Q4 2023 EDITION

Pursant
INSPIRED PURSUIT

DEAL insider

M&A and Strategic Transaction Insights

THE INVESTMENT BANK THAT ALSO BUILDS THE VALUE OF YOUR BUSINESS

Q4 2023 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 $500M.

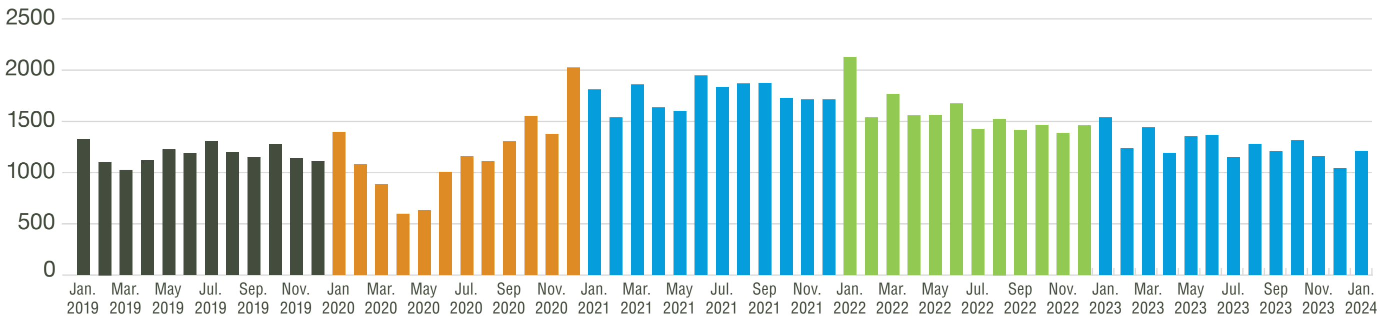
The first half of 2023 was marked with a more conservative posture from Buyers as they contemplated the timing and potential magnitude of a recession and the impact of rising interest rates. The recession never came to be and the Fed finally stopped raising rates, sparking an increase in M&A appetite in the second half of the year.

Due to a continued strong economy, 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 in most sectors, so their desire to transact remained intact, but even with these market-favorable conditions for half of 2023, lower middle market activity for the year was down nearly one third from 2022.

Looking closer at the 2023 M&A activity trends:

1. Overal, 2023 M&A activity levels closely mirrored 2019 pre-pandemic levels.
2. As uncertainty around the fate of the macroeconomy festered in 2023, M&A activity ratcheted down, leveling off mid-year as rate hikes paused and fears of a major recession abated.
3. Looking at 2023 vs. 2022 activity by deal size:
   - Deals $25M-$500M were down ~ 30%
   - Deals $10M-$25M were down over 40%
   - Deals under $10M were down 26%

2019-2023 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.

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 scary predictions for the 2023 year, the broader economic environment remained healthy and conducive to getting deals done.

Some notable deal-Impacting macroeconomic conditions we watch:

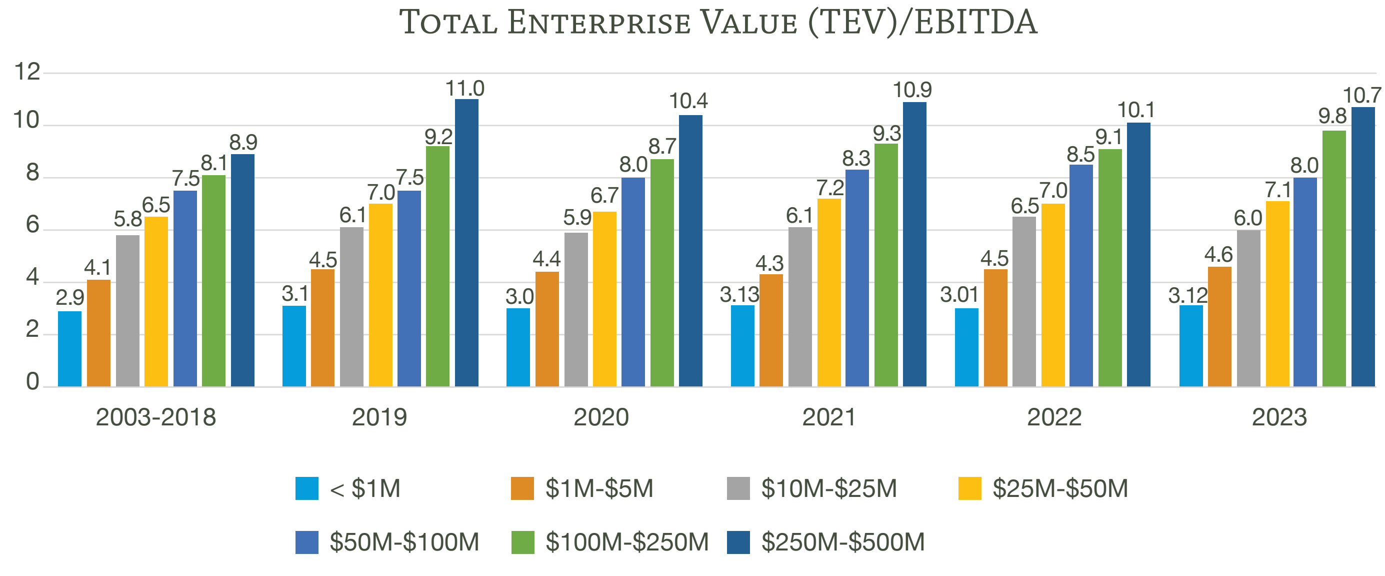
1. **GDP –** The US economy expanded an annualized 3.2% in Q4 2023, following a 4.9% rate in Q3. Considering full 2023, the US economy grew 2.5%, compared to 1.9% in 2022. Healthy GDP growth bodes well for M&A activity.

2. **Inflation –** The annual inflation rate in the US went up to 3.4% in December 2023 from a five-month low of 3.1% in November, higher than market forecasts of 3.2%. Annual core inflation rate eased to 3.9%, below 4% in the previous period but above expectations of 3.8%. While inflation made a steady decline, the Fed remained concerned and committed to holding interest rates at this elevated rate until inflation had further abated. This higher interest rate environment keeps M&A borrowing costs elevated and some Buyers on the sidelines.

3. **Interest Rates –** The Fed Funds rate finished the 2023 year at 5.5% up 100 basis points from year-end 2022 and 500 basis points from year-end 2021, pushing borrowing costs to their highest level since 2007. Despite the markedly higher cost of capital, meaningful downward pressure on lower middle market multiples was not seen. Expectations are that rates will start their decline in 2024, which is expected to fuel increased M&A activity, but exactly when in 2023 is uncertain.

4. **ISM Purchasing Managers Index (PMI) –** The ISM Manufacturing PMI in the US finished the year at 47.4, better than market forecasts of 47.1. Still, the reading pointed to the 14th month of contraction in factory activity, prolonging the most extended period of declining activity since 2000-2001. Americans are spending more on services than goods. A PMI reading above 50 percent indicates that the manufacturing economy is generally expanding; below 50 percent indicates that it is generally declining.

Overall, Lower Middle Market 2023 valuation multiples for deals under $500M in enterprise value were down slightly compared to 2022 at an average of 7.3x EBITDA vs. 7.6x in 2022.



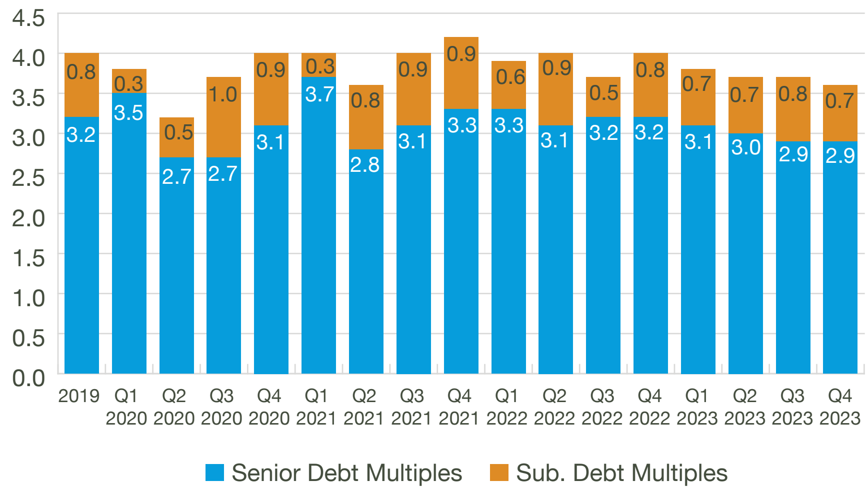
Source: Pepperdine Private Capital Markets and GF Data

Lenders Remained Eager to Fund M&A in 2023

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) borrowing for M&A still ~ 4x EBITDA or approximately 50% of the deal
- Senior Debt availability by EBITDA
  - 1.5x for $1M EBITDA
  - 2 x for $5M EBITDA
  - 3x for $10M EBITDA
- Top 5 Reasons for Declined Loans
  - #1. QoE/cash flow
  - #2. Too much Buyer debt
  - #3. Insufficient collateral
  - #4. Customer concentration
  - #5. Company too small

Total Debt/EBITDA

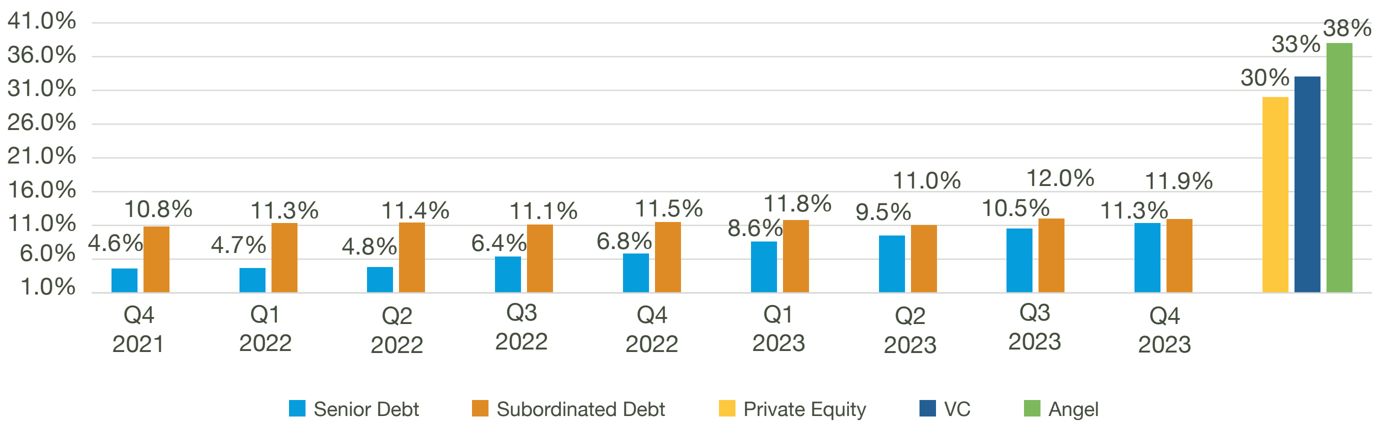


Source: GF Data®

The chart below shows how last year's Fed rate increases not only moved rates to more than double that of year-end 2021, but also pushed rates to near parity with subordinated lenders. Regardless, pricing was not high enough to deter Buyers from borrowing aggressively to get deals funded. For many, especially Private Equity, higher interest rates are the lesser evil when compared to not doing deals at all. Also when compared to the cost of equity, ranging between 30 and 40% expected return rates, debt is much cheaper.

M&A Interest Rates Vs. Expected Investor Returns

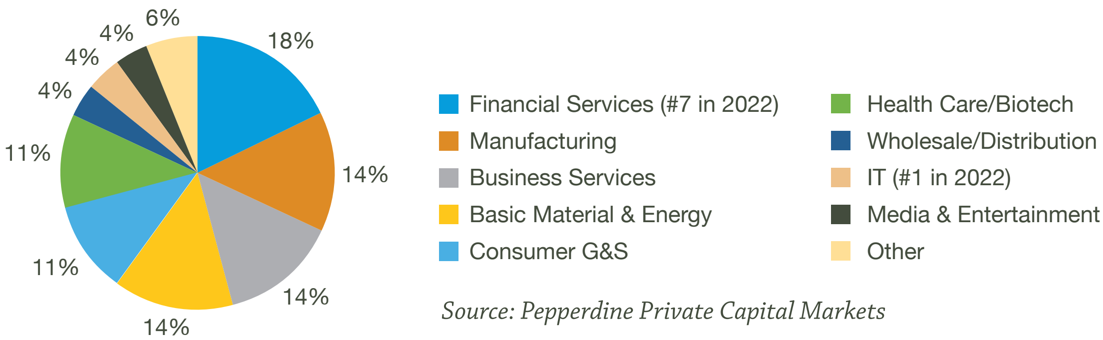
Interest/Return Rates by Investor Type



Source: GF Data & Pepperdine Private Capital Markets

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. Note that IT dropped significantly from the #1 spot in 2022 to #8 in 2023.

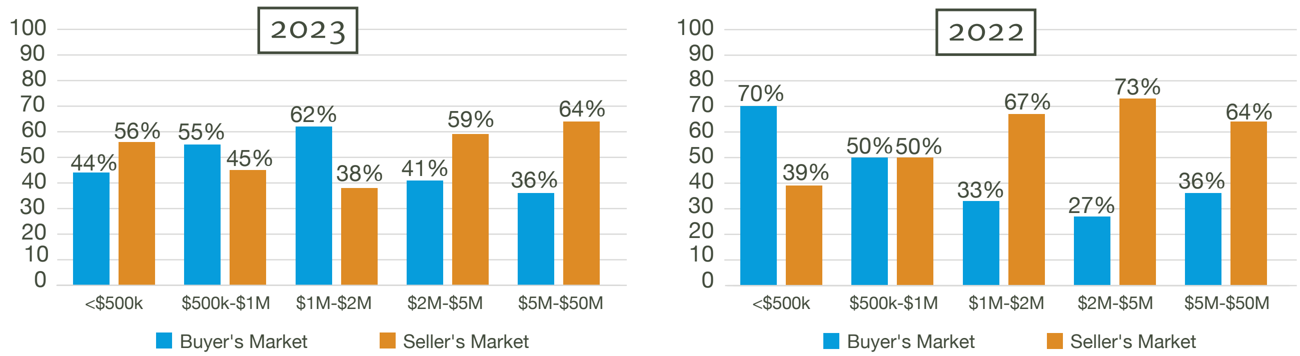
Sectors with Best Risk/Reward Trade-off



Source: Pepperdine Private Capital Markets

When comparing broker survey results from 2022 to 2023 we see signs that with the exception of very small and larger broker-sized deals, sentiment is that sentiment has shifted in favor of the Buyer.

Buyer's or Seller's Market by Transaction Value



Source: Pepperdine Private Capital Markets

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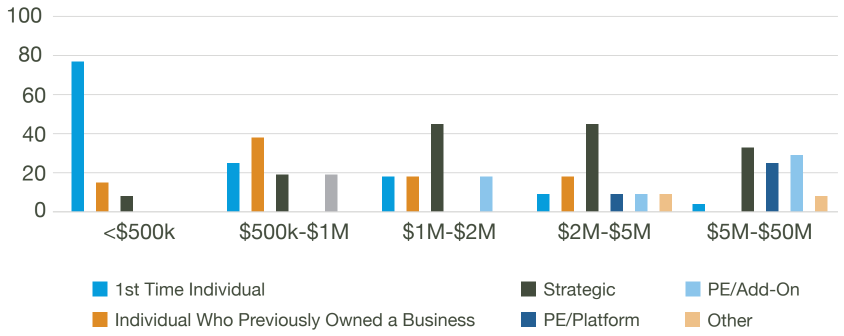
Who are the Buyers (sorted by TEV)?

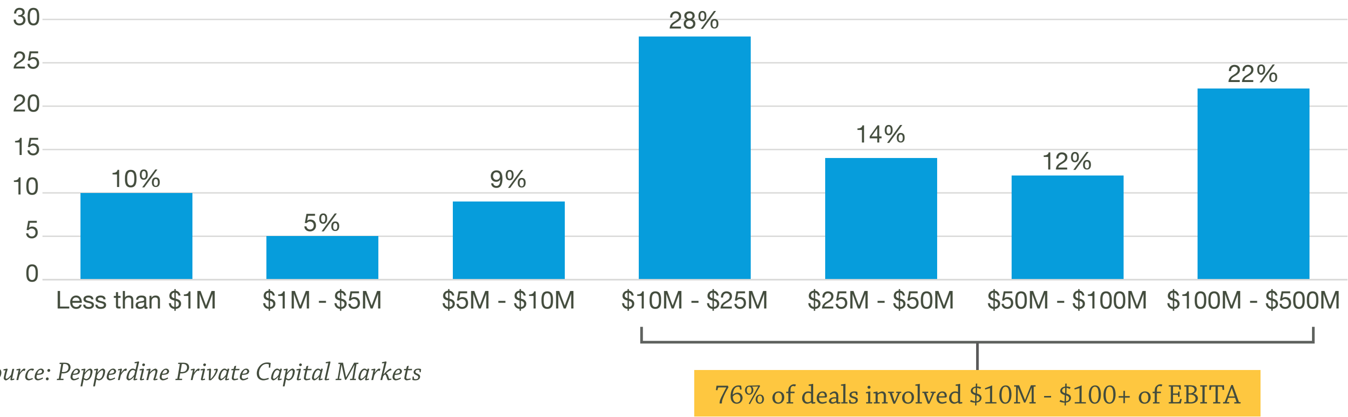
- *Strategics still buying across the size spectrum*
- *PE willing to do smaller add-ons in 2023 as they required less expensive capital, but platform deals don't generally happen under $10M+ in Purchase Price*
- *Smaller PE oriented deals increasingly being done by independent/fundless sponsors (individuals backed by investors)*



Source: Pepperdine Private Capital Markets

As mentioned earlier, private equity does not generally transact with smaller businesses. The chart below provides more visibility into the size ranges more appealing to private equity.

Private Equity Investment Size (EBITDA)

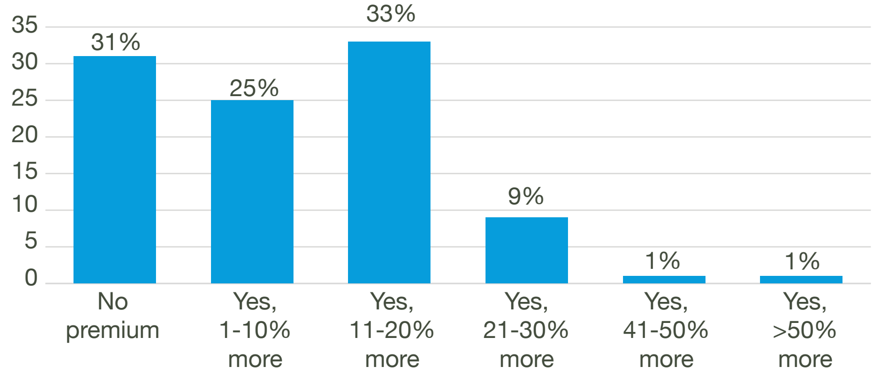


Source: Pepperdine Private Capital Markets

Putting aside the potential significant value that can come with cashing in on the "second bite of the apple" scenario available through transacting with 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.

Premium Paid by Strategic Buyers VS. Financial Buyers

- *In 2023, 51% of deals involved Financial Buyers, same as 2022*
- *In 2023, 69% of Strategic Buyers paid a premium over Financial Buyers vs. 59% in 2022*
- *In 2023, 25% of the time Strategics paid a 1%-10% premium vs. 14% in 2022*
- *"Second bite of the apple" puts PE into to a position to potentially pay more over time*

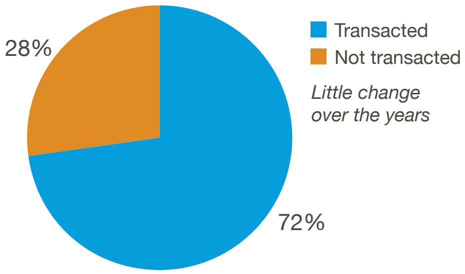


Source: Pepperdine Private Capital Markets

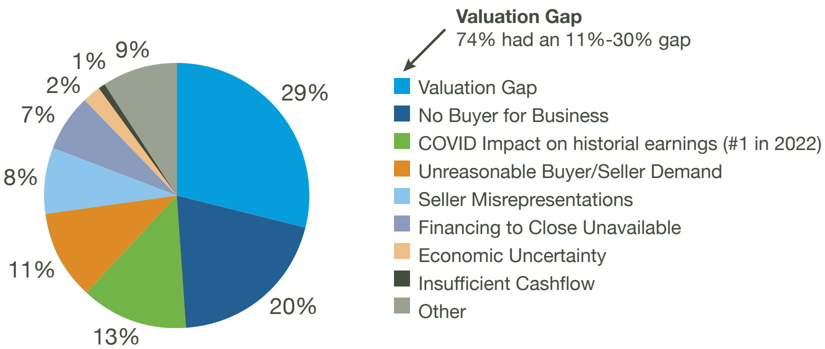
If you embarked on a sale process in 2023, odds are that the transaction did not close approximately a quarter of the time. the predominant reason for deals not closing was Buyer/Seller misalignment on valuation expectations, but COVID related issues remained in the top 3, mostly related to how covid causes lack of clarity around historical results.

Will the deal close?

Deals Closing



Reason for not Transacting



Source: Pepperdine Private Capital Markets

Phases Of The Business Transfer Cycle

For decades, the cost of capital has driven **marked** favorability changes in the business transfer cycle. That has not been the case in 2023.

Rising interest rates have historically been a catalyst to moving the market from a ***Seller's market*** to a ***Neutral market*** and then ultimately a ***Buyer's market***. Rising interest rates historically cause a drop in activity and valuation multiples. That has not been **entirely** the case in 2023.

We finished 2023 in what could be characterized as a Neutral market. The sharp increase in the cost of capital did not push us into what many where expecting to be a pure Buyers market. The strong economy, cash strong corporate balance sheets and abundant PE dry powder kept us from tipping into that pure Buyers 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 – 2021	2022 – 2023

Source: Rob Slee - Private Capital Markets

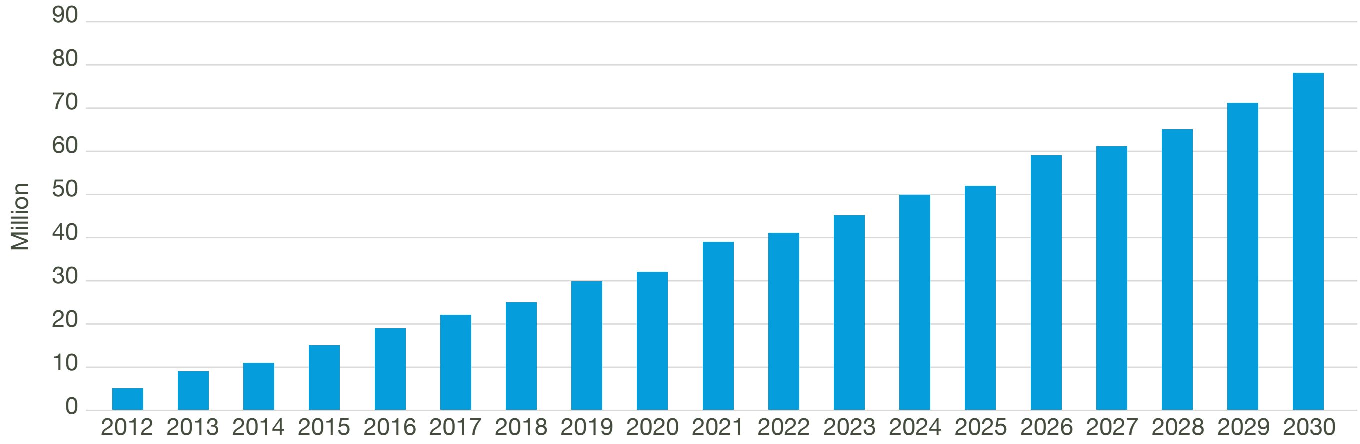
Expectations For 2024

1. Improving economy over 2023 (Only 21% of recently surveyed CEOs felt 2024 would be worse)
2. Interest rates expected to fall, making borrowing for M&A more affordable, increasing Buyer activity
3. Disparity in valuation multiples narrowing with less inflation, financing costs and less overall macroeconomic uncertainty, increasing deal closing rates
4. Private Equity sitting on over $1Trillion in dry powder and many portfolio companies overdue for monetization (2/3rds recently surveyed by EY said dealmaking higher in 2024 than 2023)
5. Many parties motivated to transact in an election year due to uncertainty in tax policy the following year
6. Recent Citizens Bank survey of 400 CEO's showed valuations in 2024:
   - 38% felt valuations would increase
   - 43% felt valuations would stay the same
   - 19% felt valuations would decrease
7. Same Citizens Bank survey showed the following market favorability:
   - 36% felt it would be a Buyer's Market
   - 31% felt it would be a Seller's Market
   - Balance felt it was neutral

Expectations For 2024

#1 Driver of Small Business and Lower Middle Market M&A (Retirement) cannot be stopped (In 2024, over $4M people will turn 65, the most ever in one year!)

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.

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