Pursant
INSPIRED PURSUIT

Q2 2023 EDITION

DEAL insider

M&A and Strategic Transaction Insights

THE INVESTMENT BANK THAT ALSO BUILDS THE VALUE OF YOUR BUSINESS

Q2 2023 Highlights:

- The cost of capital rose, while middle market M&A activity continued to fall
- Valuation multiples began to decline in some sectors and deal size ranges more than others
- Despite slowing deal activity, Private Equity dry powder increased by 11% from year-end 2022

Pursant's Thoughts on the Near Future

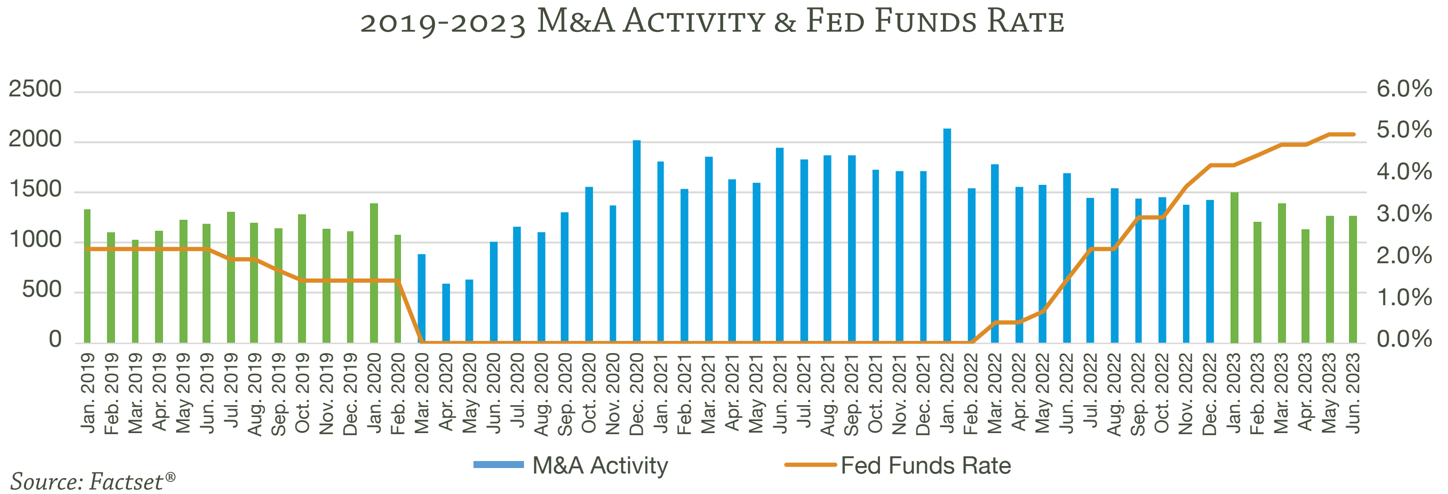
- Deal flow is likely to stabilize at current levels
- Valuation multiples will continue to feel the pressure of sustained higher rates
- The market remains more favorable to Buyers, with fewer active Buyers chasing more available deals

Cost of Capital Slowed Q2 2023 M&A Activity

The cost of borrowing continues to drag down M&A activity in 2023; however, the downturn is not severe due to the offsetting health of the economy overall. More specifically, according to Factset, for the lower middle market (deals ranging from $10M-$250M in enterprise value), M&A activity for the trailing twelve months (TTM) through June 2023 is down 49% compared to the same TTM activity through June 2022. As mentioned in the past though, this measure compares the current period against one with record-high M&A activity. As illustrated by the green bars in Chart 1, current M&A activity can be seen as healthy when compared to that of a more analogous pre-pandemic period.

If the cost of capital continues to increase, it's likely we will see further erosion of M&A activity. Once the Fed feels inflation has been tamed and rate increases cease, we may see this erosion reversed, but most likely not in a meaningful way until rate decreases start to kick in. As we have discussed in the past, historical data points to a very predictable relationship between the cost of capital and M&A activity.

Chart #1



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.

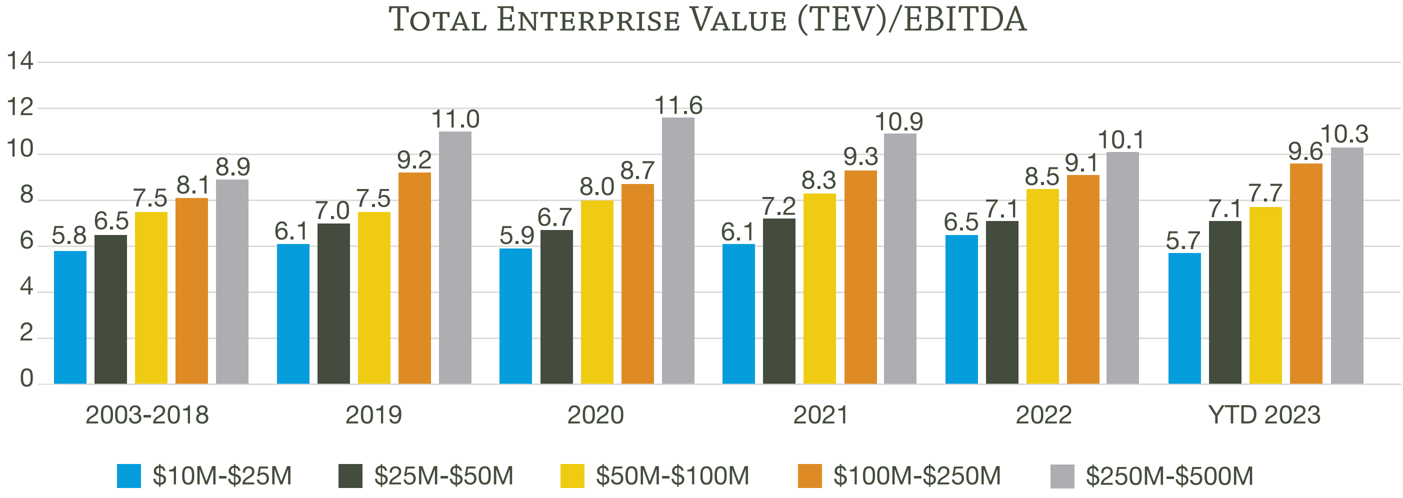
Pressure on Valuation Multiples Begins

Middle market valuation multiples are starting to experience the compression expected due to continually rising rates. Average EBITDA multiples were 6.4x in Q2 2023—a drop of 1.3x compared to Q1 2023. The 2023 YTD EBITDA multiple for the lower middle market is 7.2x, compared with 7.6x for full year 2022. It's important to note that this data is sector-agnostic. Some more resilient sectors with limited high-quality targets available have held strong on valuation, while other sectors have seen significant multiple contraction.

Even though it may not be readily apparent when considering YTD EBITDA valuation multiples rather than quarterly, there was a pronounced drop in multiples for deals in the \$250M-\$500M range. For the cohort of this size, the average deal dropped a full 3 turns between Q1 and Q2 2023 (12.2x vs. 9.0x). By comparison, EBITDA multiples for other cohorts dropped 1.0 – 1.5 turns in this time period.

We often highlight the "Quality Premium" (market increase in valuation multiples) for businesses with above-average financial performance—those with TTM EBITDA margin growth rates and revenue growth rates both above 10%, or one metric above 12% and the other at least 8%. This Quality Premium is nearing its lowest level in 5 years: just 8%. For example, if two identical companies trade hands and one company meets the Quality Premium criteria, that company would currently sell for, on average, 8% more than the other. This is markedly lower than the double-digit Quality Premium measures of 2022. This changing dynamic suggests that Buyers are less trusting of the sustainability of a Seller's financial performance in that current and historic performance is not viewed as a guarantee of future performance, given a challenging lending environment and a still uncertain macroeconomic horizon.

Chart #2



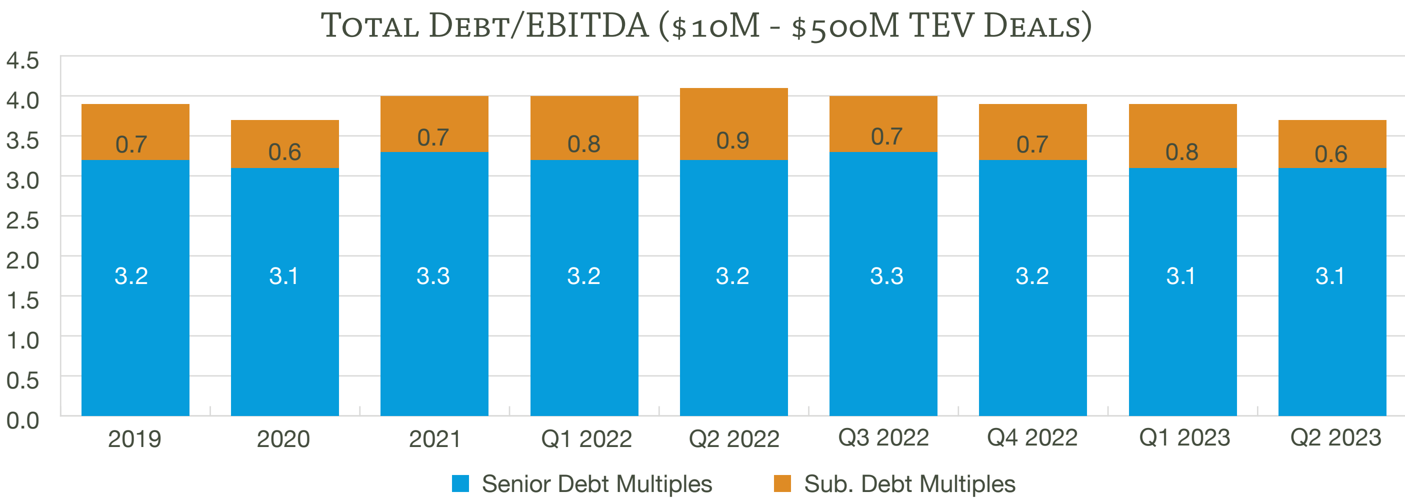
Source: GF Data®

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.*

Expensive Capital Continues to Flow – Chart 3 reveals that debt utilization has been virtually unaffected by the Fed increase in rates to the highest level in 17 years. Total debt for deals averaged 3.7x EBITDA in Q2 2023, with senior debt accounting for 3.1x and subordinated debt accounting for .6x.

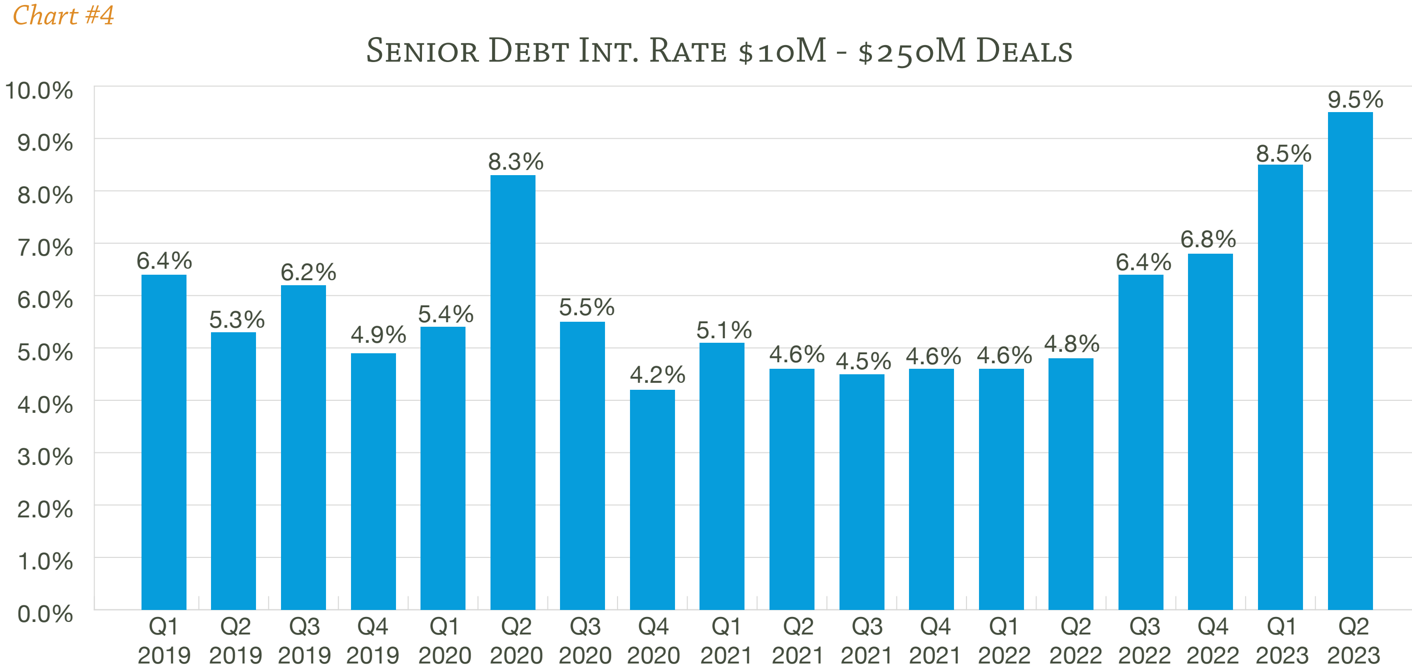
In Chart 4 we can see that in the second quarter of 2023, there was significant upward pressure on debt pricing, with the average interest rate for senior debt reaching 9.5%—nearly 3 points higher than the average rate in the fourth quarter of 2022.

Chart #3



Source: GF Data®

Chart #4



Source: GF Data®

The 10.8% average interest rate for sub-debt in Q1 2023 is relatively unchanged from previous periods. Year-to-date, the average interest rate for this category of debt has averaged 11.4% (15.4% when adding in fees). Many M&A borrowers utilize what is called Unitranche debt, which is essentially a blend of senior and subordinated debt. For 2023 YTD, the interest rate for this debt type has averaged 12.4%. As mentioned earlier this year, there is also a notable increase in reports of Mezzanine deals that include warrants, confirming the idea that subordinated debt is in much higher demand now—likely due to heightened underwriting standards from senior lenders.

The US Macroeconomic Picture for Q1 2023 and Its Impact on M&A

Q2 GDP Growth Exceeds Expectations – The US economy expanded by an annualized 2.4% quarter-over-quarter in the second quarter of 2023—higher than the preceding quarterly increase of 2%. Nonresidential fixed investment accelerated sharply in Q2 (+7.7% vs +0.6% in Q1), led by a rebound in equipment (+10.8% vs -8.9%) and intellectual property products (+3.9% vs +3.1%). Also, private inventories added 0.14 percentage points to the growth (vs -2.14 in Q1). On the other hand, consumer spending slowed sharply (+1.6% vs +4.2%) but still overshot market estimates as inflation eased while the labor market remained tight. Consumption of goods slowed sharply (+0.7% vs +6%), but spending on services remained strong (+2.1% vs +3.2%).*

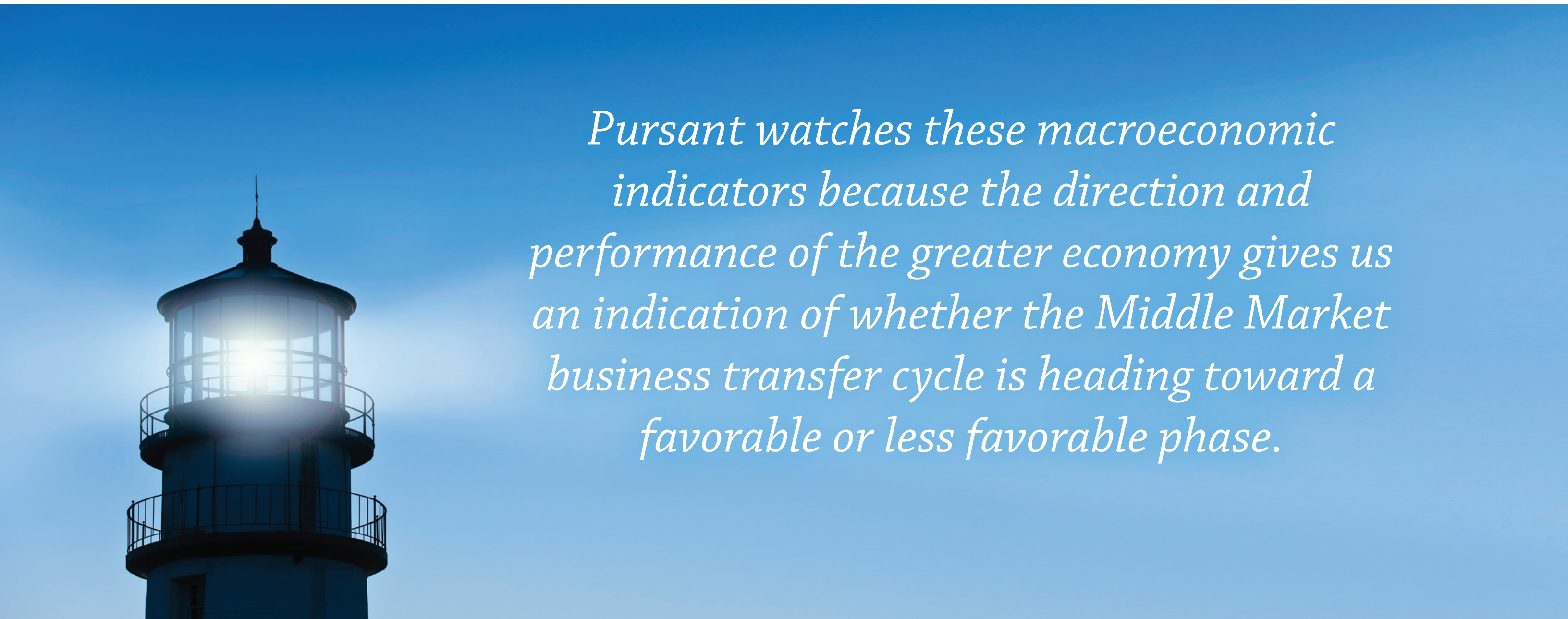
Inflation Falls More Than Expected – The annual inflation rate in the US slowed to 3%, as measured at the end of Q2 2023—the lowest since March 2021 and markedly lower than the 5.2% rate at the end of Q1 2023. The slowdown is partly due to a high base effect from 2022, when a surge in energy and food prices pushed the headline inflation rate to 1981-level highs of 9.1%.*

Business Confidence Continues to Decline – The June 2023 ISM Manufacturing PMI in the United States of 46 was relatively consistent with the measure at the end of Q1 2023, 46.3. Companies are managing down outputs as softness continues and optimism about the second half of 2023 weakens. "There are signs of more employment reduction actions in the near term," said Timothy Fiore, Chair of the ISM. In June, declines were seen in new orders, production, employment, inventories and backlog of orders. Also, price pressures eased. The reading pointed to a fifth straight month of contraction in factory activity to better match demand for the first half of 2023 and prepare for growth in the late summer/early fall of this year. A PMI reading above 50 percent indicates that the manufacturing economy is generally expanding; below 50 percent indicates that it is generally declining.*

Fed Lending Rate Continues to Rise – Q2 2023 ended with a jump in the Federal funds rate to the 5% - 5.25% range (which happened during the May meeting). This May increase is the tenth consecutive rate increase since the Fed began to tighten monetary policy last year. Interest rates have increased from nearly zero in March 2022 to 5.00-5.25%—the highest in 17 years. Fed Chairman Jerome Powell stated that the Fed is "prepared to do more if greater monetary policy restraint is warranted."

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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FP&A—An Often-Missed Best Practice for Managing Enterprise Value Growth

It is important for all types of business professionals to have an awareness of the FP&A role and function, especially given today's challenging lending environment. FP&A is an acronym that stands for Financial Planning and Analysis, which is defined by The Institute of Management Accountants as a decision-making platform that includes reporting and analysis, planning and budgeting, forecasting and financial modeling.

FP&A as a concept is not new, and tools to facilitate effective FP&A have been around for decades. However, FP&A has evolved to be a specialized competency; very large and scaled businesses have more recently established entire FP&A functions with dedicated resources. Whether managed by a single person or an entire department, today FP&A is considered a best-in-class discipline and is often cited as a key reason companies are able to scale more quickly and efficiently optimize enterprise value.

In its simplest form, FP&A is a continuous cycle of data collection and analysis. It combines planning, forecasting, budgeting and analytical activities to support key strategic and tactical, decisions. FP&A entails processes that takes the company's high-level strategies and translates them into actionable plans that can be easily communicated and accurately measured/tracked.

The best FP&A functions combine financial data, operational data and external data to drive (i) in-depth insights to facilitate future planning, (ii) identification of emerging trends and (iii) recommendations.

The evolution of the FP&A function resulted from advances in cost effective business intelligence technologies; cloud-based software now exists with automated computing capabilities to transform large data sets into easy-to-consume dashboards, graphs and reports. As a result, Finance/Accounting teams have evolved too—from back-office record-keepers and manual spreadsheet-creators to a forward-looking, strategic decision-making function. Finance/Accounting teams no longer "just reporting the news" but instead are expected to provide accurate, data-driven insights to help inform confident planning and decision-making across the entire enterprise.

Generally, the FP&A role and function is managed by a company's CFO. However, there is an emerging trend (particularly in larger corporations) for CEOs to oversee the FP&A function as part of an enterprise-wide business performance management system.

The profile of an FP&A professional is typically someone with a bachelor's degree in a field such as finance, accounting, mathematics or economics. FP&A professionals require a solid working knowledge of financial statements (P&L, balance sheet and cash flows) and strong financial modeling skills. Importantly, FP&A professionals need to possess strong communication skills to present analysis and recommendations to key stakeholders in an organization.

The FP&A role and function is here to stay. While it can take many shapes, forms and sizes, if your organization is not intentional about this type of role and function, the organization is most likely missing opportunities for greater profitability, growth and value enhancement.

Benefits of FP&A

- Create agile, integrated financial plans that can incorporate changing scenarios
- Build and maintain detailed financial models and forecasts
- Identify and assess new opportunities
- Predict the impact of potential decisions on cash flow and profitability
- Provide fast and accurate financial analysis and advice to business leaders

Consider A Buyer's Motivations to Transact

The business sale process is nuanced and multifaceted, with each phase crucial to ensuring the desired outcome for the Seller. Curating a list of potential Buyers who align with the Seller's objectives and vision is one of the most pivotal steps in the process and can dramatically influence the outcome of the sale—the likelihood of closing and the potential to achieve maximum enterprise value. It is important to consider a wide range of Buyers, balancing broad outreach with specific gating criteria, to maximize efficiency of outreach and evaluation.

In building a pool of prospective Buyers, it is helpful to consider the reasons why a strategic or financial Buyer would be interested in the acquisition. Here are some of the most common Buyer motivations, with specific examples and insights into how Sellers might conduct a search for each:

Buyers Looking to Accelerate Growth and Market Dominance:

- **Motivation:** The opportunity to quickly expand into a new market, product line, or customer demographic—potentially to eliminate a competitor.
- **Example:** A regional distributor aiming to expand its presence nationally might be interested in acquiring a local brand with an established customer base in in a different region. This not only offers immediate customer access, but also removes a competitor from the equation.
- **Search for:** Companies bearing resemblance to the Seller in terms of product or service offering, regulatory framework or competitive landscape.

Buyers Seeking Operational Synergies and Cost Efficiency:

- **Motivation:** To obtain economies of scale and resulting cost advantages.
- **Example:** An established manufacturer with production facilities in the North might want to save on shipping costs and improve distribution efficiency in the South.
- **Search for:** Companies with a similar geographic footprint, service network, manufacturing/production or operational methodologies.

Buyers Seeking Strategic Capability and Transformation:

- **Motivation:** To acquire crucial technology, intellectual property or human capital.
- **Example:** A Buyer aiming to expand its product range might acquire the IP of a smaller competitor with similar certifications and a proven track record.
- **Search for:** Companies with similar compliance to certification or regulatory bodies.

Buyers Seeking Diversification and Risk Mitigation:

- **Motivation:** To diversify into a new or varied market sector in order to reduce over-reliance on a singular revenue stream.
- **Example:** A Buyer offering a seasonal product might decide to diversify by acquiring a company with an established, counter-seasonal product line catering to the same customer base—possibly one that uses a similar sales channel.
- **Search for:** Companies that sell a different product or service through a similar channel or to a similar group of customers.

Buyers Looking to Strengthen the Value Chain and Financial Leverage:

- **Motivation:** To acquire part of the production process in order to enhance quality control and profitability.
- **Example:** A Buyer that produces raw material might acquire a company with capabilities to produce finished goods.
- **Search for:** Companies that use the Seller's product or service as part of a larger process.

Building a Buyer pool is not just about listing potential purchasers, but also entails understanding intricate buying dynamics. Having insight into why a company is being sold and why another entity would be interested in acquiring it can amplify the success of the transaction and boost prosperity for both Buyer and Seller.

Pursant's Expectations for the Near Future

We often speak of the cycles of market favorability for M&A as Buyer-Favorable, Seller-Favorable or Neutral. These cycles are largely driven by the cost of capital. With the most recent rounds of interest rate increases, we see the cost of capital manifesting itself in softer multiples. We expect that to be the continued theme for the balance of 2023.

Some Buyers—particularly leveraged Buyers—are taking this time of higher capital costs to shift focus to integration and margin enhancement in portfolio companies. Many leveraged Buyers still in the market are less aggressive on valuation due to sustained higher costs of debt service. Buyers that are less debt-sensitive are leaning into M&A, but pulling back on multiples due to lingering concerns about a recession. Coupled with continued demand by Sellers to exit (middle market Baby Boomers in particular), ***we are now firmly in the Buyer-Favorable phase of the M&A cycle***.

It's important to clarify that "Buyer-Favorable" does not mean that Sellers should reconsider exit plans. It means that Sellers may not be selling at the top of the market, but in many cases, they aren't selling at the bottom either. While some industries have seen significant multiple compression, others have not. For a variety of reasons, just like the public markets, trying to time the perfect transaction window is elusive.

The best time to transact, in this order, is:

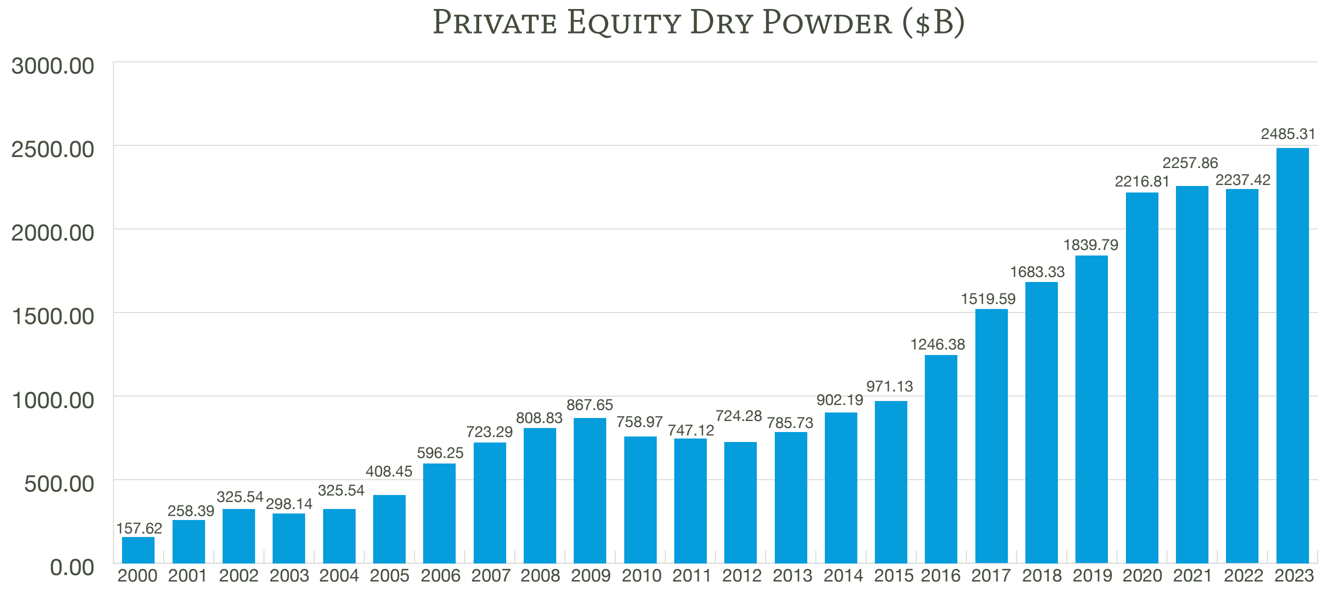
- When the business owner is emotionally ready
- When the business is performing well and on the upswing
- When the market is Seller-Favorable

While the market is not at its peak of Seller-Favorability, the balance of 2023 is still considered a market in which we expect to see healthy valuations—just not the overly-frothy, unsustainable valuations we saw a year or two ago.

Strategic Buyers still have balance sheets with healthy cash positions, so we expect them to remain active Buyers, especially with more affordable deals available. We also expect M&A activity from financial Buyers to at least remain at the present level and, potentially, to grow. Chart 5 shows that despite slowed PE dealmaking activity, levels of undeployed capital (dry powder) continues to grow. This money needs to be deployed for the Private Equity business model to work.

In short, we still see a healthy M&A environment overall. Parties may need to think creatively and be flexible to get deals done, but there is still a lot to like about the balance of 2023.

Chart #5



Source: S&P Global Market Intelligence®

Pursant is a middle market investment banking and advisory firm that provides M&A advisory and strategic transaction services, financial leadership support and consulting and coaching related to business value enhancement. Our powerful, integrative, customized suite of services delivers the insight and guidance parties seek to confidently navigate complex strategic initiatives. We use a deep immersion process, our expansive networks and experience as owner/operators, dealmakers and financial professionals to help you achieve optimal outcomes.

Our Investment Banking practice helps liquidity-minded business owners monetize their business and acquisitive parties manage acquisition initiatives and source the capital needed to fund strategic transactions.

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

Our Strategic Advisory practice provides customized solutions designed to re-shape conventional thinking about leadership performance, profitability and growing enterprise value.

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

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