Aramar
Capital Group, LLC

Deal Market Perspective

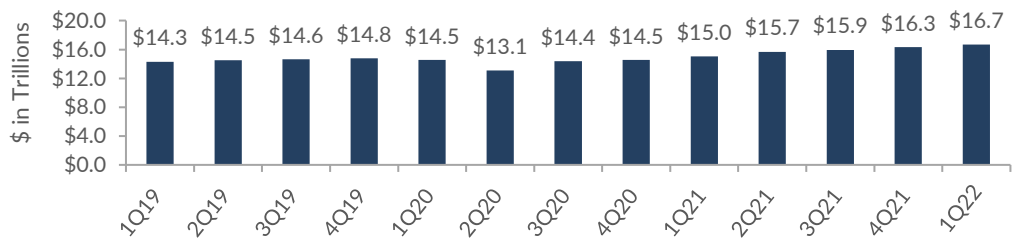
1st Quarter 2022

Economic Overview

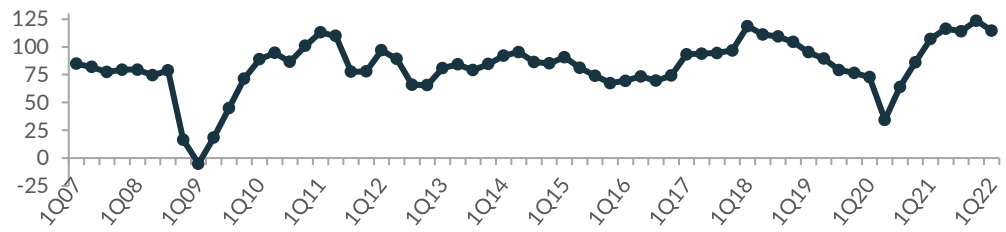
The global and U.S. economies have cooled off and the mood has turned more cautious in the face of significant headwinds. It feels as if we are in the midst of the ten plagues with the war in Ukraine, rising component and labor costs, higher prices on most consumer goods, surging cases of Covid, increasing interest rates, and a slumping stock market. Hopefully, there will be a so-called soft landing despite slowing government stimulus payments and highly-publicized moves by the Fed to tame inflation.

- U.S. GDP decreased at a 1.4% seasonally-adjusted annual rate in Q1 2022, a meaningful drop from the 6.9% increase seen in Q4, driven by a decline in private sector inventory investment, exports, and federal, state, and local government spending and an increase in imports[1]
- The World Container Index (WCI), which tracks container freight rates, is down 16% since the beginning of the year, largely due to decreasing rates for the key Shanghai to Los Angeles and Shanghai to New York routes[2]
  - Shipping rates began to ease partially due to the lockdown in Shanghai, which appears to be disrupting the flow of goods out of China and causing less need for container shipping
- Credit card loans rose 15% from a year ago at JP Morgan, 7% at Citigroup, and 14% at Wells Fargo, which could be a sign that more people have exhausted the savings they built up during the pandemic[3]
- The U.S. unemployment rate declined to a post-pandemic low of 3.6% at the end of Q1 2022, as compared to 3.9% at the end of Q4[4]
  - Total nonfarm payroll employment rose by 431,000 in March, with notable job gains in leisure and hospitality, professional and business services, retail trade, and manufacturing
- 64% of job-switchers said their current job provides more pay than their previous job; among these workers, nearly half received a raise of 11% or more and nearly 9% are now making at least 50% more[5]
- March was the first month since the pandemic hit during which e-commerce sales declined from the same period a year earlier while in-store sales rose; the drop in online spending was 3.3%, the first year-over-year decline since November 2013[6]
- Zillow Group's home value index, which estimates the value of the typical U.S. home, rose 19.6% in 2021 to $321,634, an increase of $52,667 from 2020[7]
  - The figure was slightly higher than the median amount earned by a full-time worker in the U.S, which is about $50,000 before taxes[8]
- The U.S. consumer confidence index decreased in Q1, finishing the quarter at 107.2, down from 115.2 at the end of Q4 2021, but still well above average[9]
  - Consumer confidence continues to be supported by strong employment growth and has held up despite geopolitical uncertainty and an 8.3% annual inflation rate as of April[3]
- The U.S. ranks ninth in global R&D investment, down from first place three decades ago, while China has risen from eighth to second place during that period[10]
- Business Roundtable's CEO Economic Outlook Survey, a composite index of CEO expectations for capital spending, hiring, and sales over the next six months, fell to 115.0 in Q1 2022, down from 123.5 in Q3, but still well above its long-term average[11]

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



Business Roundtable's CEO Economic Outlook Index[11]



1. *Bureau of Economic Analysis*
2. *Drewry Shipping Consultants*
3. *The Wall Street Journal*
4. *Bureau of Labor Statistics*
5. *ZipRecruiter*
6. *Mastercard Spending Pulse*
7. *Zillow Group*
8. *Census Bureau*
9. *The Conference Board*
10. *The New York Times*
11. *Business Roundtable*

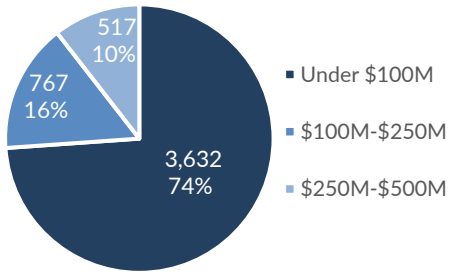
Mergers and Acquisitions

To the surprise of virtually no one, the M&A market pulled back in Q1 2022 after a torrid 2021 that had been fueled by potential tax rate hikes and easy money. Yet, activity remains strong by historical standards despite prevailing supply-chain issues, soaring inflation, and rising interest rates, as compelling reasons remain for strategic buyers to seek acquisitions and debt and equity capital continue to be readily available. (For more on inflation's impact on deal activity, see the guest article by Bain starting on page six.)

- North American M&A value was $611.3B and volume was 4,739 in Q1 2022, representing a 20% decrease in both value and transaction count as compared with Q4 2021; however, dealmakers are still acting on opportunities despite the volatility and valuation adjustments[1]
  - Higher interest rates, a shaky equity market, and inflation jitters dampened M&A activity
  - Previously negotiated deals generally closed on time, while newly announced activity diminished due in part to the economic uncertainty created by Russia's invasion of Ukraine and to rising costs
  - The extreme market turbulence of the past month, lower valuations, and higher borrowing costs could further chill M&A activity during the balance of 2022
  - The technology sector was a bright spot during the quarter, continuing a decade-long upward trend, with notable deals in the semiconductor and cybersecurity sectors

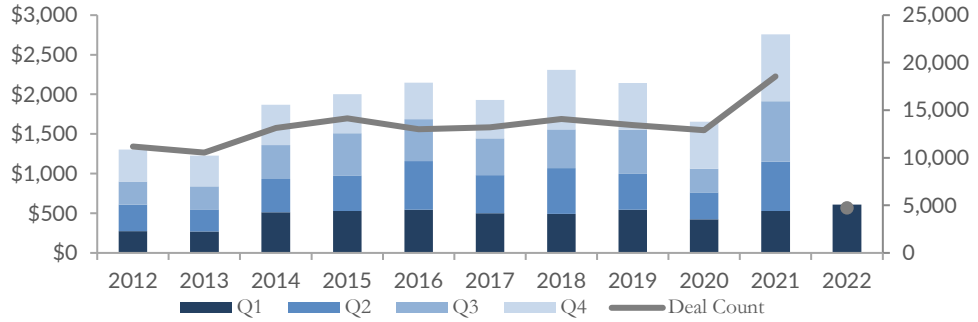
- M&A-related leveraged loan issuance decreased to $76.2B in Q1 2022, the lowest it has been in four quarters[2]
- S&P 500 company cash holdings, excluding financial institutions and utilities, remain elevated at just under $1.7T, providing strategic acquirers with ample capital to put to work[2]
  - This cash level is the lowest seen since the onset of Covid

Q1 2022 U.S. M&A <$500M[3]

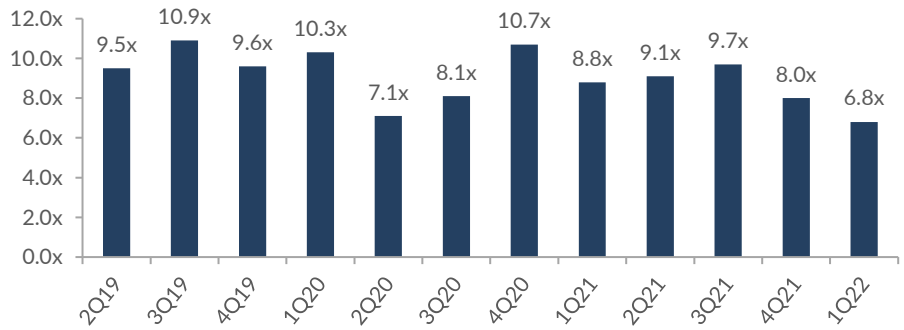


- Dealmaking in Q1 2022 was dominated by smaller transactions, as 74% of the sub-$500 million U.S. M&A market was accounted for by transactions under $100 million[3]
  - The decline in U.S. M&A deal volume and shift toward smaller transactions are largely attributable to increased global headwinds, including economic and production slowdowns in China, high energy and food prices, geopolitical concerns created by the Russia/Ukraine conflict, and inflation-induced central-bank tightening across developed and emerging markets
- Cross-border M&A deal value in N.A. in Q1 2022 (N.A. M&A transactions with non-N.A. acquirers) fell 36.9% from Q4 2021 to $68.9B[1]
- The median U.S. middle-market M&A EV/EBITDA multiple in Q1 2022 for deals between $1M and $500M was 6.8x, a sizeable drop from the 8.0x multiple in Q4 2021[3,4]

North America M&A Activity [1]



U.S. Middle-Market Median EV/EBITDA M&A Multiple[3,4]



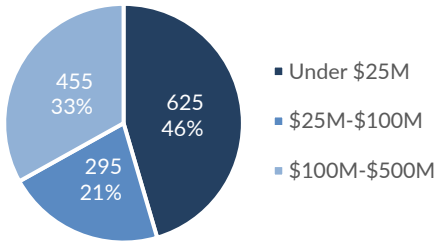
1. *PitchBook*
2. *S&P Capital IQ*
3. *FactSet*
4. *These multiples reflect prices paid for mainly large public companies and do not account for smaller private company transactions that tend to change hands at much lower multiples*

Private Equity

Private equity (PE) deal activity slowed in Q1 2022 following a blistering year-end 2021 period that prevented many firms from entertaining new investment candidates. Rising interest rates, reduced exit opportunities due to the tighter IPO market, and economic caution are driving PE firms to be more judicious in evaluating potential platform investments, but the relatively high level of dry powder and the economic attractiveness of add-on acquisitions mean that deal volume remains solid.

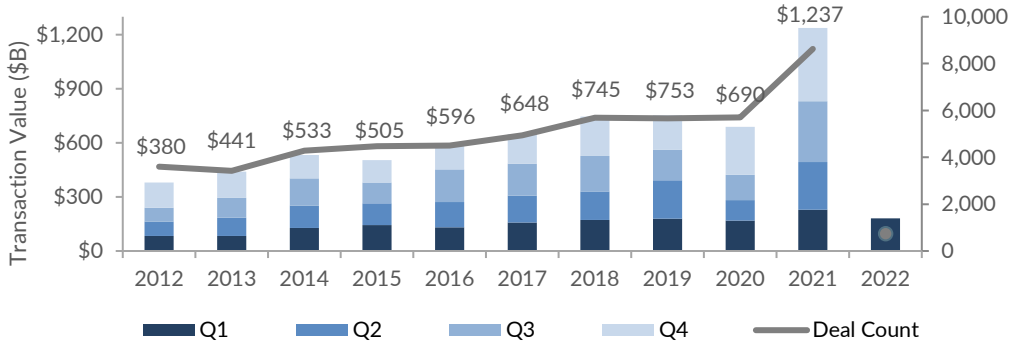
- U.S. PE investment activity had a slow start to the year with 1,399 closed deals worth a combined $142.8B, representing a 31% decrease in volume and a 17% decrease in value as compared to Q1 2021[1]
  - The threat of higher interest rates, accelerating inflation, and Russia's invasion of Ukraine complicated dealmaking for the quarter
- The invasion of Ukraine escalated supply-chain disruptions, increased already prevalent inflationary pressures on commodities, and caused dealmakers to pause for several weeks[1]
  - Financing market activity also slowed, as banks sat on tens of billions of dollars of LBO financing in March
- Dealmakers are bypassing the traditional syndicated loan market for private debt facilities, a practice that is becoming more common, including for transactions in the $1B+ value range[1]
- For PE-led transactions between $10M and $250M, the average EV/EBITDA multiple was 7.5x, according to the most recently available quarterly data[2]
- Add-on investments continue to drive the overall U.S. PE market, accounting for 60.4% of all deals in Q1 2022[1]

Q1 2022 U.S. PE Deals <$500M[1]

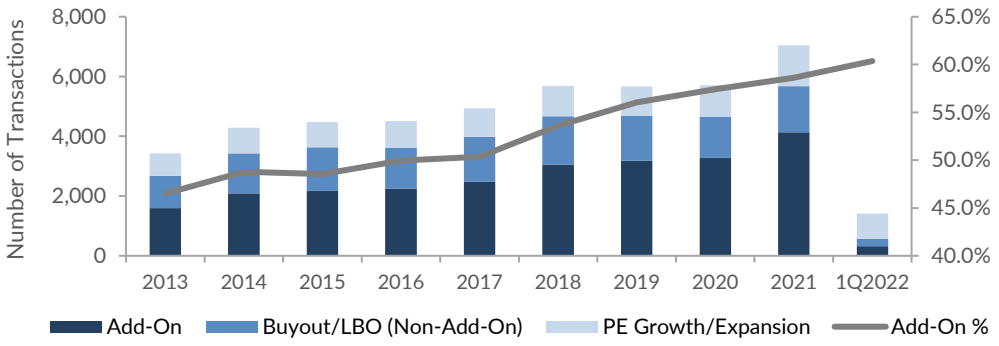


- Global PE dry powder has remained near all-time highs at $1.78T, meaning that acquirers will continue to aggressively seek opportunities to deploy their ample capital[3]
- Public listings drove the impressive exit activity in 2021, but dropped in Q1 2022 as sponsors held on to their portfolio companies due to steep stock market declines and valuation adjustments[1]
  - In Q1 2022, U.S. PE firms exited 181 companies with an aggregate enterprise value of $66.8B, an 8% decrease in the number of companies exited and a 46% decrease in exit value as compared to Q1 2021
- U.S. PE fundraising slowed in the first quarter of 2022 with a combined $64.8B raised across 98 funds, a 26% decrease in capital raised and a 1% increase in the number of funds compared to Q1 2021[1]
  - PE fundraising continues to operate with the wind at its back, as capital pours into the space seeking higher returns than offered in public markets

U.S. Private Equity Deal Flow[1]



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



1. *PitchBook*
2. *GF Data*
3. *Preqin*

Equity and Debt Capital Markets

Public equity and debt markets have had a rough time in 2022, with the tech sector navigating an especially bad road. Venture capital (VC) had been the go-to spot for investing given the ever-increasing valuations with each financing round and the robust IPO and SPAC markets. However, VC deal sizes and valuations are falling as investors become far more cautious, public equity (and debt) markets swoon, and SPACs have lost much of their luster.

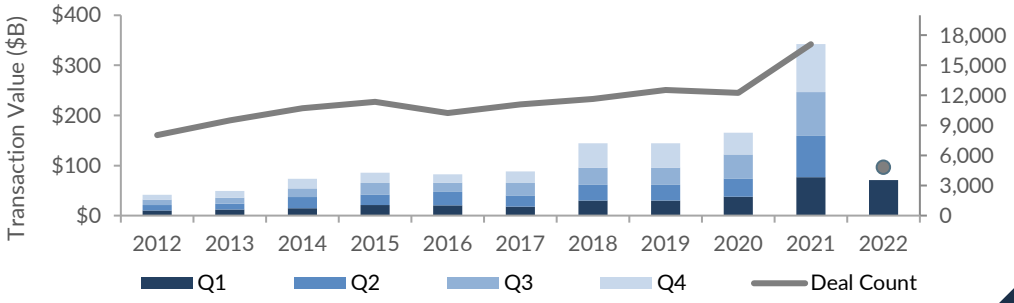
Equity Markets

- After a record-high level of global IPO activity in 2021, volatile market conditions resulted in a significant slowdown during Q1 2022[1]
  - The year started strong in January 2022, but by the second half of the quarter stock market declines reversed the trajectory[1]
  - In aggregate, Q1 2022 saw 321 IPOs raising $54.4B, decreases of 37% and 51%, respectively, on a year-over-year basis[1]
  - Despite the weak IPO volume, private equity markets continue to be active; as of the end of the first quarter, there were 1,074 private companies valued at more than $1B, up from 959 at the end of 2021[2]
- After closing out 2021 within 1.0% of its all-time high, the S&P 500 experienced increased volatility in Q1 2022, dropping into correction territory as it hit a low of 14.8% beneath its year-end value (and then sinking further so far in Q2)[3]
  - Investors' reaction to the war in Ukraine, high inflation, supply-chain shortages, and Fed tightening have driven the volatility and weakness
- Earnings for S&P 500 companies in Q1 slowed, with a blended growth rate of 7.1%, marking the lowest earnings growth rate since Q4 2020[4]
- The share prices of companies that listed publicly in Q1—IPOs, direct listings, and SPAC listings—were down an average of 5.5% since their listings through May 1, 2022[5]
  - All but three of the 53 tech companies that went public in 2021 are trading below their offering or opening price[6]
- U.S. VC deal value fell 8.2% to $70.7B in Q1 2022, while deal count increased 12.6% to 4,822 deals, relative to Q1 2021[7]
  - Lower average deal prices are largely due to late-stage VC companies holding off on sales or public listings due to the impact of declining public-market valuations
- The value of startup exits—a sale or public offering—plummeted to $33.6B in Q1 2022, a 73% decrease on a year-over-year basis[7]
- Investors pumped over $26.6B into seed- and early-stage startups in Q1 2022, a 75.3% increase over Q1 2021[7]
  - Many of the deals completed during the quarter had likely been in process, softening the impact of market headwinds on deal activity
- U.S. VC funds with under $50M of capital have continued to proliferate in an industry where larger funds are growing more in vogue[7]
  - In 2021, 339 micro-funds were raised, a new record number, collectively receiving $5B in commitments
- A study of U.S. VC funds with vintages from 1996 to 2015 found that differing industry specializations did not materially impact performance[7]
- PitchBook's deSPAC Index, which tracks the performance of companies post-IPO via a SPAC merger, has underperformed the S&P 500 by over 80% and has dropped over 30% since the beginning of 2022[7]

Debt Markets

- The 10-year yields at quarter-end on U.S. investment-grade and high-yield bond indexes have risen dramatically with the tightening of monetary policy, earning investors 3.5% and 7.1%, respectively[3]
- For PE-led transactions between $10M and $250M, the average total debt/EBITDA multiple was 4.2x according to the most recently available data, above the 3.9x to 4.1x range that existed pre-pandemic[8]
- ESG bond issuances in emerging markets are expected to increase from some $50B per year in 2021 to $360B per year by 2023[9]

U.S. Venture Capital Deal Flow[7]



1. *Ernst & Young*
2. *CB Insights*
3. *S&P Capital IQ*
4. *FactSet*
5. *IPO Scoop*
6. *CNBC*
7. *PitchBook*
8. *GF Data*
9. *IIF*

Private Equity's Inflation Challenge

By Hugh MacArthur, Mike McKay, and Karen Harris, Bain & Company

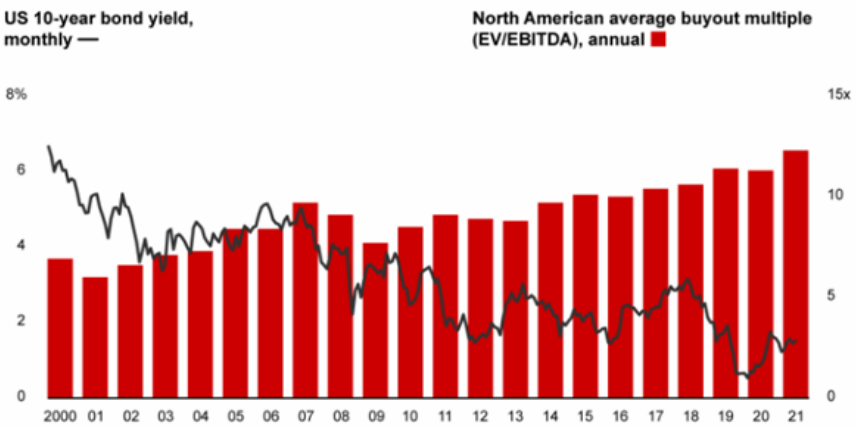
If the investment world has had one constant over the past two decades, it has been the downward trend in interest rates. For years, the global risk of deflation in developed markets has generally outweighed the risk of rising prices, persuading central bankers around the world to keep the monetary spigots open, driving real interest rates to historic lows.

Most investors can barely remember the inflation-driven days and double-digit rates of the 1970s and '80s. Their professional careers have been defined by the superabundance of capital that has energized markets globally since the run-up to the dot-com boom in the late 1990s. Although the line is jagged in both cases, the persistent downward slope of interest rates has been mirrored by a steady uptick in asset prices, creating massive wealth around the world.

Consider the last 20 years of interest rate movements. While the 10-year U.S. Treasury yield dropped from 6.0% in 2000 to around 1.5% at the end of 2021, the average leveraged buyout multiple jumped to 12.3x EBITDA from 6.8x in 2000—a 1.8-fold increase (see Figure 1).

Figure 1

The drop in Treasury yields over the past two decades has helped push deal multiples to record levels



Sources: S&P Capital IQ; S&P LCD

But the inflation outlook has shifted dramatically in the wake of the Covid-19 pandemic and the war in Ukraine. Spikes in both producer and consumer prices suggest the era of easy money may be drawing to a close. It is certainly debatable whether price increases are a temporary result of the broken global supply chain and other Covid-related disruptions, but it is clear that companies across the economy are scrambling to push through long-deferred price increases that they will be reluctant to reverse. And while the macro impacts of the war are impossible to gauge, it is likely the disruption will maintain upward pressure on prices, while creating a massive humanitarian crisis that is shaking the world.

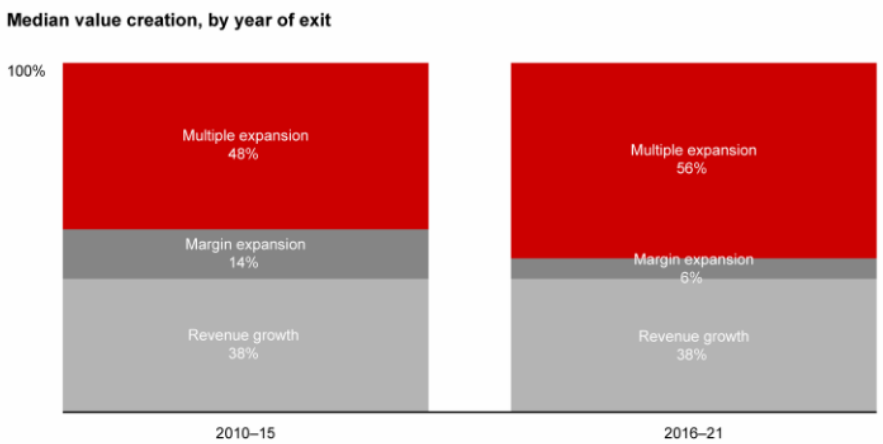
The concern, of course, is elementary finance—when discount rates fall, asset prices rise, and vice versa. All things being equal, the amount investors are willing to pay for an asset increases along with the present value of its earnings, which means that rising rates undercut the value of assets today. This shifts the tide: Rather than floating along in a market buoyed by rising multiples, investors may have to swim against the monetary current as they seek to increase value. Generating returns in such an environment can be significantly harder.

How hard? Whether or not you believe inflation is an enduring concern, there's no arguing that private equity faces a dual threat from rising rates and costs. On the one hand, dealmakers who have benefited mightily from the run-up in multiples over the past two decades risk the opposite if valuations flatten out. On the other, inflationary cost pressures and the resulting margin pressure pose a real threat to just about any portfolio company or business.

The exposure is evident in data showing the composition of returns. According to CEPRES Market Intelligence, multiple expansion has been by far the largest contributor to private equity buyout returns over the past decade, dwarfing revenue growth and margin improvement as sources of value creation. Over the past five years, the trend has become even more pronounced. While multiple expansion accounted for 48% of value creation in the average deal from 2010 to 2015, that number jumped to 56% from 2016 to 2021 (see Figure 2 on the next page).

Figure 2

Multiple expansion has been the largest driver of buyout returns over the past decade, and its contribution is only growing



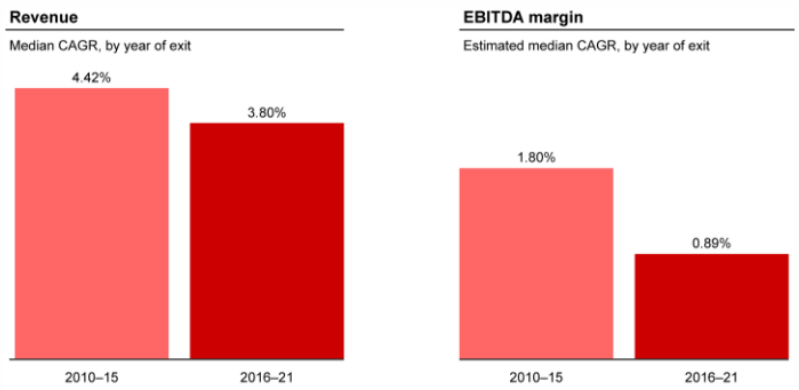
Notes: Includes fully realized global buyout deals with more than $50 million in invested capital; excludes deals with missing data; excludes real estate and infrastructure deals; 2021 data as of December 14, 2021
Source: CEPRES Market Intelligence

The imbalance owes much to the steady tailwind provided by rising asset multiples, which can allow private equity firms to buy a company and see an increase in value even if little has changed in its operational performance. Something else is going on as well: Buyout investors on average have actually become less adept at improving the performance of their portfolio companies. Comparing those same five-year periods, CEPRES data show that revenue and margin growth among buyout companies have fallen 14% and 51%, respectively (see Figure 3). For the past decade, then, private equity funds have not only developed an outsize reliance on multiple expansion to generate returns, but they have also lost ground when it comes to adding organic value.

Turning this trend around in the years to come isn't going to get easier. Well before Russian troops marched into Ukraine, firms were already seeing significant cost pressure across their portfolios from the rising price of inputs. In the wake of the invasion, food and energy prices spiked even more, and while they may ease off again in the months ahead, they are unlikely to fall back below pre-war levels anytime soon.

Figure 3

Buyout company revenue and margin growth have fallen off over the past five years



Notes: Includes fully realized global buyout deals with more than $50 million in invested capital; excludes real estate and infrastructure deals; 2021 data as of December 14, 2021
Source: CEPRES Market Intelligence

Meanwhile, demographic trends also promise to make capital more expensive. The world's baby boomers are moving from their peak savings years (ages 45–59) into retirement, when their spending could add to inflationary pressures.

Inflation aside, many other global factors also pose challenges for companies trying to improve profitability. The Covid effect and geopolitical tensions have forced companies to think hard about whether they will have to reverse years of cost optimization to shore up their global supply chains. Expensive regulation has accelerated globally as governments react to environmental and security concerns. Sustainability and ESG initiatives can add costs across the organization even as they confer other important benefits. Labor shortages, though partially offset by automation, are putting upward pressure on wages.

At the same time, political tensions, demographic trends, and a retreat from globalization have already begun to restrict the flow of cheap capital, even as labor shortages and the push for automation simultaneously increase demand. There are plenty of early signs that geopolitics and national security concerns may become impediments to global capital flows. A few examples include China's crackdown on ride-hailing company Didi Chuxing, Germany blocking

China's acquisition of satellite and radar technology firm IMST, and new disclosure requirements for Chinese companies from the US Securities & Exchange Commission. Now come new sanctions on Russia's central bank.

Together, these factors could make it significantly more challenging in the years ahead for private equity firms to deliver adequate returns. Amid the market's clear warning signs, firms should be asking themselves several key questions.

How, specifically, could inflation affect our portfolio companies and businesses, and how should we address those risks?

Companies that wait for their suppliers to send them price increases will find it is already too late to get ahead of the problem.

At the moment, markets and customers see the logic and inevitability of price moves, providing an unprecedented opportunity to capture increases. To take full advantage, however, most firms will likely have to learn how to manage effectively in a period of persistently rising prices. Having essentially ignored inflation for three decades, they will have to adopt a new mindset and acquire new skills.

Blanket pricing moves don't work. Companies need to be surgical based not just on input costs, but also on factors like the value of a customer or segment, historical performance, and the company's position in the relevant market.

Where do our returns really come from, and does that leave us vulnerable?

Breaking this question down starts with a deal-by-deal analysis to understand what factors are most responsible for returns. It's a valuable exercise at any time, but especially amid the threat of rising rates. Firms need clear visibility into two things: How much has the general buoyancy of asset prices contributed to returns, and how much has come from boosting revenue growth or improving margins? In other words, if rising rates flatten multiples, where would that leave you in terms of generating differentiated returns?

If rising rates flatten multiples, where would that leave us in terms of generating differentiated returns?

The key to embedding a powerful new strategy for value creation is a holistic approach. It's not enough to sharpen a firm's focus; it also has to ensure that every link in the value-creation chain lines up.

Are we prepared to hold onto assets longer?

The average amount of time private equity firms hold assets has slipped steadily, from 5.8 years in 2014 to 4.4 years in 2021. Dependable multiple expansion has enabled firms to buy a company, lever it up, and get out sooner, moving on to the next deal. The question now is, what happens to this formula in a more volatile environment, when cycles are more jagged and selling early is no longer so advantageous?

Trying to predict the course of inflation in a macro environment like today's is largely a waste of time. But what's clear already is that companies across the global economy are feeling cost pressures, and inflation expectations are affecting pricing behavior. This creates short-term imperatives—both offensive and defensive—to understand and manage through this dynamic, turbulent pricing environment.

It should also signal that firms may not be able to afford the luxury of surfing on multiple expansion to keep limited partners happy. In an era of inflation, top-tier returns will inevitably depend on nuts-and-bolts value creation, helping improve a portfolio company's ability to generate more revenue and cash flow. The good news: Investments in these capabilities will benefit a firm's performance in any environment.

About the Authors:

Hugh MacArthur is the leader of Bain's global private equity practice and works with a variety of private equity funds and alternative asset managers, including traditional buyout firms, hedge funds, infrastructure and real estate funds, distressed debt funds, sovereign wealth funds, venture capital firms and banks.

Mike McKay is an advisory partner in Bain's private equity practice and has extensive experience working with investment funds on strategic due diligence.

Karen Harris is the managing director of Bain's macro trends group and frequently works with institutional investors to embed macro strategy into their investment strategies and due diligence efforts.

The original article can be found at www.bain.com/insights/inflation-global-private-equity-report-2022/

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