Q4 2022 EDITION

Pursant
INSPIRED PURSUIT

DEAL insider
M&A and Strategic Transaction Insights

THE INVESTMENT BANK THAT ALSO BUILDS THE VALUE OF YOUR BUSINESS

Q4 2022 Deal insider

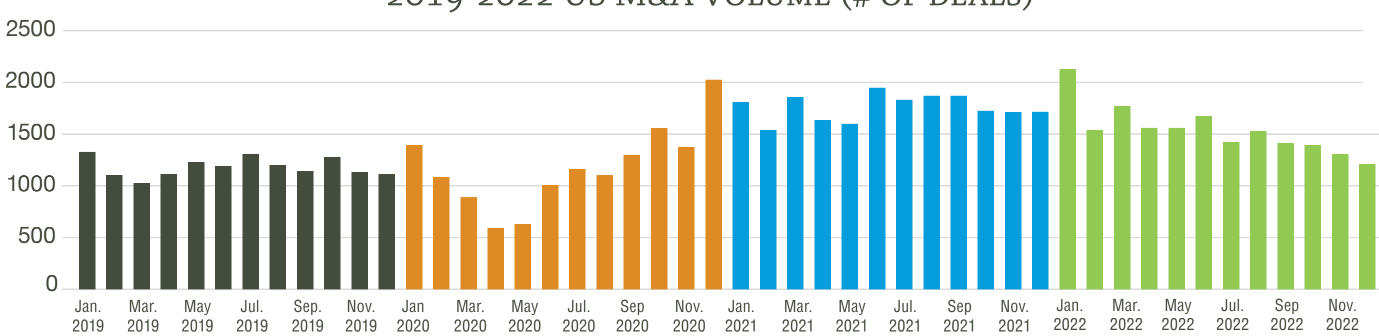
Welcome to our year-end issue of the Pursant Deal insider where we focus on key strategic transaction metrics, largely related to lower middle market M&A, transactions with enterprise value of less than $250M.

2022 mergers, acquisitions and other strategic transaction activity returned to its pre-pandemic level. This level of M&A was far more manageable and sustainable than the frenetic level we saw in 2021. Corporate balance sheets of Buyers remained flush with cash and PE firms continued to successfully raise funds and grow their coffers of dry powder. Sellers saw middle market multiples stay at healthy levels, so their desire to transact remained high.

The chart below shows:

1. Pre-2020 M&A Volume was thought to be at a "High", until we experienced the unprecedented levels of 2021.
2. Deals slowed H1 2020 due to the pandemic.
3. H2 2020, M&A came back quickly.
4. 2022 M&A Volume down from 2021, but not below pre-pandemic levels:
   - Deals $100M-$250M -21.2%
   - Deals $50M-$100M -24.7%
   - Deals $25M-$50M -19.4%
   - Deals $10M-$25M -20.8%
   - Deals under $10M -30.5%

2019-2022 US M&A VOLUME (# OF DEALS)

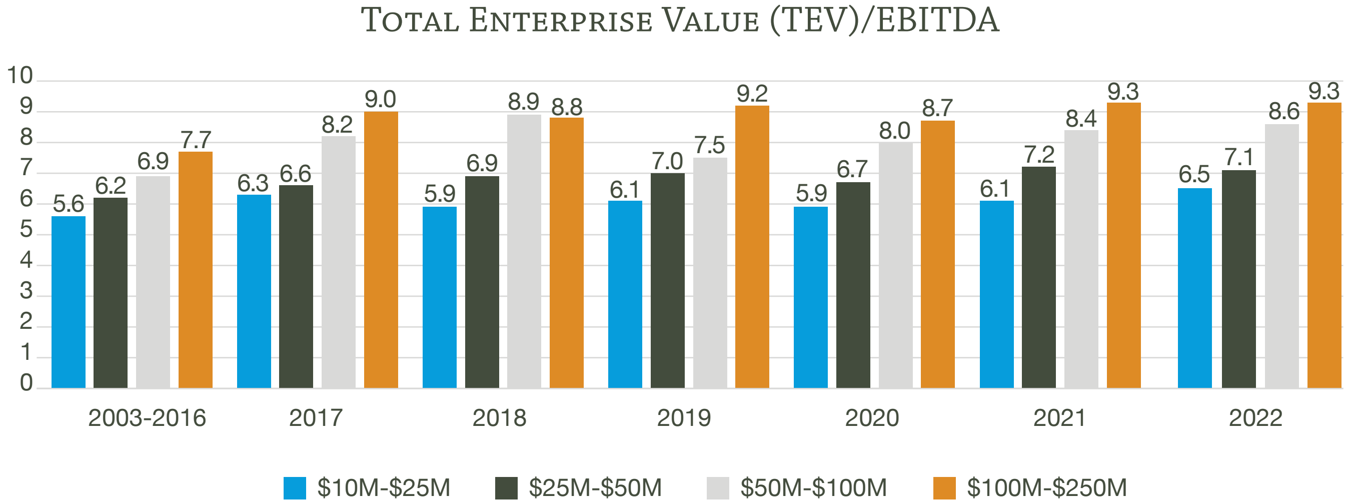


Source: Factset®

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.

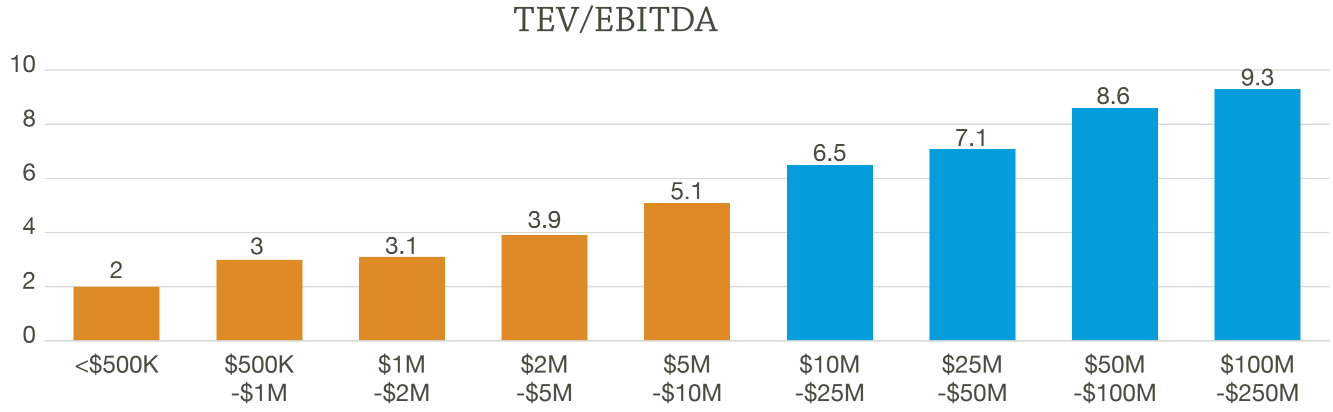
Overall Valuations Remained at Healthy Levels in 2022

The chart below shows that overall, Lower Middle Market 2022 valuation multiples for deals under $250M in enterprise value were similar to 2021 at an average of 7.5x EBITDA vs. 7.4x in 2021.



Source: GF Data®

The chart below shows how average valuation multiples of EBITDA 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®

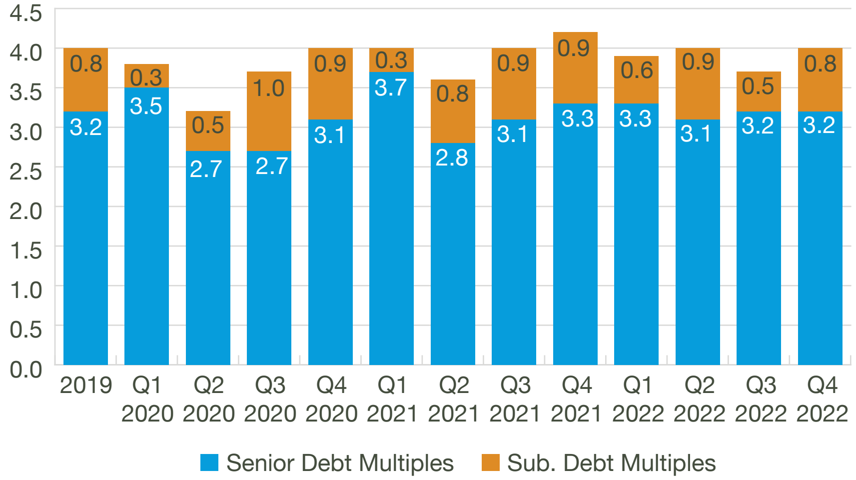
EBITDA Defined *– For most middle-market businesses, valuation is typically expressed in the form of a multiple of EBITDA (earnings before interest, taxes, depreciation and amortization)—a measurement of a company's ability to generate cash flow. EBITDA figures also serve as a barometer of the company's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

Lenders Remained Eager to Fund M&A in 2022

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

- Total Debt (Senior and Subordinated) for lower middle market M&A was ~ 4x EBITDA in 2022, consistent with recent periods with the exception of pullbacks during the midyear periods of the Pandemic.
- First choice for Buyers is the Senior lender and Subordinated lenders then fill the gap

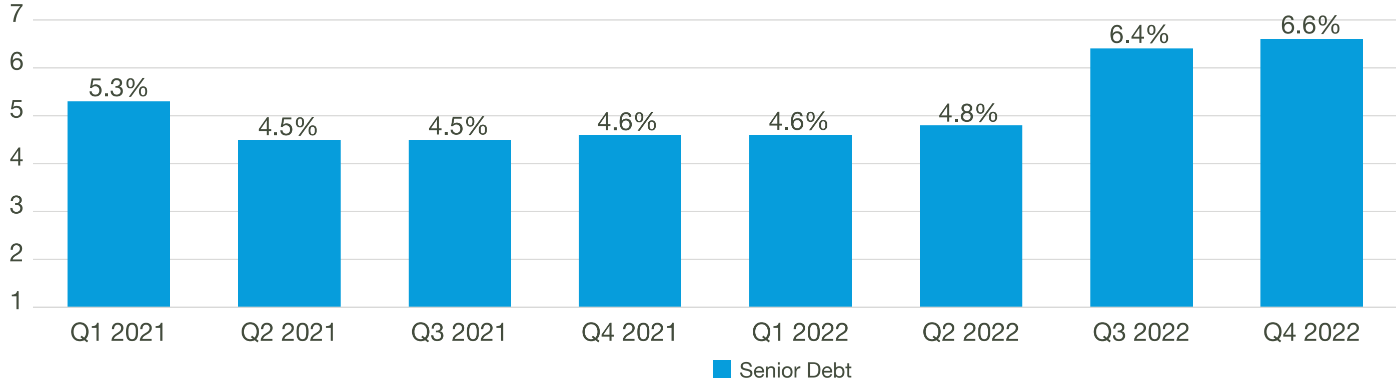
Total Debt/EBITDA



Source: GF Data®

The chart below shows how last year's frequent and significant Fed rate increases finally caught up with M&A lending rates in Q3 of 2022. While capital is more expensive than it was in 2021, pricing is not high enough to deter Buyers from borrowing aggressively to get deals funded.

Senior Debt Interest Rates



Source: GF Data®

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 macro-economic level eventually impacts the Middle Market and Main Street. Despite the uncertainty that presided over the year, the 2022 broader economic environment remained conducive to getting deals done.

Some notable deal-Impacting macroeconomic conditions we watch:

1. **GDP -** The US economy expanded an annualized 2.7% in Q4 2022, following a 3.2% jump in Q3. Factoring in two declines in the first half of the 2022 year, full 2022 year GDP expanded 2.1%. Healthy GDP growth bodes well for M&A activity.

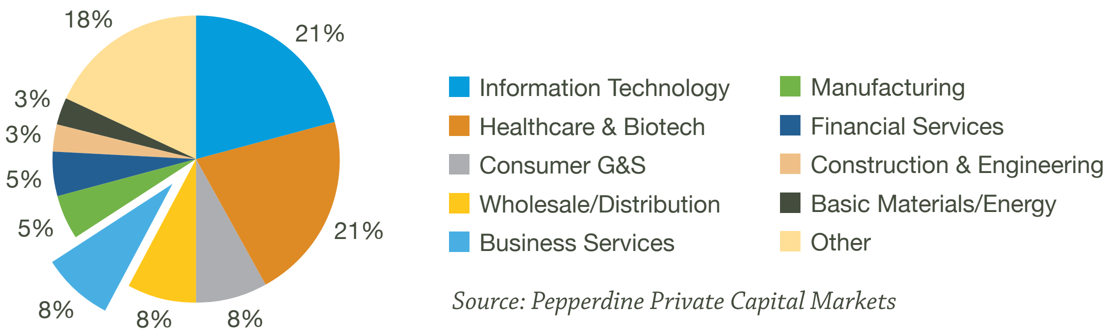
2. **Inflation –** 2022 inflation finished at 6.5%, while down from its mid-year highs, still stubbornly higher than the Fed wants to see. This higher inflation rate keeps the Fed in a hawkish mindset and poised for continuing rate hikes which are notching up M&A borrowing costs.

3. **Interest Rates –** The Fed Funds rate finished the 2022 year at 4.25% - 4.5%, up 400 basis points from year-end 2021, pushing borrowing costs to the highest level since 2007. Despite the markedly higher cost of capital, downward pressure on lower middle market multiples has not yet been seen, but expected as the Fed continues to raise rates in 2023.

4. **ISM Purchasing Managers Index (PMI) –** The PMI for the US fell to 48.4 in December of 2022, pointing to the 2nd month of contraction in factory activity as Americans are shifting spending away from goods to services. Excluding the decline in April 2020 at height of the covid pandemic, this was the lowest reading since February 2016. A PMI reading above 50 percent indicates that the manufacturing economy is generally expanding; below 50 percent indicates that it is generally declining. We will continue to watch the PMI closely to gauge its impact on M&A should the contraction continue.

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 Health Care/Biotech hold the top spots in 2022.

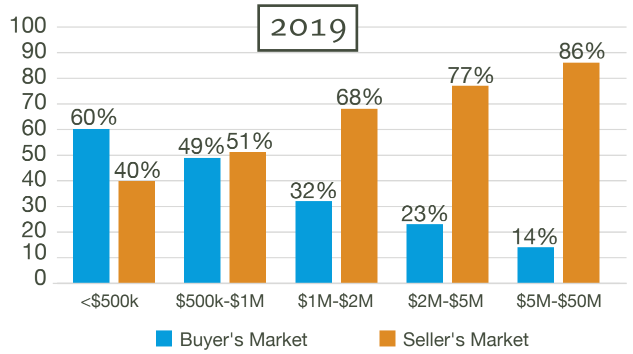
Sectors with Best Risk/Reward Trade-off

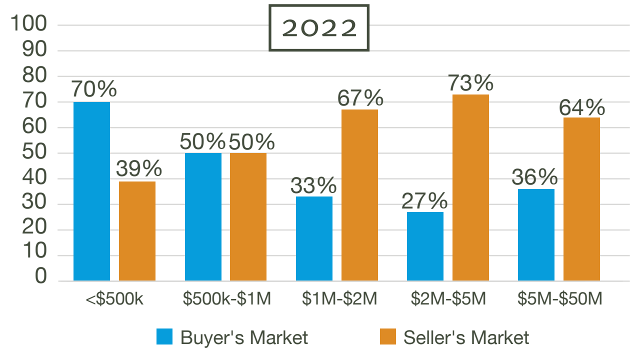


Source: Pepperdine Private Capital Markets

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)

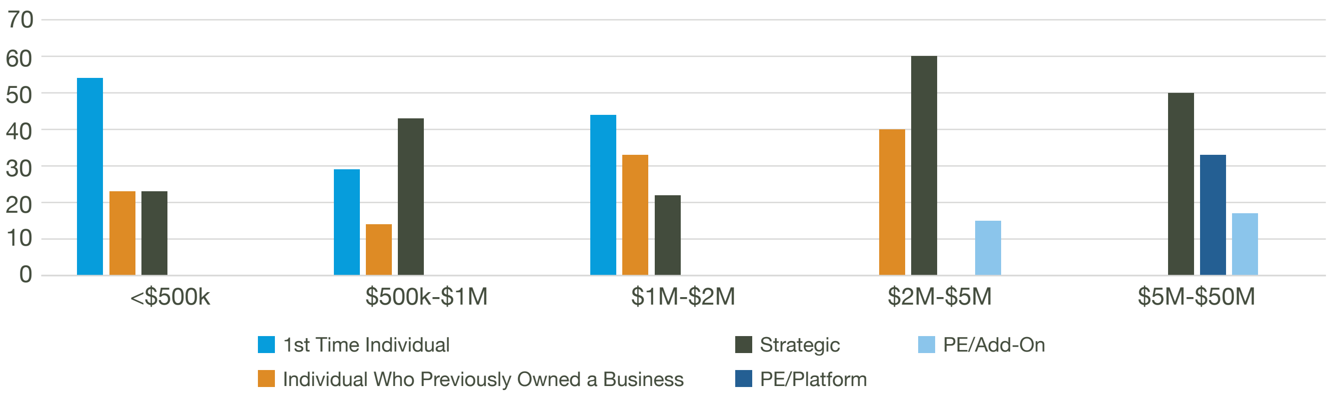




Source: Pepperdine Private Capital Markets Report

Eager to grow top-line revenue, Strategic Buyers appear across the deal size spectrum. With higher transaction costs and the need for bigger returns, PE platform Buyers generally don't take interest until Total Enterprise Value (TEV) exceeds $5M, but are willing to do smaller add-on transactions in an effort to maximize their ability to deploy more capital. As expected, individual parties are the most prevalent Buyer type for small businesses.

Who are the Buyers (sorted by TEV)

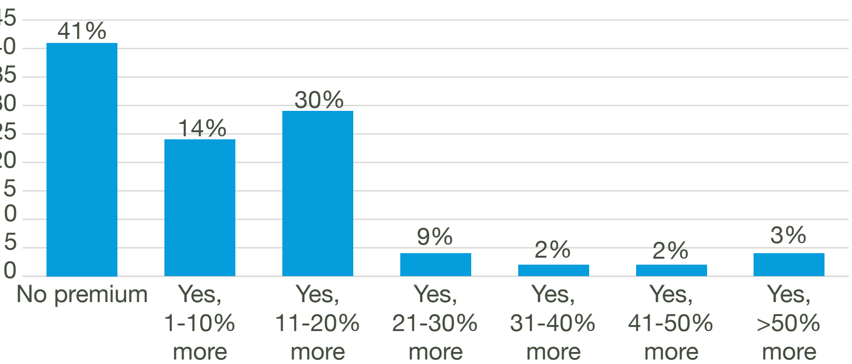


Source: Pepperdine Private Capital Markets Report

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.

- 51% of deals involved Financial Buyers.
- 59% of Strategic Buyers paid a premium over Financial Buyers
  - Note that in this survey, Pre-Pandemic, 79% of Strategic Buyers paid a premium (Financial Buyers are "stepping up")

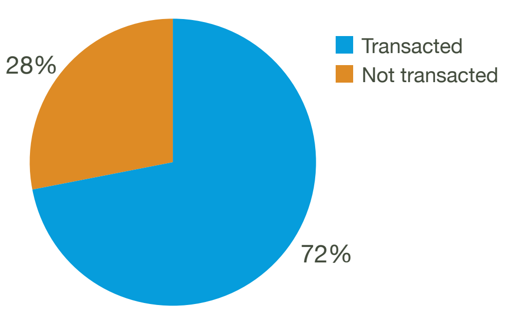
Premium Paid by Strategic Vs. Financial Buyers



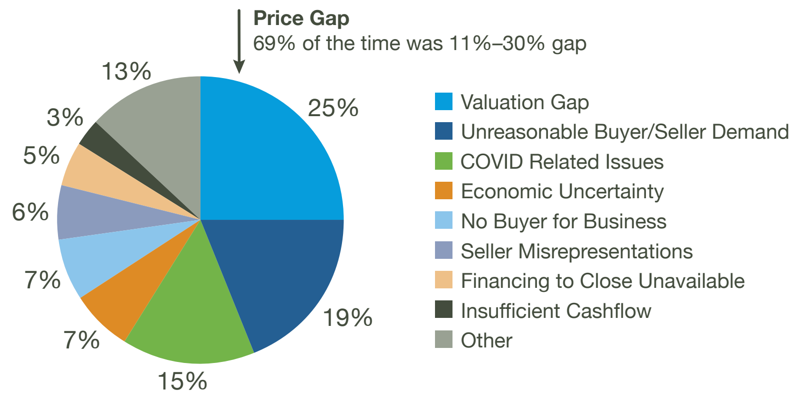
Source: Pepperdine Private Capital Markets Report

If you embarked on a sale or acquisition process in 2022, odds are that the transaction did not close approximately a quarter of the time. Not surprisingly, the predominant reason for deals not closing were, Buyer/Seller misalignment on valuation expectations, but COVID related issues remained in the top 3.

Deals Closing



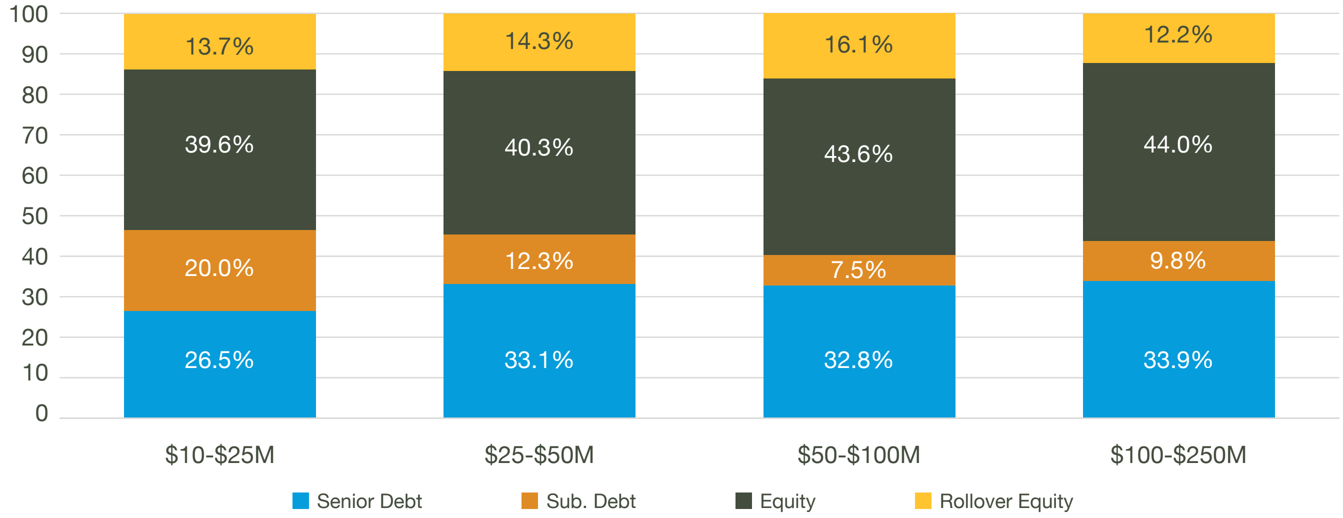
Reason for not Transacting



Source: Pepperdine Private Capital Markets Report

If you sold your company to a Private Equity (PE) Buyer in 2022, the chart below reflects the common breakdown for how PE funded the transaction. 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

Historically, the cost of capital has driven changes in the business transfer cycle.

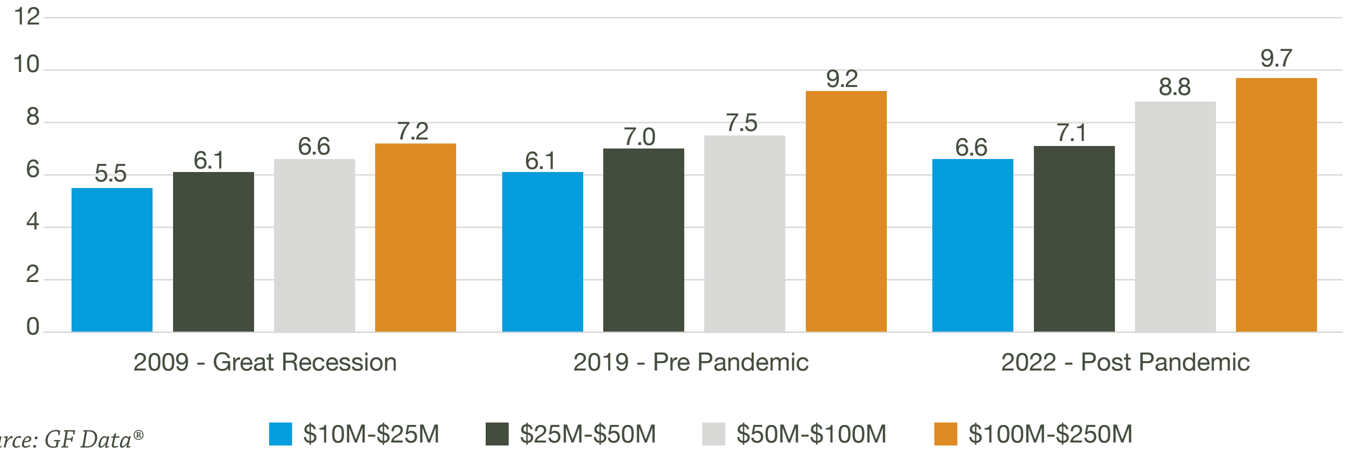
Rising interest rates have been a catalyst, moving us from a pure ***Seller's*** market to a ***Neutral/Buyer's*** market. Some businesses will capture full value in a sale and others not. Not ALL businesses will trade at premiums, only GOOD ones. It remains to be seen how future cycles unfold given current macro-economic circumstances.

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 – 2021**	**2022 – 2023**
? – ?	**? – ?**	**? – ?**

Source: Rob Slee - Private Capital Markets

Expectations for 2023

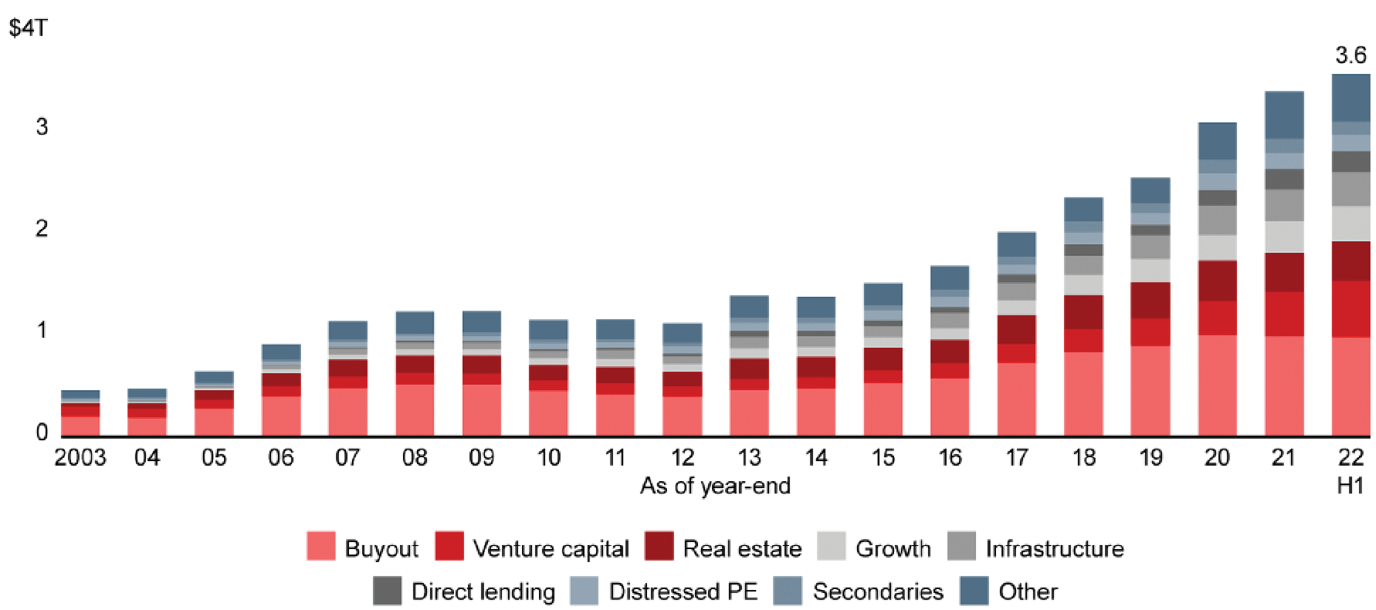
A recession may have some impact on higher valuation businesses where significant lending is involved; otherwise, valuation multiples of EBITDA stay healthy. When we look back at the data set from the great recession of 2009, we can envision a worst case scenario; however, a recession in 2023 is not predicted to be anything like the 2009 recession. With that, we do not expect meaningful downward pressure on lower middle market multiples.



Source: GF Data®

For Financial Buyers, we expect M&A to remain **necessary**, even as borrowing rates rise. The amount of funds raised but not invested (dry powder) continues to grow, putting pressure on Financial Buyers to do deals or risk performance issues with their funds.

Global Private Capital Dry Powder (by Fund Type)



Source: Preqin

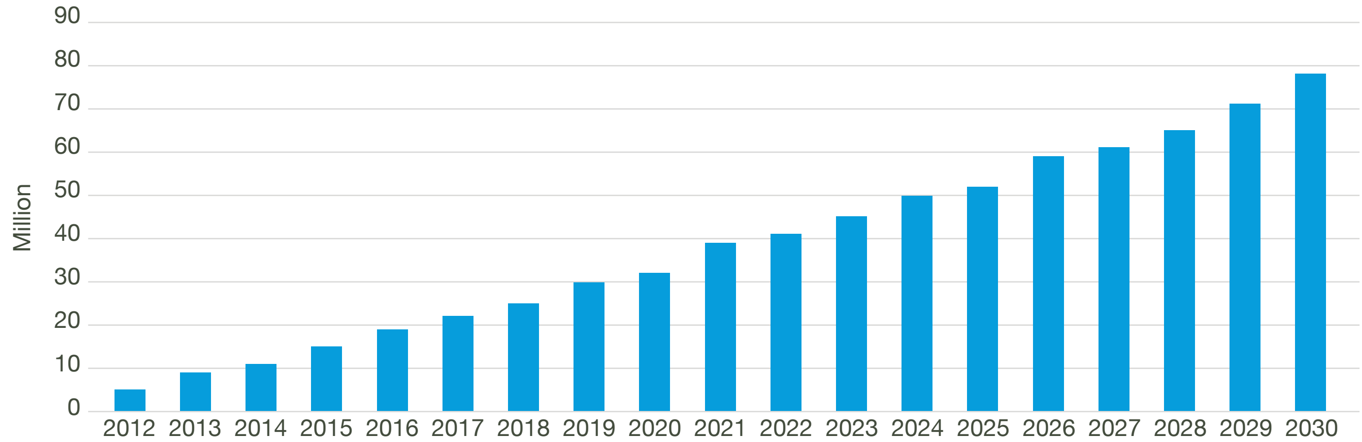
For Strategic Buyers, the appetite for acquisitive growth remains strong. According to a recent EY CEO survey, 63% of CEOs surveyed plan to do M&A in 2023.

Do you expect to actively pursue any of the following transaction initiatives over the next 12 months?

Source: January 2023 EY CEO Survey

The #1 reason for lower middle market business to transact is retirement. We see no slowing in that activity for a number of years.

Baby Boomers Over 65: 2012 - 2030(e)



Source: Mauldin Economics © 2017

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.

Pursant

INSPIRED PURSUIT

847.229.7000 | info@pursant.com | www.pursant.com