Q2 2022 EDITION

Pursant
INSPIRED PURSUIT

DEAL insider

M&A and Strategic Transaction Insights

THE INVESTMENT BANK THAT ALSO BUILDS THE VALUE OF YOUR BUSINESS

Q2 2022 Highlights:

- Middle market M&A activity continues to trend downward, but the level of activity is still healthy
- Valuation multiples are still attractive despite continuing Fed rate increases
- Well capitalized banks remain bullish on M&A lending

Pursant's Thoughts on the Near Future

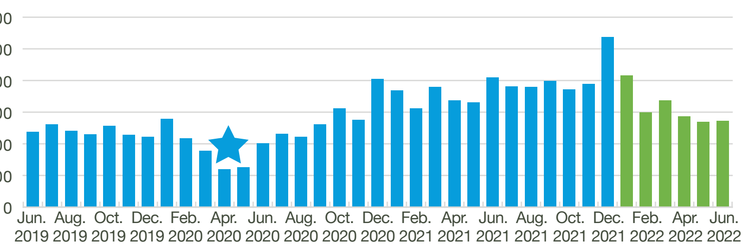
- Macroeconomic, geopolitical and public equity market issues persist, but not enough to dampen middle market M&A
- Fed rate increases continue, but not enough to compress lower middle market multiples in a meaningful way
- Persistent business climate issues motivate business owners to plan their exits, especially while the "getting is still good"

2022 M&A Activity Continues Trending Downward

There is an overall environment of uncertainty that has been fueled by a cocktail of factors: high inflation, equity market drops, cheap capital, rising interest rates, deeper political divisions, pent-up consumer demand paired with supply-chain issues, recession chatter, China COVID lockdowns, energy underinvestment, the Russia-Ukraine war, etc. This uncertainty is contributing to the overall decline in 2022 M&A activity (number of deals), which settled in near pre-pandemic levels at the end of Q2 (see Chart 1); however, the rate of decline is not consistent across all deal sizes. For example, over the last twelve months (LTM), deals valued at over $1B (Wall Street) and under $10M (Main Street) were down 26.5% and 19.9%, respectively over the last twelve months (LTM), whereas deals in other size categories (middle market) declined only 4% on an LTM basis. Reasons why the middle market M&A remains resilient compared to the public market are discussed further in this report.

Chart #1

US M&A Activity: June 2019 - June 2022



Source: Factset®

Nearly all industries are feeling the impact of the macro headwinds. However, in most sectors, good businesses are still attracting strong levels of interest from potential acquirers and commanding attractive multiples; underperformers are trading markedly lower, if at all.

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

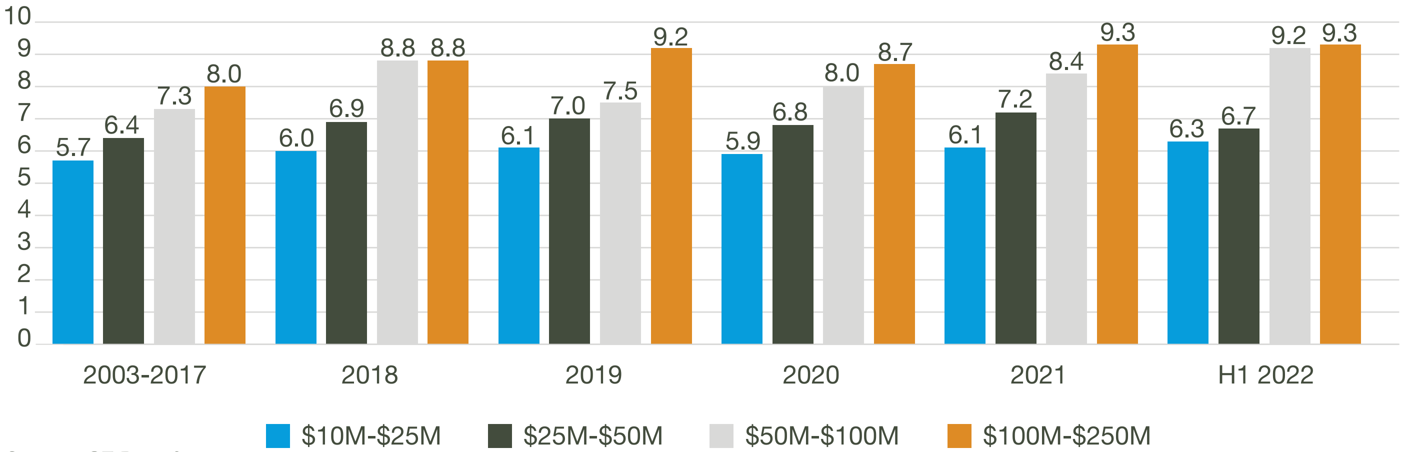
Chart 2 shows that lower middle market valuations for the first half of 2022 averaged 7.4x, matching the multiple for full year 2021. It's notable that valuations have held steady despite a host of complicating factors, including Russia's war in Ukraine, a surge in commodity prices, rising interest rates and ongoing supply-chain issues.

The total number of deals reported YTD continues to trend downward, but a higher than usual percentage of deals occurring involve companies that meet the standards for "above-average" financial performance underlying the calculation of a "quality premium." Sellers designated as "above-average" based on TTM EBITDA margin and revenue growth represent 68% of the total deal volume YTD, as opposed to a pre-pandemic norm of 57%. This reinforces the belief that volume is down because many businesses are not performing at optimal levels, making it less prudent to go to market at this time.

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

Chart #2

TOTAL ENTERPRISE VALUE (TEV)/EBITDA



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.*

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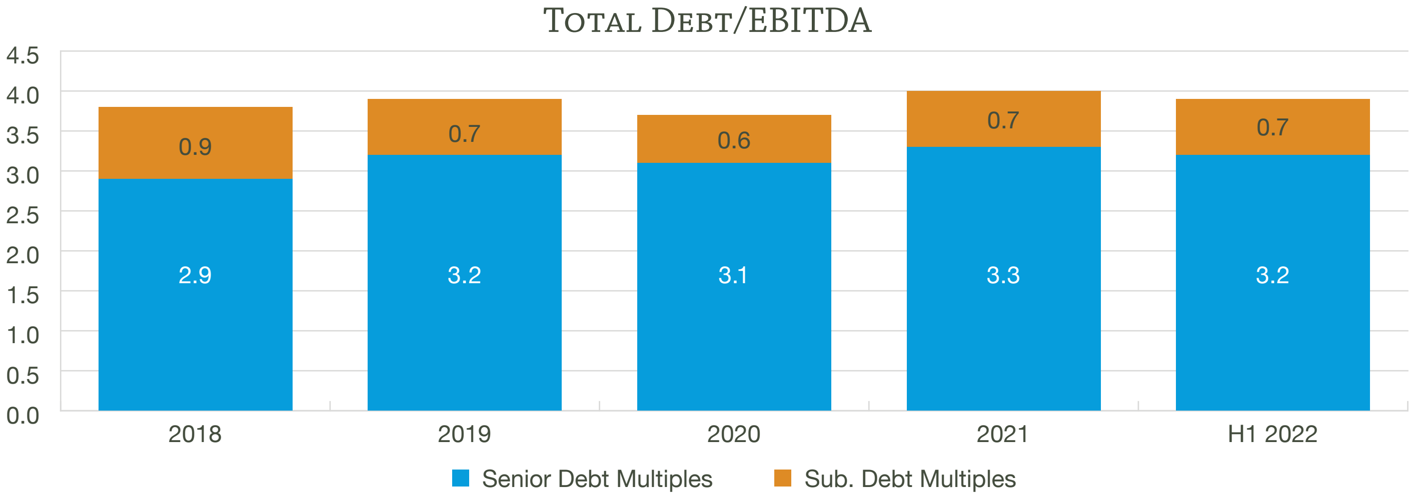
M&A Borrowing Appetite Remains High and Rates Affordable – Chart 3 shows us that debt utilization has been virtually unaffected despite the base borrowing rate having increased by 150 basis points through June since the beginning of the year. Total debt for deals has averaged 3.9x EBITDA YTD, with senior debt accounting for 3.2x and subordinated debt accounting for .7x.

The average senior debt rate in Q2 2022 was 4.6%—not meaningfully different than the rate for the same period last year. Larger deals have seen rate increases of more than a hundred basis points, to the mid-fives ("larger" defined as ranging from $50M-$250M with more aggressive debt levels and where non-bank lenders have been more prevalent). The average sub-debt rate has increased over the same period from 10.9% to to 11.4%.

The world's top central bankers have warned that the era of low interest rates and moderate inflation has come to an end following the "massive geopolitical shock" from Russia's invasion of Ukraine and from the Coronavirus pandemic.

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®

Why Middle Market M&A Does Not Often Follow Wall Street M&A

Most discussions we have with parties thinking about M&A starts with the question, "How is the market?" Often their perception is formed by what they hear and read in the news—currently, that the market has shifted in a meaningful way from being excellent in 2021 to not-so-good in 2022.

However, for those considering M&A, context is important. As indicated earlier in this report, while the number of M&A transactions greater than $1B has declined more than 25% on an LTM basis, the number of middle market M&A transactions ($10M - $1B in value) only declined by 4% on an LTM basis.

The difference between what is happening on Wall Street and the Middle Market is due in large part to differences in the drivers of M&A activity. Large private market or public market M&A activity is largely driven by factors such as macroeconomic conditions, the state of the public capital markets, structural regulatory changes, industrial and technological innovation and the need for companies to adapt to sector changes and/or changes in the economic environment. If macro tailwinds are strong and the public capital markets are favorable, it is compelling for boards, shareholders and big business owners to transact and then move on to the next investment opportunity.

While middle market M&A activity is also affected by similar factors to some degree, the biggest motivators for a lower middle market business owner to transact are retirement or fatigue—considerations that don't come into play in Wall Street deals. For the middle market business owner, retirement, fatigue, or both, is inevitable. Regardless of larger economic factors, owners must transact at some point for these reasons. Given the smaller size of such transactions, Buyers are generally abundant and able to transact at all times, regardless of market conditions or the cost and availability of capital.

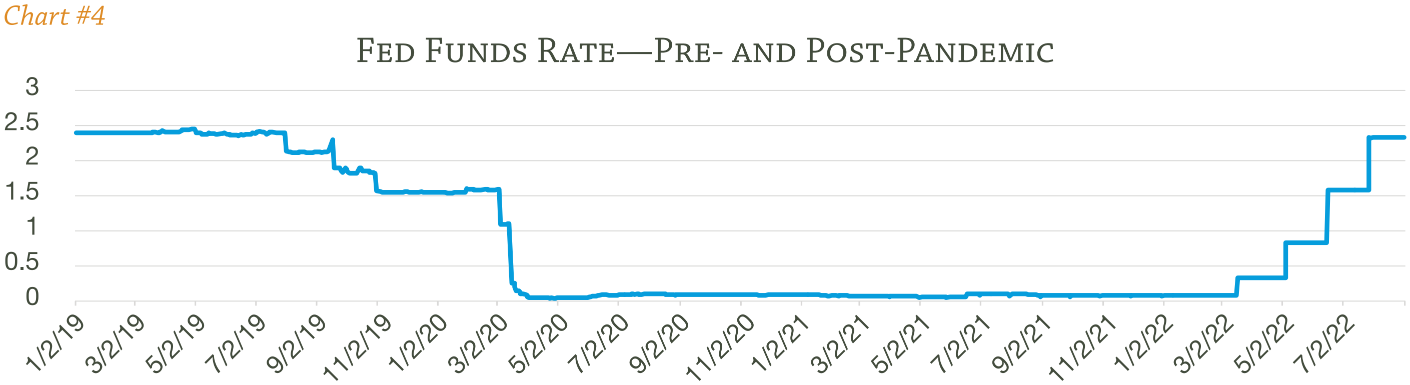
In fact, when the big deals get challenging to execute, Buyers often move downstream to the middle market, as the small deals are less sensitive to the cost of capital and the Buyers generally stand to gain a lot from a multiple arbitrage perspective.

There is a strong correlation between the cost and availability of capital and M&A activity. Business owners hear about potential rate increases in the media and may be concerned that this will negatively affect deals getting done and valuations. The response to that concern is that we are not there yet. Unlike the last major recession of 2008, which devastated financial institutions, banks have strong balance sheets, so we are seeing no slowdown in lending. Most are aware of the Federal Reserve's position on the cost of capital and the resulting gradual increase in rates through this year, but rates are just now returning to pre-pandemic levels (see Chart 4 below) and are still far from the 5.5% rate seen before the great recession in 2007—a very solid lending year.

Private Equity groups have billions in undeployed capital, and strategic balance sheets remain strong. This combination of motivated Sellers and well-capitalized Buyers will keep middle market M&A activity healthy for quite a while.

Many business owners put a sale-related retirement on hold during the pandemic and now that the worst of that appears to be behind us, they are ready to continue with their exit plans. And even if retirement wasn't part of an owner's plan in the last two and half years, after dealing with the stress of the pandemic and related labor and supply chain issues, many business owners are just fatigued and ready to tap out. We expect that business owners will continue planning their exits and that Middle Market M&A activity will continue to outpace Wall Street M&A for the foreseeable future.

Chart #4



The US Macroeconomic Picture for Q2 2022 and Its Impact on M&A

Q2 GDP Growth Rate Shows Technical Recession – According to the US Bureau of Economic Analysis, the US economy contracted by an annualized 0.6% on quarter in Q2 2022 The economy technically entered a recession, following a 1.6% drop in GDP in Q1. PCE grew 1.5%, led by food services and accommodations, while spending on goods—food and beverages—declined 2.4%. *

Inflation Peaked in Q2 – The annual inflation rate in the US accelerated to 9.1% at the end of Q2—the highest since November of 1981. It rose from 8.6% in May and above market forecasts of 8.8%. Energy prices rose 41.6%—the most since April 1980—boosted by gasoline (59.9%, the largest increase since March 1980), fuel oil (98.5%), electricity (13.7%, the largest increase since April 2006), and natural gas (38.4%, the largest increase since October 2005). Food costs surged 10.4%—the most since February 1981—with food at home jumping 12.2%, the most since April 1979. Prices also increased significantly for shelter (5.6%, the most since February 1991), household furnishings and operations (9.5%), new vehicles (11.4%), used cars and trucks (1.7%) and airline fares (34.1%). Core CPI, which excludes food and energy, increased 5.9%—slightly below 6% in May, but above forecasts of 5.7%. *

Business Confidence Remains Positive – The ISM Manufacturing PMI fell to 53 at the end of Q2, pointing to the slowest growth in factory activity since June of 2020, and below market forecasts of 54.9. New orders contracted for the first time in two years (49.2 vs 55.1)—a sign that rising interest rates are hurting demand. Also, employment declined further (47.3 vs 49.6), although companies improved at addressing moderate-term labor shortages at all tiers of the supply chain. At the same time, supplier deliveries slowed (57.3 vs 65.7) while production (54.9 vs 54.2) and inventories (56.0 vs 55.9) increased slightly faster and price pressures eased (78.5 vs 82.2). Meanwhile, business sentiment remained optimistic regarding demand, but firms continue to note supply chain and pricing issues as their biggest concerns. 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. *

Fed Lending Rate Continues to Rise – Q2 ended with the Federal Reserve increasing the Fed funds rate to 1.5%-1.75% in response to the inflation rate unexpectedly accelerating to 41-year highs. It is the biggest rate increase since 1994. At the time of this report, policymakers anticipate that interest rates will increase to 3.4% this year—well above 1.9% expected in March. Meanwhile, the economy is expected to expand by 1.7% this year, below the 2.8% estimated in March. The growth outlook was also lowered for both 2023 (1.7% vs 2.2%) and 2024 (1.9% vs 2%). The estimate for PCE inflation in 2022 is expected to be higher (5.2% vs 4.3% expected in March) while the outlook was lowered for both 2023 (2.6% vs 2.7%) and 2024 (2.2% vs 2.3%). The anticipated jobless rate for the 3-year period has risen: 3.7% for 2022 (vs 3.5%), 3.9% in 2023 (3.5%) and 4.1% in 2024 (vs 3.6%). *

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.

**Trading Economics®*

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SPACs: What Are They and Are They Here to Stay?

For decades, conventional initial public offerings ("IPOs") served as the primary path for growth companies to raise money in the public markets. Approximately 30 years ago, a new option emerged that allows companies to pursue an alternative and streamlined path to entering public markets: the use of a special purpose acquisition company, more commonly referred to as a SPAC or a SPAC IPO.

Well-known companies that emerged through the SPAC channel include DraftKings (NASDAQ: DKNG) and Virgin Galactic (NYSE: SPCE).

The Data

Sometimes referred to as "blank check companies," SPACs have existed for decades. However, their popularity has soared in recent years.

As we can see from Chart 5 below, SPACS were not a well-known or commonly-utilized investment vehicle until 2021. That year, the capital raised across 600 SPAC IPOs rose to an all-time high of over $100 billion. Through July 2022 and consistent with the US stock market, SPAC activity came off its all-time highs of 2021, as 70 SPAC IPOs were completed, raising $10 billion. While the pace and velocity of SPAC IPOs slowed, SPACs outpaced traditional IPOs during the same period, demonstrating their continued popularity.

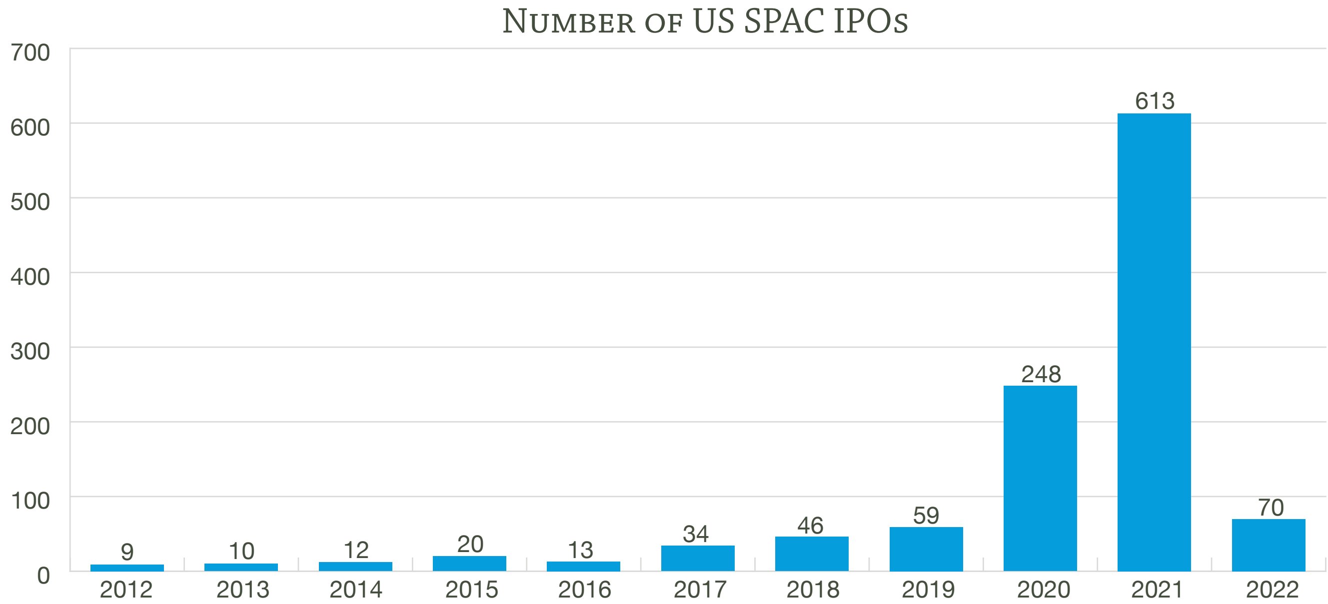
What is a SPAC?

SPACs are shell companies without commercial operations. They are formed strictly to raise capital through an IPO for the purpose of merging at a future date with an existing company that is not identified at the time of the SPAC IPO. SPACs typically price at $10 per unit.

SPACs are formed by a sponsor that makes initial investments and raises outside capital. The sponsor generally is a sophisticated investor (such as a private equity firm or venture capital group) with a track record for identifying companies to acquire, managing the acquisition process, closing the deal and monitoring the business post close. When investing in a SPAC, investors are relying heavily on the reputation of the sponsor.

SPACs have two years from their IPO to find and merge with a company. The funds SPACs raise in the IPO are placed in an interest-bearing trust account that cannot be disbursed except to complete an acquisition, which includes fees and compensation of the sponsor (fees and compensation typically consume one-third of the funds raised). If the SPAC doesn't merge with a target company within the two-year time period, the SPAC is dissolved and the remaining funds are returned to the SPAC shareholders.

Chart #5



Source: Statista®

Once a SPAC has identified a company with which to merge, the sponsor will coordinate the due diligence, ultimately leading to the execution of a merger agreement. During that process, SPAC investors vote to approve the transaction. If the investors give the green light to proceed, the SPAC and target company merge into a single new publicly traded company. This process is referred to as DeSPACing. Investors that choose not to participate in the DeSPACing are allowed to redeem their shares (including accumulated interest) in the SPAC prior to the acquisition of the target company.

Why SPACs are "en vogue"

SPACs gained popularity in large part due to the speed with which they can be created. The SPAC IPO process can be completed in as little as eight weeks, as documentation is less onerous than that of a conventional IPO, which typically takes at least six months and oftentimes more than a year.

Another and important reason SPACs have become popular is that they allow retail investors the opportunity to invest in promising privately-held companies alongside "sophisticated" investors such as private equity managers and venture capital firms.

With the rise in their popularity, SPACs have caught the attention of regulators. Recently, the SEC proposed new rules intended to enhance investor protections in SPAC IPOs—such as requiring SPAC sponsors to obtain a third-party fairness opinion in connection with a DeSPAC transaction.

Conclusion

Despite the increased SEC scrutiny, SPACs are here to stay and will continue to grab headlines as more and more well-known companies emerge through this channel.

SPACs present another investment channel available to public investors to help further diversify portfolios. They should be considered to fall on the higher end of the risk spectrum, but with increased risk can come increased returns.

Pursant's Expectations for the Near Future

After a record year of M&A activity in 2021, M&A activity in H1 2022 appears to pale in comparison—but remember: Wall Street activity is not necessarily consistent with Middle Market or Main Street activity. As a result of economic and geopolitical uncertainty, all markets have slowed, but not at the same rate. The M&A activity for all sectors is still very healthy. Think of 2021 like a marathon-running pace of 5 minutes per mile (the fastest speed an average treadmill can reach) compared to a 2022 pace of 6:52 (the pace needed to achieve a 3-hour marathon time)—still very impressive. The deal volume in 2021 was simply not sustainable.

Pursant still believes that the back half of 2022 will largely mirror the front half of the year despite the headwinds we are experiencing from a variety of sources. Strategic companies still have trillions of dollars of cash sitting on their balance sheets and US Private Equity companies still hold nearly $1 trillion dollars of dry powder. Both parties are eager to put this idle money to work through M&A. A common (nearly daily) email in Pursant's Info@Pursant.com inbox reads like this:

> *Hello,*
>
> *I hope all is well. I am with XYZ Firm, a permanent equity vehicle. We currently own a company operating in the XYZ industry and are looking to grow that business through acquisition. In particular, we are looking for XYZ companies that are between $X and $Y in EBITDA. Please let us know if you are currently working with any clients that may be a fit.*

The Fed continues to raise rates, but as mentioned earlier, rates are still very reasonable and we do not yet expect a compression in multiples for better businesses in the back half of 2022.

Wage inflation, staffing and supply chain issues remain sources of fatigue for middle market business owners and can be an impetus to exit. Many owners are taking steps now with the intent of launching a sale process in early 2023.

To summarize, the balance of this year is expected to have a profile similar to that of other healthy M&A years with H2 activity largely focused on closing deals currently in the market and preparing new deals for a 2023 launch.

Pursant is an investment banking, financial and management consulting firm that supports and executes middle market M&A related initiatives and helps business owners grow enterprise value.

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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