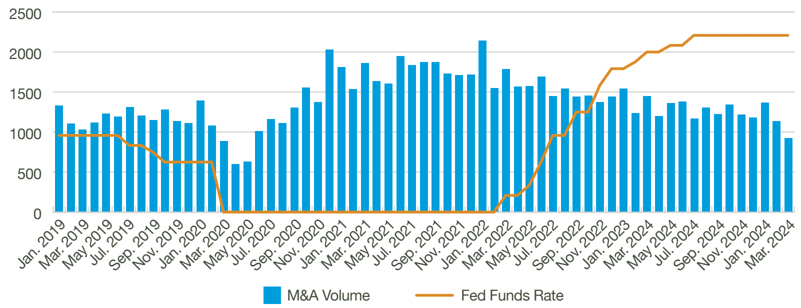
Q1 2024 M&A Activity Continues at a Conservative Pace

Middle Market M&A activity continues to feel the drag caused by persistently higher borrowing rates. The "higher for longer" Fed policy—under which interest rates are expected to remain elevated for an extended period—is notably slowing M&A activity, weighing on valuation multiples, and sidelining many parties from transacting. We can see from Chart 1 that M&A activity is down when compared to activity in the same period in 2023. There was a decline in activity of approximately 17% when comparing March 31, 2023 last twelve month (LTM) activity to that of LTM March 31, 2024. For the middle market specifically (transactions under $250M in enterprise value), the percentage decline was closer to 20%.

Despite the decline in activity, the M&A environment is still considered healthy. A number of factors have offset the impact of higher rates, including: favorable economic conditions, high levels of available capital, strong corporate balance sheets, Private Equity's abundant dry powder and the need to deploy it. All have kept M&A activity from being dragged into a meaningful deal flow slump.

Chart #1

2019-2024 US M&A Volume (# of deals) & Fed Funds Rate



Source: Factset®

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 dealmakers with the insights needed to optimize transaction outcomes.

Valuation Multiples Feel the Weight of Higher Borrowing Costs

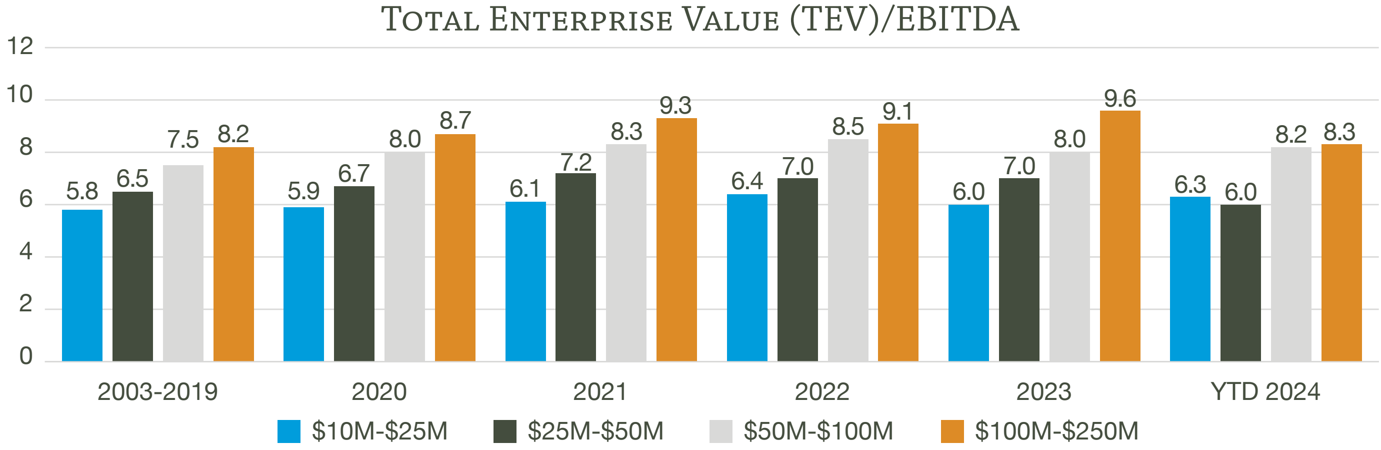
Chart 2 says it all. We can clearly see the impact of the higher cost of capital in valuation multiples, with declines in average valuation observed for three of the four deal size tiers. It appears that Sellers have accepted lower sale prices—as well as value bridging mechanisms like earnouts and Seller rollover equity—as the new reality of today's middle market.

Larger transactions saw the greatest erosion in average valuation, with deals valued between $100 million and $250 million falling by almost a turn-and-a-half of EBITDA, at 8.3x in Q1 2024 compared to 9.6x for all of 2023. According to GF Data, many of the companies represented in this data set that completed transactions in the first quarter posted low or negative revenue growth for the prior 12-month period—a sign that at least for some companies, continued growth out of COVID has proven elusive.

Small deals represented a bright spot for the market in terms of valuation. Deals valued between $10 million and $25 million held firm at an average multiple of 6.3x—the same multiple as in Q4 2023. On an annualized basis, valuations on deals in this cohort in Q1 2024 were up by 0.3x when compared to full-year 2023.

The first quarter of 2024 also saw a significant decline in both incidence and valuations for Above-Average Financial Performers (AAFP)—businesses with TTM EBITDA margins and revenue growth rates both above 10%, or one above 12% and the other metric at least 8%, with outliers on the high side excluded. This is notable because it is a category that traditionally has achieved better valuations from the market. ***The premium for AAFP companies slid Q1 2024 by more than a turn of EBITDA*** to 7.0x, compared to an average of 8.2x for all of last year, and compared to a historical average of 7.2x. ***This reduced to 12% the premium AAFP companies hold over the rest of the market—the lowest seen in the previous five years.*** The incidence of AAFP companies transacting in the first quarter dropped to 38%, compared to 47% for all of last year and against a historical average of 56%. We take this as a sign that more non-AAFP companies are relenting on pricing to get deals completed, but that a significant number of AAFP companies are still waiting on the sidelines for better market conditions.

Chart #2



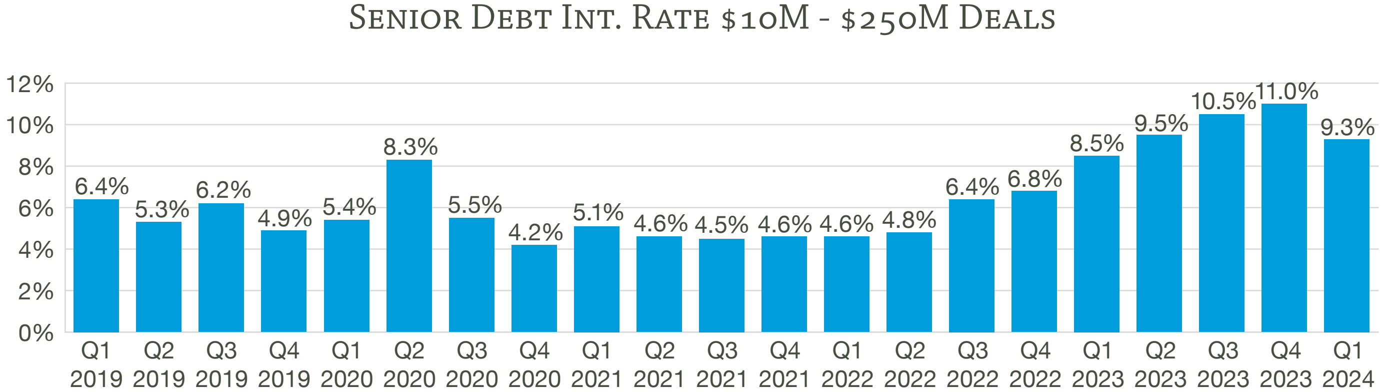
Source: GF Data®

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.*

Increased Bank Lending Activity Lowers the Cost of Capital—The strong economy and healthy bank balance sheets are fueling banking activity. This activity is prompting banks to compete for deals more aggressively, thus lowering borrowing costs for Buyers. Senior debt fell to 9.3% on average in Q1 2024 (see Chart 3), while subordinated debt held steady at an average of 12%.

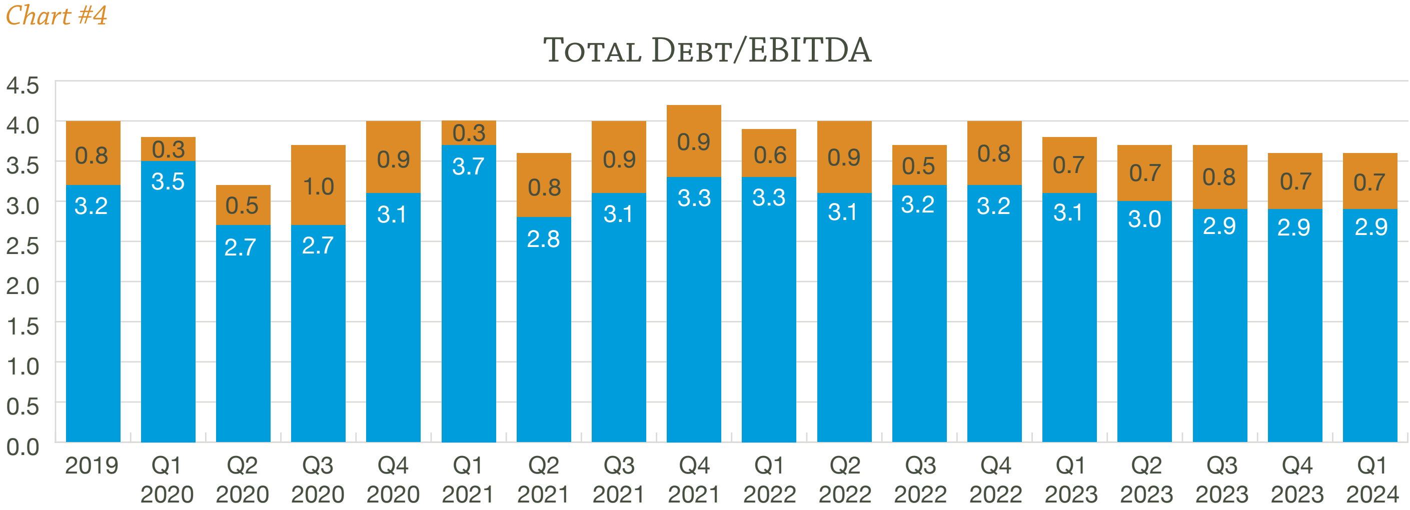
Chart 4 shows that the amount of borrowed capital available for the average middle market M&A loan remains steady at approximately 3x EBITDA for senior debt. It's worth clarifying that this 3x figure is a rolling four-quarter average inclusive of the last three quarters of 2023 and Q1 2024, and is a blended average of both Platform acquisitions and Add-on acquisitions. ***There is notable difference between Platform loans and Add-on loans, with Platform loans averaging 2.4x and Add-ons averaging 3.9x.***

Chart #3



Source: GF Data®

Chart #4



Source: GF Data®

The US Macroeconomic Picture for Q1 2024

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 more or less favorable phase.

- **Q1 2024 GDP Growth Slowed Significantly**—The US economy expanded an annualized 1.6% in Q1 2024, compared to 3.4% in the previous quarter and below forecasts of 2.5%. It was the lowest growth since the contractions in the first half of 2022, the advance estimate showed. A slowdown was seen for consumer spending (2.5% vs 3.3%), mainly due to a fall in goods consumption (-0.4% vs 3%) while spending on services rose faster (4% vs 3.4%).*

- **Q1 2024 Inflation Finishes Uncomfortably High**—The annual US inflation rate accelerated for a second straight month to 3.5% in March 2024, the highest since September, compared to 3.2% in February and forecasts of 3.4%. Energy costs rose 2.1% (vs -1.9% in February), with gasoline increasing 1.3% (vs -3.9%) while utility gas service (-3.2% vs -8.8%) and fuel oil (-3.7% vs -5.4%) fell less. Also, inflation steadied for food (2.2%) and shelter (5.7%), but rose sharply for transportation (10.7% vs 9.9%) and apparel (0.4% vs 0%). On the other hand, prices declined for new vehicles (-0.1% vs 0.4%) and used cars and trucks (-2.2% vs -1.8%).*

- **Business Confidence Moving Higher**—The ISM Manufacturing PMI in the United States increased to 50.3 in March 2024, up from 47.8 in February and beating market expectations of 48.4. This marked a return to expansion in the manufacturing sector for the first time after 16 months of contraction. There were positive trends in demand, with indicators such as the new orders Index (51.4 vs 49.2 in the previous month) and new export orders Index (51.6, the same as in February) showing expansion, while backlogs (46.3) remained in moderate contraction. A PMI reading above 50 percent indicates that the manufacturing economy is generally expanding; below 50 percent indicates that it is generally declining.*

- **Still No Rate Cut**—Minutes from the March FOMC meeting stated that the Federal Reserve did not feel it would be appropriate to reduce the target rate range until it has gained greater confidence that inflation is moving sustainably toward 2%. Policymakers generally noted their uncertainty about the persistence of high inflation and expressed the view that recent data had not increased their confidence that inflation was moving sustainably down to 2%. At the same time, the central bank remains highly attentive to inflation risks, but it had also anticipated that there would be some unevenness in monthly inflation readings as inflation returned to target. The Federal Reserve left the Fed funds rate steady at a 23-year high of 5.25%-5.5% for a fifth consecutive meeting, in line with market expectations. The so-called "dot plot" showed that policymakers were still planning to cut interest rates three times this year—similar to the quarterly forecasts in December.

**Trading Economics®*

The Case for Inorganic Growth – Organic Growth May Not Be Enough

A recent Ernst & Young (EY) survey indicated that 36% of surveyed CEOs planned to grow inorganically—through acquisitions—in 2024. Why buy and not simply rely on organic growth?

Growing a business by adding new customers, launching new products, developing new capabilities, improving efficiencies and/or realizing cost saving opportunities are all very prudent strategies to build a better business and optimize enterprise value. These types of initiatives promote organic growth—i.e. the expansion of a company through its own internal efforts focused on sales, marketing and optimization of operations.

While organic growth should be a focus for any business, it is typically measured with the impact being realized over an extended period. Often business owners/executives are eager to "move the needle" with greater velocity than can be achieved via organic growth opportunities. Since Private Equity often holds a company for 3-7 years—a shorter timeframe than other types of investors—there is a need to accelerate growth to maximize returns quickly. It is this healthy impatience that necessitates strategies that increase enterprise value at a more exciting pace and velocity.

Acquisition strategies—also known as buy-and-build, rollups, bolt-ons, add-ons, tuck-ins and others—can help an organization quickly address multiple objectives tied to growth, including capturing economies of scale, accessing new customers/markets/products/services/capabilities, expanding market share, improving purchasing power, extending geographic footprint, gaining more density, and acquiring talent. Businesses using an acquisition strategy may be referred to as acquisitive companies, aggregators or consolidators.

Whether under the leadership of a Private Equity firm or managed in an owner/operator model, an acquisition strategy starting point is typically the same. It starts with a business that possesses size, scale, sophistication, processes, solid management and resources that can be leveraged to integrate and unlock value in companies being acquired. The starting business is commonly referred to as a "platform" to which other businesses can be added.

Examples of sectors that are experiencing significant consolidation as a result of acquisition include janitorial services, pavement maintenance companies, medical/dental/physician/vet practices, car wash businesses, professional services firms (e.g., tax advisory), landscaping services, wealth management firms, HVAC services, laundromats, roofing companies and restoration businesses. These sectors are ripe for consolidation because of market fragmentation across localities and regions and due to attractive characteristics such as recurring/repeat revenue models, recession resistance and relatively low operating complexity.

Here's a simple example to demonstrate the power of the acquisition strategy and its impact on enterprise value:

- Let's assume that a platform business is generating $5M in annual EBITDA and, given that size/scale, commands a valuation multiple of 7x its EBITDA, resulting in an enterprise value of $35M.
- Let's further assume that this platform acquires a $2M EBITDA business which (given the smaller size and scale) is purchased at an EBITDA multiple of 4x, resulting in a purchase price of $8M.
- The acquisition results in a combined entity with EBITDA of $7M, which is valued at the platform's multiple of 7x, resulting in an enterprise value of $49M.
- The $8M acquisition was immediately accretive, as the enterprise value of the company purchased for $8M is now worth $14M, since it will trade at a multiple of 7x, instead of 4x, as a result of being part of the platform company. This is referred to as multiple arbitrage and is the "academic" part of the acquisition strategy.

In addition to driving enterprise value via the multiple arbitrage, total enterprise value can grow through acquisition as the two companies together increase EBITDA so that it is greater than the sum of the two parts. This makes the acquisition even more exciting. To realize such accretion, it is critical the integration is properly planned and executed such that the platform and the acquisition operate as a streamlined, cohesive unit.

Enhancing M&A Outcomes Through Strategic Market Research

The Strategic Importance of Market Research in M&A

In the dynamic realm of mergers and acquisitions, the precision and foresight strategic market research affords are not merely advantageous—they are indispensable. For companies on the Sell-side of these transactions, comprehensive market research underpins every aspect of the negotiation, offering a robust framework that enhances valuation, attracts discerning investors, and ensures a strategic fit. This detailed insight into the marketplace serves as a critical tool that helps prospective Buyers realize the full potential of the transaction.

Unveiling Future Potential and Market Opportunities

The primary allure for a potential acquirer lies in the future growth and profitability that a business can offer. Market research provides a detailed examination of the current market environment, offering an expansive view of the total addressable market (TAM), competitive landscape, and the company's relative market share, which together help reveal untapped market potential and strategic positioning opportunities.

Targeted market research aims to craft a compelling narrative for potential Buyers, painting a vivid picture of the market dynamics and a company's capacity to capitalize on these opportunities. It demonstrates not just where the targeted company stands today, but how it is positioned to leverage market trends and expand its footprint. This foresight is invaluable as it outlines the upside potential of an investment in the business, transforming raw data into a strategic asset that informs investment decisions.

Substantiating Company Valuation During Due Diligence

During the due diligence process, potential Buyers thoroughly review the details of a potential acquisition and rigorously evaluate the claimed benefits. Here, market research plays a pivotal role by substantiating the claims about a company's market position and its future prospects. Detailed market analyses, growth forecasts, and industry comparisons provide a factual basis to support the company's financial projections and strategic plans.

Effective market research delves into customer segmentation and buying behaviors, offering a means to cross-check the company's valuation model. In addition to helping to defend the company's projected worth, such insight also equips the sellers to address Buyer queries regarding market trends, competitive positioning, and growth strategies. Such thorough preparation significantly mitigates risks for the Buyer, enhances the Seller's credibility, and smooths the negotiation process.

Laying the Groundwork for Post-Acquisition Integration and Growth

The utility of market research extends beyond the immediate needs of transaction facilitation to set the stage for effective integration and future expansion post-acquisition. It provides both parties with a clear understanding of the market dynamics, customer expectations, and potential synergies, which are crucial for integrating the acquired entity into the business framework of the Buyer.

Moreover, this type of research serves as the foundation to develop robust post-acquisition sales and marketing strategies. It ensures that the transition phase is backed by strategic insights, aligning the combined entity's objectives with market realities. This preparation is vital for accelerating post-deal integration and achieving projected growth outcomes, ultimately maximizing the return on investment for the acquirer.

In Summary:

Market research is a critical component of the M&A process, serving as a foundation for successful outcomes. It not only enhances the transaction's value through rigorous analysis and substantiation of the company's market position and potential but also facilitates smoother negotiations and integration processes.

Private Debt: An Often-Overlooked Source of Financing

Debt capital markets have evolved considerably since the global financial crisis of 2007 – 2009. The crisis drove a tightening of lending standards at banks and had a disproportionate impact on borrowers in the middle market (companies with $10M to $1B of revenue) in terms of access to debt financing—particularly leveraged financing. However, the void was quickly filled by private debt funds which, by several measures, now dominate the middle market lending landscape. In fact, in 2022 and 2023 such funds financed 86% of LBOs and 65% of non-LBO deals, according to research by Owl Capital. Moreover, per Pitchbook's 2023 Global Private Debt Report, a staggering $1.9 trillion has been invested in these funds over the past ten years.

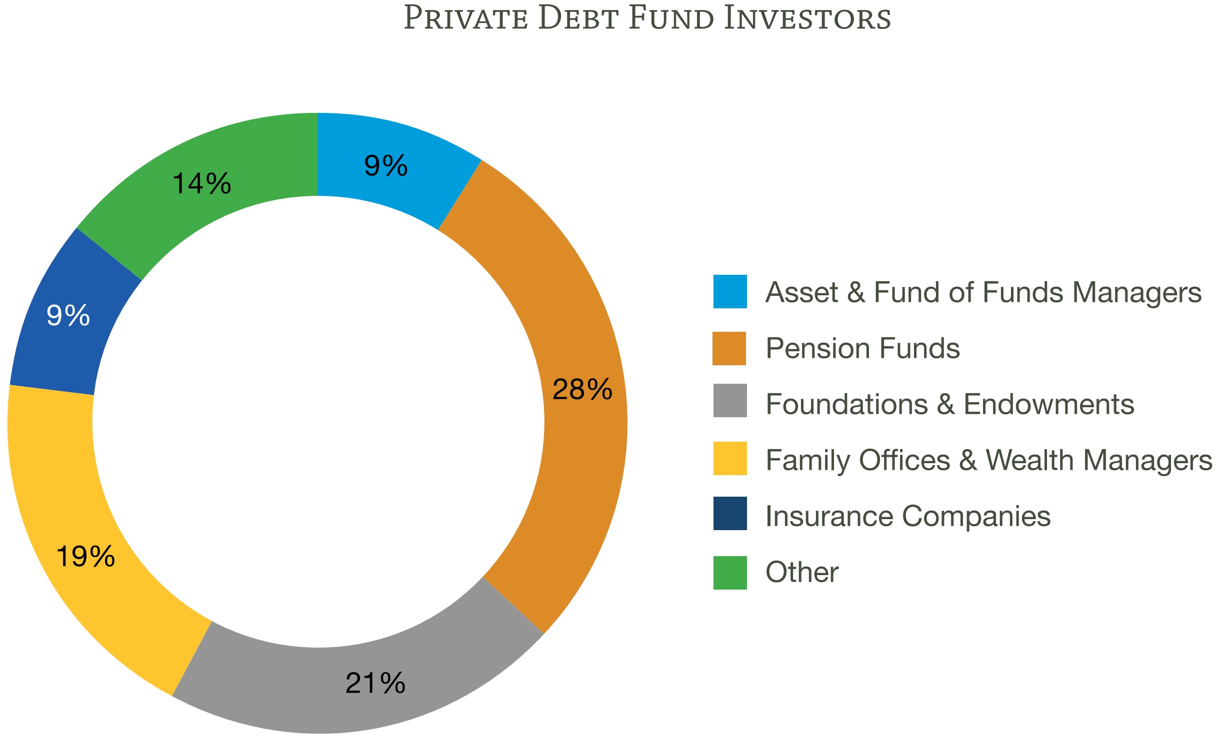
Let's dive further into private debt funds and how they are beneficial to middle market companies.

Private debt funds are non-bank lenders that invest in various types of private transactions (i.e. not publicly traded), including real estate and infrastructure as well as making direct loans to private companies. Private debt strategies include:

- Direct Lending
- Distressed Debt
- Mezzanine
- Private Debt Fund of Funds
- Special Situations
- Venture Debt

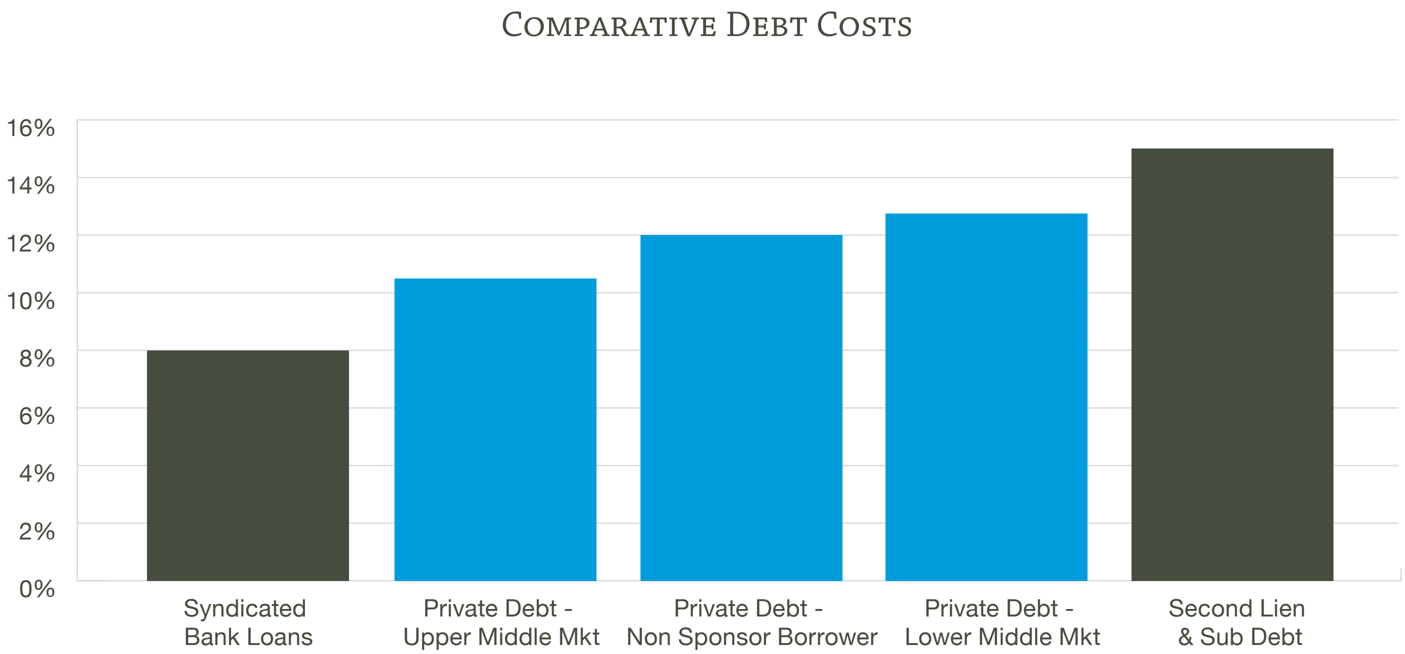
As non-bank lenders who do not accept consumer deposits, private debt avoids the same capital requirements and regulatory scrutiny that apply to banks. This freedom affords the ability to accept levels of credit risk that banks cannot. Private debt funds raise capital from public markets and direct private investments from endowments, pension funds, and other asset managers looking to diversify asset allocations (see Chart 5).

Chart #5



While the risk profile of a portion of the capital private debt funds provide may overlap with that of a bank, private debt commonly seeks riskier opportunities in which returns are higher—for example, cash flow loans with less than full collateral coverage or ones that offer repayment terms that seem more akin to equity than a traditional loan. This flexibility, and appetite for risk, is well suited to situations that require a high amount of leverage—for example in an acquisition. This also benefits Sellers, as Buyers can potentially offer higher valuations. Commensurate with the added risk, private debt lenders are able to command higher loan spreads. As illustrated in chart 6, pricing on senior secured loans averages 200 - 400 basis points higher than pricing from a bank, depending on factors such as company size (higher for smaller companies) and whether a financial sponsor is involved (which reduces pricing).

Chart #6



Source: Pitchbook LCD

In conclusion, borrowers seeking capital for acquisitions or growth would be remiss to not consider private debt capital providers. While the capital will likely be more expensive—perhaps as much as 4% higher on a senior secured loan—the more aggressive lending parameters of private debt lenders may enable the borrower to avoid needing to raise even more expensive types of capital such as subordinated debt or equity to meet its funding needs. Private debt lenders may also offer more flexible repayment terms, thereby enabling the business to continue to invest in its growth.

Buyers Beware: 10 Areas of Focus When Evaluating a Target Company

Due diligence is a critical step in the acquisition process that enables Buyers to make informed decisions, minimize risks, and maximize the potential value of the deal. It provides a comprehensive understanding of the target company's strengths, weaknesses, opportunities, and threats, helping Buyers effectively navigate the complexities of mergers and acquisitions. During due diligence, Buyers should thoroughly understand the business they're considering acquiring.

Here are 10 areas of focus to guide you through your due diligence process when evaluating a company:

1. **Financial Statements** – What is the overall quality of the financial statement? Are there confusing and unexplained line items on the balance sheet, P&L, or other reporting? Are there one-time expenses that could become recurring expenses? Any significant debt? Any significant trends or changes in the revenues, margins, and other key measures of operating success? How do the numbers compare with those of competitors in the industry, if known? Does the business have any non-operating income (i.e. licensing fees, royalties, interest income, rental income)?

2. **Operational Details** – What do the company's day-to-day operations look like? Consider key processes, suppliers, and distribution channels. Are processes efficient and are there significant areas for improvement?

3. **Management Team** – To minimize business disruption after the transaction, will a strong team of leaders and other personnel stay on for smooth integration and continued operations? Would their departure jeopardize the performance of the business?

4. **Key Relationship Owners** – Who are the key relationship owners for customers, suppliers, partners and other third parties? If any one individual owns a high percentage of key relationships, will that executive or employee be staying with the company after the acquisition?

5. **Company Culture** – Is the company culture compatible with yours? Are there customer and employee feedback reports that can be shared? Is there a strong employee retention rate? Does the company have a collaborative or a command-and-control culture?

6. **Competitive Landscape** – How does the company's sales, reputation, team talent, and product/service innovation look, in comparison to its competitors?

7. **Customer Concentration and Retention** – Does the company have a diverse group of long-term, loyal customers?

8. **Technology** – Does the company have any technological advantages or disadvantages?

9. **Acquisitions / Divestitures** – Has the company made any strategic transactions or divestitures? If so, how recent and how successful were these events?

10. **Legal and Compliance Matters** – Is the company involved in or has the company been previously threatened with any material litigation?

Finally, trust your gut instinct, as it can be a valuable aspect of decision-making. While it can complement analytical reasoning and provide valuable insights, it should be used as one of many inputs in the decision-making process. By combining intuition with thorough research, analysis, and expert advice, Buyers can make more informed decisions when acquiring a company, ultimately increasing the likelihood of a successful acquisition.

Pursant's Expectations for the Near Future

The outlook for middle market mergers and acquisitions (M&A) for the remainder of 2024 is shaped by several factors, including economic conditions, sector-specific dynamics, and broader market trends.

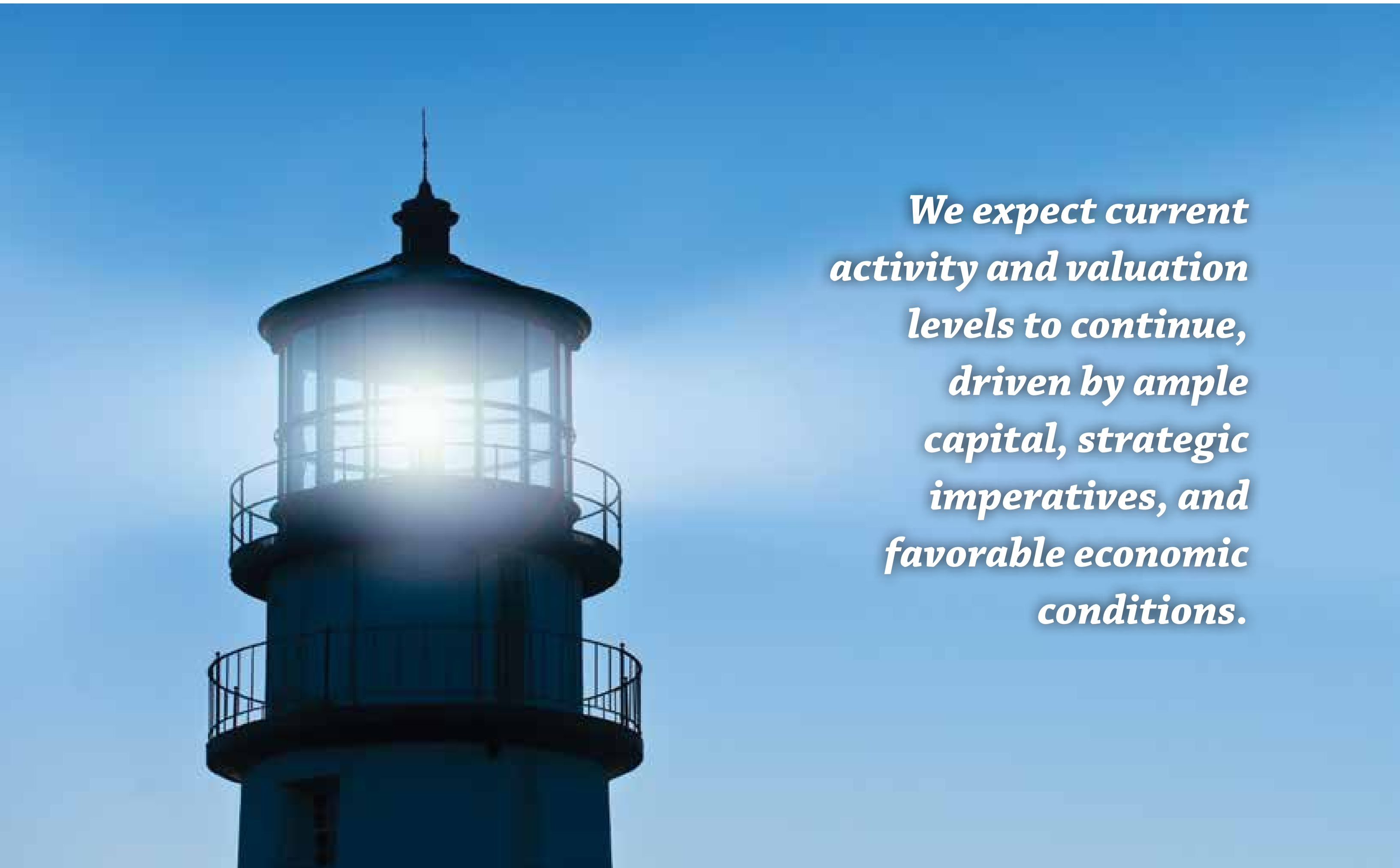
We expect current activity and valuation levels to continue, driven by ample capital, strategic imperatives, and favorable economic conditions. Corporate Buyers are likely to pursue M&A for a number of reasons, including to achieve growth targets, expand market share, and acquire new capabilities. The level of Private Equity activity is expected to remain high, leveraging substantial dry powder to pursue platform acquisitions and add-ons to existing portfolio companies.

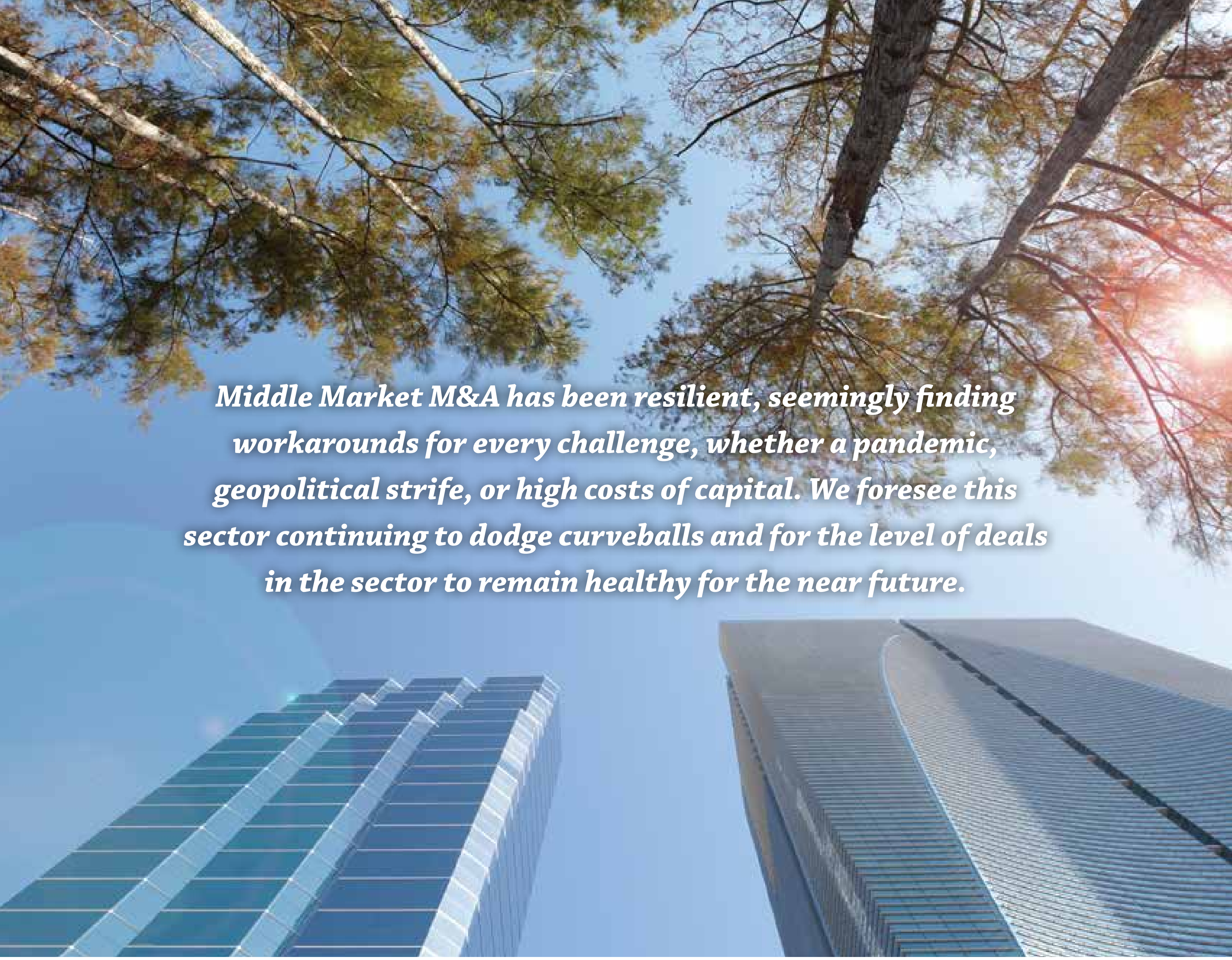
Overall, valuations for most sectors—particularly for high-quality assets in growth sectors—are expected to remain attractive, but no longer at frothy levels of valuation. Competitive bidding processes will maximize Seller outcomes, but valuation disparities will persist, driven by the cost of capital, murky visibility into historical earnings driven by COVID, and a Sellers ability to substantiate future earnings.

Despite elevated rates, the financing environment is expected to remain favorable. There is ample liquidity to support M&A activity. Lenders will continue to be supportive, though they may exercise greater caution in certain sectors and situations. The use of alternative financing options, such as private credit and mezzanine debt, will remain prevalent, offering more flexibility for deal structures.

The use of earnouts and contingent payments will remain common, helping to bridge valuation gaps and align interests between Buyers and Sellers. Contingent payments, combined with Seller rollover investment, will be a common solution to bridging valuation gaps between Buyer and Sellers.

Middle Market M&A has been resilient, seemingly finding workarounds for every challenge, whether a pandemic, geopolitical strife, or high costs of capital. We foresee this sector continuing to dodge curveballs and for the level of deals in the sector to remain healthy for the near future.





Pursant is a middle market advisory firm specializing in M&A, private capital market financing, transaction advisory, financial leadership support, business value enhancement consulting and coaching. Our powerful, integrative, and customized suite of services deliver the insight and guidance parties seek to:

- Confidently navigate strategic transactions and complex financial matters
- Enhance enterprise value
- Optimize leadership performance

We use a deep immersion process, our expansive networks and experience as owner/operators, dealmakers and financial professionals to achieve optimal outcomes throughout the lifecycle of a company.

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

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