Cautious OPTIMISM

Positive signs in M&A can be found despite inflation, interest rate constraints

BY ADAM BURROUGHS
aburroughs@sbnonline.com

There seems to be a bifurcation taking place in the M&A deal market, according to David Jaffe, a member at Metz Lewis Brodman Must O'Keefe LLC. Large-cap and mid-cap M&A activity, which he says strongly correlate with the debt capital markets and are therefore highly interest-rate sensitive, slowed considerably in 2023. However, in the lower middle-market sector, dealmaking activity was very robust in 2023, leading to a transaction backlog for the firm that remains strong going into Q1 of 2024.

David Jaffe
Member
Metz Lewis Brodman Must O'Keefe LLC

"We closed over 30 transactions in each of the last two years and we expect to do the same in 2024," Jaffe says.

GrayMatter Co-founder and CEO James Gillespie also sees a stable M&A market, saying there are more opportunities to grow as the year has progressed, something he expects will continue.

"We've completed five strategic mergers since 2018, including our latest in mid-2023," Gillespie says. "Every year is different, but in our market, there is a ton of investment and consolidation happening. It's a truly exciting time."

Stephen Gurgovits, Jr., managing partner at Tecum Capital Partners, however, says the current M&A environment has been challenging since the banking dislocations in March 2023.

"Since that time, and perhaps even before, it has been very difficult to get senior bank deals done, especially syndications," Gurgovits says. "When you combine financing challenges with stubbornly high valuation levels and a more challenging backdrop for the macro economy, the M&A market is negatively impacted."

Dealmakers we spoke with are mixed — on their characterizations of the market, how they're faring in it and the major factors at play in M&A deals. They offer their perspective on the conditions on the ground and how they see the deal year wrapping up.

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> METZ LEWIS BRODMAN MUST O'KEEFE LLC

BIGGER PICTURE

Looking across the macro environment, Ray Milhem, founder and CEO of MILHEM DTL, says the high interest rates have been obstacles to many deals, as has inflation, specifically with the rising cost of labor and materials. Also factoring into the equation are political and geopolitical issues impacting the U.S. economy.

Gurgovits agrees that when it comes to the bigger economic picture, the primary challenge is rising interest rates.

"Cost of capital is increasing and it impacts everything from mortgages to deal financing," Gurgovits says. "So, while deals are still getting done, they are certainly more costly to finance in this challenging environment."

In the early stages, Bob Stein, associate vice chancellor for Innovation & Entrepreneurship at the University of Pittsburgh, says traditional funding is tight, but entrepreneurs have more options to pursue alternative funding.

"Exits, though not guaranteed, reward strategic planning with more selling options," Stein says. "Adaptability and value are key in this unpredictable market."

He says he's watching inflation and possible disruptions from geopolitical conflicts in the coming year for their impact on entrepreneurs. And while interest rates can always be a factor, they could be in the rearview.

"It seems that interest rates may be turning the corner, with stability or rate drops easing the burdens of businesses with debt or looking to borrow," he says.

GrayMatter's Gillespie says a big factor affecting manufacturers in the deal space is their decisions to maintain or reshore operations in the U.S. He says supply chain issues, more remote work options and political instability abroad persuaded many manufacturers they've worked with to grow and modernize their domestic operations. However, the current trend of falling interest rates is probably the biggest positive influence affecting M&A right now, and that could continue into 2024.

While buyer demand is more heavily influenced by the availability and cost of capital, Jaffe says lower-middle-market deals are generally less leveraged than large- or mid-cap transactions. That could be positive for private equity buyers seeking to build out their platforms through add-on acquisitions who cannot sit on the sidelines forever.

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they must deploy capital," Jaffe says. "So, they tend to be buyers of companies throughout the normal ebb and flow of the economic cycle."

Additionally, he says all market participants will benefit if the Fed can engineer a soft landing in 2024 by continuing to ease interest rates and hold inflationary pressures down.

However, as it relates to seller motivations, Jaffe says demographic trends are a very significant factor in lower-middle-market deals, perhaps even more significant than normal fluctuations in the economic cycle.

"This is especially true in the owner-operated and family-owned business segment where the cohort of owners between the ages of 55 and 75 is large and growing," Jaffe says. "Many of these owners do not have a younger generation of operators in the family to whom the business can be transferred. This dynamic often creates the impetus for considering a sale transaction. We see this profile repeatedly among our sell-side clients."

Those demographic trends, he says, have afforded buyers an ample supply of family and owner-operated businesses that are increasingly willing to consider selling.

As Milhem puts it: "I see what I call 'opportunistic selling' — when an owner of a company is retiring and wants to exit. The multiples are high."

DEAL TO BE MADE

Whatever the view of the macroenvironment in which deals are made, Jaffe says companies within certain sectors remain of great interest to buyers.

"Broadly speaking, sponsors remain eager to acquire companies that fit within their various investment theses, including the continued consolidation of fragmented industries where scale and operating efficiencies can be achieved," Jaffe says. "We are seeing active buyer interest in factory automation, precision machining, distribution and various sub-sectors in business services and professional services."

Additionally, he says the volume of add-ons to existing platform companies has held up well in the face of the slowdown that affected larger platform transactions in 2023, and he doesn't expect that to change.

Gurgovits says sellers will be happy to know valuations remain stubbornly elevated and there is still ample capital chasing deals. Therefore, it is a still a great time to sell a business. It is just a bit harder to transact these days. Buyers, however, are in the tougher spot, he says.

"Deals are still expensive and the cost of capital is rising, while it is also difficult to even obtain traditional bank financing," Gurgovits says. "These are not fun times for buyers."

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–STEPHEN GURGOVITS, JR., MANAGING PARTNER, TECUM CAPITAL PARTNERS

There's probably some untapped demand from buyers who didn't find a best fit in 2023, Gillespie says, which could be good for sellers looking for just the right opportunity.

"If they didn't make as many big deals in 2023, that could mean they have the capital available to deal with whatever headwinds might pop up in early 2024," Gillespie says.

Net Health Founder Patrick Colletti says buyers are seeing two distinct stories from a range of targets, from startups through scaled assets.

"Many well-managed companies quickly adjusted to the economic uncertainty by improving margins and doubling down on organic growth," Colletti says. "Startups did their own version by tightening belts and focusing on product market fit to extend runway. The second category is companies frozen in some form of hibernation mode because they relied too heavily on cheap interest rates to boost inorganic growth or spent too quickly, and their runway has shortened. Both represent opportunities for buyers, albeit with very different valuations."

For its part, Stein says the entrepreneurial ecosystem is thriving with ample resources for business support and access to education. Investor interest is growing, as are government initiatives to boost funding opportunities, and there are innovations that are having a substantial impact.

"The adoption of new technologies — like AI and e-commerce — present more cost-efficient opportunities to level the playing field for some new businesses entering the market," he says.

However, Stein says entrepreneurs today grapple with adaptability.

"The landscape is rapidly changing," he says. "Challenges of inflation and supply chain disruptions put pressure on cost management and rising costs drive the need for innovative and efficient operations. Talent acquisition and retention pose additional challenges as attracting skilled individuals becomes more competitive."

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–RAY MILHEM, FOUNDER AND CEO, MILHEM DTL

RIGHT PARTNER, RIGHT DEAL

While transactions are still getting done, the pace seems to be a little less frenetic than it was in 2022 and early 2023, Metz Lewis' Jaffe says.

"Buyers are digging a little deeper in diligence and QoE, and being very thoughtful and conservative on EBITDA adjustments," he says. "Lenders also are

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–BOB STEIN, ASSOCIATE VICE CHANCELLOR FOR INNOVATION & ENTREPRENEURSHIP, UNIVERSITY OF PITTSBURGH

exercising more caution with leverage multiples and slightly tighter underwriting criteria. While it seems that professional services firms have worked through the backlog of transactions that was constraining the market at the end of last year, the ability to engage competent advisers to perform work on a timely basis is still a gating item for sellers."

Further, coming out of the frothy market of 2022 and early 2023, holding periods have increased and leverage multiples have decreased, Jaffe says. But in competitive deals for good assets, buyers still must pay full value.

"This implies that transactions will require greater amounts of equity and returns may decrease," he says. "The days of easy profits from financial engineering may be coming to a close. Going forward, deals may require sponsors to make more operating improvements to generate returns, and that is a more difficult game to play."

Milhem says it can be difficult for sellers to find the right buyers — those who appreciate their companies and can give them higher returns, and that have cultural alignment between the buyer-seller. And for their part, he says buyers are facing challenges in finding the right deals that fit their portfolio (e.g., product, service, management, ROI, etc.) as well as their investment strategy.

Similarly, Gillespie says sellers are focused on being prepared and prioritizing the right fit with potential buyers. And if they're not, they should be.

"Sellers win when they put in the work to demonstrate their value now and in the future, and that's great news for everyone in the M&A market," he says.

Generally, the smaller the transaction is, the more idiosyncratic, or "off market" the deal terms can be, Jaffe says. This characteristic of smaller transactions creates more closing risk if the parties' expectations are too far apart.

Investors focused on the early stages are benefiting from increased M&A activity, Stein says, creating opportunities in industry consolidation resulting in high returns. However, investors face challenges from increased market volatility due to global conflicts and instability.

"Concerns about inflated valuations and heightened competition for new opportunities require constant adaptability," he says.

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Despite the current challenges and the fact that things may get even more difficult in early 2024, Gurgovits expects to see a recovery in the second half of 2024, and that the economy and M&A market will be poised to get even stronger in the back part of 2024, especially after the election cycle.

Jaffe says if his theory holds that LMM deals are influenced more by demographics than by economic fluctuations, he expects 2024 to be a year of robust dealmaking activity.

"To the extent that there is a backdrop of relative economic stability and a soft landing scenario, so much the better," Jaffe says. ●

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