CBIZ PRIVATE EQUITY ADVISORY

Q3
2023

M&A MARKET UPDATE

CONTENTS:

Deals Closed (#): 1,972 (QoQ ↓7%) Deals Closed Value: $172.7B (QoQ ↓18%) PE Fundraising: $89.05B (QoQ ↑3%)

M&A MARKET PERSPECTIVE
Reading Beyond the Headlines

While buyer appetite remains strong for high-quality assets, overall M&A activity remained weak through the third quarter – largely reflecting the impact of continued economic uncertainty, higher debt financing costs, and disparate views on valuation. With that backdrop, we see signs of improvement that give us optimism when looking ahead to the deal environment in Q4 2023 and 1H 2024. Here are some of the key themes we are tracking that reinforce our current thinking and should result in a positive uplift to near-term transaction activity.

Debt financing markets have stabilized: Although far costlier than a year ago, financing remains available at the levels needed for M&A markets to be more active, with the credit market volatility experienced earlier in the year potentially in the rear-view mirror. Although lenders continue to be selective, modestly favorable shifts in both spreads and leverage levels are hopefully signs of improving conditions.

Micro-cap deal activity remains strong: Sellers at this end of the market are not market timers – they don't have to be. There is a ready market for these businesses as PE firms pursue buy-and-build strategies. These transactions also carry less financing risk as direct lenders have continued to support PE add-on activity, particularly in incumbent situations – albeit at lender-friendly terms.

Investment banks are touting stronger pipelines: Across the M&A market, the slowdown since the start of 2H 2022 has resulted in a large backlog of transactions waiting to go to market. The number of sell-side mandates has grown in recent months relative to earlier in the year, foreshadowing an increase in marketing launches later this year and early next.

Holding periods for PE-backed portfolio companies have reached record lengths: The median holding period is now 5.6 years – the highest value in 20+ years over three economic downturns.[1] As such, we see the potential for PE firms to enhance M&A market activity by moving forward on plans to sell portfolio companies, thereby expanding the pool of attractive assets available. The combination of the slowdown in selling activity since 2H 2022 and sunsetting investment periods contribute to the growing backlog of PE-backed companies waiting to enter the market as macro visibility and financing dynamics improve.

PE dry powder remains at levels near all-time highs: At $1.35 trillion as of the end of Q2 2023, PE dry powder is just 9.7% shy of its historical high.[2] This tug-of-war between near-record dry powder pushing acquirers to spend and tight credit conditions holding them back has resulted in the stalemate we have seen – consisting of high-frequency dealmaking at smaller sizes (micro-cap) and lower aggregate deal value. There is increased urgency in the private equity community, as there are limits to how long capital can sit idle. We expect sponsors to be more aggressive in deploying capital to close out existing funds and see portfolio company realizations to support fundraising.

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[1] Private Equity Info (www.PrivateEquityInfo.com)
[2] Pitchbook Data, Inc. Global M&A Report

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Q3 2023 BY THE NUMBERS
Deal Metrics Update

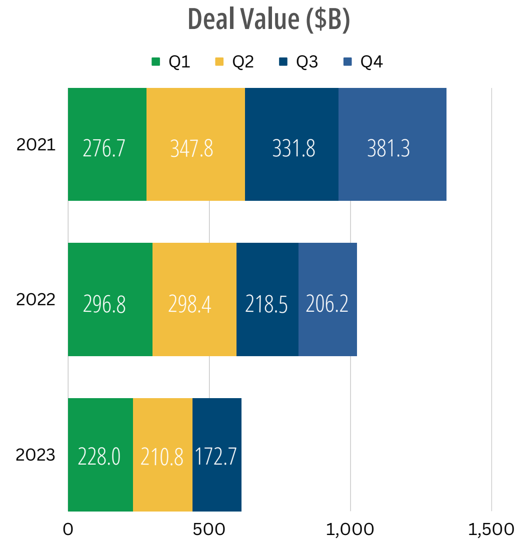
Deal Landscape & the Continued Surge of Add-on Activity

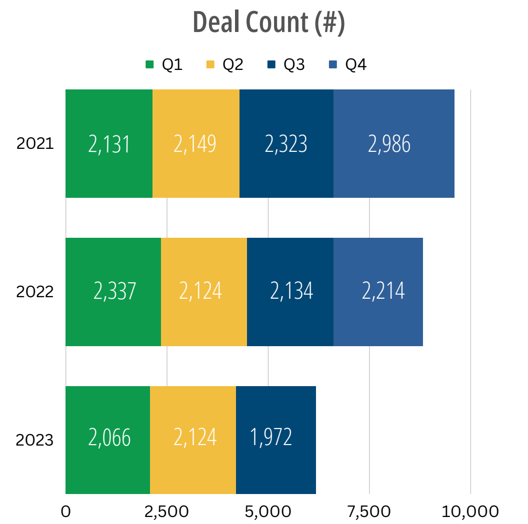
Q3 2023 results show a decline in both the quantity and value of deals closed when compared to Q2 2023. Since its peak in Q4 2021, quarterly deal volume is down 34%, and deal count is down almost 55%. The continued downward trend implies we haven't yet found the bottom.

Platform activity continued to decline, a total of approximately 43% year-to-date, due to broader economic conditions including investment risk and financing costs. However, stabilization in debt financing markets and the anticipation of sell-side activity in the market could improve these results as we finish out 2023 and head into Q1 2024.

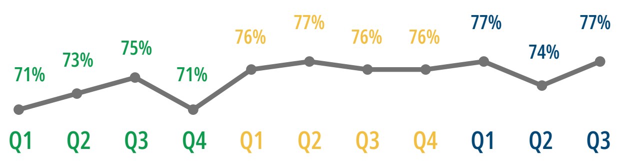
Despite the overall results, conditions are still sustaining the middle market. Add-on activity has remained steady across quarters and is at a near-record high share of total PE buyouts, coming in at over 76% YTD 2023, a percent consistent with 2022's overall results. PE continues to use add-on opportunities to deploy dry powder while the market awaits a more favorable environment for platform acquisitions. Lagging performance results through Q1 2023 reveal that middle-market funds have maintained performance over megafunds, continuing a streak that began in Q2 2022. The middle market is expected to continue thriving in the near term, given middle-market deal success in the absence of megafund and platform activity.

Quarterly PE Deal Activity





Quarterly PE Add-On Activity (% of Deal Count)



Source: PitchBook Data, Inc. US PE Breakdown

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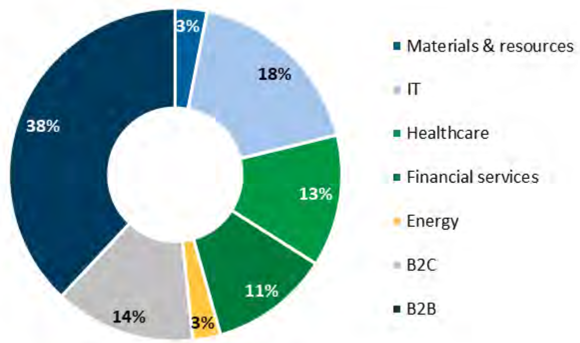
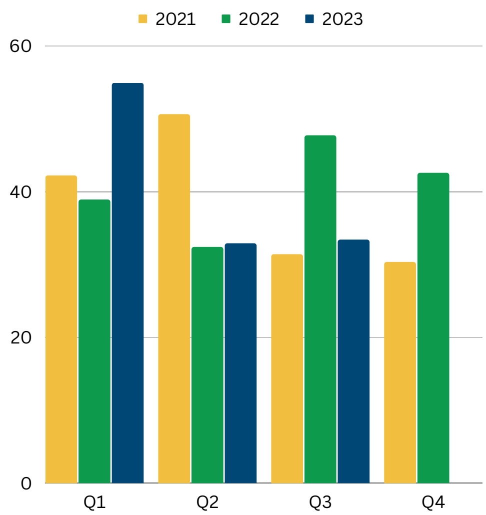
Q3 2023 BY THE NUMBERS
Deal Metrics Update

Quarterly Deal Activity Breakdown

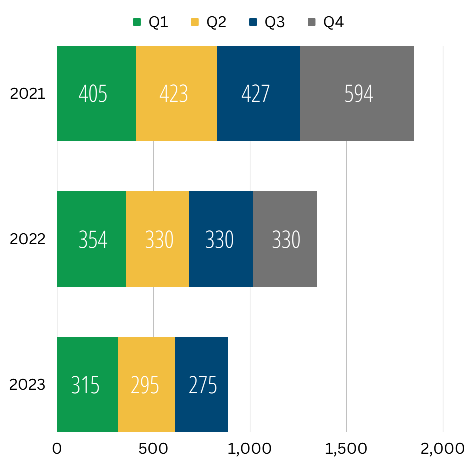
PE Deals by Sector (#)



Quarterly PE Middle Market Fundraising ($B)



Quarterly PE Exit Activity (Deal Count)



Source: PitchBook Data, Inc. US PE Breakdown

Peaks & Valleys of Fundraising and Exits

All eyes remain focused on exits as we roll past Q3 with a disappointing downturn in the trend – Q2 exits were up over 40% over Q1, but Q3 cannibalized that upswing with a 42% decline over Q2. Q3's exit value marks the lowest results in over 10 years which could suggest the bottom for PE exits and highlights the downward shift in valuations. The extended hold periods demonstrate private equity's efforts to avoid forced sales, opting instead to wait for improved exit conditions. When we look at deal and exit activity holistically, it highlights the sizable imbalance in the investment life cycle, which threatens industry growth. These forces pressure buyout firms to find paths to offer fund investors liquidity options as investments near termination dates. The pressure of this coupled with unfavorable exit conditions will likely continue to pave the way for continuation funds, which provide cash-out opportunities for current investors and secondary sales for funds. The challenge to fund managers is balancing fair transactions for both the exiting LPs and new investors under market conditions that are very different from those during initial investment periods.

Middle-market fundraising demonstrated resilience through challenging market conditions through Q3, accounting for over 50% of the total value of closed PE funds in YTD 2023, up more than 2% from 2022, and on track for one of its best fundraising years ever. However, those results are not coming easily – LPs are not as willing to commit dollars, and as a result, it is taking firms an average of 15.6 months to close new funds, the longest timeline since 2011. Despite low exit activity and the laborious fundraising circuit, year-to-date results are bolstered by forward-looking macroeconomic conditions and continued success for add-on activity (which remains easier to close and finance compared to upmarket deals).

STATE OF THE ECONOMY
A Soft Landing Doesn't Mean We Are Out of the Woods

Heading into the final months of 2023, the American economy seems to be achieving a "soft landing" despite the steep rate hikes implemented by the Federal Reserve. While we celebrate the resilience of consumers and businesses, we also note the challenges that lie ahead beyond this year.

- **The labor market is tight, but there is more:** The 3.8% unemployment rate[1] is low by historical standards, and businesses are short on skilled workers. Underneath signs of strength, however, wage growth is faltering, and multiple job holders are increasing while full-time workers are decreasing. These are signs of fraying at the edges in an otherwise tight job market.

- **Inflation remains elevated:** The Consumer Price Index (CPI) reading for September revealed persistent price pressures across the American economy. Inflation has been a stubborn problem, particularly in areas of essentials like energy, food, insurance, and medical services. At a 4.1% year-over-year core CPI rate, inflation remains above the Fed's target of 2%, keeping pressure on the Fed to maintain its "higher for longer" stance.

- **A recessionary tone for 2024:** Higher prices eat into the purchasing power of individuals and businesses alike. Americans are also running out of pandemic stimulus savings, student loan payments resume this fall, and higher rates are hitting mortgages and car loans. The average annual rate on credit card balances has risen to 22.8% from 16.3% a year ago, which translates to a year-over-year increase in interest payments of $40 billion.[2] For an economy that is 70% driven by consumption, a shrinking American wallet remains a recessionary threat.

- **The cost of borrowing money has risen, may rise more:** When the Fed began its hiking cycle in Q1 2022, financing activity paused while rates were changing rapidly. As the Fed tapered its pace of hiking mid-year, debt financing activity resumed. However, credit spreads remain compressed compared to history, and recessionary trends may spur widening of spreads on top of an already high risk-free rate.[3]

- **Dispersions in public equity markets:** Despite the double-digit gains in the S&P 500 Index year-to-date,[4] the performance is dispersed under the hood. Year-to-date, the winning sector is Communication Services with a 40.4% gain, led by Meta's whopping 149.5% return.[5] In the other extreme, the Utilities sector lost 14.4% as its bond proxy status was challenged by rising yields. The delta between the top and bottom sectors reflects how "The Magnificent Seven"[6] stocks have driven the headline gains, but the rest of the market may indicate underlying risks in the system.

In a heavily indebted and credit-driven society, a soft landing of our economy is not the most obvious scenario that comes to mind after a 525-basis-point rate hike in the span of a year and a half. Remember, monetary policy works with a lag, and it can feel like a soft landing until it is not. Still, one more hike from the Fed in 2023 is not off the table, and we will be watching how the financial tightening in the last two years makes its way through Main Street in 2024.

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[1] Bureau of Labor Statistics
[2] FT and WalletHub
[3] Treasury yields
[4] Year-to-date through 9/30/2023
[5] All returns are total return
[6] The Magnificent Seven: Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta, Tesla

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WHAT'S TRENDING

How Improper ERTC Claims Can Threaten a Transaction

Created by the CARES Act in March 2020, the Employee Retention Tax Credit (ERTC) has been offered as financial support via a tax break to organizations that lost significant business or experienced a full or partial suspension of operations due to COVID-19-related disruptions.

Last month, the IRS announced a moratorium on processing new ERTC claims in response to rising concerns over fraudulent applications.

While sellers may have been eager to file ERTC claims before closing a deal to maximize tax benefits, these filings should raise a buyer's skepticism. When acquiring equity in a target company, the buyer is taking on entity-level liability, including exposure from an erroneous ERTC claim, given the claim's impact on overall payroll tax expense. This risk extends beyond the credit claim amount to include accruing penalties and interest until the IRS recovers the owed amount.

For a buyer to avoid serious consequences and potential future liability resulting from a seller's improper or fraudulent claims, buyers should expand their pre-acquisition process to include identifying and addressing potential risks resulting from the ERTC.

Identifying the Risk

Buyers should conduct specific due diligence on ERTC claims to identify potential issues in claim filings. This should include:

- Understanding why and how the target qualified for an ERTC;
- Obtaining copies of support for claim filings;
- Obtaining support related to government orders and how they impacted the target company for any credits claimed on the full or partial shutdown of operations, and finally;
- Providing compiled support to a qualified tax professional to review and confirm qualifications and calculations.

Protecting Against the Risk

If due diligence raises concerns of an improper filing, buyers should consider escrows or holdback terms within the sale and purchase agreement to protect themselves from potential exposure throughout the statute of limitations, which can be unusually long depending on when the ERTC claim was filed.

By conducting upfront due diligence and asking the right questions, buyers can avoid unexpected ERTC-related obligations.

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- ERP Transformation & Technology Strategy
- Executive Search

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