Q3 2022 EDITION

Pursant
INSPIRED PURSUIT

DEAL insider

M&A and Strategic Transaction Insights

Q3 2022 Highlights

- Middle market M&A activity continues to trend downward, but the level of activity is still healthy.
- Valuation multiples generally held strong despite the increase in the average cost of Senior debt to 6.5%.
- There is an overall sense of now being in "choppy" M&A waters after smooth sailing in 2021.

Pursant's Thoughts on the Near Future

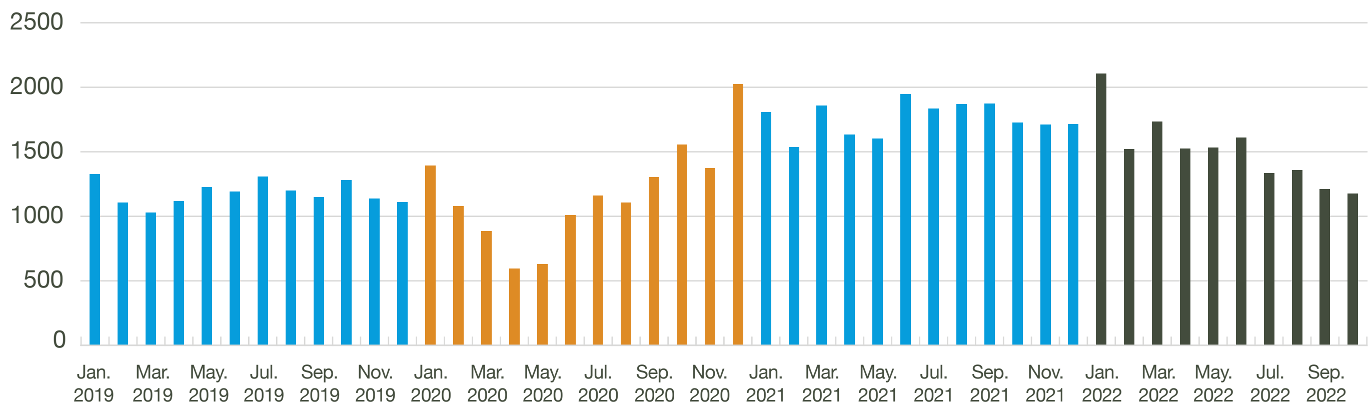
- Macroeconomic, geopolitical and public equity market issues and 2023 recession fears are expected to further slow M&A activity, but less so in the lower end of the middle market.
- Fed rate increases continue. Where they top out will affect the duration of this slowing M&A trend.
- All said and done, 2022 is expected to look like the pre-pandemic 2021 period.

Third Quarter 2022 M&A Activity Back to Pre-Pandemic Levels

Bearish sentiment around public markets continues to dominate business headlines, and the 2022 downward trend in Chart 1 does not paint a pretty picture of the direction of M&A activity. However, when comparing 2022 to the pre-pandemic 2019 environment, we see a half-full glass because activity is healthy and sustainable, as opposed to the frenetic activity in 2021.

Chart #1

US M&A ACTIVITY: JAN. 2019 - SEP. 2022



Source: Factset®

The top of the funnel (new deals coming to market) shows a similar visual of slowing, likely due to uncertainty that persists due to: high inflation, the equity market roller coaster, rising interest rates, deepening political divisions, pent-up consumer demand paired with supply-chain issues, recession chatter, COVID lockdowns in China, energy underinvestment, the Russia-Ukraine war, and more. M&A will continue to slow in Q4 (with the exception of a traditional December spike).

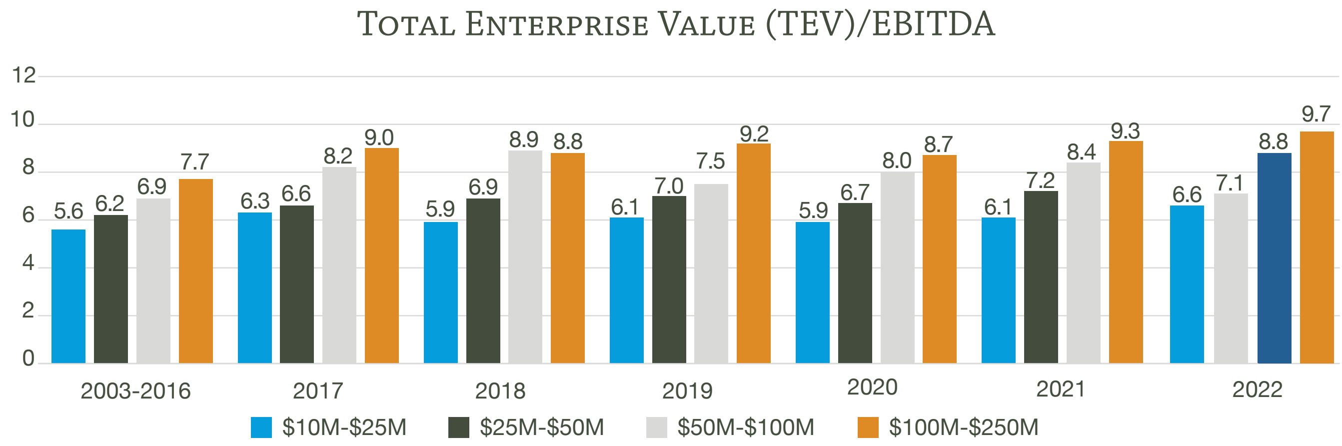
In Q2 we reported that the decline in M&A activity was not consistent across the deal size spectrum. In Q2, over the last twelve months (LTM), deals valued at over $1B (Wall Street) and under $10M (Main Street) were down 26.5% and 19.9%, respectively, whereas deals in other size categories (middle market) declined only 4% on an LTM basis. In Q3, deal activity level in the $25M - $250M range aligned with other deal size ranges, declining 16.4% on an LTM basis.

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.

Middle market, valuation multiples continue to show resilience against the more challenging macroeconomic backdrop—at least for the better performing businesses. Companies with marginal performance and those in struggling sectors are finding it challenging to capture the 2021 premiums.

Chart 2 shows that lower middle market valuations for the first half of 2022 averaged 7.7x, similar to Q2 2022. It's notable that valuations have held steady quarter over quarter despite senior M&A lending rates rising from an average of 4.7% in Q2 to 6.5% in Q3. For larger transactions valued between $250 million and $500 million, the average purchase price multiple was 10.1x EBITDA.

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 Despite Climbing Rates – Chart 3 shows us that debt utilization has been virtually unaffected despite a 300 basis point increase in the base borrowing rate from the beginning of the year through September. Total debt for deals has averaged 3.9x EBITDA YTD, with senior debt accounting for 3.2x and subordinated debt accounting for .7x.

Until Q3, ongoing Increases in the Federal Reserve interest rate have not translated into higher borrowing costs on private transactions. In the third quarter, the impact of those increases became evident in full force. Initial pricing on senior debt leapt from 4.5-4.7% in Q1 and Q2 to 6.5% in Q3. Surprisingly, this has not meaningfully impacted Buyers' willingness to borrow at the same level as the first half of the year. Buyers still have an overabundance of capital to deploy and need to get deals done, even if it means paying more for the non-equity portion of their deals. The level of leverage at these higher rates, combined with multiples holding strong, support this position. At last count "overabundance" of capital in the PE world means $1.8 trillion.

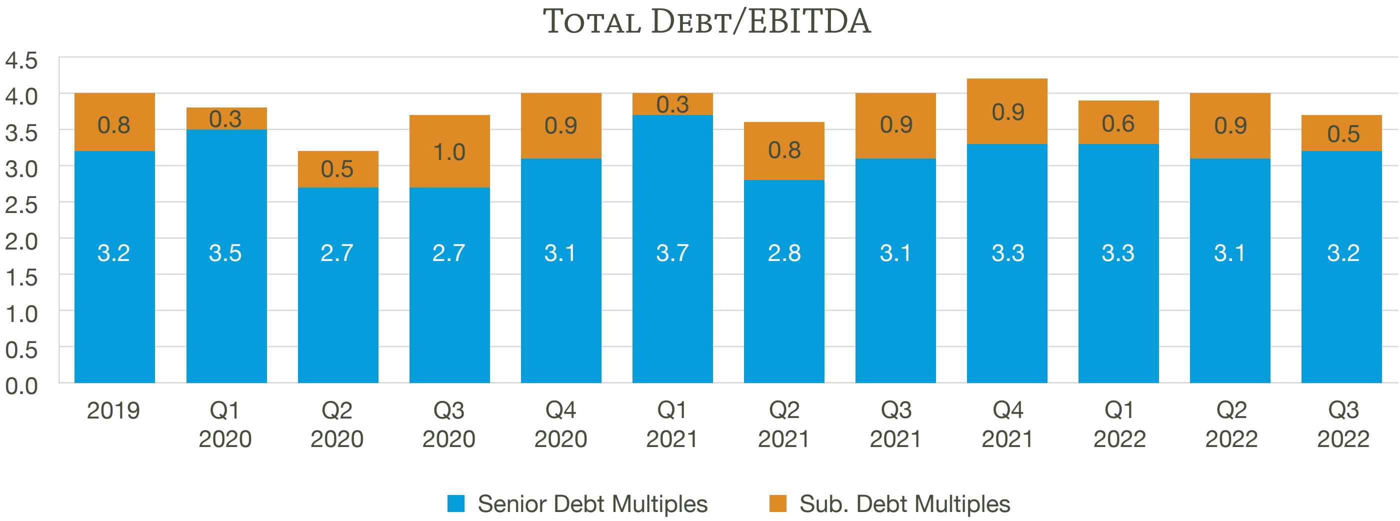
Buyers are addressing any borrowed funds shortfalls by upping the amount of equity they contribute to deals. Average equity commitment on platform deals year to date increased by 2.5 percentage points to 57%, compared to an average of 54.5% for all of 2021.

The average Q3 sub-debt rate of 11.2% is largely unchanged from Q2's 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.

Monitoring debt utilization in M&A is relevant because 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®

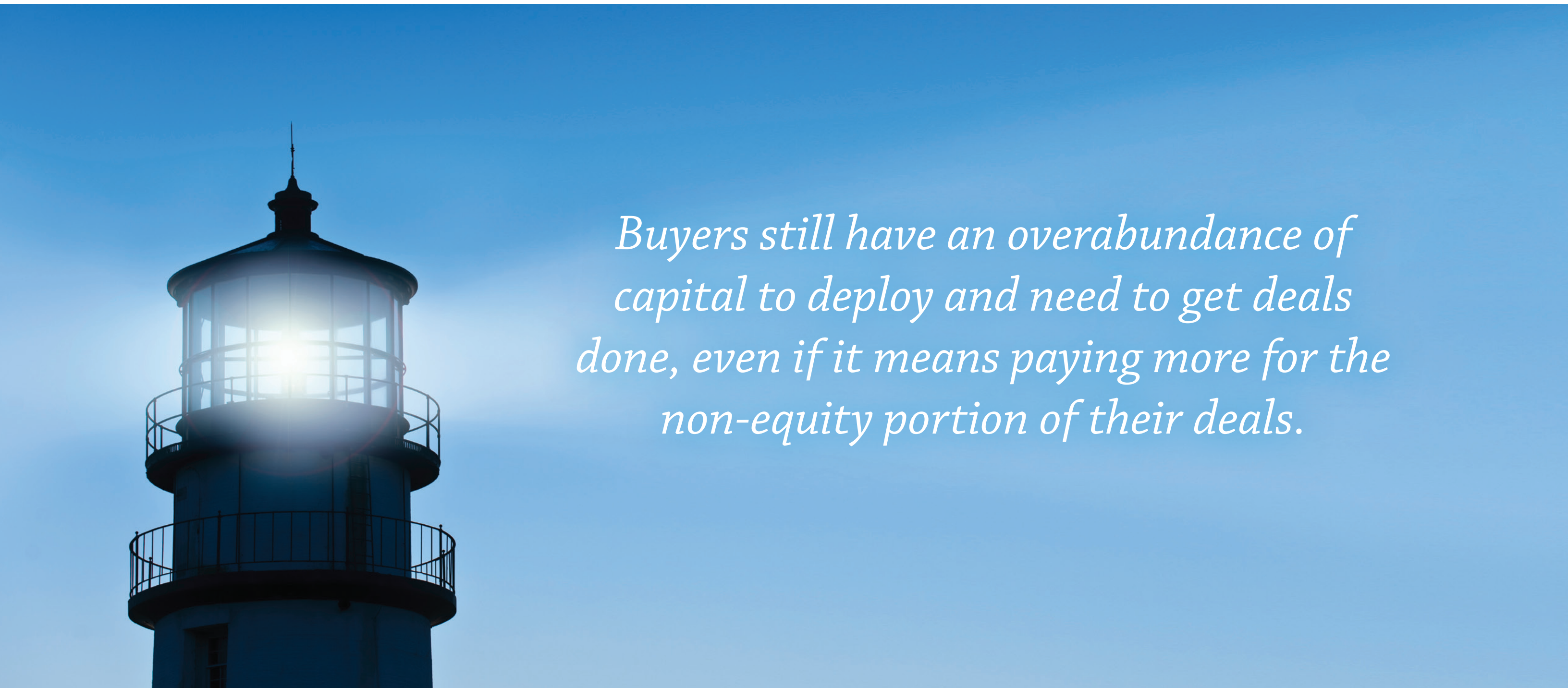


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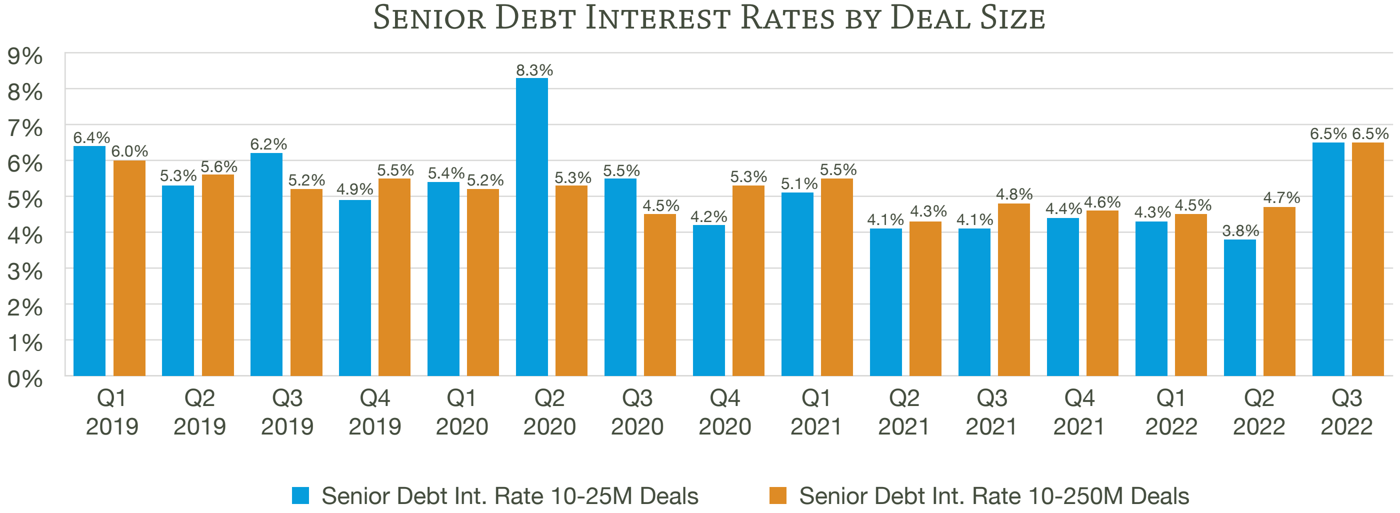
Chart #4



Source: GF Data®

The US Macroeconomic Picture for Q3 2022 and Its Impact on M&A

Q3 Shows GDP Growth – According to the US Bureau of Economic Analysis, the US economy grew an annualized 2.6% in Q3 2022, beating forecasts of a 2.4% rise and rebounding from a contraction in the first half of the year. The biggest positive contribution came from net trade (+2.77 pp vs +1.16 pp in Q2), as the trade gap narrowed. Imports sank 6.9% while exports were up 14.4%, led by petroleum products, nonautomotive capital goods and financial services. At the same time, nonresidential investment jumped 3.7%, boosted by increases in equipment and intellectual property. On the other hand, residential investment sank for the 6th quarter (-26.4%) as the housing market has been hit by soaring mortgage rates. Finally, consumer spending grew at a slower pace (+1.4% vs +2.0%) but remained resilient as higher outlays on services (led by health care) offset a decrease in goods, namely motor vehicles and food and beverages.*

Inflation Slowed in Q3 – The annual inflation rate in the US slowed for the third month, running to 8.2% at the end of Q3 2022—the lowest in seven months—compared to 8.3% in August; the rate was above market forecasts of 8.1%. The energy index fell to +19.8%, below +23.8% in August. There also was a small slowdown in the cost of food (+11.2% vs +11.4%, which was the highest since 1979) and used cars and trucks (+7.2% vs +7.8%). On the other hand, prices for shelter increased faster (+6.6% vs +6.2%). Meanwhile, the core rate, which excludes volatile food and energy, rose to +6.6%, the highest since August of 1982, and above market expectations of +6.5%, in a sign that inflationary pressures remain elevated.*

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.

Business Confidence Falls – The ISM Manufacturing PMI unexpectedly fell to 50.9 at the end of Q3 2022, pointing to the slowest growth in factory activity since the contraction in 2020. New orders (47.1 vs 51.3 in August) and employment (48.7 vs 54.2) contracted and production increased only slightly (48.7 vs 54.2). Meanwhile, price pressures continued to ease (51.7, the lowest since June 2020, vs 52.5). "Following four straight months of panelists' companies reporting softening new orders rates, the September index reading reflects companies adjusting to potential future lower demand. Many Business Survey Committee panelists' companies are now managing head counts through hiring freezes and attrition to lower levels, with medium- and long-term demand more uncertain," said Timothy R. Fiore, Chair of ISM.*

Fed Lending Rate Continues to Rise – Chart 5 below shows that Q3 2022 closed out with the Federal funds rate jumping to the 3%-3.25% range. Three-quarter point increases have been the recent norm, pushing borrowing costs to the highest level since 2008. Policymakers also anticipate that ongoing increases in the target range will be appropriate, which was reinforced by Chair Powell, who stated, "We have got to get inflation behind us. I wish there were a painless way to do that. There isn't."*

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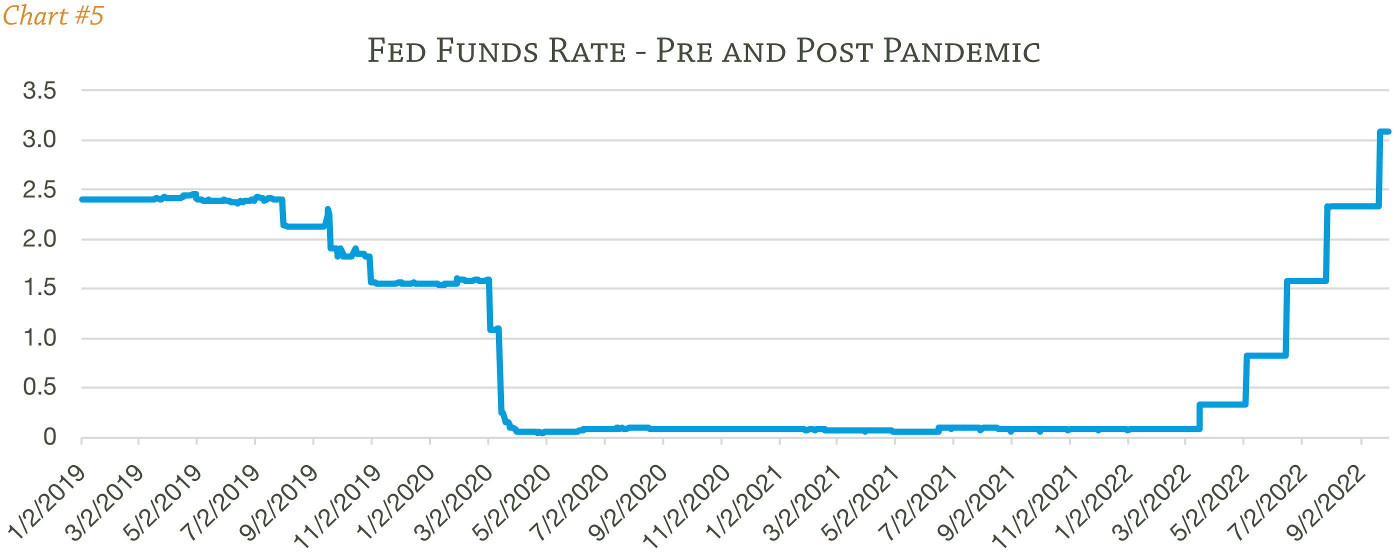
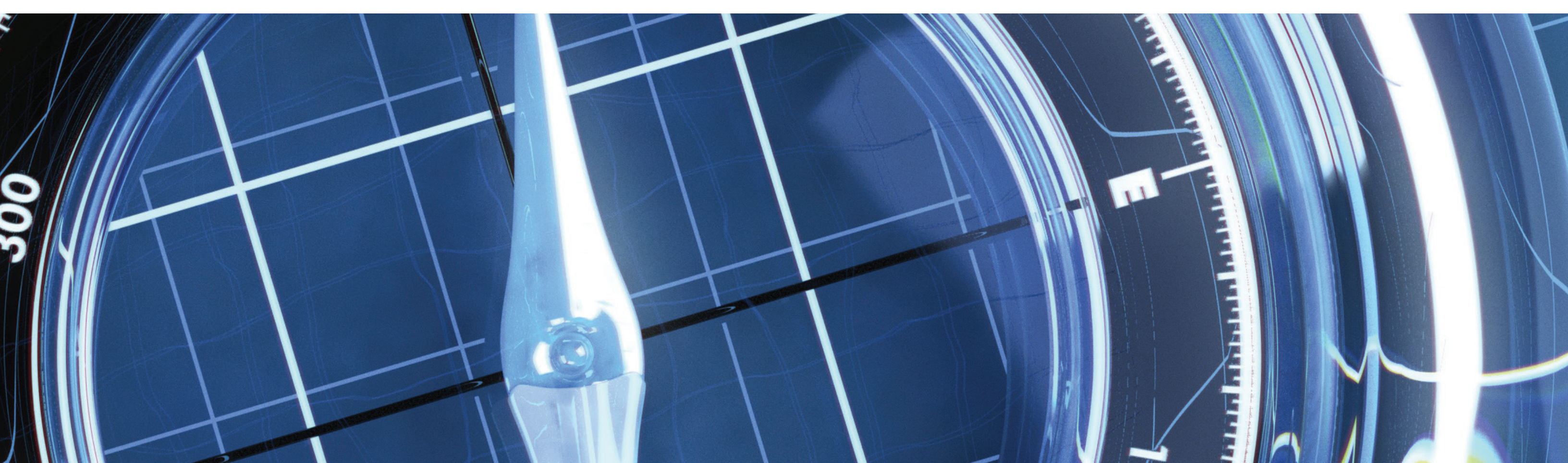
**Trading Economics®*

Chart #5





Post-Close Legal Issues – How Often Do They Occur and What Do They Cost?

Anyone who has been through more than one M&A transaction knows that post-close legal issues do arise and not infrequently. This means that there is tremendous value to having specialized M&A legal counsel representing owners in a strategic transaction. Your day-to-day attorney should not be handling your M&A transaction, no more than your day-to-day MD should be doing specialized surgery on you. Poor attorney choices can be detrimental to your deal.

At Pursant, we often get asked about the most common post-close legal issue. The answer is indemnification claims. Here is a list of fast facts to consider, according to SRS Acquiom's 2022 Deal Terms study:

1. **30% of deals face an indemnification claim.**
2. **28% of deals with Rep & Warranty Insurance (RWI) face indemnification claims as well, but generally at lower amounts.**
3. **Median time to resolve claims is 4.4 months although some claim types (fraud, breach of fiduciary duties, customer contracts, etc.) took longer to resolve.**
4. **Fraud claims have the largest claim amounts; all other claim types except undisclosed liabilities and employee-related claims generally don't exceed escrow amounts.**
5. **71% of indemnification claims were related to a rep and warranty breach.**
6. **45% of breaches were tax related, second most common was employee related, and third was related to undisclosed liabilities.**
7. **70% of claim sizes were under $500k and 20% were $500k-$2M.**
8. **Likelihood of a claim occurring does not vary meaningfully between Private Equity, Private Companies, Public Companies and Foreign Companies.**
9. **The average survival period for claims to be asserted is 13.6 months.**
10. **94% of the time Indemnification is the sole remedy for breach.**

To summarize, there is a reasonable chance that post-close legal issues will arise. The good news is that the issues rarely amount to meaningful dollars as a percentage of the total consideration. Additionally, the fact that these post-close matters are not that uncommon provides the rationale for escrows, rep and warranty insurance and other contingent payment structures in strategic transactions.

Sandbagging – What Does That Have to Do with M&A????

Since we are on a theme of indemnification this issue, let's review a common source of confusion and risk: sandbagging. A term most commonly associated with golf, sandbagging is also important to understand in the context of an M&A transaction.

M&A transactions are governed by a legal document referred to as the Purchase Agreement ("PA"). Depending on the transaction structure, the Purchase Agreement may be called an SPA when involving the purchase of Stock, an APA when involving the purchase of Assets, or a MIPA when purchasing the Membership Interests of an LLC. Sandbagging is addressed within the indemnification provisions of a PA. In addition to purchase price and payment mechanisms, indemnification provisions (including sandbagging) are among the most heavily negotiated provisions in the PA.

In golf, sandbagging occurs when a player represents to be worse than they actually are in order to gain additional accommodations (referred to as strokes) to improve the chances of winning. In an M&A transaction, sandbagging is very different. It refers to a practice employed by Buyers to claim a breach of a contractual representation made by the Seller along with seeking indemnification for damages (usually in the form of monetary settlement) from the Seller. Here's the important part and what makes it "sandbagging": the Buyer had knowledge that the representation was not true at the time the deal closed.

Buyers' and Sellers' Positions

Buyers will argue for the inclusion of sandbagging/pro-sandbagging provisions in the PA. The provisions typically provide that the Buyer will be entitled to recoveries for any breaches of the Seller's representations, whether or not the Buyer had knowledge of the facts or circumstances giving rise to the indemnification claim at or prior to closing. Buyers are ***not*** required to show reliance in order to make an indemnification claim for a Seller's breach of a representation. A typical sandbagging/pro-sandbagging provision will read: *"The rights of Buyer to indemnification or any other remedy shall not be impacted or limited by any knowledge that Buyer acquired (or could have acquired) before closing the transaction. Seller acknowledges that Buyer has entered into the agreement in express reliance on the representations of the Seller."*

On the contrary, Sellers will want to include an anti-sandbagging provision to prevent Buyers from being indemnified for the breach of any representation of which that the Buyer had (or should have had) knowledge prior to closing the deal. In connection with anti-sandbagging and even if the Buyer did not have knowledge before the closing, Buyers are required to show a reliance on the representation in order to make an indemnification claim for a Seller's breach of the representation. A typical anti-sandbagging provision will read: *"Buyer acknowledges and agrees that it has had an opportunity to conduct a thorough investigation and due diligence on the company and in no event shall Seller have any liability to Buyer with respect to a breach of any representation to the extent Buyer knew (or should have known) of such breach at the time of closing the transaction."*

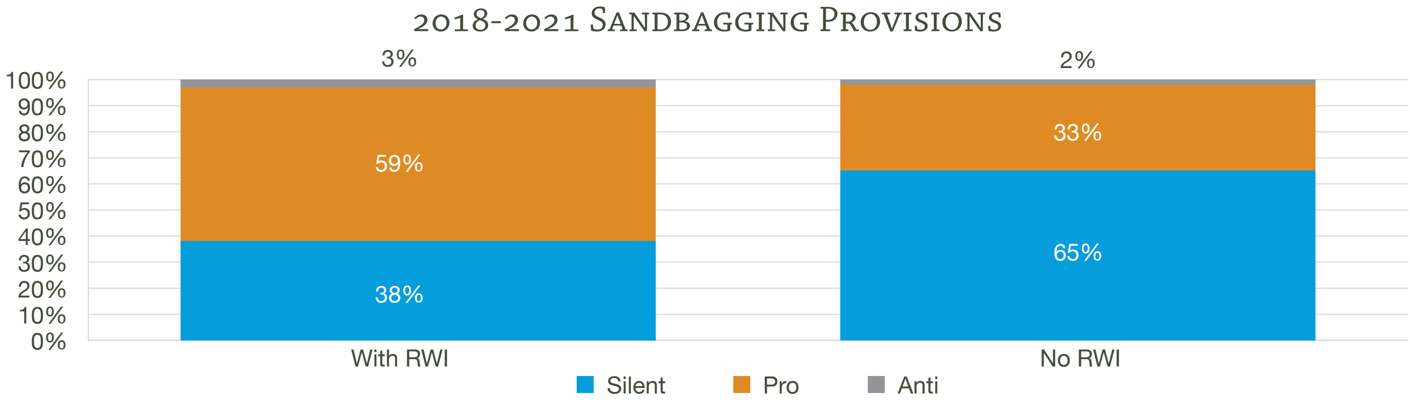
Addressing Sandbagging in the PA

In negotiating a PA, Sellers will seek to limit the scope, duration and amount of damages subject to indemnification claims, while Buyers attempt to expand their indemnification rights. The extent of and the outcome for negotiating sandbagging provisions in the PA depends on a variety of factors, including but not limited to the type of business, the nature of the transaction, the relationship between the transacting parties and the risk tolerances of each party. As we see in Chart 6, whether or not Rep and Warranty insurance (RWI) was used in a deal can dictate how sandbagging language is handled. When there is no RWI used, the majority of PAs are silent with respect to sandbagging. When a PA is silent to the provision, if a post-closing sandbagging claim arises it will be determined based on the state law governing the purchase/sale agreement. Different states have different rules.

Typically, there are two rules. The Modern Rule permits a Buyer to bring an indemnification claim for inaccurate representations and warranties regardless of the Buyer's knowledge of the inaccuracies prior to closing. The Traditional Rule requires a Buyer to prove that they relied on the representation or warranty as an element of the indemnification claim. In the absence of a sandbagging provision within the PA, which happens most of the time in deals with no RWI, parties to M&A transactions should understand the default sandbagging rule of the state whose law will govern the PA. We can see how Sellers put less rigor into negotiating this term when RWI is in place to protect them against claims.

Whether sandbagging is included in the PA or addressed otherwise, such disputes are typically very contentious issues and costly to resolve. It is best to avoid a sandbagging issue by addressing it in the PA and, if that can't be accomplished, to understand the default governing law that will address it should an issue arise.

Chart #6



Source: SRS Acquiom®

Pursant's Expectations for the Near Future

Despite regular and meaningful increases in the cost of capital, M&A activity and valuation multiples have stayed at healthy levels in the middle market this year. The bulk of the impact of the interest rate increase is likely to be reflected in the Q4 period, so there may be a bite out of valuation multiples in Q4—especially for businesses with less-than-optimal financial profiles.

For 2023, the combination of higher interest rates and an expected corresponding softening in valuations will create headwinds for future M&A activity. Higher rates increase the cost of acquisition financing and will push some Buyers that rely on leverage—such as private equity firms—to the dealmaking sidelines; however, the majority of PE Buyers still have capital they must deploy, forcing them to stay in the game.

Many strategic operators are burning through the stimulus money received and may also be pulling back on M&A in 2023. This sets the stage for overall continued slowing of M&A activity. The big question is: by how much? We were spoiled with the frenetic level of M&A activity in 2021, so what we are seeing now and on the horizon is markedly different. However, the number one driver of lower middle market M&A is retirement and Father Time is the ultimate decision maker of when business owners should transact, not the Fed.

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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