Q3 2024 EDITION

Pursant
INSPIRED PURSUIT

DEAL insider
M&A and Strategic Transaction Insights

Q3 2024 Highlights

- M&A activity is getting some lift from a decrease in rates
- Valuation multiples for smaller deals are performing better than those for bigger deals
- The combination of declining interest rates and positive macroeconomic factors are creating a favorable market for Buyers and Sellers

Pursant's Thoughts on the Near Future

- Further rate cuts (whenever they may happen) should fuel activity and may bolster valuations
- The election process closure and outcome has created significant dealmaker optimism about 2025
- Both Private Equity and Strategics see 2025 as a favorable year to transact

Rates Begin Declining, But M&A Activity Has Yet to Respond as Hoped

Many expected the Fed's reduction of interest rates to spark more M&A activity that has been waiting on the sidelines. However, despite improved debt markets and lower interest rates, we have yet to see the market as a whole respond accordingly. Dealmakers expect more of the same for the balance of 2024.

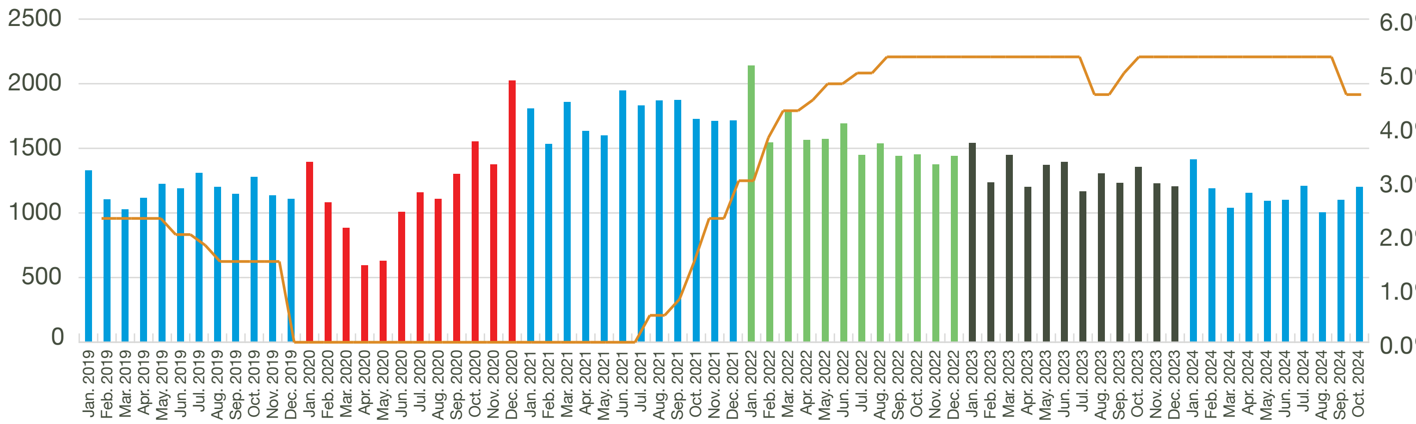
Chart 1 shows that overall M&A activity is down 13.8% on a last twelve-month (LTM) basis through September 30, 2024, when compared to September 30, 2023 LTM; but if we dig deeper by reviewing data by deal size, we can see the signs of improvement in appetite.

Despite the lingering higher cost of capital, the availability of debt is keeping lower middle M&A market running—but not so much for small businesses (sub $25M in enterprise value). As we have written in previous reports, the M&A environment is still considered healthy, regardless of the fact that activity levels are lower than in 2023 and 2022. Consider that M&A borrowing rates in 2019 were half of what they are today, but the volume of M&A activity today is the same as it was in 2019. The impact of higher rates is being offset by factors including favorable economic conditions, high levels of available capital, strong corporate balance sheets, and the abundance of Private Equity dry powder and the need to deploy it.

Deal Size in Enterprise Value	LTM September 2024 vs. LTM 2023
Under $10M	Down 22.1%
$10M - $24.9M	Down 17%
$25M- $49.9M	Up 8.2%
$50M - $99.9M	Up 2.6%
$100M - $249.9M	Up 1.2%
$250M- $499.9M	Up 13.3%

Chart #1

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



Source: Factset®

Bigger Deal Valuation Multiples Taking the Back Seat to Smaller Deals

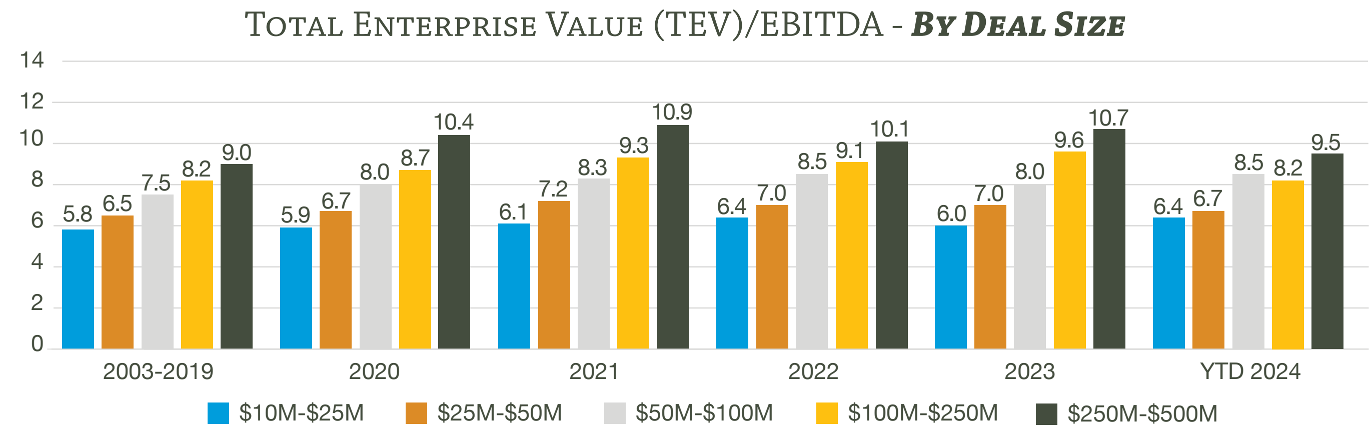
Chart 2 shows us that average purchase price multiples on completed deals in the third quarter dropped by three-tenths of a turn of Trailing Twelve Month (TTM) EBITDA from the second quarter, falling to an average of 7.1x TTM EBITDA. Average valuations of all deal sizes were impacted, except for those valued between $10M and $25M and between $50M and $100M. The top deal size tier of $100M to $500M was hardest hit, as smaller deals make up a larger proportion of completed transactions this year than in past years, and private equity (PE) groups continue to focus on improving existing platforms rather than investing in new ones. For the first three quarters of 2024, average valuations were down by a tenth of a turn—7.1x compared to 7.2x for all of 2023, but still above the historical average of 6.9x.

For the Private Equity (PE) sector, add-on investments continued to play an outsized role in deal activity through the first three quarters of 2024, accounting for more than 42% of transactions, compared to 35% for all of 2023. While the tally for add-on investments remains high—and reflects a market in which PE firms continued to focus on improving portfolio companies versus launching new platform investments—it does mark a minor decline from the first half of 2024, when add-ons accounted for 44% of deal volume.

Increased add-on activity has improved valuations of the smallest businesses. Valuations of companies with Total Enterprise Value (TEV) between $10 million and $25 million reached an average of 6.4x, compared to an average of 6.0x in all of 2023 and a half-turn above the historical average of 5.9x.

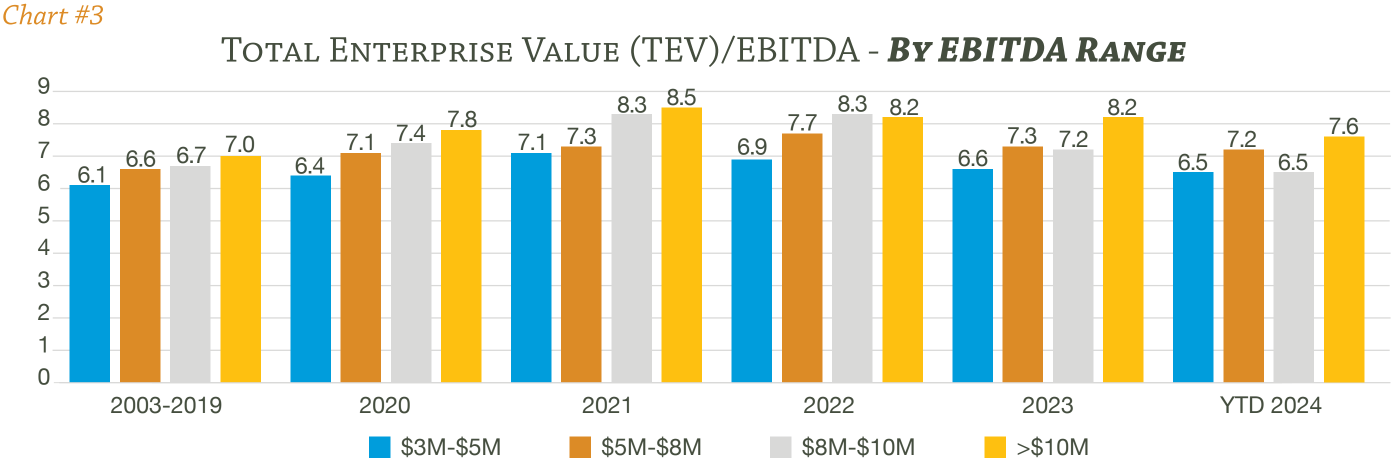
For a different perspective on valuation multiples, see Chart 3, which shows valuation multiples on an all-industries basis by EBITDA range, rather than by deal size.

Chart #2



Source: GF Data®

Chart #3



Source: GF Data®

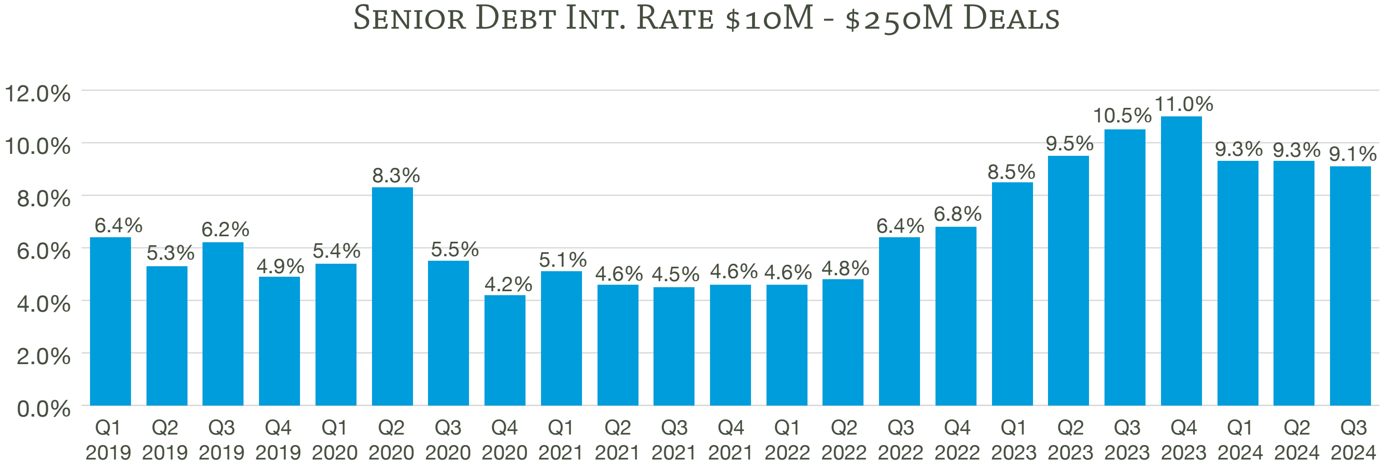
EBITDA Defined – *For most middle-market businesses, valuation is typically expressed in the form of a multiple of EBITDA (earnings before interest, taxes, depreciation and amortization)—a measurement of a company's ability to generate cash flow. EBITDA figures also serve as a barometer of the company's 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 Markets Experiencing Slight Rate Declines and Good Access to Capital

M&A borrowing rates have begun to retract in response to the recent rate reduction by the Fed; leverage levels remain healthy. Lending markets continued to improve in the third quarter as commercial banks became more active in the middle market, and debt funds became more competitive in debt coverage and pricing (see Charts 4 & 5). Senior debt rates fell ever-so-slightly to 9.1% on average in Q3 2024, while subordinated debt rates ticked slightly lower to an average of 11.3%. However, subordinated debt-related average fees and payment-in-kind notes increased year-to-date and now exceed the average for all of last year: ***all-in subordinated debt pricing rose to an average of nearly 16%, compared to just north of 15% for all of 2023.***

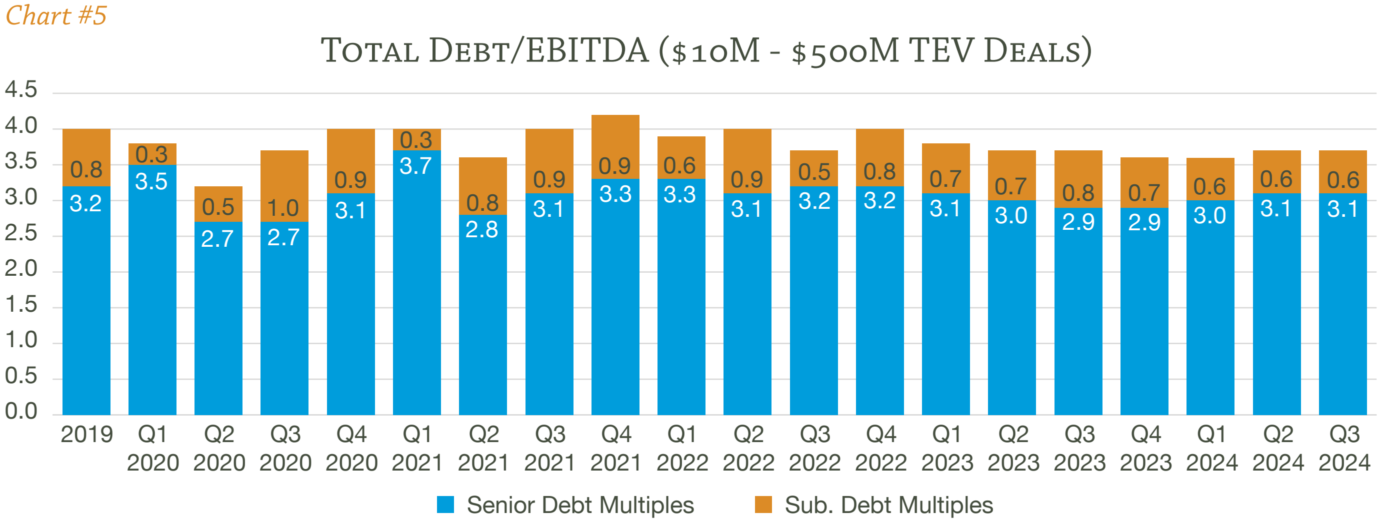
The multiples in Chart 5 reflect a rolling four-quarter average inclusive of the fourth quarter of 2023 and the first three quarters of 2024, and comprise a blended average of Platform acquisitions and Add-on acquisitions. ***Senior Debt Platform loans YTD are receiving funding at an average of 2.4x EBITDA, compared with 3.1x for a blend of Add-on and Platform loans.***

Chart #4



Source: GF Data®

Chart #5



Source: GF Data®

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The US Macroeconomic Picture for Q3 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. The performance of these four macro-indicators keeps us in a neutral phase of the business transfer cycle, benefiting both Buyers and Sellers, with neither party having a meaningful edge.

- **Q3 2024 GDP Expanded By an Annualized 2.8%—**The US economy expanded by an annualized 2.8% in Q3 2024, compared to 3% in Q2. Personal spending increased at the fastest pace since Q1 2023, propelled by a 5.6% surge in consumption of goods and robust spending on services, up 2.6%. *
- **Q3 2024 Concluded with Inflation at 2.4%—**The annual inflation rate in the US slowed for a sixth consecutive month to 2.4% in September 2024—the lowest since February 2021. Prices continue to rise for shelter, food and transportation, while energy costs declined, mainly due to dips in the cost of gasoline and fuel oil. Also, prices continued to fall for new and used vehicles. *
- **Business Confidence Continues Its Slow Decline—**The ISM Manufacturing PMI finished Q3 at 47.2, versus a measure of 48.5 at the end of Q3. The reading continued to point to a contraction in the manufacturing sector, now extended for six straight months. Demand continues to be weak, output declined and inputs stayed accommodative. Demand remains subdued, as companies showed an unwillingness to invest in capital and inventory due to federal monetary policy and election uncertainty. Suppliers continue to have capacity, with lead times improving and shortages occurring. A PMI reading above 50 percent indicates that the manufacturing economy is generally expanding; below 50 percent indicates that it is generally declining. *
- **Q3 2024 Sees First Rate Cut in Four Years—**The Federal Reserve cut the target range for the Fed funds rate by a jumbo 50bps to 4.75%-5% in September 2024. It was the first reduction in borrowing costs since March 2020. While the decision to cut rates was anticipated, there was speculation about whether the central bank would choose a more conservative 25 bps reduction. *

**Trading Economics®*

In Q3 of 2024, Pursant held a two-day educational seminar in Chicago focused on M&A, which featured insights from highly-respected thought leaders from our firm and others including Levenfeld Pearlstein, Alliance Bernstein, Miller Cooper and TMT Capital, about how to maximize outcomes in liquidity events.

The D.E.A.L Playbook Seminar

The Ultimate Road Map for Business Owners & CEOs to Explore and Plan a Divestiture, Exit, Acquisition, or Liquidity (D.E.A.L) Event

In this issue of the Pursant Deal Insider, we are sharing key takeaways from some of the seminar sessions.

Planning For the Next Chapter in Life

- **The difference between an employee and an owner is that an owner is inextricably linked to their business. Don't underestimate how hard it will be to separate yourself from your life's work.**
- **You can't start the next chapter of your life if you keep re-reading the last one.**

To start planning forward, start with a self-assessment of your current self and think through these topics:

1. Current age and life expectancy
2. Clarification on where you are emotionally (frustrated, bored, grinding, feeling passion, complacency, etc.)
3. Age of significant other
4. Physical health—full evaluation (Mayo, Fountain Life, etc.)
5. Mental health—cognitive ability
6. Current hobbies and interests
7. Children, their ages, aspirations for joining the business, and whether they are the right "fit" for the business
8. Current "dependents"—those counting on you for some level of support (children, parents, other significant relationships, charities, your foundation)
9. The situation for your business partners, if applicable
10. Current commitments, such as boards
11. Current support systems (personal assistant, teams, groups, church, etc.)
12. Your current physical place of work
13. Your current identity (title and cocktail party pitch)
    (for most, business is identity)
14. Current goals—personal and professional
15. Current routines
16. Financial review
17. Current lifestyle financial needs
18. Generational wealth needs

Write the Next Chapter and Make Sure it Addresses These Five Needs:

- ✓ Sense of Accomplishment
- ✓ Adventure
- ✓ Learning & Development
- ✓ Relationships
- ✓ Meaning and Purpose

For most, these needs have been provided by their business.

Ten Steps for Acquisition Strategy Execution

1. **Target Identification**
   - Geographic location
   - Types of customers, services and products offered
   - Business practices
   - Culture
   - Financial profile
   - Talent

 ▸ Define the “must haves” and “must avoids” in advance.

2. **Setting the Budget**
   - Get credit facilities arranged early
   - Plan for cash to be at least 50% of the funding and be ready and able to borrow the rest or pay in an earnout

 ▸ Don’t forget to account for your deal team expenses:

   1. **Intermediary** for negotiation and process management
   2. **Attorney:** use an M&A attorney (better agreements, lower cost and shorter timeline)
   3. **Quality of Earnings analysis:** for financial due diligence

3. **Initial Discussions and Meetings Between Parties**
   - Treat it as a first date (keep it light—it is not an interrogation)
   - Discussion generally starts with the Buyer telling their story, then the Seller and then natural Q&A follows
   - Check for criteria alignment through the discussion (have your checklist)
   - Generally ends with both parties agreeing to reflect on the discussion and reconnect later

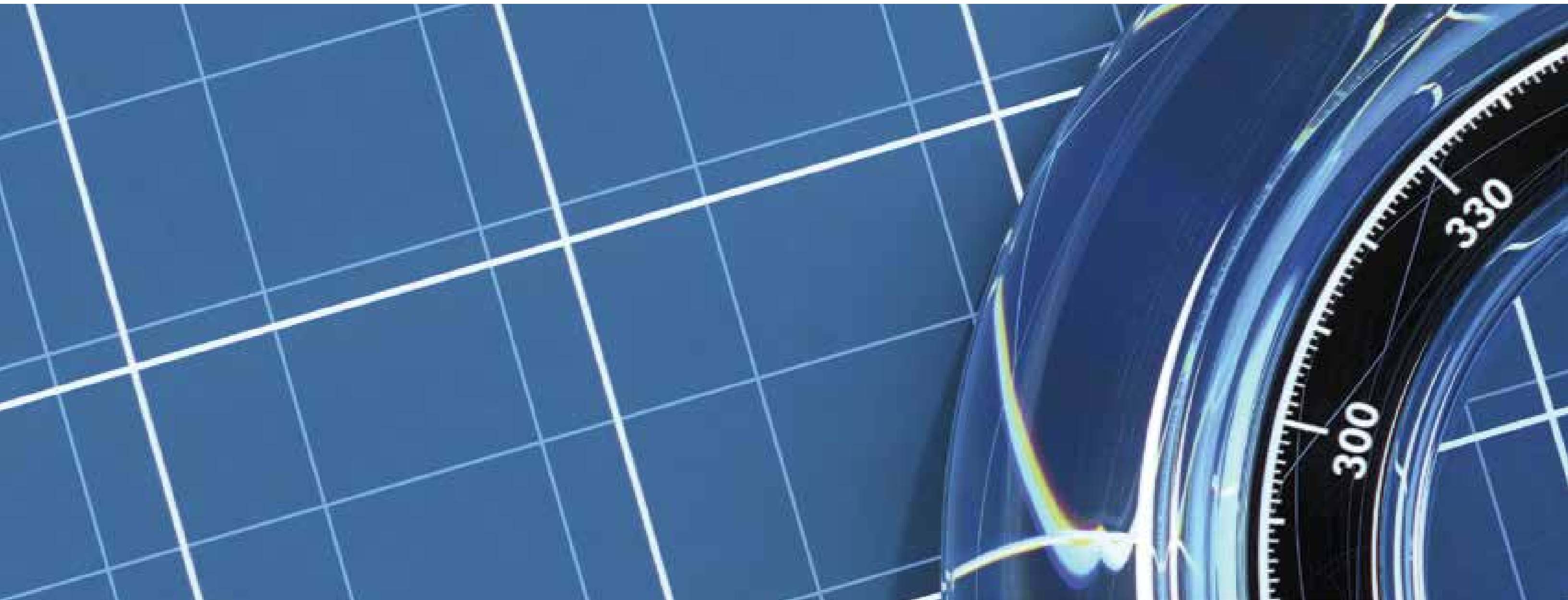
 ▸ Try to ascertain the Seller’s rationale for a potential sale. Knowing their state of urgency can help set your expectations and timeline.

4. **Initial Data Request & Review—Generally Includes:**
   - Last three years of complete accrual basis financial statements
   - Blind customer list with relevant metrics about concentration, tenure, industry, contract structure and end date
   - Blind organizational chart with titles, tenure and annual compensation

 ▸ Get enough information to assess fit, potential enterprise value and deal structure. Trust now, verify later.

5. **Valuation & Deal Structure**
   - Risk Profile = Multiple x EBITDA = Purchase Price
   - Cash/Earnout percentages driven by Risk Profile
   - Earnouts can be driven by Revenue, Gross Profit or EBITDA
     1. Generally, 1-3 year terms
     2. Keep it simple!

 ▸ Value capture for both parties is key.



6. Indication of Interest (IOI) and Letter of Intent (LOI)

- IOI = Are we in the same ballpark (not a legal document—no cost)
  1. Purchase price and terms
  2. Time needed to close
  3. Contingencies (financing, ownership consulting agreement, key employees sign-on with Buyer)
  4. Due diligence process
- LOI = Legal document (requires attorney review)—business from the IOI terms combined with binding legal terms such as:
  5. Exclusivity provision
  6. Legal jurisdiction
  7. LOI termination terms

7. Negotiation

- Depersonalize the valuation rationale; point to 3rd party valuation data
- Don’t underestimate the value of conveying how you will care for customers and employees
- Be patient, as most Sellers need to be slowly educated on value
- Use an intermediary to preserve your relationship and not show your cards

▸ For Buyers it’s Business. For Sellers it’s Personal.

8. Due Diligence

- Who will handle--build this team in advance
- Develop a Due Diligence checklist (typically involves 100s of documents)
- Plan for Sellers to move slowly, as they are also running their business

▸ Sellers will be defensive at times. Due diligence presumes guilt until proven innocent.

9. Definitive Agreements

- Use a deal attorney, not your general counsel (you wouldn’t use a general MD for specialized surgery)
- Attorney should manage risk, but also be constructive and solution oriented

10. Closing

- Generally done electronically, with attorneys holding signature pages and then funds wired
- Be prepared to hit the ground running the moment after closing, which requires many pre-close integration discussions with the Seller early in the deal process

▸ Celebrate the event but be mindful of the Integration hangover to follow!

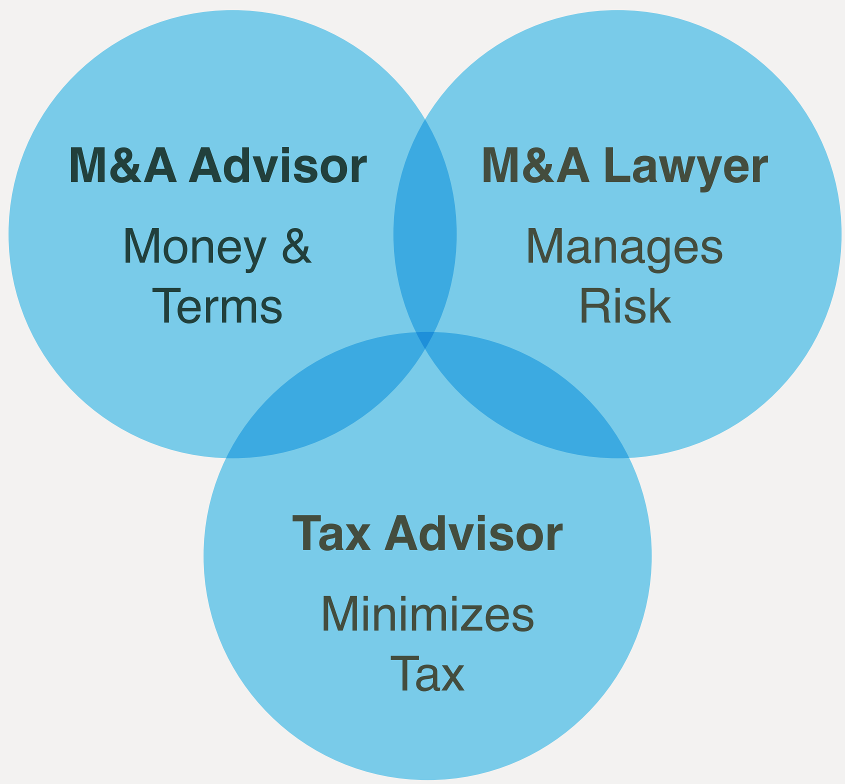
Building Your Deal Team

To get the best deal, you need a team that is at least as skilled as the Buyer's!

Your deal team ideally includes:

- **You and, potentially, your hired CEO**
- **Your M&A Advisor/Investment Banker**
- **Your M&A Lawyer**
- **External accounting firm**
- **Your Tax Advisor**
- **Your Quality of Earnings Advisor**
- **A Chief Exit Advisor (CEA) (occasionally)**

▸ **The M&A advisor is the quarterback**



When selecting your M&A Advisor:

- Meet several firms
- Beware the firm that promises to get your deal done faster
- Have the firms compete for your business, but beware the low bidder
- Do not think that hiring the cheapest provider provides you the best result
- People and process trump industry specialization
- The advisor that specializes in your industry may not always be the best advisor
- Evaluate the right Investment Banker based upon anticipated ROI

▸ The Investment Banker that charges more but delivers greater ROI makes more sense.

The M&A Attorney and Tax Advisor you select must:

- Specialize in M&A
- Have glowing references
- Know what is "Market" as it relates to terms
- Ideally represent a medium-sized or large firm that can muster multiple in-firm experts, with capacity to move quickly
- Be recommended by M&A advisors
- Balance risk avoidance with closing the deal
- Prioritize the open issues, be honest with you and teach you
- Get along with the other side's team

▸ Get an attorney that is a Closer and not a Blocker—a deal is about risk management and not risk avoidance.

M&A Legal Matters – Pre-sale Prep and LOIs

Pre-Sale Planning

- Make sure your key contracts are in order and renewed and that you are keeping good records regarding sales, customers and vendors
- Make sure that files are up-to-date and that you have signed copies of key contracts and amendments
- Do a legal wellness check or audit to uncover potential issues that could create liability in a sale transaction, including a review of the following:
  - ✔ Corporate organization
  - ✔ Contracts
  - ✔ Governance
  - ✔ Licenses
  - ✔ Tax
  - ✔ Labor & Employment—common areas are employee/contractor classification (W2 vs. 1099) and I-9 compliance
  - ✔ Intellectual Property
  - ✔ Environmental
  - ✔ Lien search

Key Terms to Address in the Letter of Intent

- Parties to the LOI (consider execution by Buyer's parent if Buyer is a shell).
- Purchase price and terms
- Assets and liabilities included (especially working capital that is required to operate the business)
- Form of consideration, such as cash, stock, earnout or notes
- Legal transaction structure (asset sale or stock sale)
- Seller's ongoing role and compensation
- Conditions to close (e.g., execution of definitive documentation, completion of due diligence, financing contingency and third-party consents)
- Due diligence process
- Exclusivity
- Deadlines or transaction milestones (i.e., transaction roadmap)
- Escrow or holdback obligations
- Representations, warranties and indemnification (specific list versus customary)
- Pre-Closing Covenants (including conduct of the business prior to closing)
- Post-Closing Restrictive Covenants
- Due diligence access (including employees and customers)
- Allocation of fees and expenses, such as attorneys' fees and investment banker's fees
- Confidentiality (especially if there is no confidentiality agreement)

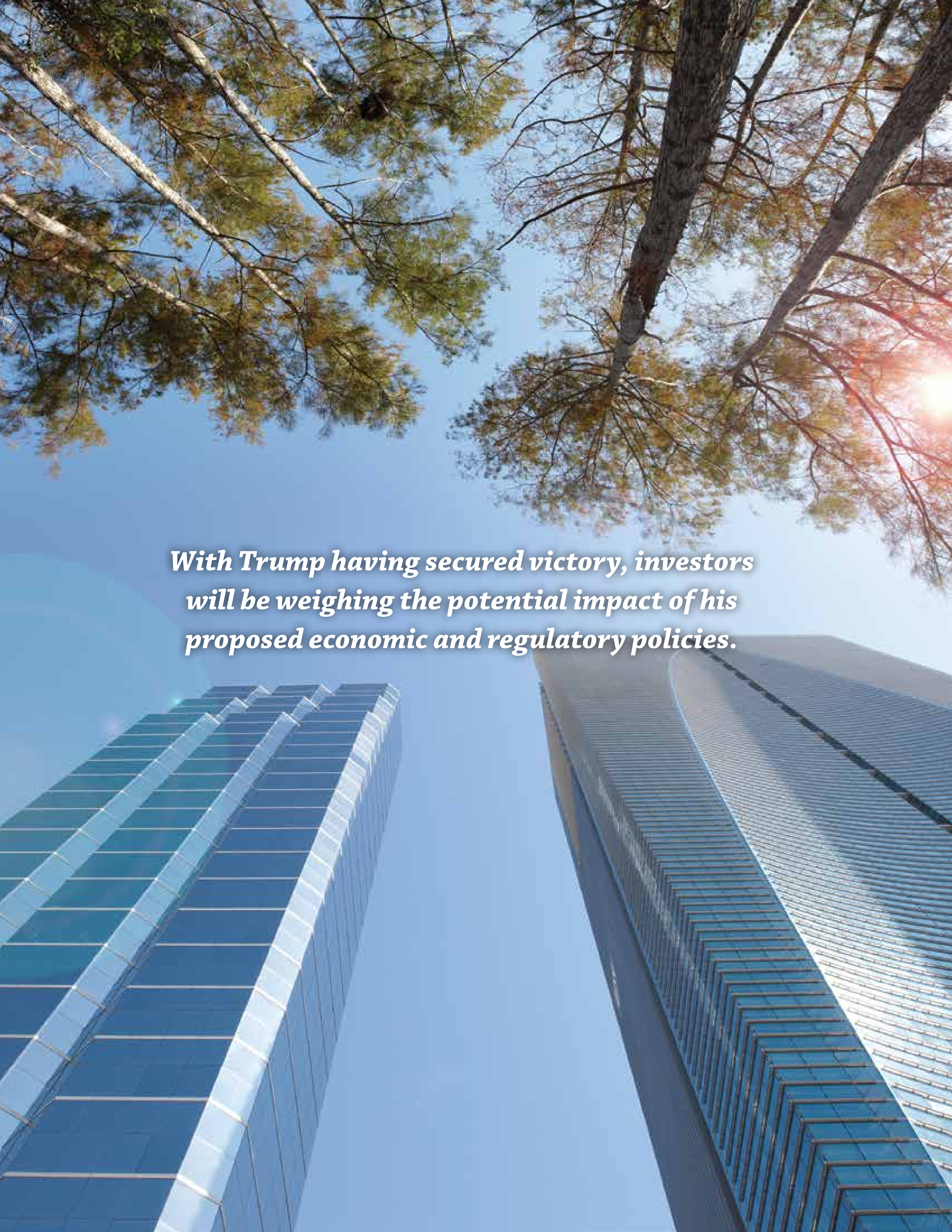
Due Diligence

Goals of Due Diligence

- Goal is to understand:
    - ✔ If this can be a great investment
    - ✔ Industry dynamics
    - ✔ Business positioning
    - ✔ How well the business is run
    - ✔ Risks and opportunities
    - ✔ Value Drivers
        - Industry—is the business well-positioned in an attractive industry?
        - Market—how could this business be disrupted?
        - Position—is there a clear path to profitable business growth?
        - Revenue Sources—how predictable is revenue and what could disrupt it?
        - Management Practices—is this a professional team with management processes and activities that are measurable and scalable?
        - Operations and Technology—does the current infrastructure manage risk and support growth?
        - Team—is this a high-quality team with whom we can successfully grow the company?
        - Financial Metrics—can and does this team consistently measure the right things accurately and in a timely manner?

Primary Due Diligence Categories

- Corporate and Governance Matters
- Securities
- Tax
- Financial & Accounting
- Risk Management: Insurance, Process Documentation, Disaster Recovery
- Asset, Real Property, and Personal Property
- Environmental
- Conduct of Business
- Customers
- Intellectual Property
- Management, Labor and Personnel
- Legal, Litigation, Disputes and Claims
- Regulatory Compliance
- Information Systems



With Trump having secured victory, investors will be weighing the potential impact of his proposed economic and regulatory policies.

Pursant's Expectations for the Near Future

With the election cycle complete, there is more clarity on future policy and confidence in an M&A-friendly environment for Buyers and Sellers. All other factors that influence M&A—the economy, the banking sector, corporate balance sheets, private equity dry powder—are in good shape. Given this, we expect 2024 to finish with a continued upswing and for that to continue into 2025. The Boston Consulting Group (BCG) M&A Sentiment Index continues to show similar signs of a strengthening market, albeit slow and steady.

Private equity firms' dry powder—capital available for new investments—reached a record $2.1 trillion at the end of Q3 2024, fueling the resurgence of Private Equity (PE) dealmaking. This sophisticated investor group now sees conditions as more favorable and is willing to deploy this capital at the same time that interest rates are declining.

The US is likely to benefit most from the return of PE acquirers whose debt-fueled buyouts were hit hard by the Fed's aggressive rate hikes in the aftermath of the Pandemic that were intended to combat inflation. The Fed's reduction in interest rates, planned future rate cuts and the convergence of Seller and Buyer valuation expectations have created an environment conducive for PE dealmaking.

According to a recent report by EY, M&A activity is likely to firm up in 2025, given the robust deal fundamentals and the improved deal appetite of corporates and PE firms. Moreover, factors such as stabilized inflation, healthy debt markets, improved financing conditions and better M&A valuations are likely to stimulate M&A amid a favorable backdrop in the coming months.

With Trump having secured victory, investors will be weighing the potential impact of his proposed economic and regulatory policies. Deal momentum in the longer term will likely depend on how much of Trump's tax, energy, trade and regulatory agenda is enacted.

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 $500M. Our goal is to arm business owners and dealmakers with the insights needed to optimize transaction outcomes.

Pursant is a middle market advisory firm specializing in M&A, private capital market financing, transaction advisory, financial leadership support and business value enhancement consulting. 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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847.229.7000 | info@pursant.com | www.pursant.com