Q3 2023 EDITION

Pursant
INSPIRED PURSUIT

DEAL insider
M&A and Strategic Transaction Insights

Q3 2022 Highlights

- Interest rates continued to rise, with a surprisingly minimal impact on activity
- Valuation multiples have been resilient in the face of higher rates
- Private Equity is moving down stream to smaller deals to avoid the higher interest costs of larger deals

Pursant's Thoughts on the Near Future

- Deal flow is stabilizing and may increase in the months ahead
- Until there is more clarity on the status of interest rate cuts and broader future economic health, instances of disparate views on valuation will be more frequent
- Higher interest rates continue to imply Buyer-favorability, which is likely to cap what Sellers can expect to capture in a sale transaction

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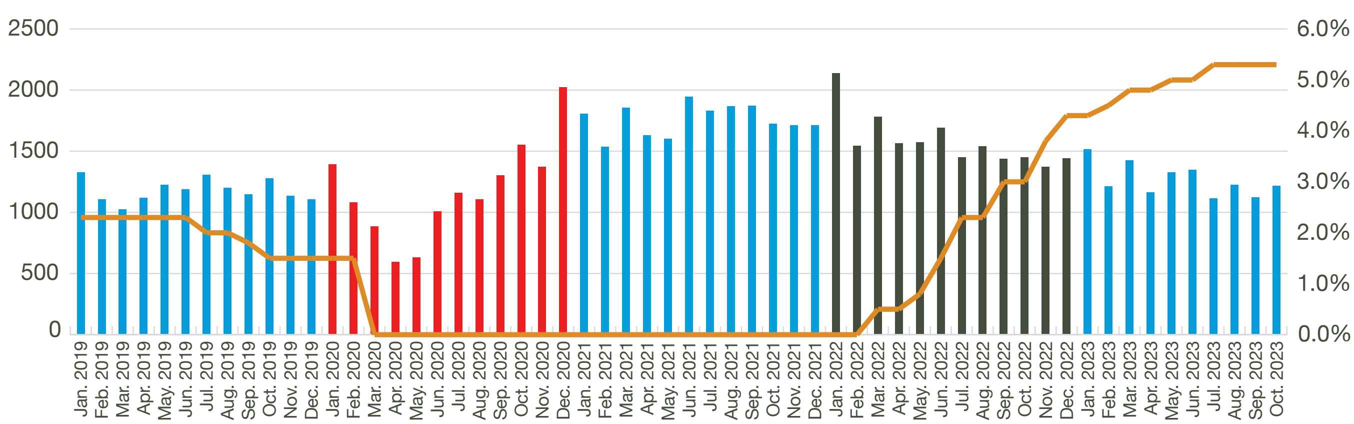
Healthy M&A Optimism Despite High Interest Rates

The decline of 2023 M&A activity stopped in Q3, reflecting a higher level of overall confidence for both Buyers and Sellers—the feeling that now is a prudent time to transact, despite an environment of very high interest rates. As we see in Chart 1, 2023 activity has stabilized at a level similar to that of pre-pandemic 2019, despite the fact that interest rates are now double what they were at that time. There is enough to like about the overall business environment despite the cost of capital. A heightened need to acquire for PE and Strategics is compelling Buyers to swallow this giant interest rate pill and press on with M&A.

Chart #1

2019-2023 US M&A Volume (# of deals) & Fed Funds Rate



Source: Factset®

Valuation Multiples Increase Slightly vs Q2

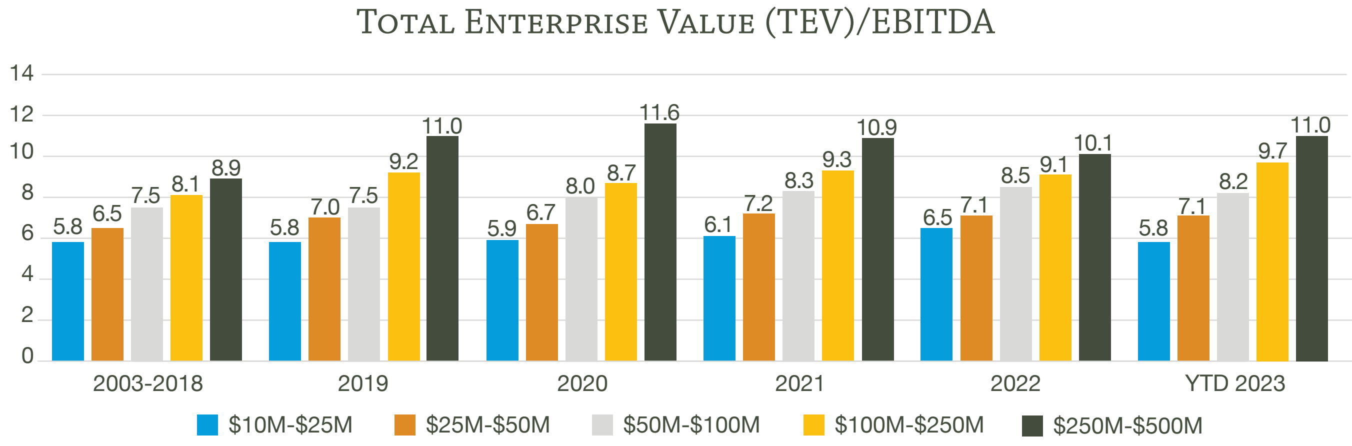
As mentioned earlier, deal flow has declined this year and has now settled in at a relatively stable and healthy level. In contrast with the general economic uncertainly and softened multiples of Q2, in Q3 we are actually seeing an increase in multiples. This demonstrates a renewed level of confidence to pay-up for better businesses. However, given the continued uncertainty about the future of rate cuts and general economic conditions, there is a much wider degree of variance when it comes to views on valuation.

Valuations on completed deals in the third quarter of 2023 averaged 7.5x Trailing Twelve Months (TTM) adjusted EBITDA—an increase of 0.9x from the second quarter and on par with the first quarter. The increased quarterly total brings it in line with the 7.6x average from the first quarter. Year to date, 2023 now stands at an average of 7.3x—just off the 7.4x average recorded in 2022 and not far off the average of 7.5x in 2022.

Average purchase price was up in the third quarter across all size tiers, apart from the $25 million to $50 million tier, which was only off by a tenth of a turn of EBITDA. Larger transactions valued above $50 million recorded gains in average purchase price between nearly a full multiple and 2.5x.

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%. ***Above average financial performers on average garnered a purchase price of 8.1x, two-tenths of a turn more than the average for all of 2022 and well above the historical average of 7.2x.*** The average for standard financial performers is still two-tenths above its historical average, despite being a tenth of a turn below last year's average at 6.4x. ***We take this as a sign that more than just the strongest companies are going through processes which likely speaks to better times and higher deal volume in the coming quarters.***

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.*

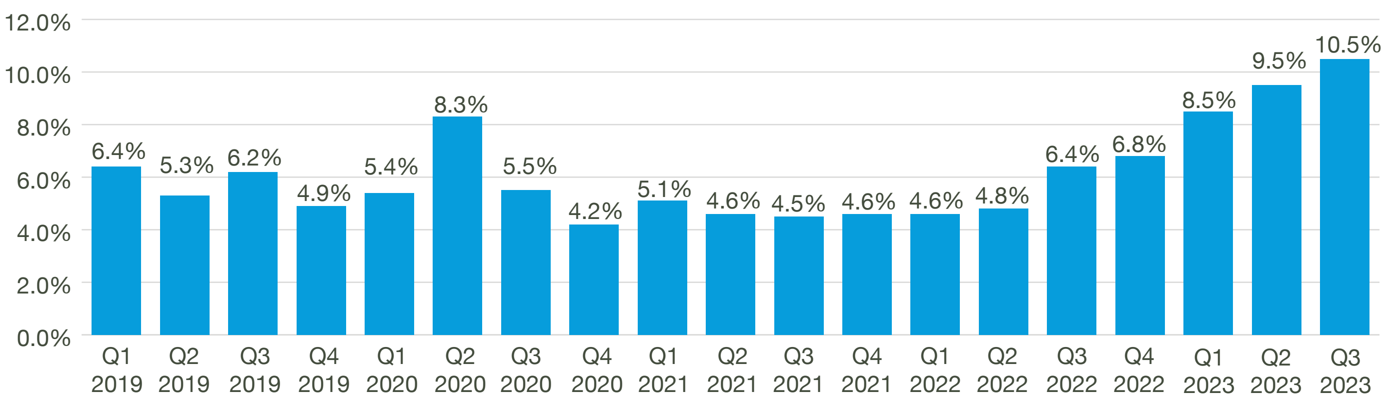
Expensive Capital Continues to Flow—Even though debt pricing remains stubbornly high, debt coverage improved in the third quarter. Senior debt averaged 10.5%—up by another percentage point compared to last quarter (see Chart 3). For larger deals in the $100M - $250M range, debt pricing averaged 11.5%

Platform deals received an average multiple of 3.5x EBITDA in total debt last quarter—up two-tenths from the second quarter—and 2.7x coverage for senior debt—up half a turn from the previous quarter. When looking at ***all deals***, whether platform or add-on (see Chart 4), we can see that total debt utilization remains high at 3.7x EBITDA, despite the increase in interest rates during Q2.

Subordinated debt in Q3 is up too—a full percentage point over Q2 at 12%.

Chart #3

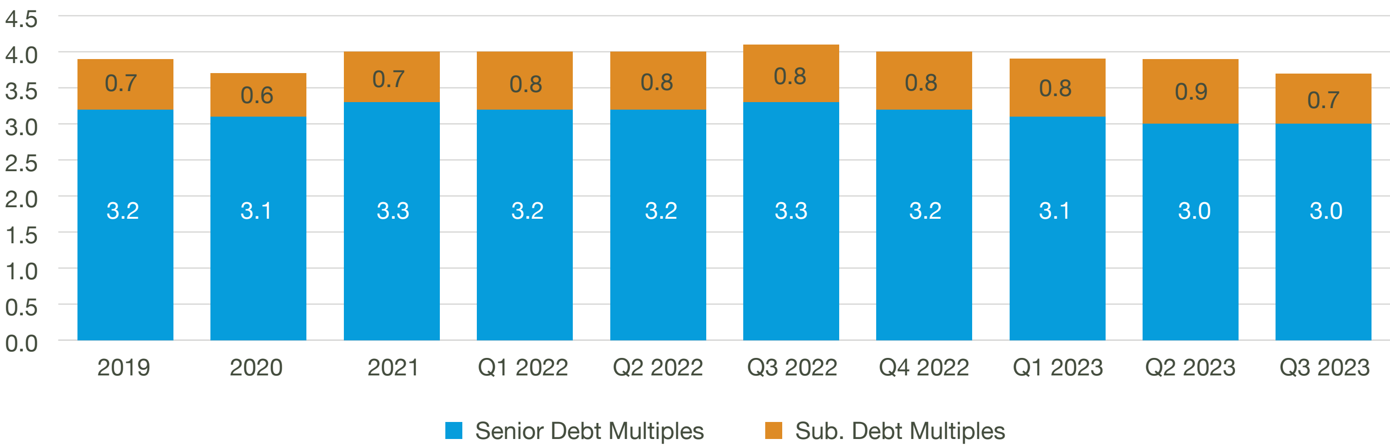
Senior Debt Int. Rate $10M - $250M Deals



Source: GF Data®

Chart #4

Total Debt/EBITDA ($10M - $500M TEV Deals)



Source: GF Data®

The US Macroeconomic Picture for Q3 2023

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.

- **Q3 GDP Growth Exceeds Expectations—**The US economy expanded an annualized 5.2% in Q3 2023. ***It marks the strongest level of growth since Q4 2021.*** Nonresidential investment was revised to show a 1.3% rise instead of the 0.1% fall initially estimated, as the drop in equipment was shorter and structures surged 6.9% (vs 1.6%). Also, residential investment rose for the first time in nearly two years and at a much faster pace than initially expected (6.2% vs 3.9% in the advance estimate). Meanwhile, private inventories added 1.4 pp to growth, up from the previous 1.32 pp estimate, and government spending increased faster than anticipated (5.5% vs 4.6%). On the other hand, consumer spending rose at a slower pace than expected (3.6% vs 4%), but this remained the biggest gain since Q4 2021. The slowdown was mainly due to services spending. Exports soared 6% (vs 6.2%) and imports increased at a slower pace (5.2% vs 5.7%).*

- **Inflation: Core CPI Falls to Lowest Level Since Sept. 2021—**The US inflation rate at the end of Q3 came in at 3.7%, up from 3% at the end of Q2. There was a softer decline in energy prices, offset by slowing inflationary pressures in other categories. Energy costs fell by 0.5%, following a 3.6% decrease in August, primarily driven by a rebound in fuel prices. Additionally, prices increased at softer rates for food (3.7% vs. 4.3%), new vehicles (2.5% vs. 2.9%), apparel (2.3% vs. 3.1%), medical care commodities (4.2% vs. 4.5%), shelter (7.2% vs. 7.3%), and transportation services (9.1% vs. 10.3%). Costs for used cars and trucks, as well as medical care services, continued to decline. ***The core CPI, which excludes volatile food and energy prices, slowed to 4.1%, marking its lowest reading since September 2021.****

- **Business Confidence Is More Upbeat in Q3—**The ISM Manufacturing PMI rose to 49 at the end of Q3, compared to 46 at the end of Q2—well above market expectations of 47.8—to reflect the slowest contraction in the US manufacturing sector in ten months. Despite the softened slowdown, the data still pointed to nearly one year's worth of consecutive monthly contractions in US factory activity, underscoring the impact of higher borrowing costs from the Federal Reserve in the sector. Despite declining for the 13th month, new orders fell at a significantly slower pace, as the evolving supply chain environment drove customers to take on more projects. Consequently, production rebounded from the stagnation in August and grew the most since July 2022, also supported by the rapid depletion of backlogs. Employment was also solid and rebounded from 3 periods of contraction. 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 Rises Again in Q3—**Minutes from the September 2023 FOMC meeting showed that a majority of Fed policymakers judged that it would be appropriate to initiate one more increase in the federal funds rate at a future meeting, while some judged that no further increases would be warranted. However, all agreed that policy should remain restrictive for some time until a sustainable decrease in inflation to 2%. Also, participants expected that the data arriving in the coming months would help clarify the extent to which the disinflation process was continuing and would illustrate whether labor markets were reaching a better balance. At the same time, the future path of the economy is seen as highly uncertain. Many noted that data volatility and potential data revisions made it difficult to estimate the neutral policy rate, supporting the case for proceeding carefully in determining the extent of additional policy. The Fed kept the target range for the federal funds rate at a 22-year high of 5.25%-5.5% in its September 2023 meeting.

**Trading Economics®*

Business Broker, M&A Advisor, Investment Banker—What's the Difference?

Exploring the process of acquiring a business or developing an exit strategy reveals a landscape filled with diverse service providers. **Investment Bankers**, **Business Brokers**, and **M&A Advisors** are key players in this arena. Despite some overlap in their offerings, each category of service providers is different, with different transactional needs.

Types of Services Offered

- **Business Brokers** primarily represent Sell-Side clients. Their expertise is invaluable for small-scale transactions, and they tend to focus on local or regional markets.
- **M&A Advisors** offer a balance between Sell-Side and Buy-Side engagements on a regional or national level, occasionally raising capital and managing more complex deal structures like management buyouts or recapitalizations.
- **Investment Banks** also offer a balance between Sell-Side and Buy-Side engagements in addition to more comprehensive services, including capital raising. They are adept at handling large-scale, complex transactions and may offer ancillary services on a national or global level.

Transaction Size and Bandwidth

- **Business Brokers** often cater to smaller, local businesses with less than $5M in annual revenue. They often focus on transactions in local or regional markets, and may have deep knowledge of local market conditions for specific segments. However, they may not have the resources or expertise for larger, more complex deals.
- **M&A Advisors** typically transact with companies of between $5M and $500M revenue, and often have a regional or nationwide presence.
- **Investment Bankers** tend toward larger transactions (often starting at $50M) with a national or global presence.

Cost of Engagement

- **Business Brokers** generally work on a success basis, and may charge a fixed fee dependent upon deal size. The fee may be scaled down to preserve the benefit of sale proceeds for the Seller.
- **M&A Advisors** and **Investment Banks** have varied fee structures. Sell-Side services typically include an initial fee for preliminary work, followed by a success fee. Buy-Side services often involve a monthly retainer for dedicated search efforts, followed by a success fee. In both Sell-Side and Buy-side engagements, this structure may not be economically feasible for transactions below a certain size.

Go-to-Market Approach

- **Business Brokers** tend to publicly list the Sell-Side businesses they represent; a posting of businesses for sale can found on their websites and in marketing collateral. This enables them to work with smaller businesses, as the selling process is less customized for that segment, and therefore requires less upfront cost.
- **M&A Advisors** and **Investment Bankers** will typically search for Buy-Side targets and share Sell-Side deals through private networks via a customized approach.
  - On the Buy-Side, both **M&A Advisors** and **Investment Banks** are likely to have the resource bandwidth to search for off-market deals. The firm will then vet potential targets to confirm fit before making an introduction to the client.
  - On the Sell-Side, **M&A Advisors** and **Investment Bankers** will develop marketing material, including a Confidential Information Memorandum (CIM) and abbreviated "teaser" summary, and will share the information with a select network of qualified Buyers in favor of a private auction approach. One of the benefits of this selling process is that the Buyer audience can be customized to avoid informing the Seller's competitors of an intent to exit.

	Business Broker	M&A Advisor	Investment Bank
Sell-Side Services	Yes	Yes	Yes
Buy-Side Services	No	Yes	Yes
Complex Deal Structures	No	Yes	Yes
Capital Raising	No	Sometimes	Yes
Transaction Size (Avg)	Less than $5M	$5M-$500M	More than $50M
Bandwidth	Local/Regional	Regional/Nationwide	Nationwide/Global
Sell-Side Fee Structure	Success fee	Initial Fee + Success Fee	Initial Fee + Success Fee
Buy-Side Fee Structure	N/A	Retainer + Success Fee	Retainer + Success Fee
G2M Approach Sell-Side	Public Listing	Proprietary Network	Proprietary Network
G2M Approach Buy-Side	N/A	Off Market Sourcing	Off Market Sourcing

Conclusion

Selecting the right M&A service provider is pivotal to achieving your transaction goals. **Business Brokers** are well-suited for smaller, localized Sell-Side engagements, offering a direct and cost-effective approach. **M&A Advisors** provide a balance of specialized services and market reach—ideal for mid-sized transactions. **Investment Banks** offer scalable resources and expertise for larger, more complex transactions, albeit at a higher cost. Understanding these distinctions will guide you in making an informed choice that aligns with your business objectives and transaction requirements.

Are You Ready to Acquire in 2024? Undertaking a Critical Readiness Assessment

As the business landscape continues to evolve, acquisitions remain a strategic tool for growth and diversification. However, embarking on this path requires a deep understanding of your company's “readiness.” Much like couples should assess their readiness to have children and take on the demands of being a parent, companies should assess their readiness to take on the demands of an acquired company. This article delves into the critical aspects of an acquisition readiness assessment, providing a framework for companies contemplating this significant step. This exercise, ideally facilitated by an experienced advisor, is crucial to ensure that your company is well-prepared for the complexities of the acquisition process.

Assessing Your Organization's Readiness for Acquisition

The first step in your acquisition journey involves a comprehensive assessment of your organization's readiness in several key areas. Reflect upon your motivation for acquisition—whether it's to expand market share, penetrate new territories or perhaps to bolster your talent pool and financial strength.

- **Financial Assessment:** Analyze the health of your balance sheet, including cash reserves and debt. It's also important to consider the availability of credit facilities and the strength of your financial analysis practices.
- **Operational Readiness:** Assess the consistency and quality of your service execution, the capacity of your current operations team and the managerial capabilities within your organization.
- **Human Resources:** Review HR practices to ensure that they represent best practices, and evaluate the capacity and managerial capabilities of your team.
- **Quality Control and Customer Service:** Determine how your organization ensures quality for your customers and builds relationships with them, noting that customers acquired through mergers may differ from those earned organically.
- **Business Development:** Examine the effectiveness of your business development strategy and assess whether acquired business development personnel would be redundant or complementary.
- **Leadership Evaluation:** Assess the strength and capabilities of your leadership team, including accounting, HR and operations management, and consider your leadership style and ability to lead other leaders.

A comprehensive SWOT analysis at this stage can highlight internal and external factors influencing your acquisition plans, helping you make informed decisions.

Understanding the Acquisition Process

Making acquisitions is a multifaceted process involving several stages, each critical to the success of the venture:

- **Strategy and Target Identification:** Define the ideal target, considering geographic location, client type, services offered and business practices. Evaluate whether the target’s culture, financial health and people align with your goals.
- **Budgeting and Initial Engagements:** Set an acquisition budget, engage in initial discussions and assess the alignment with potential targets.
- **Data Review and Valuation:** Conduct an initial review of financials, understand the Seller's debt situation and analyze working capital needs. Value the target based on a risk profile and EBITDA or SDE multiples.
- **Negotiation and Agreements:** Engage in negotiation, remembering the personal investment of Sellers in their businesses. Prepare for due diligence and draft definitive agreements including NDAs, IOI, LOIs and asset purchase agreements.
- **Closing the Deal:** Closing generally involves electronic signatures and wire transfers. Be prepared for immediate post-closing action, which requires significant pre-closure integration discussions with the Seller.

Post-Acquisition Integration: Ensuring a Smooth Transition

The journey doesn't end with closing the deal. Post-acquisition, the focus shifts to integration—a phase as critical as the acquisition itself.

- **Define Integration Goals:** Establish clear objectives for leadership and communication, personnel management, financial control and customer engagement.
- **Ensure Stable Operations:** Focus on maintaining stable operations, managing sales pipelines and aligning marketing strategies.
- **Policies and Technology Integration:** Work on aligning and updating policies and procedures; integrate technology systems for smooth operations.
- **Legal and Insurance Considerations:** Address all legal and insurance aspects post-acquisition, including contracts and compliance issues.

Best practices during integration include focusing on due diligence findings, setting realistic timelines and breaking down tasks into manageable steps. Remember, managing acquired customers and employees requires a different approach than the one you use with your existing team.

As you contemplate embarking on an acquisition in 2024, remember that preparation, strategic planning, and effective integration are key to success. This guide provides a foundational framework, but each acquisition is unique. Tailoring these steps to fit your specific context will be crucial. With careful planning and execution, your acquisition can lead to new horizons of growth and success. Our team offers the expertise and unbiased perspective necessary to ensure that your company is fully prepared for this significant step.

20 Questions Sellers Should Ask Potential Buyers

Twenty questions was a 19th century parlor game which encouraged deductive reasoning and creativity to find an answer to a question. In the late 1940s, it became the format for a successful weekly radio quiz program, expanding to television in 1949. Careful selection of questions greatly improved the odds of the questioner winning the game. Similarly, when choosing a Buyer, a Seller dramatically improves the chances of developing a winning Buyer Pool by asking the right questions.

For many business owners, selling a company is a once-in-a-lifetime opportunity. There's only one chance to get it right. Therefore, it is critical to ask the right questions when evaluating Buyers, just as it's important for the potential Buyer to conduct the right due diligence on a target company.

Frequently, Sellers accept an offer not only based on financial gains, but also on the connection, chemistry and relationship with the Buyer. With good questioning, Sellers can better understand a Buyer's fit, hot buttons, process and post-transaction plans. Additionally, and importantly, we can gain visibility into what a Buyer sees as value drivers, ultimately allowing a Seller to capture maximum enterprise value in a sale process.

Here are 20 solid questions that we hope will lead you to answer the question *Who is my best Buyer?*:

1. Why are you interested in acquiring our company?
2. Based on what you know so far, what do you see as unique or special about our company?
3. What is your vision for our company after the acquisition?
4. How does our company fit into your current business model?
5. What do you envision my role and level of involvement being after the acquisition?
6. (For PE Buyers) What is the ultimate exit plan and timeline?
7. How would the acquisition impact our leadership, employees and culture (understanding that there would be process and team integration after the acquisition)?
8. How will a transaction with you affect the legacy and brand of our company?
9. What is your company culture like? (For PE Buyers) What are the culture themes in your portfolio companies?
10. How are decisions are made in your company? (For PE Buyers) What is the level of involvement your PE group has in portfolio company decision making?
11. (For PE Buyers) Can you share your experience in my company's industry?
12. Have you made similar acquisitions in the past? May I speak to the previous owners?
13. Can you detail the best deal you did and why it was the best?
14. What was the most memorable worst deal or dead deal you were involved with? What drove the outcome?
15. Tell me about the members of your deal team (internal and external)? Who is involved and when?
16. Can you walk me through your post-transaction steps (first 90 days) and ultimate integration plans?
17. How have you structured your deals, historically?
18. How will you fund this deal?
19. How do you perform due diligence (the process and parties involved)?
20. Can you provide an overall timeline for the deal (i.e. LOI, draft of sales and purchase agreement, due diligence, closing, etc.)?

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Pursant's Expectations for the Near Future

Sentiment is that 2023 M&A activity has leveled off and many dealmakers are bullish on 2024; however, accurately predicting M&A trends for 2024 involves a lot of uncertainty, as it depends on various factors such as economic conditions, cost of capital, Buyer appetite, geopolitical situations, regulatory changes and availability of acquisition targets. Historically, lower middle market M&A activity has been influenced by several ongoing trends:

Economic Conditions: If the global economy continues to show signs of stability and growth, it could fuel M&A activity. Factors like interest rates, inflation and overall market confidence play crucial roles.

Cost of Financing: Debt markets have finally stabilized. Even though interest rates are high, financing remains available at all levels. There are signs of modestly favorable shifts in spreads and leverage levels, which may be signs of improving conditions.

Private Equity Lower Middle Market Appetite and Ample Dry Powder: Lower middle market companies are more favorable targets for M&A these days, as opposed to large corporations. Because of the higher cost to finance deals amid elevated interest rates, private equity firms have been pulling back on mega deals. The migration downstream that began in 2023 will likely carry into 2024. And with $1.35 trillion of dry powder available at the end of Q2 2023 (9.7% shy of its historical high), PE needs to transact in a meaningful way in the near future.

Private Equity Overdue to Sell: Median hold periods for PE-backed portfolio companies have reached record lengths: 5.6 years. Combine this backlog of deals that need to come to market with a steady stream of strategic exits and you have a healthy supply of assets to purchase.

Geopolitical Stability: Political stability, trade agreements and geopolitical tensions can greatly affect investor confidence and cross-border deals.

Regulatory Environment: Changes in regulations—especially in antitrust laws (for large deals) or tax policies (for all deals)—can impact M&A activity by affecting deal structures and the overall attractiveness of transacting.

Baby Boomer Transition: Baby Boomers continue to retire at a rate of 10,000 a day, and many of these Boomers are middle market business owners. This movement will continue to fuel the supply of acquisition opportunities at the sub $500M transaction value level.

Considering these factors, if the economy remains healthy and other factors are favorable for M&A, it's plausible that middle market M&A activity could continue at a steady pace or even increase in 2024. However, unforeseen events or shifts could alter these expectations.

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.

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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