Aramar Capital Group, LLC

Deal Market Perspective

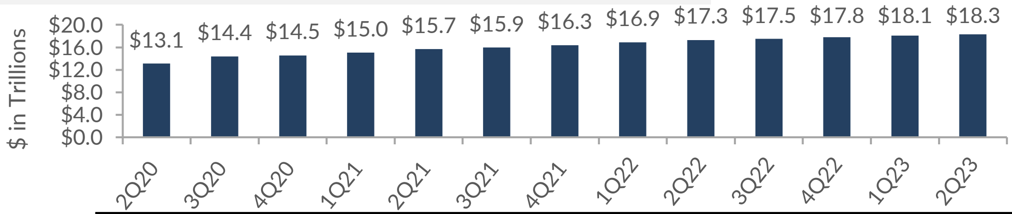
2nd Quarter 2023

Economic Overview

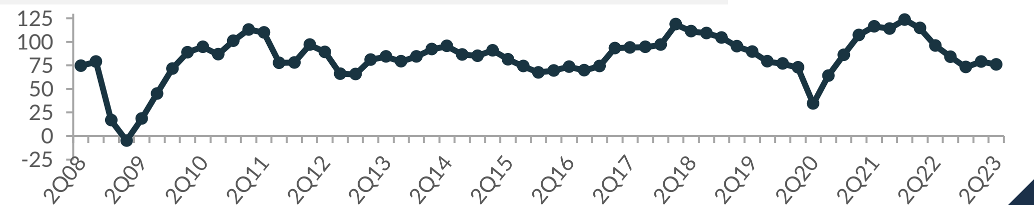
The U.S. economy continues to exhibit resilience despite ongoing recession fears and rising interest rates. The so-called soft landing we all hoped for shows signs of becoming a reality. But Fitch's threw some cold water on the party by downgrading the U.S. government credit rating. Still, inflation seems to be abating, employment remains strong, and the Fed may pause rate hikes, as the (steamy) summer winds down and eyes have turned toward presidential and Congressional budget skirmishes (and Barbenheimer).

- U.S. GDP increased at a 2.4% seasonally-adjusted annual rate in Q2 2023, an acceleration from the 1.1% rise seen in Q1 2023[1]
- At the end of Q2 2023, the U.S. unemployment rate was 3.6%, up slightly from 3.5% in Q1 2023 (the level to which it returned at the end of July)[2]
  - Because of the tight labor market and state ballot initiatives, the effective national minimum wage — a weighted average of state minimum wages, adjusted for inflation — has risen to nearly its highest level in 40 years[3]
- The International Monetary Fund raised its outlook for global economic growth to 3.0% for 2023, up from its 2.8% projection last quarter, but still below the 6.1% and 3.2% levels in 2021 and 2022, respectively[4]
- Core CPI — which excludes food and energy — rose a seasonally adjusted 5.3% over the past 12 months; the 0.2% gain in June marked the first time in the past six months that the monthly gain was below 0.4%[5]
  - Food price inflation remains a concern due to disrupted exports, unusually hot weather, and increased pounding of grain production and shipping facilities in Ukraine[6]
- The Federal Reserve raised interests by a quarter of a point in July to a target range between 5.0% and 5.25%, the 11th rate hike in its past 12 meetings, and left room for a pause or another increase in September[7]
- Fitch Ratings downgraded the U.S. government's credit rating from AAA to AA+, the first downgrade by a major ratings firm in more than a decade[8]
  - Fitch expects the U.S. economy to slip into a recession and the government deficit to rise to 6.3% of GDP in 2023, up from 3.7% last year, reflecting weaker federal revenues, new spending initiatives, and higher interest costs
- Americans have about $500B in so-called excess savings above what would be expected had pre-pandemic trends persisted; these savings could likely support consumer spending late into this year[9]
- Consumer and business behavior changes due to the pandemic and economy are adversely impacting many sectors
  - Private-label brands had an 18.8% share of center-aisle groceries by unit sales in the 52 weeks through June 30th, up from 17.9% in the same period a year earlier and reversing two years of declines[10]
  - In 2019, almost 95% of New York City and 85% of Chicago corporate lunch orders came from their business districts; this year the share is down to around 85% and 60%, respectively[11]
  - About a fifth of all malls financed through commercial mortgage-backed securities are underwater; $14B of loans are coming due in the next year[12]
- Generative AI could add $2.6T to $4.4T to the global economy, automating 60% to 70% of all work tasks[13]
- The U.S. consumer confidence index rose in Q2 2023, finishing the quarter at 117.0; it now stands at the highest level since July 2021[14]
- Business Roundtable's CEO Economic Outlook Survey, a composite index of CEO expectations for capital spending, hiring, and sales over the next six months, decreased three points from last quarter to 76, making it the fourth consecutive quarter at or below the long-run average of 84[15]

U.S. Consumer Spending (Annualized)[1]



Business Roundtable's CEO Economic Outlook Index[15]



1. *Bureau of Economic Analysis*
2. *Bureau of Labor Statistics*
3. *The New York Times*
4. *International Monetary Fund*
5. *U.S. Department of Labor*
6. *The Wall Street Journal*
7. *Federal Reserve Bank*
8. *Fitch Ratings*
9. *Federal Reserve Bank of San Francisco*
10. *Nielsen*
11. *Grubhub*
12. *Moody's Analytics*
13. *McKinsey Global Institute*
14. *The Conference Board*
15. *Business Roundtable*

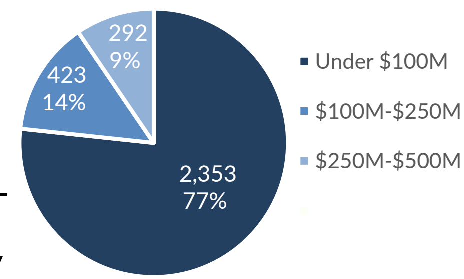
Mergers and Acquisitions

M&A activity remains tepid, largely because of higher interest rates and buyer caution due to economic and geopolitical issues, but also because of a paucity of potential sellers, many of which are experiencing lower profits but not adjusting their sale price expectations. Given the high amount of cash available to be deployed and the prospect of favorable quarter-to-quarter earnings comparisons for many private companies over the balance of the year and into Q1 of 2024, deal volume could pick up handsomely.

- North America (N.A.) M&A deal value was $466.5B and volume was 4,276 in Q2 2023, representing a 29.0% decrease in value and a 5.6% slide in transaction count as compared with Q2 2022[1]
  - The disconnect between buyer and seller valuation expectations, higher financing costs, and tighter credit availability relative to the same period in 2022 all restrained deal activity
  - Banking sector turmoil that lingered into May created an additional headwind for dealmaking, as buyers hoped to find distressed sellers, and sellers hunkered down for the storm's passing
- Acquirers are marking time until headwinds fade, with plenty of deals getting announced, just smaller ones, resulting in a stalemate between near-record corporate/private equity dry powder and stubbornly high interest rates[1]
- U.S. non-financial companies are sitting on over $1.76T of cash, with much of it held by technology, automotive, and healthcare companies[2]
- M&A-related leveraged loan issuance decreased to $13.2B in Q2 2023, down 76.0% from Q2 2022[3]

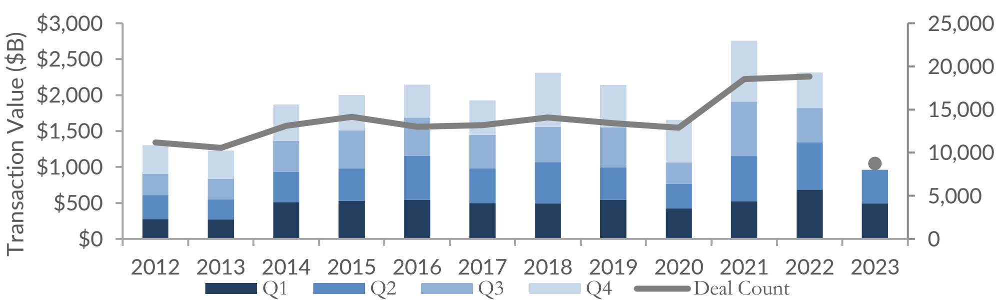
- Dealmaking in Q2 2023 was again dominated by smaller transactions, as 77% of the sub-$500M U.S. M&A market was accounted for by transactions under $100M, up from 75% in Q2 2022[4]
- The share of M&A deals with founder-owned companies as targets reached 61.5%, according to the most recently available quarterly data, a 15-year high, and the share of total deal value increased from 31.3% to 43.5%[1]

Q2 2023 U.S. M&A <$500M[4]

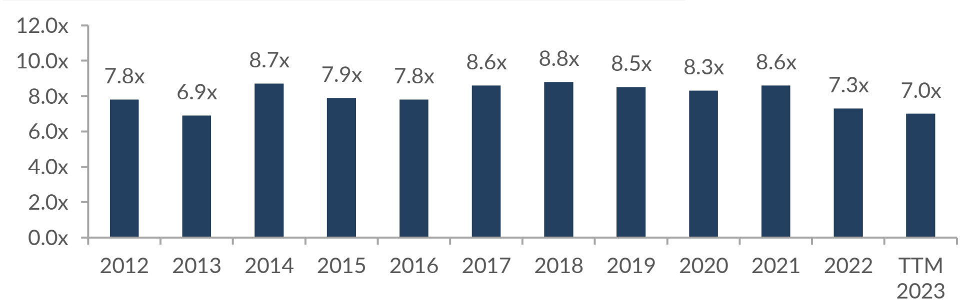


- Purchase price multiples for global M&A transactions are in correction mode, down 24.0% based on revenue multiples and off 16.2% based on EBITDA multiples from the 2021 peak[1]
  - The decline in multiples might be surprising given the strong rally in public markets, where multiples are back to lofty levels (3.3x revenues based on the S&P 500), but the M&A market is notoriously slow to catch up to the whipsaw action of public markets, both on the way up and down
- The median trailing 12-month N.A. middle-market M&A EV/EBITDA multiple in Q2 2023 for deals between $1M and $200M fell to 7.0x, down from 7.3x in 2022[1]
  - A clear relationship between purchase price multiples paid and size emerged, with valuations stepping down for smaller companies and bolt-on deals, in particular for transactions below $500 million

N.A. M&A Activity [1]



N.A. Middle-Market EV/EBITDA M&A Multiple[1]



1. *PitchBook*
2. *Moody's Investor Service*
3. *S&P Capital IQ*
4. *FactSet*

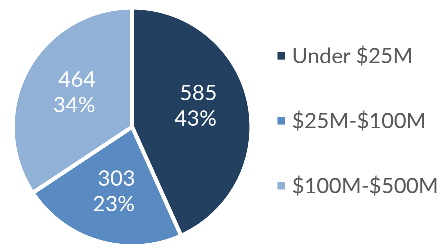
Private Equity

Private equity (PE) transaction activity also has been relatively slow and investment holding periods have lengthened because of tighter and higher-cost credit and fewer attractive exit opportunities. Dry powder remains lofty despite fundraising challenges caused by the so-called denominator effect and general investor caution. This pent-up capital waiting to be deployed along with the backlog of potential sellers awaiting upturns in performance should boost dealmaking later in the year and early in 2024, with a likely continuation of the trend toward more contingent purchase price consideration to share risk and reward.

- U.S. PE investment activity slowed in Q2 2023, with 1,383 closed deals worth a combined $191.2B, representing a 34.3% decline in volume and a 36.1% decrease in value as compared to Q2 2022[1]
- The industry continues to battle through a stubbornly high interest-rate environment that makes the cost of borrowing and servicing floating-rate debt prohibitively expensive for deals that might otherwise get done[1]
  - Across North America, interest costs at the median PE-backed company ballooned to 43% of EBITDA last year, six times as much as the median S&P 500 company[2]
  - The average loan-to-value ratio for LBOs has fallen to 43% this year, down from the five-year average of 52%[1]
- So far this year, U.S. PE-backed deals have an average value of $65.9M, the smallest for the comparable period since the global financial crisis[3]
  - Smaller takeovers and add-on deals are in vogue, because they often require little or no debt and allow firms to keep investing despite the tougher economic backdrop

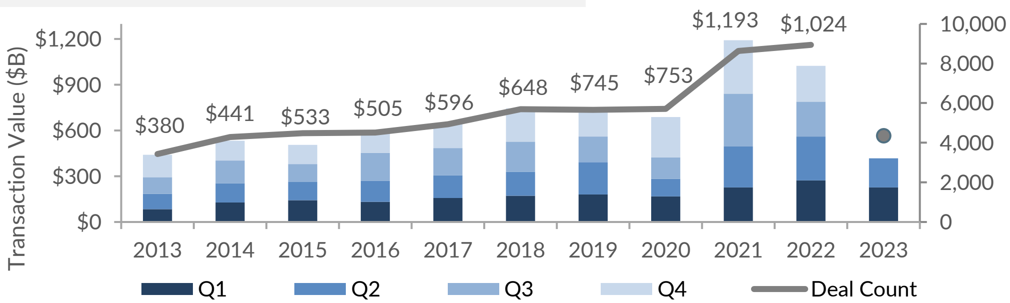
- Add-on investments continue to drive the U.S. PE market, accounting for 59.0% of all deals in Q2 2023[1]
- For U.S PE-led transactions between $10M and $250M, the average EV/EBITDA multiple was 8.0x, according to the most recently available quarterly data, rebounding from the 6.9x average recorded in Q4 2022[4]

Q2 2023 U.S. PE Deals <$500M[1]

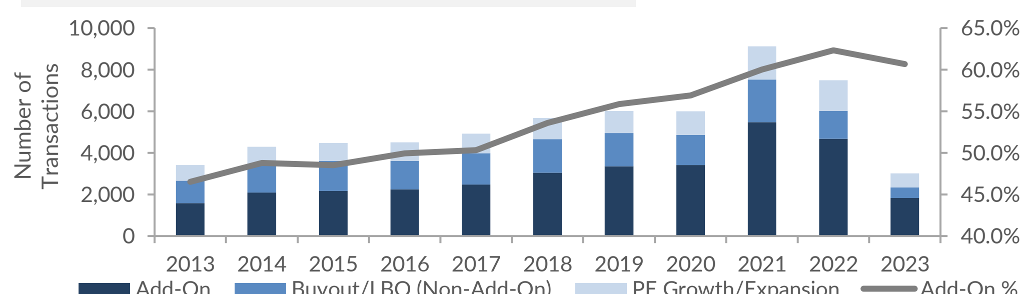


- Middle-market funds ($100M to $5B in size), have outperformed megafunds for three consecutive quarters, with the gap widening to 917 basis points based on median one-year horizon returns[1]
- Global PE dry powder surged to $2.49T in Q2 2023, up from $1.86T in Q2 2022, as sluggish dealmaking limited opportunities for the deployment of uncommitted capital[5]
- U.S. PE fundraising declined in Q2 2023, with $86.2B raised across 87 funds, a 22.5% decrease in capital raised and a 6.5% reduction in the number of new funds raised as compared to Q2 2022[1]
  - Fund performance, while still handily ahead of most asset classes and strategies on a 10-year basis, has fallen to the middle of the pack on a one-year horizon basis
- U.S. PE exit activity is down 4.4% by deal enterprise value and 11.5% by volume in Q2 2023 relative to Q2 2022, with 289 exits worth a combined $87.3B[1]

U.S. Private Equity Deal Flow[1]



U.S. Private Equity Deal Activity by Type[1]



1. *PitchBook*
2. *Verdad Advisers*
3. *Refinitiv*
4. *GF Data*
5. *S&P Capital IQ*

Equity markets have been strong, as investors have been increasingly buying into the prospect of a continued strong economy with ebbing inflation. There are signs of life in the IPO market with the recent issuances by Cava and Oddity Tech and planned ones by Arm, Birkenstock, and other unicorns (including many related to the AI sector). But high P-E ratios, tighter and more costly credit, and softer venture capital (VC) markets all lurk as possible roadblocks, as do cash shortfalls at many startups (see the guest article on the ensuing page for more on this topic).

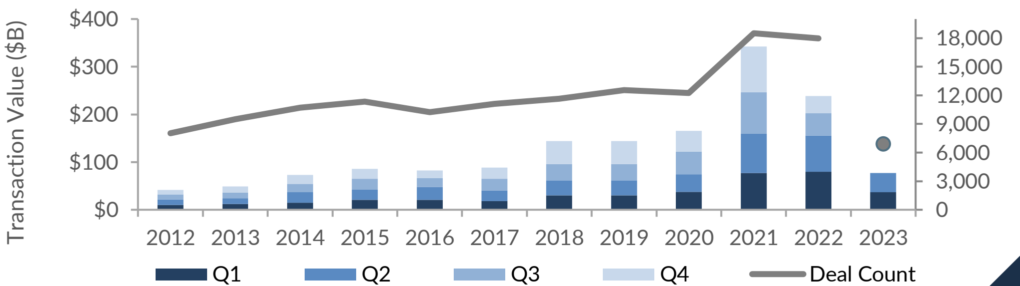
Equity Markets

- Despite low market volatility and strong stock performance in certain major financial markets, IPO activity declined from the previous quarter; Q2 2023 saw 310 global IPOs raising $39.0B, decreases of 3% and 5%, respectively, on a year-over-year basis[1]
  - While deal numbers have remained on almost the same level as YTD 2022, global IPO proceeds raised were down more than 30%, as fewer mega IPOs were launched[1]
  - Companies going public in the U.S. through traditional IPOs raised just $9.1B in the first half of 2023, far below the $27.0B average for the same period over the past decade[2]
- The S&P 500 was up 17.6% year-over-year at the end of Q2 2023[3]
  - This rise occurred despite the fact that earnings growth for S&P 500 companies in Q2 2023 dropped significantly, with a blended rate of -7.3%, marking the largest earnings decline reported by the index since Q2 2020[4]
- Despite broader stock indexes' gains, shares of companies that went public in recent years are struggling, casting a shadow on the IPO market[2]
  - Class of 2020 IPOs are down an average of 34% from their listing prices, the class of 2021 has fallen 46%, and last year's IPO class is off 49%
- U.S. VC deal value fell 48.1% to $39.0B in Q2 2023, while deal count dropped 33.5% to 3,011 transactions, relative to Q2 2022[5]
- There are now 50,000 VC-backed companies, double the 2016 level, demonstrating the risks of a prolonged capital shortage[5,6]
  - The pressures facing late-stage startups are appearing earlier in the venture lifecycle; the median early-stage valuation for U.S. VC-backed companies has declined 20% this year to $39.8M, following two years of rapid growth[5]
- Pre-money valuations for venture growth-stage companies fell to a median of $90M, a nearly 75% decline from the 2021 full-year record high of $355M[5]
  - In 2022, 26.2% of all U.S. venture funding rounds included an investment from a corporate VC investor, the highest such percentage ever recorded[5]
  - About 45% of some 1,100 companies that raised a seed financing round in 2017 never raised follow-on funding[7]
  - The proportion of flat and down rounds as part of all completed rounds rose for the fourth consecutive quarter, reaching 15.4%, according to the most recently available data[5]
- The value of startup exits — a sale or public offering — plummeted to $5.5B in Q2 2023, a 69.2% drop on a year-over-year basis[5]

Debt Markets

- The 10-year yields at quarter-end on U.S. investment-grade and high-yield bond indices continued to rise with the tightening of monetary policy, earning investors 3.82% and 8.79%, respectively[3]
- Roughly half the risky bonds that companies have used to fund themselves will need to be refinanced by the end of 2025[3]
- For PE-led transactions between $10M and $250M, the average total debt/EBITDA multiple was 3.4x, according to the most recently available data, well below the 3.9x to 4.1x range that existed pre-pandemic[8]
- Refinancing volume accounted for much of the U.S leveraged loan market in Q2 2023, at $31.6B, or 63.0% of the total[5]
  - The U.S. leveraged loan market has been plagued by tightening credit conditions, a languishing M&A pipeline, and rising debt costs from rate hikes that came at the fastest pace in decades

U.S. Venture Capital Deal Flow[5]



1. *Ernst & Young*
2. *Dealogic*
3. *S&P Capital IQ*
4. *FactSet*
5. *PitchBook*
6. *National Venture Capital Association*
7. *Carta*
8. *GF Data*

Cash is King: How a Capital Strategy Can Enable Today's Startups to Survive

Thus far, 2023 has proved to be challenging for many cash-conscious startups, especially those that anticipated raising venture capital in the first half of the year. As the Federal Reserve continues to increase interest rates in an effort to curb high inflation, choppy public markets and fears of a looming recession have made many investors hesitant to deploy new capital. Such fears have largely quelled the pandemic era of high valuations and easy access to cash for startups. During the "good times" of the past few years, many startups (including those with relatively limited track records) and their founders were able to access venture debt to bolster balance sheets and extend cash runways without the dilutive effect of raising investor money. However, bank failures have significantly impacted the venture community, upending access to venture debt facilities. Although there are a few bright spots (like artificial intelligence and climate tech), with private company valuations falling, lower availability of venture debt, and a dormant IPO market, we expect startups will need to further preserve cash and resources to navigate the expected continued rocky terrain ahead. Here are some measures that startups should consider in the near term:

Clear Cash Flow Projections

Startups should optimize their balance sheets and scrutinize all accounts receivable and accounts payable. Startups should send routine reminders of all outstanding debts to any customer that is delinquent on payments and should do so until such debts are fully paid. To the extent possible, companies should ensure that all accounts payable are paid on time and in full to avoid any unnecessary late fees or interest payments. Startups should make sure their financial systems are accurately capturing all transactions to ensure the management team can make financial decisions confident in the fidelity of company cash flow and obligations. Further, companies should take a conservative approach when modeling expected cash flow projections over the next few months or quarters. These steps will allow a company to get a true understanding of its current cash position and help provide clarity on what can be scaled back, if necessary.

Reduce Cash Burn

Startups should look for ways to reduce their monthly spend and extend their cash runway. Companies may want to consider the following:

Remote Work: Consider whether it is important for the business that the team be in a central location or whether a remote workforce or a hybrid of both makes more financial sense. The pandemic has proven that, in some instances, a remote workforce is more efficient and cost effective than a workforce that reports to a central location on a daily basis. Commercial rents are expensive, especially in big cities, and oftentimes drive up a company's budget. Removing expensive rents from a company's budget could be a pivotal cash-saving move. Of course, startups will need to weigh the impact of going remote on company culture and measure any financial (and nonfinancial) costs associated with shifting to a remote workforce. Many fully remote companies have increased company off-sites and other gatherings to preserve company culture. The costs of these events are sometimes not well understood when a company decides to shift to a remote workforce.

Review Critical Talent Needs: Assess staffing needs and determine which positions are absolutely critical to maintain business operations. Consider scaling back positions that are not critical to the business and/or reassigning employees to duties that are more impactful to the business. Companies may also consider (i) renegotiating employee compensation and offering employees more equity and less cash compensation, which many startups are already inclined to do, (ii) moving some employees to a part-time schedule, (iii) furloughing noncritical employees for a period of time as the company navigates the current economic conditions, and (iv) laying off employees in noncritical departments. Of course, companies should consult qualified legal counsel before undertaking these steps to ensure compliance with the myriad of applicable employment laws.

Minimum Viable Product: Companies may also need to consider whether it is possible to bring their products to market faster than anticipated. Adopting a product iteration approach to product launch is well-worn territory, especially for tech startups, and having a working product will help balance sheets if early customer adoption can translate into early revenue.

Potential Sources of Funding

It is important that startups maintain frequent communications about their progress and financial position with current investors. These investors are already incentivized to help the company, as they have a financial stake in the company's survival. Existing investors may be persuaded to inject fresh capital to extend the runway of a portfolio company they have strong ties to and may ask peers to do the same. These same investors may also have other suggestions that could be helpful and/or make introductions to potential new customers or investors. Companies can also extend their cash runway in the near term by obtaining funding from conventional or alternative sources, such as those detailed below.

Extensions or Flat Rounds: Startups may consider extending the terms of their last financing round or even doing a new round at the same price as their last round. While this would dilute current shareholders, it may be a viable option for companies that need to shore up their cash positions.

Bridge Rounds: Startups should also consider bridge rounds of financing. A Simple Agreement for Future Equity (SAFE) or a Convertible Note could be a path to a quick cash injection with relatively low legal fees. SAFE and Convertible Notes have fewer terms to negotiate with investors, thus reducing the negotiation time and also allowing companies to delay setting a valuation on the company (which is often the subject of much negotiation).

Venture Debt: While some of the most prominent and well-known venture debt lenders have pulled out entirely or scaled back their venture loan activity, there are a number of other banks that offer venture debt services for startups that could be explored, and new product offerings seem to be popping up from other lenders on a regular basis. Companies are well advised to speak with their banking partners, legal counsel, and financial advisers to understand what options may be available.

Government Grants: There are a number of research-based government grants that startups can apply for that can potentially provide a necessary cash injection. Some state governments, such as New York, have announced programs that provide matching investment funds for startups that qualify. Similarly, certain financial institutions have pools of capital targeting underrepresented founders and communities.

In the event that the current economic challenges remain constant or worsen over the next few months, many startups may be forced to take more austere measures. Negotiations between companies and investors will lengthen, and investors generally will be able to demand more investor-favorable deal terms. Before initiating any of the options detailed below, companies should consult qualified legal counsel and determine whether any investor rights (*e.g.*, blocking rights, voting rights, anti-dilution triggers, and pro-rata rights of others) are implicated or triggered by these options.

Extended Financing Rounds: The time between financing rounds could be longer than before, as investors may require (i) stringent due diligence and have less tolerance for deals outside the investor's risk parameters, (ii) stricter (*i.e.*, less company-favorable) deal terms, and (iii) lower valuations. Whereas in 2021 a company may have been able to close a Series A financing within one to three months, that same round may now take between three and six months.

Down Rounds: Companies may need to consider new rounds of financing where the pre-money valuation is lower than the post-money valuation of their prior round (known as a "down round"). Startups generally try to avoid down rounds because the lower valuation may imply that investors have lost confidence in the company and because investors are frequently protected from down round dilution. However, in some instances, a down round could be beneficial and may be a sacrifice that some companies and investors are willing to make to better the company's chances of surviving.

Consolidation: In times of economic uncertainty, many companies will consider consolidating with competitors to gain better market efficiencies, be better positioned to weather a financial downturn, and share costs. Companies that need additional funding should identify their well-funded competitors and consider approaching them as potential merger partners, and well-funded companies should evaluate the opportunity to target companies with interesting technology (or talent) with favorable valuations.

Sale: Many large companies earned and accumulated cash during the pandemic and have the financial resources to acquire startups and fund their operations until they become cash-flow positive. Existing investors may be able to recoup some of their capital in a sale or roll over equity in the hope of earning more in the future, and existing employees may be able to land in a more stable long-term environment.

Pivot or Wind Down: The unfortunate truth is that, even under the best economic conditions, most startups fail. Some startups will exhaust their cash reserves and be forced to suspend all operations and wind down. While this is not what founders and investors wished for the company, if identified early enough, it could be an opportunity for founders to pivot and redouble efforts to find product-market fit. Of course, some startups may be better served by shutting down completely and returning some of their investors' money rather than attempting to make a hard pivot and restarting the search for product-market fit.

Startups will need to implement elevated cash management, capital raising, and exit measures to withstand the current market tumult. Companies should fully understand their economic position, scale back where possible, and frequently communicate with their investors. Making decisions early, before the situation is critical, will often result in a better outcome. We know the terrain will be rocky, but the companies that can extend runway and lower their cash burn may be in the best position to survive.

By: Richard McDerby, Kalon Gutierrez, and Darren Bartlette, Manatt, Phelps & Phillips, LLP

About the Authors:

Manatt, Phelps & Phillips, LLP is a leading professional services firm, providing integrated legal and consulting services to a global client base. With offices in California (Los Angeles, Orange County, San Francisco, Sacramento, and Silicon Valley), New York City, Albany, Chicago, Washington, D.C., and Boston, the firm represents sophisticated clients — including Fortune 500, middle-market, and emerging companies — across a range of industry sectors such as health care; financial services; entertainment; digital and technology; and energy, environmental, and real estate. Richard McDerby is a partner and Darren Bartlette is an associate who work with emerging companies and venture capital firms. Kalon Gutierrez is a managing director focused on digital and technology consulting.

Differentiation

Aramar is a boutique investment bank focused on providing merger, acquisition, and strategic private placement services; we are unique among our investment banking peers in that we:

- Focus on middle-market transactions; these transactions are a priority, not a default for when larger deals are dormant
- Have significant transactional expertise
- Provide senior-level attention
- Have a proprietary marketing process that follows a comprehensive approach tailored to each buyer or investor candidate, rather than a typical generic approach utilizing blast teaser e-mails and other automated contacts

Services

Aramar offers a highly focused set of corporate finance services to assist our clients in conceiving, defining, executing, and optimizing their objectives:

- Mergers and acquisitions
  - Negotiated sales of closely-held companies
  - Corporate and private equity firm divestitures
  - Leveraged and managed buyouts
  - Buy-side advisory
- Private placements and recapitalizations
- Fairness opinions, valuations, and financial advisory

Clientele

Aramar focuses on providing high-quality, high-touch services to middle-market clients

- Our M&A transactions range in size from approximately $10 million to $250 million and strategic private placements range in size from approximately $10 million to $100 million
- We provide the high quality of service and substantial transactional experience offered by a major national investment bank, but to a clientele that either is too small for, or cannot receive, the proper level of attention from a larger investment bank, or would receive lesser services and capabilities from a business broker, consultant, or smaller investment bank

Team

Aramar has assembled a unique team of professionals with a comprehensive and attractive mix of skills and backgrounds

- Significant investment banking experience, including stints at many other prominent financial services firms
- Entrepreneurial, managerial, and ownership experience that sets apart Aramar's "principal" perspective from that of most investment banks; our team members have founded, sold, and merged our own companies; acquired businesses; and acted as officers and directors of both public and private enterprises
  - As such, we can relate more closely to our clients and better advise them, at the same time as ensuring senior-level investment banking attention