Deal Market Perspective

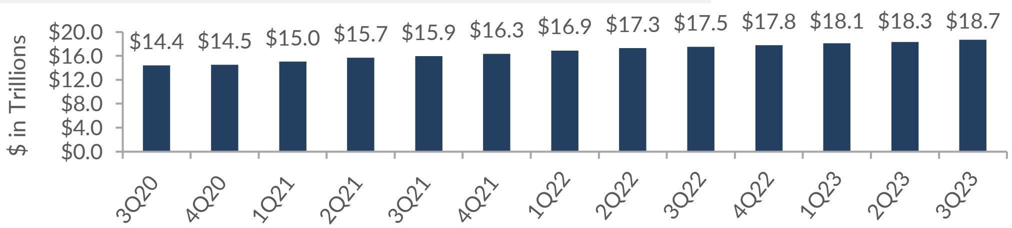
3rd Quarter 2023

Economic Overview

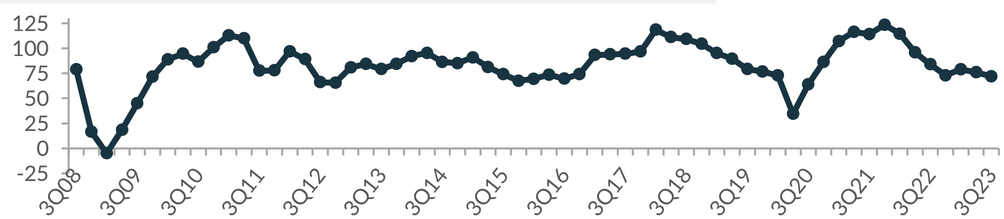
The U.S. economy remains strong, despite substantial geopolitical disruptions and elevated interest and inflation rates. Corporate earnings are faring well, but the Ukraine and the Middle East wars, resultant oil price volatility, pending government shutdown, lackluster Treasury bond auction last week, potential resumption of trade wars, and dwindling consumer savings loom large. Some of those factors along with slowing inflation and job growth helped lead the Fed to hold rates steady and the Treasury Department to skew its borrowing to shorter-term debt. If only we could just focus on Taylor Swift and Travis Kelce!

- The U.S. GDP increased at a 4.9% seasonally-adjusted annual rate in Q3 2023, an acceleration from the 2.4% rise seen in Q2 2023[1]
- The U.S. unemployment rate was 3.8% and 3.9% at the end of September and October, respectively, up from 3.6% in Q2 2023[2]
  - Job satisfaction is at the highest it has been in the 36 years it has been tracked, and it is highest among workers who do some work remotely[3]
- Non-farm employers added 297,000 jobs in September, the strongest gain since January and up sharply from August's 227,000 gain, but the uptick slowed to 150,000 new jobs in October[4]
- The International Monetary Fund raised its outlook for global economic growth to 3.5% for 2023, up from its 3.0% projection last quarter and the 3.2% seen in 2022, but still well below the 6.1% level in 2021[5]
- The annualized core CPI — which excludes food and energy — rose 4.1% in September and then 4.0% in October, a two-year low[4]
  - Higher costs for items such as airfare and vehicle insurance are major drivers for core CPI, which remains above the Fed's 2.0% target[6]
- A study published on rate increases for 17 developed countries over 150 years concluded that monetary policy rate hikes that were preceded by a series of cuts (or a long period of low rates) materially raise crisis risk[7]
- American households are attempting to stave off post-Covid inflation
  - Private-label foods and beverages have crept up to a 20.6% share of grocery dollars spend from 18.7% before the pandemic[8]
  - Two-thirds of consumers said in Q3 2023 they bought less-expensive groceries, an increase of 4.0% from a year earlier[9]
  - American households making $50,000 to $100,000 per year had about 50% more in their savings and checking accounts than pre-pandemic levels, down from an excess of nearly 100% during the pandemic[10]
- Despite relatively strong economic data pointing to greener pastures ahead, small businesses remain tepid and with reason
  - Nearly 1,500 small businesses filed for Subchapter V bankruptcy this year through the end of Q3, almost as many as in all of 2022[11]
  - Small-business loan delinquencies and defaults have edged upward since June 2022 and are now above pre-pandemic averages[12]
  - A survey of small business owners found that 52% of respondents believed the country is approaching or in a recession[13]
  - The average interest rate small businesses have paid on short-term loans has stood at 9% or higher over the past three months, up from 6.7% a year earlier and 4.6% in August 2021[14]
- The U.S. consumer confidence index fell in Q3 2023, finishing the quarter at 103.0; down from 117.0 in Q2 2023[3]
- 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 four points from last quarter to 72, making it the fifth consecutive quarter at or below the 83 long-run average[15]

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



Business Roundtable's CEO Economic Outlook Index[15]



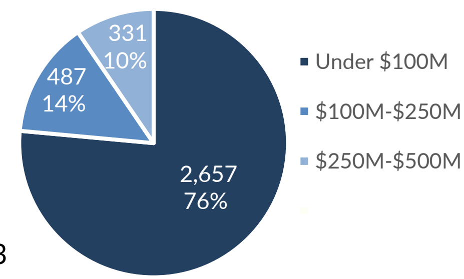
1. *Bureau of Economic Analysis*
2. *Bureau of Labor Statistics*
3. *The Conference Board*
4. *U.S. Department of Labor*
5. *International Monetary Fund*
6. *The Wall Street Journal*
7. *Bank of Spain*
8. *Circana*
9. *McKinsey Global Institute*
10. *Bank of America Institute*
11. *American Bankruptcy Institute*
12. *Equifax*
13. *Vistage Worldwide*
14. *National Federation of Independent Business*
15. *Business Roundtable*

Mergers and Acquisitions

M&A activity continues to be slow. Capital is abundant and acquirers are seeking avenues to expand revenues, but buyers are acting cautiously amid global uncertainty and a higher interest rate environment. And many sellers have not yet adjusted their sale price expectations accordingly. With 2023 profits becoming normalized in comparison to the prior black swan event years with Covid, supply-chain bottlenecks, and other issues, it seems likely that 2024 will bring buyers and sellers closer together and generate greater deal flow. The increased use of earnouts certainly should help (see SRS Acquiom's guest article on the topic starting on page 6).

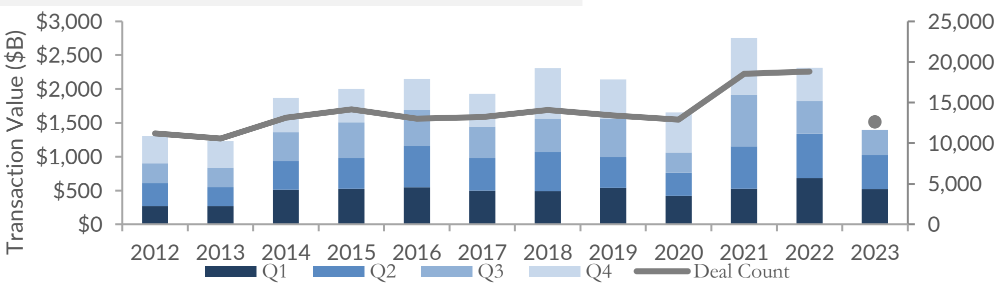
- North America (N.A.) M&A deal value was $375.2B and volume was 2,812 in Q3 2023, representing a 22.6% decrease in value and a 34.4% slide in transaction count as compared with Q3 2022[1]
  - Nearly two years after reaching its zenith in Q4 2021, M&A activity has been on a decline
  - The quarter began with a budding recovery in equity and debt underwriting; however, it ended with the threat of a U.S. government shutdown and a less friendly interest rate outlook by central banks, which gave M&A dealmakers pause
- Global M&A value fell by 19.9% in Q3 2023; outside of the Covid-induced lockdown of Q2 2020, the $776.8B recorded deal value was the lowest quarterly total in nearly ten years[1]
- Judging by past cycles, it could take years for M&A activity to get back to 2021 record levels; for example, global M&A volume in 2007 was $4.6T—it took until 2014 to reach just three-quarters of that level again and until 2021 to surpass it[2]

Q3 2023 U.S. M&A <$500M[3]

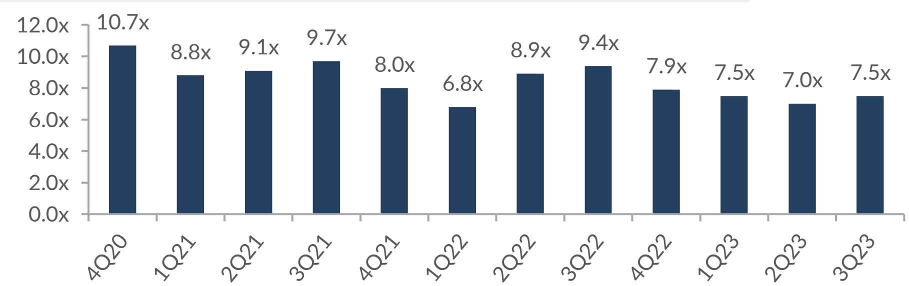


- Dealmaking in Q3 2023 was again dominated by smaller transactions, as 76% of the sub-$500M U.S. M&A market was accounted for by transactions under $100M, matching the 76% in Q3 2022[3]
- Dealmakers are still biding time with smaller deals until conditions improve for megadeals (valued over $1.0B); Q3 2023 saw just 13 megadeals, down 30.7% from Q3 2022, but recent announcements point to stronger quarters ahead[1]
- U.S. non-financial companies are sitting on over $2.0T in cash, with 13 companies hoarding over $1.0T of cash in the aggregate[4]
  - The biggest holders are mainly tech giants like Apple, Alphabet, and Microsoft[5]
- U.S. M&A-related leveraged loan issuance fell to $12.5B in Q3 2023, down 41.6% from Q3 2022[1]
- Cross-border M&A deal value in N.A. in Q3 2023 (N.A. M&A transactions with non-N.A. acquirers) fell 66.9% from Q3 2022 to $15.0B[1]
- The median U.S. middle-market M&A EV/EBITDA multiple in Q3 2023 for deals between $1M and $500M was 7.5x, down from 9.4x in Q3 2022[3,6]

N.A. M&A Activity [1]



U.S. Middle-Market Median EV/EBITDA M&A Multiple[3,6]



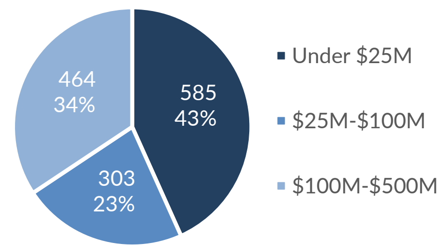
1. *PitchBook*
2. *Dealogic*
3. *FactSet*
4. *S&P Capital IQ*
5. *The Wall Street Journal*
6. *These multiples reflect prices paid for mainly large public companies and do not account for smaller private company transactions that tend to change hands at much lower multiples*

Private Equity

Private equity (PE) firms still are sitting on relatively large piles of cash they are paid to invest. As profits normalize and excess caution hopefully abates, these firms should become more active, though higher interest rates and tighter debt availability may crimp valuations and activity, particularly for large deals that tend to be more heavily leveraged in comparison to middle-market ones, where the impact is not nearly as pronounced. The increase in private credit should facilitate leverage and resultant deal flow as well.

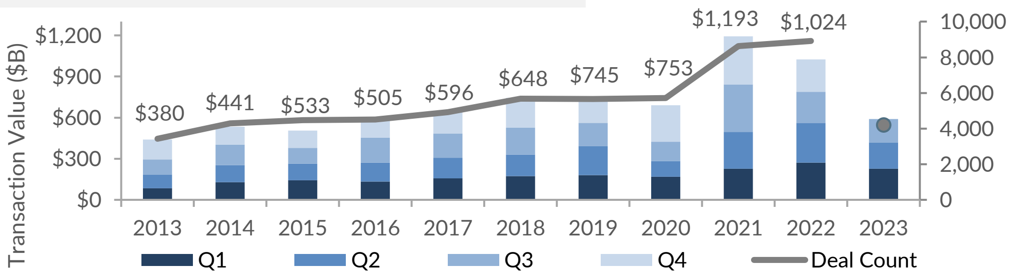
- U.S. PE investment activity slowed in Q3 2023, with 1,265 closed deals worth a combined $172.7B, representing a 40.7% decline in volume and a 21.0% decrease in value as compared to Q3 2022[1]
- Many PE firms are facing a tidal wave of challenges going into next year in their portfolios as a wall of debt maturities from the 2017 to 2019 era start to come due; $106.7B of speculative-grade non-financial debt will have matured in 2023, more than doubling to $247.7B in 2024, and rising further to $389.3B in 2025[2]
  - Analysts expect the trailing 12-month speculative-grade corporate default rate to reach 4.25% by March 2024, rising even further if inflation ramps back up or the economy falls into a recession
- PE firms are now stepping up for a whopping 51% equity stake to clear LBO deals in the syndicated loan market; that's the most ever—and up considerably from the 41% average seen during the more accommodating interest rate environment of the ten years ending in 2021[3]
- 2023 has seen a 62% increase in the number of PE deals with earnouts; nearly one-third of 2023 deals (excluding life sciences) have an earnout[4]
- Add-on investments continue to drive the U.S. PE market, accounting for 60.7% of all deals in Q3 2023[1]
- For U.S. PE-led transactions between $10M and $250M, the average EV/EBITDA multiple was 7.5x, according to the most recently available quarterly data, down from 8.0x recorded in the previous quarter[5]

Q3 2023 U.S. PE Deals <$500M[1]

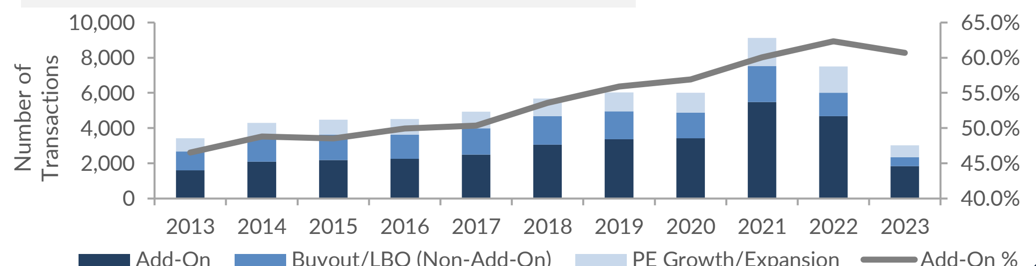


- Global PE dry powder remained elevated at $2.5T in Q3 2023, in line with the second quarter, as high costs of capital and fears of a looming recession limited the desire to deploy capital[2]
- U.S. PE fundraising increased in Q3 2023, with $89.0B raised across 98 funds, a 3.3% rise in capital raised and a 12.6% increase in the number of new funds raised as compared to Q3 2022[1]
- U.S. PE exit activity was down 45.4% by deal enterprise value and 46.4% by volume in Q3 2023 relative to Q3 2022, with 177 exits worth a combined $44.1B[1]
  - In the first nine months of the year, there were just 885 PE exits in the U.S. worth a combined $182.9B, putting the year on track for the lowest annual totals in a decade
- PE exit value equated to 25.5% of what PE firms announced or closed in buy-side deals in Q3 2023; that's the lowest percentage ever recorded going back to 2006[1]
  - Exit activity is arguably the most important link in the PE chain of capital formation and a lead indicator of industry growth; a large imbalance between selling and buying often undermines industry growth

U.S. Private Equity Deal Flow[1]



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



1. *PitchBook*
2. *S&P Capital IQ*
3. *Leveraged Commentary & Data*
4. *SRS Acquiom*
5. *GF Data*

Equity and Debt Capital Markets

Equity markets corrected somewhat in Q3 in response to global shocks and higher interest rates but have bounced back and remain relatively strong. Upward interest rate movements have adversely affected the bond market and credit availability, though that tightness has been partially offset by a proliferation of private credit options. Venture capital (VC) investing and fundraising continue to be soft. A few high-profile IPOs provided hope for potential exit opportunities that could generate returns and capital for investors to plow back into new deals, but the aftermarket performance of these companies was less than stellar and has dashed such hopes.

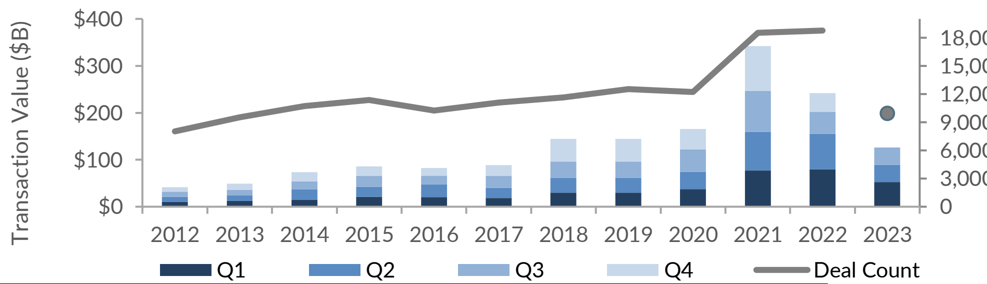
Equity Markets

- Q3 2023 saw 350 global IPOs raising $38.4B, decreases of 6% and 27%, respectively, on a year-over-year basis[1]
  - Emerging markets made up 77% of the global share by number of IPOs and 75% by IPO proceeds in Q3 2023[1]
  - The quarter saw three high-profile IPOs – Arm, Instacart, and Klaviyo – followed by Birkenstock early in Q4; the latter three are trading below their offering prices, and Arm is barely above
- More than two-thirds of the companies that have gone public this year are now trading below their IPO prices[2]
- After a strong start to 2023, the S&P 500 was down 3.3% in Q3; the Q4 quarter-to-date gain as of November 13th was 2.9%[3]
  - The U.S. stock market is more concentrated in the largest companies than ever before, led primarily by the strong performance of giant technology stocks; the ten largest companies in the S&P 500 accounted for 32% of the index at quarter-end
- Earnings growth for S&P 500 companies in Q3 2023 rose significantly, with a blended growth rate of 3.7%, up from 2.2% in Q2 2023[4]
- In Q3 2023, 82% of S&P 500 companies reported a positive EPS surprise and 62% reported a positive revenue suprise[4]
- U.S. VC deal value fell 20.8% to $36.7B in Q3 2023, while deal count dropped 30.9% to 2,716 transactions, relative to Q3 2022, the sixth straight quarter that investing has dropped[5]
  - Q3 2023 experienced nearly the lowest overall venture deal value in six years and the lowest deal count in about three years
  - 17% of Q3 VC deals were down rounds, the highest percentage in a decade
- For U.S. startups with at least $1 million in seed funding, the median time between seed and series A rounds has stretched to 25 months, compared with 21 months in 2022 and 14 months roughly a decade ago[6]
- Investors allocated $11.6B to seed- and early-stage startups in Q3 2023, a 55.5% decrease from Q3 2022[5]
- The total value of U.S. VC-backed companies that exited in Q3 2023 was $35.8B, more than the three prior quarters combined, which admittedly were very slow quarters[5]
  - This surge in exits represents a 117.7% increase by deal value on a year-over-year basis and a 441.1% increase by deal value from Q2 2023[5]
- Only 13.5% of companies that raised a pre-seed round between 2010 and 2016 eventually exited[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 4.58% and 9.18%, respectively[7]
- For PE-led transactions between $10M and $250M, the average total debt/EBITDA multiple was 3.1x, according to the most recently available data, well below the 3.9x to 4.1x range that existed pre-pandemic[8]
- The U.S. leveraged loan default rate fell to 1.27% in September, well below the 1.86% average over the past ten years[9]
  - Despite this fall, leveraged finance professionals expect the loan default rate to rise to around 2.75% over the next 12 months, with many citing increased defaults and restructurings due to tightening monetary policy[1]
- The U.S. private credit market in Q3 2023 was approximately $1.5T, compared to $875B in 2020, and is estimated to grow to $2.3T by 2027[3,10]

U.S. Venture Capital Deal Flow[5]



1. Ernst & Young
2. Renaissance Capital
3. S&P Capital IQ
4. FactSet
5. PitchBook
6. Crunchbase
7. S&P Capital IQ
8. GF Data
9. Morningstar
10. Preqin

Valuation Disconnects Driving a Spike in Earnouts

Amid a material drop in deal volume, the 2023 private M&A market is seeing more and bigger earnouts. Earnouts can help bridge valuation gaps, which seem to be frequent in today's marketplace. Higher interest rates, uncertainty over future Fed actions, and the economy in general are key drivers in the disconnect of valuation expectations.

The 2023 M&A market to date is in many ways a continuation of 2022, with a few notable exceptions. U.S. public and private strategic buyers have a larger piece of the buy-side market share compared to the midpoint of last year. Buyers are using their equity more to finance acquisitions (more than two times the number of all stock deals compared to this time last year). There are double the number of deals with management carveouts (7.2% compared to 3.4% in 2022); although these carveouts are not quite as big on a median basis (7.2% of transaction value compared to 10% in 2022). But perhaps the most notable trend is the prevalence of earnouts in 2023 private M&A deals.

Buyers active in the 2022-2023 M&A market are strategically opportunistic in selecting potential targets and thoroughly diligent throughout the dealmaking process. This appears to include a focus on smaller (and more likely domestic) acquisitions, which may also have the added benefits of avoiding regulatory scrutiny and a reduced need for interest rate sensitive financing. Gone are the fast-paced, high-value, relatively seller-favorable deals of 2021, at least for now.

Nonetheless, many sellers struggle to accept that the value of their businesses has declined, especially if they continue to perform well. Hence, the valuation disconnect. Heavily negotiated earnout provisions can sometimes help get the parties across the finish line[1]. This is manifesting itself in the data. SRS Acquiom has observed a 62% increase in the number of deals with earnouts in 2023. Nearly one-third of 2023 deals (excluding life sciences deals) have an earnout, compared to 21% in 2022 and 17% in 2021.

In addition to frequency, the amount of deal consideration tied up in earnouts also went up.

Prior to the pandemic, the median size of earnouts was approaching as low as 18% (as a percentage of the up-front consideration paid at closing) and, for the last two years, plateaued at around 30% after a Covid peak of 38% in 2020. 2023 deals with earnouts have come in higher—somewhere north of 40% to date.

The shifting of the legal terms of the earnout provisions is another sign that parties are working hard to get these deals across the finish line. This is an area where strategic buyers may be leading the way. Only 6% of 2023 deals with an earnout have included a covenant that buyers operate the target business in accordance with past practices, compared to 23% in 2022. Some decrease here makes sense given the higher number of strategic buyers, whereas financial buyers are more likely to keep the target's existing management team in place and, therefore, more often agree to this operational covenant language. However, given this significant decrease (nearly 75%), the increase in strategic buyers is likely not the only factor driving this shift in earnout provisions.

Interestingly, the frequency of certain efforts language for earnouts have held steady with about 85% of deals in both 2022 and 2023, including language along the lines of "Buyer shall not take any actions the primary purpose of which is to prevent achievement of the milestone payment." Nearly 40% of 2023 deals have included "commercially reasonable efforts" (CRE) language, compared to 30% of 2022 deals. Strategic buyers are more likely to agree to CRE language, and the higher percentage of strategic buyers in 2023 likely explains most or all the increased inclusion of a CRE standard.

Aramar's Commentary:

[1]Earnouts allow acquirers to reduce the risk associated with underperformance at the same time as they enable sellers to realize the appropriate value they perceive for their businesses if they perform within expectations.

Generally, financial buyers tend not to push for earnouts as often as strategic buyers[2]. For example, in 2022, 18% of deals with a private-equity fund as the buyer included an earnout, compared to 30% of deals with a U.S. public buyer. The slow return of strategic buyers to the M&A market in 2023, valuation gaps, low deal volumes, and macroeconomic conditions are all factors driving more and bigger earnouts.

It is important to note that early trends in deal-term data may not hold going forward, particularly with optimism for increased deal activity in the fourth quarter among M&A practitioners. Time will tell. For now, we know the first part of 2023 saw a higher prevalence of earnouts on private M&A deals, as deal parties found ways to close deals in a tough market.

By: Kip Wallen, SRS Acquiom

About the Author:

SRS Acquiom is a provider of services used for the administration of complex financial transactions, including paying and escrow agent services, online document solicitation and reporting, professional shareholder representation, and virtual data rooms. In addition, for loan and credit transactions, SRS Acquiom provides independent administrative, collateral, and sub-agent services. SRS Acquiom was founded in 2007 and is headquartered in Denver, Colorado.

Kip Wallen is a senior director leading the SRS Acquiom thought leadership practice. He leverages his extensive expertise and SRS Acquiom proprietary data to produce resourceful content regularly utilized by market practitioners. Kip has broad experience in M&A and provides guidance on market standards and trends.

This article was originally published by Private Equity Professional on October 17, 2023.

Aramar's Commentary:

[2]This is because financial buyers generally want owner-operators to remain with and continue to manage their businesses and thus prefer that sellers roll over equity to align their interests with those of the acquirers; *viz.*, focus on the exit valuation rather than continued near-term transition profits.

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

380 Lexington Avenue, 4th Floor • New York, NY 10168 • (212) 708-0700