M&A Update

U.S. Micro Middle Market

1H 2023

HOULIHAN CAPITAL

1 | Executive Summary

Key Takeaways

M&A Activity

Transaction activity in Q2 2023 falls to lowest point in past two years

Valuation Multiples

Purchase price multiples dragged down by high interest rates and economic uncertainty

Sector Activity

Reduced activity across the board, multiples remain strong in healthcare and business services

Leverage

Credit markets tighten as senior debt rates rise

In this report:

Who we are:

Houlihan Capital is a leading valuation and investment banking firm committed to delivering superior client value and thought leadership in an ever-changing landscape.

Micro Middle Market Overview:

Houlihan's Investment Banking group specializes in providing sell-side M&A advisory services to owners of privately-held businesses within the Micro Middle Market ("MMM"), which we define as those with total enterprise value ("TEV") below $250M.

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Data Source:

The data used in this report was primarily sourced from GF Data, using information provided by 400+ private equity firms on their recent transaction activity.

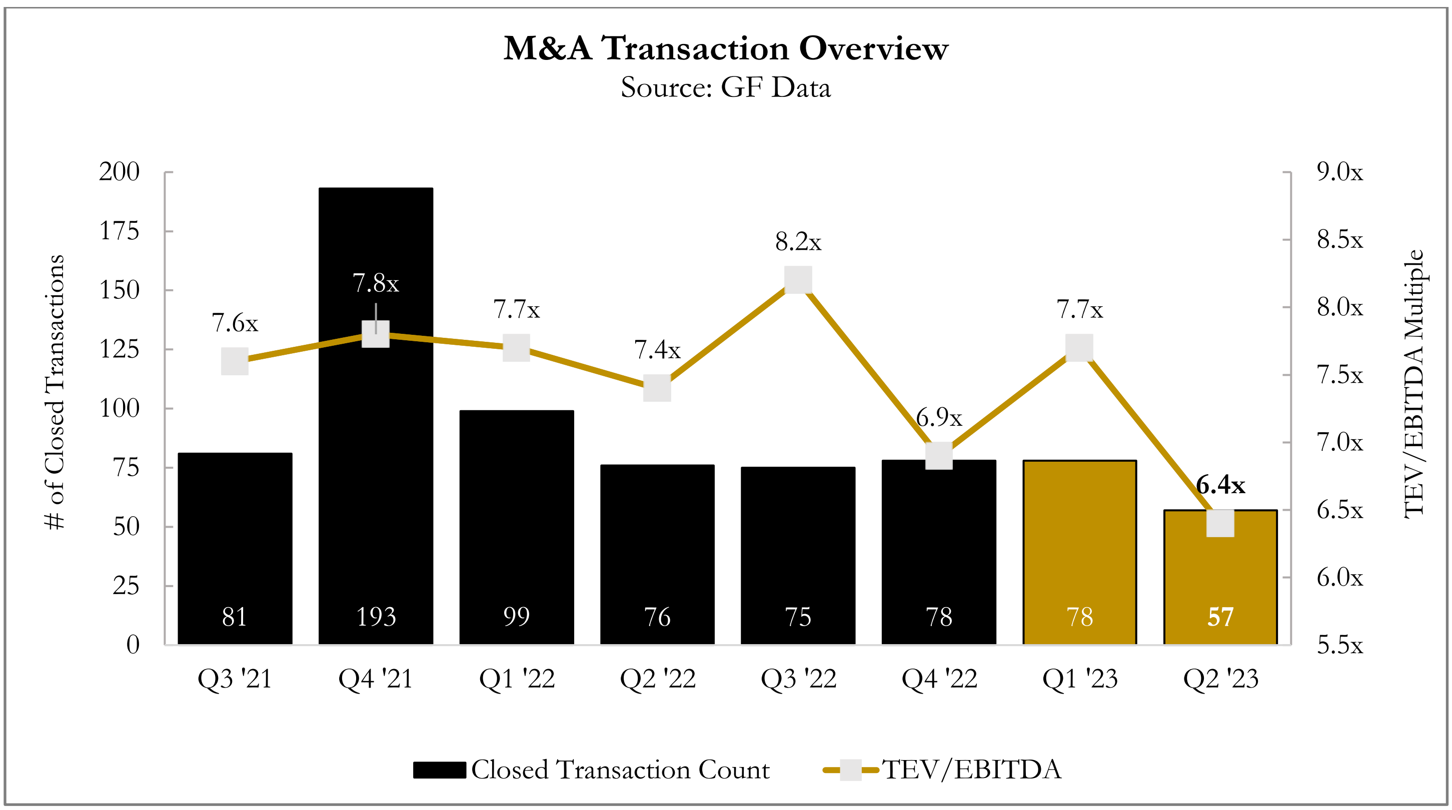
2 M&A Overview

Sharp Decline in Deal Activity and Valuation Multiples

After a year of steady deal closings in 2022, M&A activity in the Micro Middle Market ("MMM") exhibited a notable decrease in the first half of 2023 compared to the preceding two (2) years due to a combination of factors, including economic uncertainties and shifting investor sentiments. Persistent economic challenges, marked by supply chain disruptions and inflation concerns, led many potential buyers and sellers to exercise caution, resulting in more modest M&A activity.

Valuation multiples on completed deals decreased notably in Q2 2023, averaging just 6.4x trailing twelve-month (TTM) adjusted EBITDA, compared to 7.7x in Q1 and an average of 7.6x across the prior three (3) years. This recent shift was influenced by the surge in interest rates – as the central bank shifts towards tightening monetary policies to combat inflation, borrowing costs for buyers have increased significantly. Consequently, this higher interest rate environment not only tempered enthusiasm for M&A transactions but also contributed to a pronounced decline in valuation multiples, signaling a notable shift in the investment landscape during Q2 2023.

Despite recent challenges, the lower middle market remains a dynamic space, and the decrease in activity in Q2 2023 can be viewed as a temporary adjustment rather than a long-term trend, with the potential for resurgence as conditions stabilize.

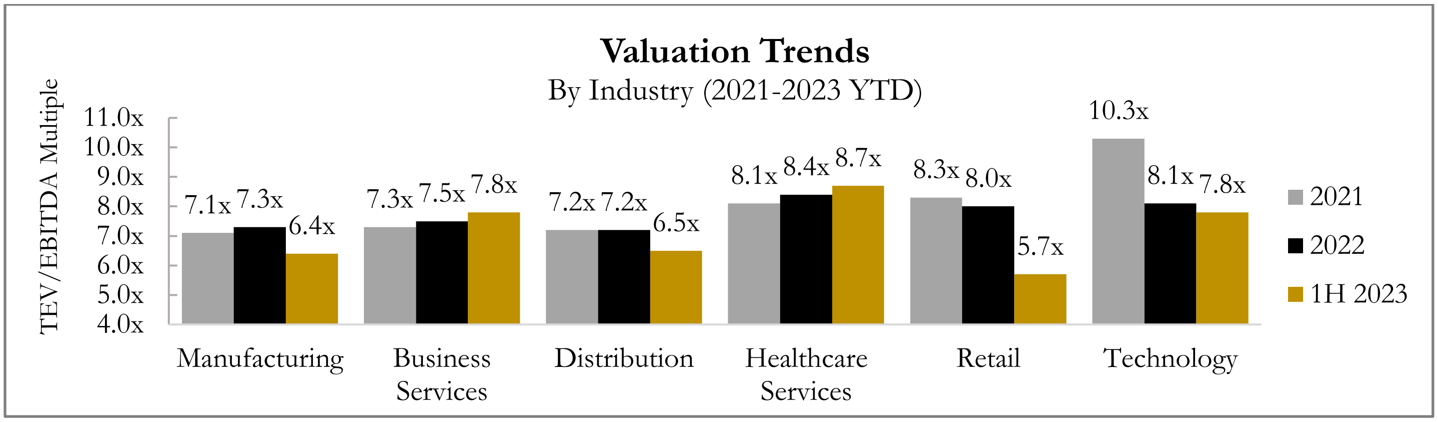


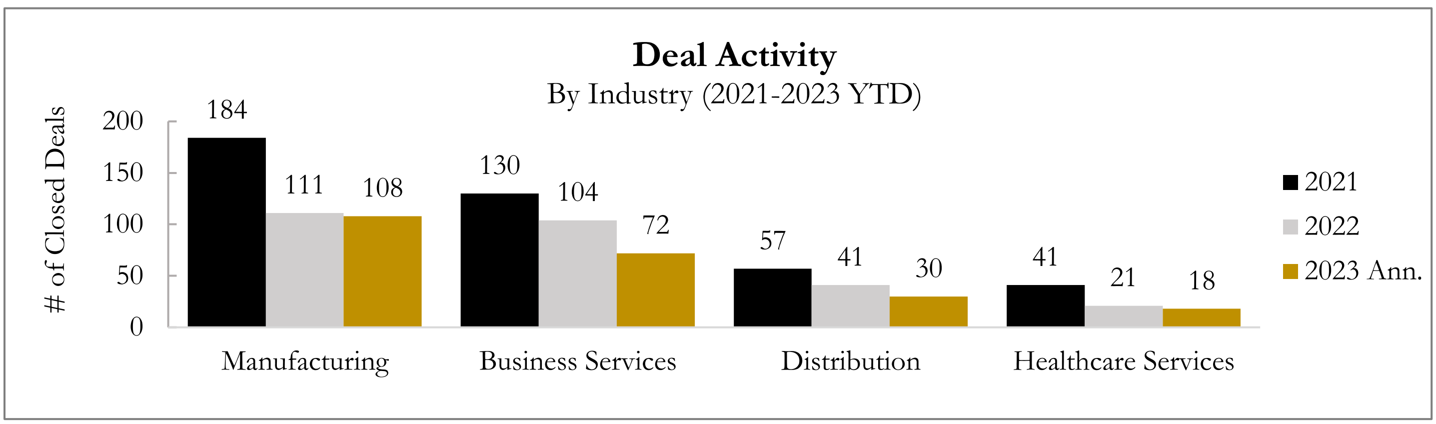
3 Sector Breakdown

Decreased Volume Across Sectors, Multiples Remain Strong in Healthcare and Businesses Services

While the broader M&A market cooled off in the first half of 2023, valuation trends have differed across industries. The table below compares TEV/EBITDA multiples in 2022 vs. 1H 2023 in six (6) major industries.

The largest valuation declines occurred in asset-heavy businesses such as manufacturing, distribution, and retail. During the same period, there was a slight increase in multiples paid for business services (B2B) and healthcare companies.





The chart above analyzes deal volume broken down by industry from 2021-2023, with 2023 annualized based on data through Q2. As shown, the decrease in M&A activity has been consistent across the board, with each sector showing year-over-year (YoY) declines since 2021.

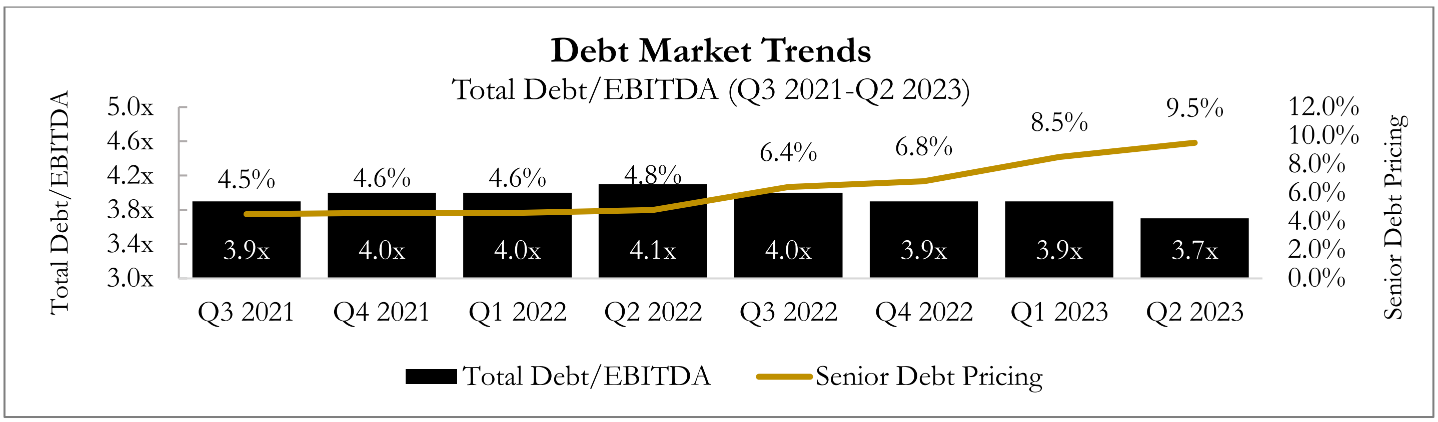
Another notable M&A trend has occurred amongst financial buyers in recent quarters. A number of private equity firms have pulled back in 2023, focusing on optimizing their portfolio companies rather than pursuing new platform acquisitions. This has contributed to a notable decline in sponsor-to-sponsor deal activity thus far in 2023.

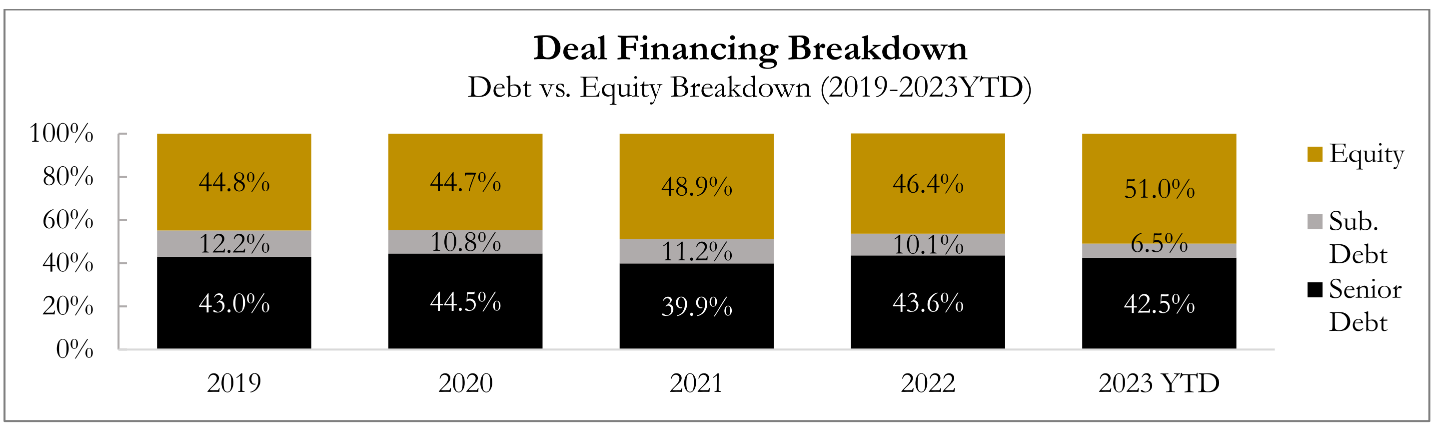
4 Leverage

Debt Markets Tighten as Rates Continue to Rise

M&A lending markets have tightened in recent periods due to rising interest rates. Banks and lending institutions have become more selective in their lending practices while requiring a more rigorous evaluation process. This has made it essential for companies to demonstrate strong financial health and a clear strategic rationale for their proposed transactions.

The chart below shows total debt/EBITDA on a rolling four-quarter basis from Q3 2021 to Q2 2023. Inflation in the US peaked in June 2022 at 9.1%, causing the Fed to hike rates more aggressively in the months following, ultimately sending senior debt rates climbing from 4.8% in Q2 2022 to 9.5% in Q2 2023. During this same period, the average total debt on deals declined by nearly a half turn from 4.1x to 3.7x EBITDA.





As illustrated in the chart above, acquirers have used an increasing amount of equity financing to fund their acquisitions as debt markets have tightened. This is another key driver in declining valuation multiples, as higher equity contributions mean buyers aim to reduce purchase price to achieve their target rate of return.

5 Houlihan Capital

Investment Banking team

Houlihan Capital's Investment Banking group offers an integrated advisory approach that draws upon our strategic and technical expertise, industry knowledge, transactional and financing experience, and expansive network of institutional and private investors to guide shareholders and management teams. We understand the time sensitivity of many of our assignments and work diligently to meet these demands while minimizing operational disruption, allowing clients to focus on their business.

Our team works with businesses across all major industries with an enterprise value greater than $5.0 million and EBITDA between $1.0 million than $20.0 million. Many businesses of this size have a unique story to tell, and we are committed to structuring a tailored approach to assist clients in achieving their strategic, financial, and risk-management objectives.

Our investment banking professionals function as an extension of our client's management team, providing specialized transaction advisory support derived from years of hands-on experience. Our clients can stay focused on running their business while Houlihan runs a successful sale process.

To find out more about how Houlihan can assist in the deal process, please contact one of the following members from our team:

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