Q4 2021 EDITION

Pursant
INSPIRED PURSUIT

DEAL insider

M&A and Strategic Transaction Insights

THE INVESTMENT BANK THAT ALSO BUILDS THE VALUE OF YOUR BUSINESS

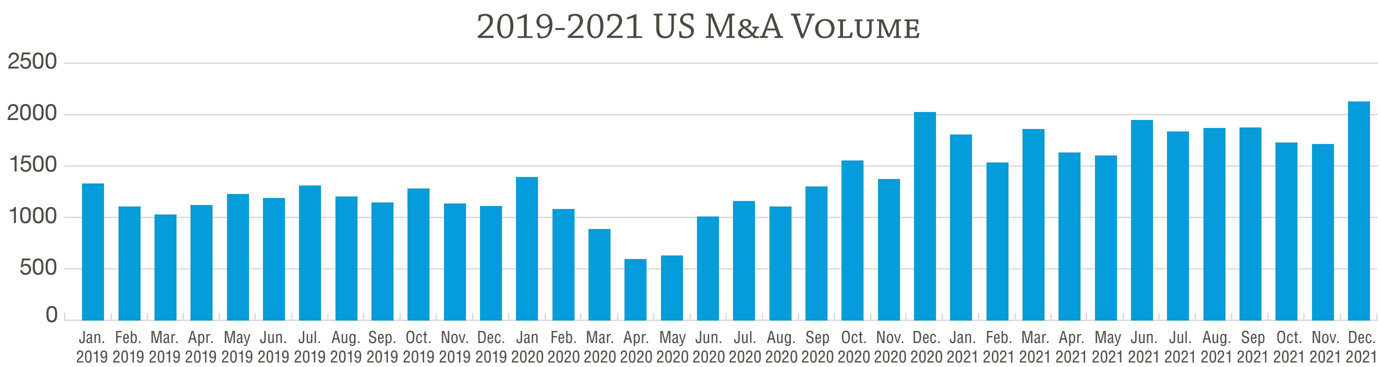
Q4 2021 Deal Insider

Our year-end issue historically focuses on key strategic transaction metrics, largely related to lower middle market M&A.

2021 mergers, acquisitions and other strategic transactions continued at the same blistering pace as late 2020, exceeding already elevated pre-pandemic levels. Corporate balance sheets flush with cash, strong earnings, stimulus money, PE funds loaded with dry powder and abundant cheap capital were the perfect recipe for creating abundant buyer interest. Many middle market business owners (especially baby-boomers) were motivated to transact as a result of the fatigue caused by managing through the health crisis, whether their business fared well or not. Additionally, there was fear of an eminent 2022 Biden administration tax increase which motivated many to close before year-end.

The chart below shows:

1. 2019 M&A volume was strong, the calm before the early 2020 pandemic storm
2. Deals slowed significantly or stopped with US shutdowns in March/April 2020
3. Overall, 2021 M&A was up 39.8% over 2020
   - Deals $25M-$250M up 41%
   - Deals $10M-$25M up 1%
   - Deals under $10M down 10%



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 other parties with insight to help prepare for such transactions in order to optimize transaction outcomes.

Macroeconomic Indicators

Pursant looks at a number of macroeconomic indicators that may impact deals in order to gain insight into M&A and strategic transaction trends. What happens at the global and macro-economic levels eventually impact the Middle Market and Main Street.

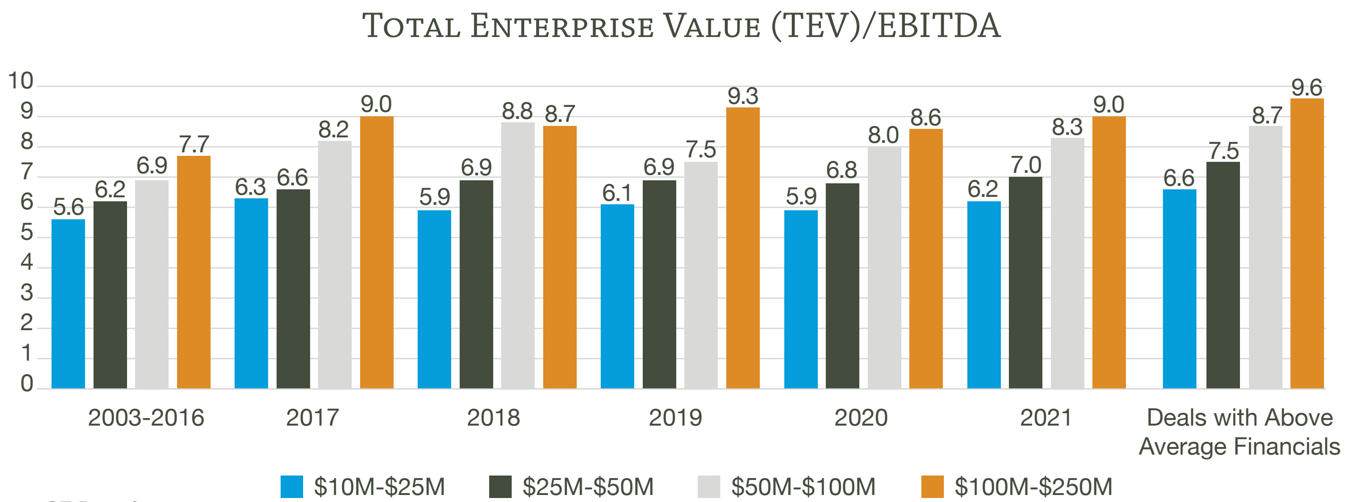
5 Deal-Impacting Macroeconomic conditions we watch:

1. **GDP** – The US economy expanded an annualized 6.9% in Q4 2021, much higher than 2.3% in Q3 and well above forecasts of 5.5%. It is the strongest GDP growth in five quarters. Healthy GDP growth bodes well for M&A activity.
2. **Unemployment** – We finished 2021 with unemployment at 3.9% down sharply from year-end 2020 at 6.7%. Low unemployment is good for the economy and M&A.
3. **Inflation** – The year-end 2021 inflation rate in the US accelerated to 7%, a fresh high since June of 1982. This rate is a sharp contrast to year-end 2020 at 1.4%. This higher inflation rate sets the stage for a number of key fed interest rate increases which at some point will impact M&A borrowing costs.
4. **Interest Rates** – The Fed Funds rate finished the 2021 year at .25%, same as year-end 2020; however, multiple rate increases are in the cards for 2022. Not immediately, but eventually these compounding rate increases will increase M&A borrowing costs, creating downward pressure on valuation multiples.
5. **ISM Purchasing Managers Index (PMI)** – The PMI for the US at year-end 2021 was 58.8, down ever so slightly from where we finished 2020 at 60.7. A PMI reading above 50 percent indicates that the manufacturing economy is generally expanding; below 50 percent indicates that it is generally declining. This is another positive indicator for M&A.

Better Businesses Trading at a Significant Premium

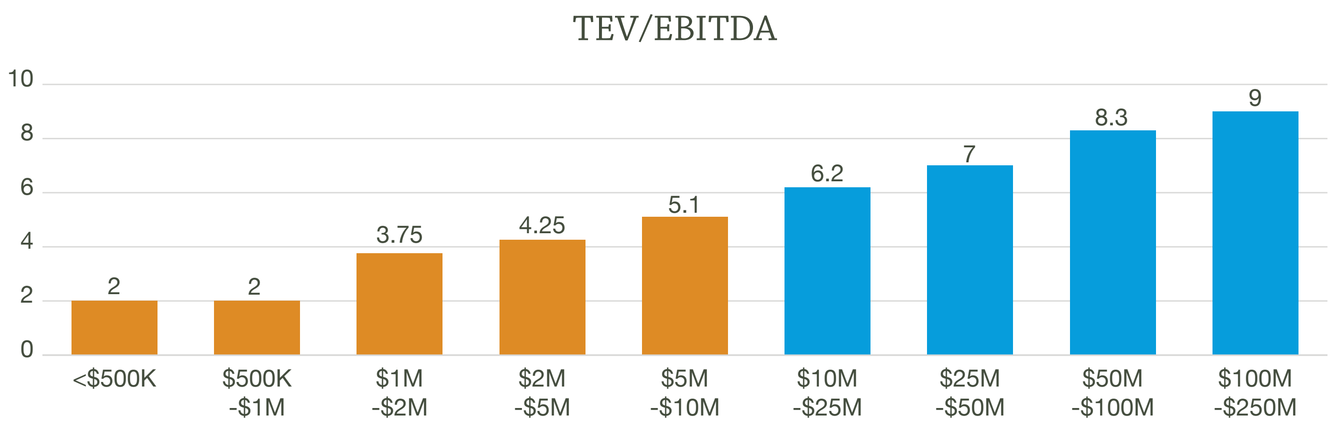
The chart below shows:

- Overall, Lower Middle Market valuation multiples for deals under $250M stayed intact, but…
  - "Above Average" performers traded at 7.9x vs 6.1x (30% premium)
- An "Above Average" performing company is one in which revenue growth and earnings are outperforming peers in the market
- Getting valuation consensus still often remains a challenge as COVID related earnings bumps and COVID related earnings reductions create extra diligence challenges for parties.
  - If a company had COVID related earnings reductions that were likely temporary, valuation gaps were often handled through contingent payment.
  - Earnings increases during COVID must be sustainable to be factored into valuations and even then, contingent payment is often added to deal structure to protect buyers.



Source: GF Data®

The chart below shows how average valuation multiples increase when moving from small businesses (<$10M in Purchase Price) to the lower middle market (>$10M in Purchase Price).



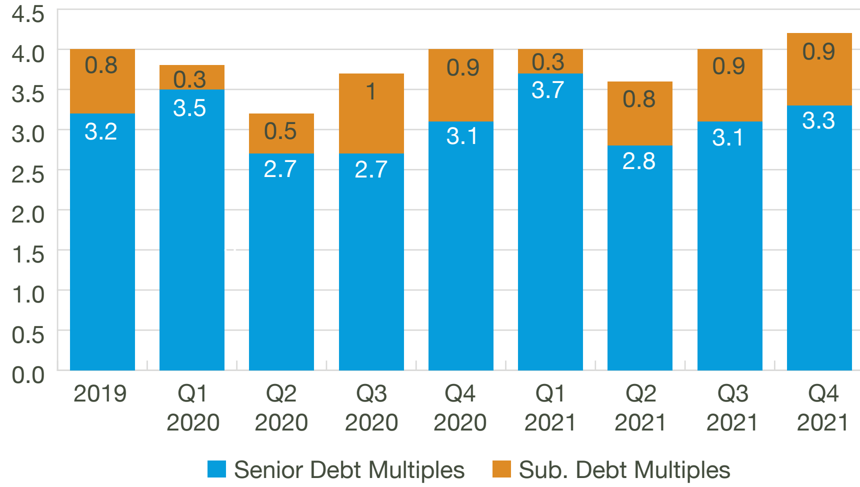
Source: Pepperdine Private Capital Markets Report & GF Data®

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.*

The chart to the right depicts the turns (multiples) of EBITDA senior and mezzanine lenders will lend on average in lower middle market M&A transactions.

- Total Debt (Senior and Subordinated) for M&A exceeded 4x EBITDA or commonly 50% of the consideration paid.
- Summer pandemic surges of 2020 and 2021 note some senior lender pullback
- First choice for buyers is the senior lender and junior lenders then fill the gap

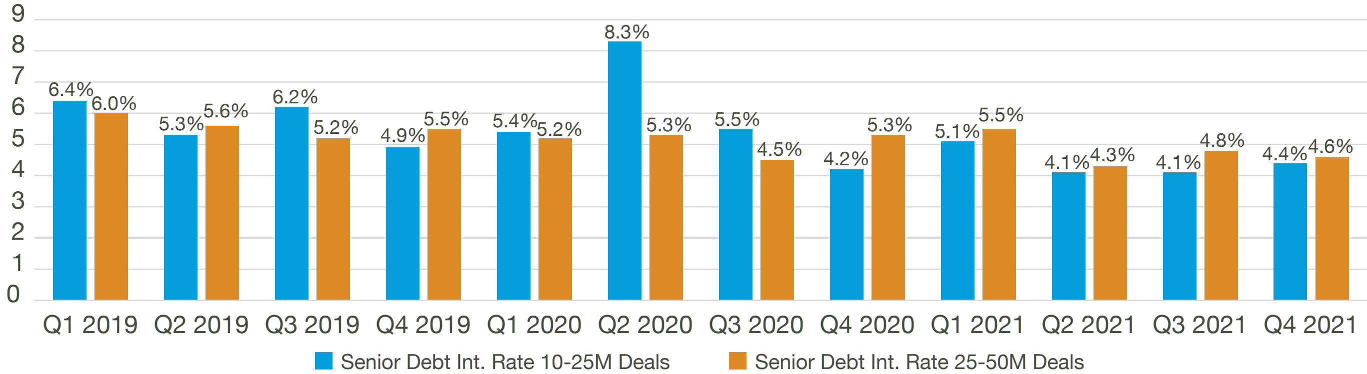
Total Debt/EBITDA



Source: GF Data®

The chart below shows that with the worst of the Pandemic behind us, Senior Debt is very affordable. Rates in this chart were for smaller transactions in the $10m-$25m and $25m-$50m ranges. Current rates are lower than pre-Pandemic.

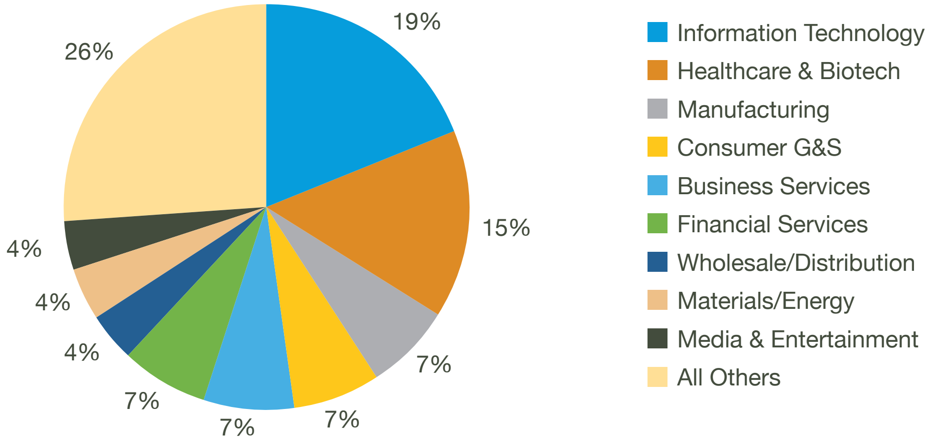
Senior Debt Interest Rates by Deal Size



Source: GF Data®

The following chart ranks most attractive to least attractive sectors for M&A risk/return trade-off according to a recent Pepperdine Private Capital Markets investor survey. No surprise that IT and Healthcare/Biotech interest have increased since the Pandemic began.

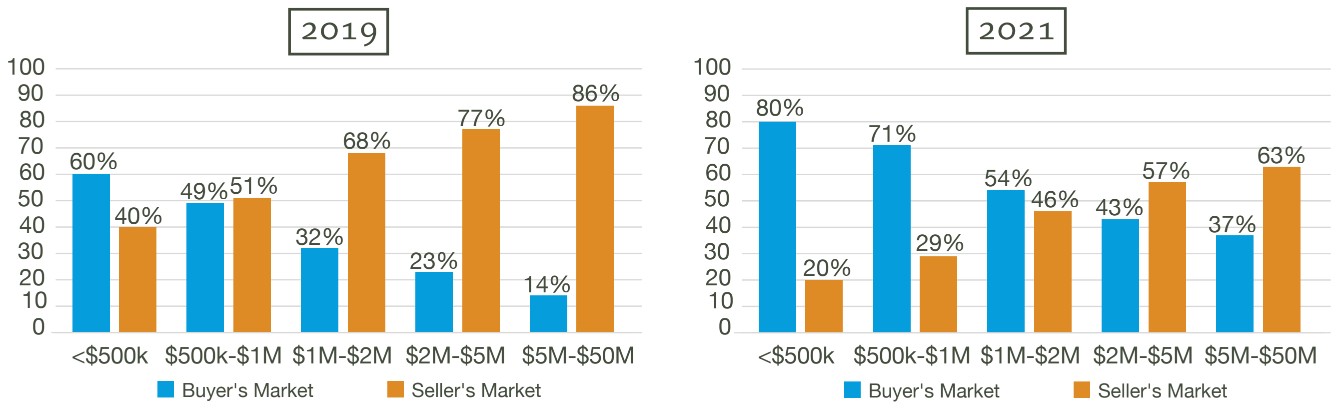
Sectors with Best Risk/Reward Trade-off



Source: Pepperdine Private Capital Markets

When comparing broker survey results from 2019 (pre-Pandemic) to 2021 we can see clearly that the pure "Seller's" market is gone and we have entered a more "Neutral" market where not all sellers are commanding premiums for their business, especially if it is a small business transaction.

Buyer's or Seller's Market (by Transaction Value)



Source: Pepperdine Private Capital Markets Report

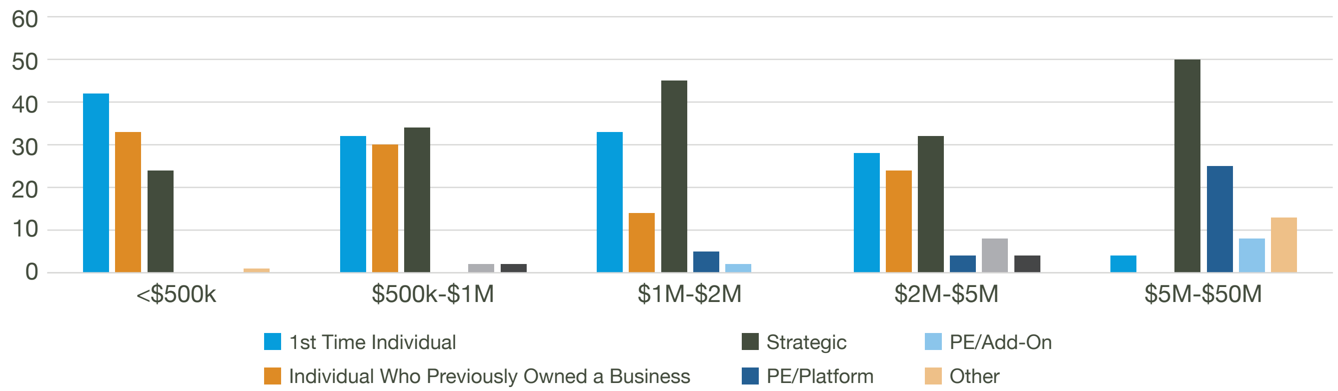
The chart below reflects slightly increased deal time frames when compared to pre-Pandemic time frames, largely due to more thorough due diligence.

How Many Months To Complete a Deal

Source: Pepperdine Private Capital Markets Report

Eager to grow top-line revenue, Strategic buyers appeared across the deal size spectrum. With higher transaction costs and the need for bigger returns, PE buyers generally don't take interest until purchase prices exceed $5M. As expected, individual parties are the most prevalent buyer type for small businesses.

Who are the Buyers (sorted by TEV)

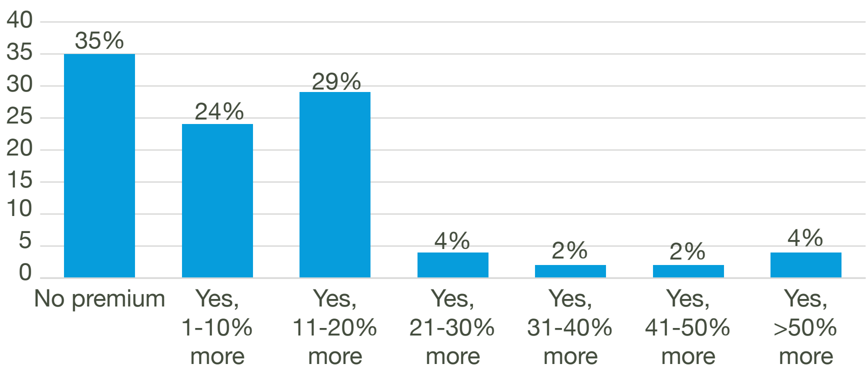


Source: Pepperdine Private Capital Markets Report

Premium Paid by Strategic Vs. Financial Buyers

Statistically, Strategic buyers are willing to pay more than Financial buyers, but not always. Strategic buyers generally have more synergistic opportunities, industry experience and operational experience to leverage in the valuation model, improving their proforma return.

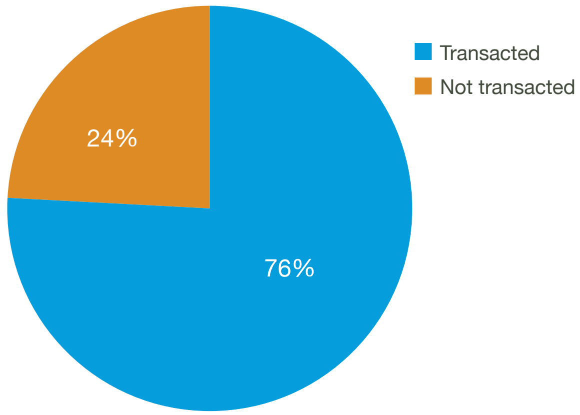
- 47% of deals involved Financial Buyers
- 65% of Strategic Buyers paid a premium over Financial Buyers
- Pre-Pandemic, 79% of Strategic Buyers paid a premium (Financial Buyers are "stepping up")



Source: Pepperdine Private Capital Markets Report

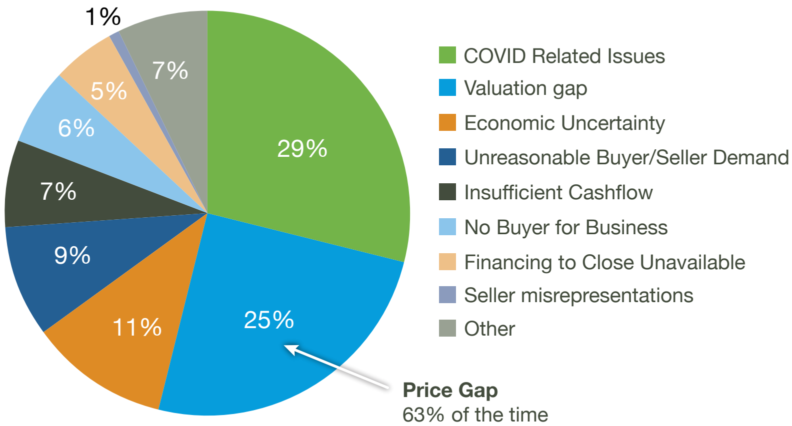
If you embarked on a sale or acquisition process in 2020, putting COVID reasons aside, odds are that the transaction did not close a quarter of the time. The predominant reasons for deals not closing were COVID related, buyer/seller misalignment on valuation expectations and economic uncertainty.

Deals Closing



Virtually unchanged since pre-pandemic

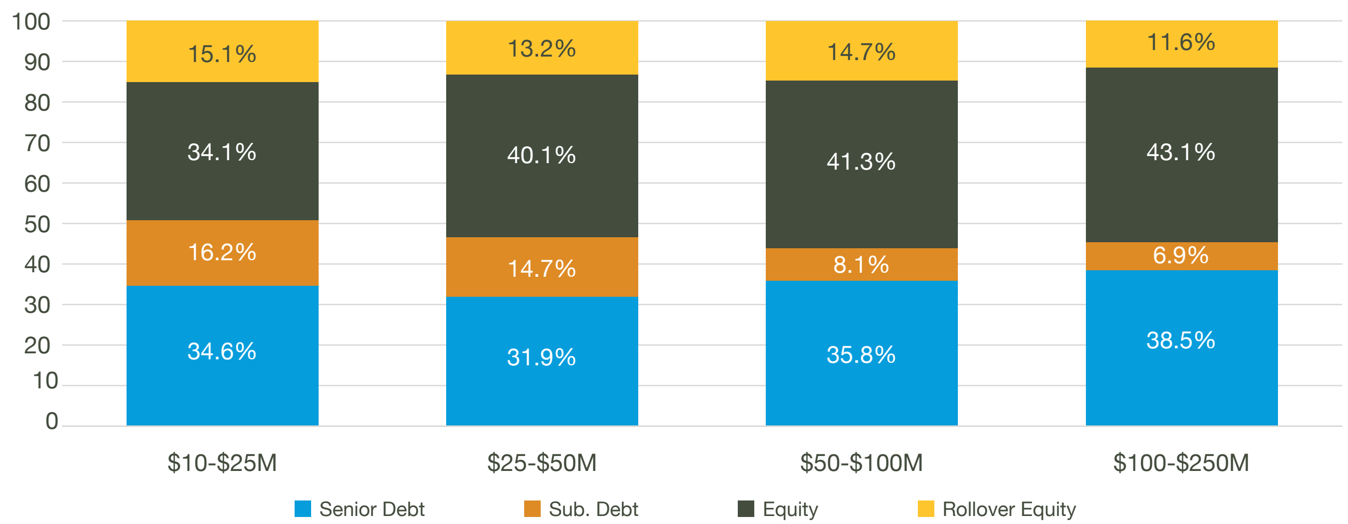
Reason for not Transacting



Source: Pepperdine Private Capital Markets Report

If you sold your company to a Private Equity (PE) buyer in 2021, the chart below reflects the common breakdown for how PE funded the transaction. Based on the leverage percentage seen here, we again see the benefits to the low cost of capital. We also see the necessity for buyers being willing to stay invested in their business (roll equity) in most cases when they transact with PE.

M&A Deal Funding Structures by Transaction Value (Platform Acquisitions Only)



Source: GF Data®

A shift in the phase of the Business Transfer Cycle

- The Pandemic has been a catalyst, moving us from a pure ***Seller's*** market to a ***Neutral*** market, meaning not ALL businesses will trade at premiums, only GOOD ones.
- Historically, the cost of capital has driven changes in the business transfer cycle, but that has not yet happened. Stimulus money and prolonged low interest rates have helped us deviate from historical patterns. It remains to be seen when rising rates and multiple compression will nudge us more towards a more Buyer favorable market.

Deal Recession (Buyer's Market)	Prime Selling Time (Seller's Market)	Uncertainty (Neutral Market)
1980 – 1983	**1983 – 1988**	**1988 – 1990**
1990 – 1993	**1993 – 1998**	**1998 – 2000**
2000 – 2003	**2003 – 2008**	**2008 – 2010**
2010 – 2013	**2013 – 2020**	**2020 – 2022**
2023 – 2023	**2023 – 2028**	**2028 – 2030**

Source: Rob Slee - Private Capital Markets

What to expect in 2022

1. Strong M&A volume (maybe better than 2021). Recent national surveys show more than 50% of PE firms and strategics feel 2022 M&A will be stronger than 2021
2. Rising interest rates not expected to dampen deal activity or overall valuations for this year
3. Senior lenders eager to lend for deals at reasonable rates
4. It will remain a "Neutral" market with only better businesses commanding premium valuations
5. "Zoom" deals are here to stay, but with more in-person deal work as well
6. Continuing COVID noise to be sorted through in financial statements and valuation/deal structure discussions
7. Good news for both Buyers and Sellers:
   - Sellers with ***good*** businesses in resilient sectors will still capture full value
   - Buyers seeing more acquisition opportunities driven largely by owner fatigue and favorable tax environment

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 monetize their business, 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 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 leadership performance, profitability and 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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