2023 Wrap-Up | 2024 Look Ahead

CBIZ PRIVATE EQUITY ADVISORY

M&A MARKET UPDATE

CONTENTS:

Deals Closed (#): 2,213 (QoQ ↑ 14%) Deals Closed Value: $135.5B (QoQ ↓ 21%) PE Fundraising: $132.76B (QoQ ↑ 49%)

M&A MARKET PERSPECTIVE
Exits are the Linchpin

Private equity continued to look for the bottom through the end of 2023. PE firms spent the year patiently waiting for improved market exit conditions and exercising more discretion over the deployment of their growing arsenals of dry powder, which hit a record high of $956 billion. In the absence of traditional exit and investor methods, PE found new favorites in secondaries and growth equity.

Given last year's results, the market is eager to say goodbye to 2023 and look ahead to 2024 with more optimism. These are some key themes we expect to make the biggest impact this year.

Hold periods grow as exits continue to stall: PE firms tend not to be forced sellers, and the steep decline in exit activity throughout the year only reinforced that characteristic. However, as investors hold on to valuation expectations and wade through a weak market, exit pressures continue to grow – LPs call for liquidity, individual funds are reaching their contractual end dates in many cases, and term loan maturities loom at an unfortunate time. This dynamic has led to the emergence of a robust and active secondaries market.

PE's ingenuity and adaptability lead to an active secondaries market: Net asset value financing, paid-in-kind loans, structured debt and mezzanine solutions, secondary sales, and continuation funds have become increasingly attractive to support securing liquidity without force-selling, with continuation funds emerging as a clear favorite. Through their relatively simplistic, albeit at times controversial, nature continuation funds give LPs their sought-after liquidity, GPs the benefit of more time, and new investors an entry point. These factors set the stage for 2024 to include more of the same execution methods.

The tug-of-war between growth equity and LBOs: Depressed exits beget depressed investments, with buy-side activity finishing 2023 at roughly half of 2021's peak. Add-ons and growth equity investments partially filled the void left by platform LBOs. However, while add-ons and platform activity's share of PE deal value declined significantly in 2023, growth equity emerged to hold a larger piece of the pie, outnumbering platform LBO deals for the first time ever. This strategy, which is not tethered to the challenges of debt costs, focuses on providing expansion capital to drive value creation through operating leverage. The emergence of and emphasis on the growth equity vehicle isn't surprising given companies' internal focus on margin expansion and top-line growth to compensate for lower multiples and to take advantage of longer holding periods.

Where we go from here: A dovish Fed influenced public markets to end 2023, signaling optimistic expectations for 2024. As the broader economy shows signs of stabilizing, PE is waiting for clarity on the direction of rates, valuations, and inflation. While lower rates could bolster activity, significant cuts in 2024 are unlikely. We could see PE recover more quickly if rate reductions were to occur amidst a strengthening macroeconomic environment. Alternatively, and more within private equity's control, firms could 'choose' to divest assets sooner when they can no longer delay exits. Restarting the exit machine is the key to a comprehensive recovery, given the symbiotic nature of the private equity market.

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DEAL METRICS UPDATE
Q4 2023 By the Numbers

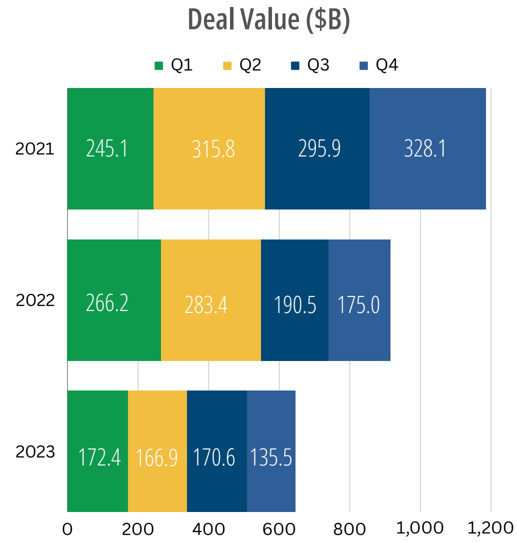
Add-Ons Remain Steadfast Amid Declining Deal Activity

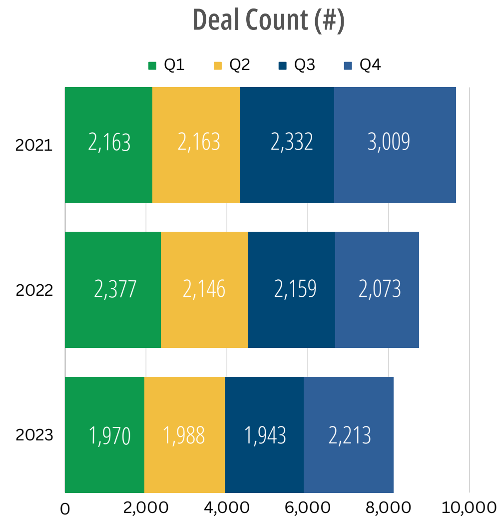
The closing of 2023 marked the second year of PE dealmaking decline. The deployment of capital for new investments in 2023 declined by a grim 29.5% over 2022, now down 73% from the high benchmark of 2021; Q4 2023 deal value also decreased by almost 23% compared to Q4 2022. Deal volume increases, however, were a bright spot. Although annual activity is down about 7% over 2022, Q3 2023 volume spiked to the highest level of activity since Q1 2022.

Given market conditions, platform deals continued their descent, down 36.5% from 2022 – results that were expected given the contraction in leverage ratios. Buy-side activity was primarily represented by smaller deals comprised of add-ons and growth equity investments. The latter has increased its share of activity by almost 3%, up to 12.7%, and represented over 20% of PE deal activity in 2023. These market gains were offset by a drop in LBOs which declined to 18.9% in 2023 (and are down over 5% compared to their five-year average).

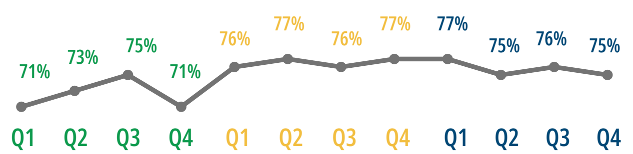
Add-ons remained a steadfast strategy through 2023, accounting for almost 76% of all PE buyouts (a total of less than 100 basis points off of 2022.) Aggregator strategies have proven increasingly valuable as a way for sponsors to continuously deploy capital without being frozen by lending constraints. As such, buy-and-build strategies of PE firms have become integral in enabling existing platforms to continue growing.

Quarterly PE Deal Activity





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

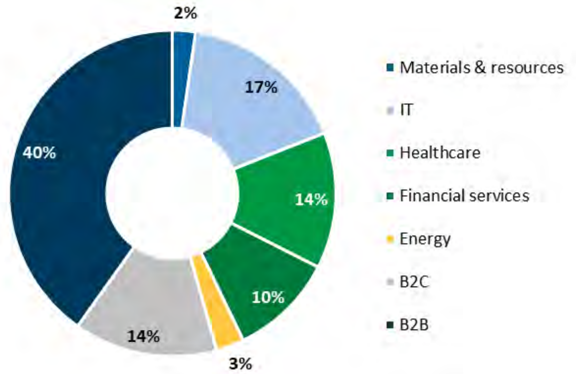


Source: PitchBook Data, Inc. US PE Breakdown

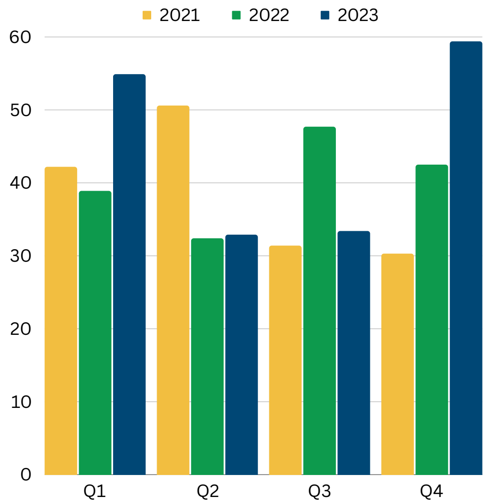
DEAL METRICS UPDATE
Q4 2023 By the Numbers

Quarterly Deal Activity Breakdown

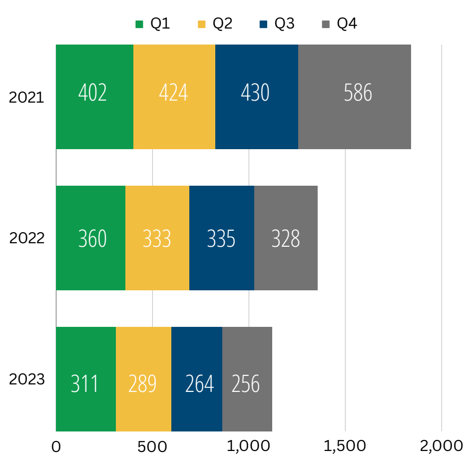
PE Deals by Sector (#)



Quarterly PE Middle Market Fundraising ($B)



Quarterly PE Exit Activity (Deal Count)



Source: PitchBook Data, Inc. US PE Breakdown

Exits are Still Looking for the Bottom

Q4 exits in both number and value came in below Q3, which was already the lowest exit period for US PE in over a decade. Prolonged inflation and valuation spreads led to a 21.5% decline in exit value over Q3 2023.

In the absence of an exit market, portfolio companies are living in their funds longer to build up valuations that are no longer inherently bolstered by broader market upswings. The current median age of a PE-owned company is 4.2 years and growing. Of the negligible exits that took place, the median hold period for those investments was 6.4 years, a new record high.

Despite Headwinds, Fundraising Prevails

In the face of declining metrics across PE and a challenging fundraising landscape, middle-market fundraising held strong, amassing over $180 billion of new investments and keeping pace with previous years. More notable is the increase in market share, with middle-market fundraising representing almost 60% of total funds raised (up from 41.5% in 2022). This shift reflects the more favorable deal environment within the middle market range, where the add-on/buy-and-build strategies are most prevalent. These positive results also reflect LPs continued commitment to PE, given its long-term prospects and expected resiliency.

Amid strong fundraising results, concerns remain about an impending slowdown. Fundraising is often a lagging indicator; therefore, the slump seen across other data points is expected to impact fundraising as well. For now, the continued deceleration of capital deployment coupled with strong fundraising equals a new record high of dry powder, which has grown by more than 9% over the past two years, and is waiting in the wings to be deployed when GPs are ready.

STATE OF THE ECONOMY

Colliding Sentiments: Optimistic Markets & A Dovish Fed meets Persistence in "Higher for Longer"

The public markets ended 2023 with unbridled optimism as the Dow Jones Industrial Average Index scored a record high, and the S&P 500 Index ended a touch below its previous record. Global sovereign yields plummeted, aiding a strong rally in the bond market. A surprisingly dovish Fed drove these gains, signaling three rate cuts in 2024 during their December Federal Open Market Committee meeting. The tug-of-war between market expectations of policy versus the actual trajectory of rates provides an interesting tension for public markets to start the new year.

- **The market is pricing in an even more dovish Fed:** Despite the three rate-cut guidance from the Fed, the fed funds futures market is pricing in six rate cuts of 25 bps each for 2024.[1] Either the market sees inflation coming down faster to the Fed's 2% target, or it is betting that an economic malaise will force the Fed's hand. Either way, a dovish market bet creates looser monetary conditions, working against the Fed's goal of keeping financial conditions tight to bring inflation down.

- **The labor market is showing a holding pattern:** On the surface, the labor market seems strong. A 3.7% unemployment rate[2] signals a tight market, and businesses still report a shortage of skilled workers. However, the December jobs report showed that 60% of the net hiring was in industries supporting the social structure of our society: Education, Health Services, and Government. Industries representing cyclical economic momentum, such as Retail, Manufacturing, and Construction, left us wanting.

- **Consumer wallets remain vulnerable:** One can always count on American consumers to spend, especially during the holiday season. In Q4, Americans achieved a record level of "buy now, pay later" purchasing, and credit card balances reached new heights above $1.3 trillion.[3] As long as the labor market stays tight, consumers can still meet their obligations, but the current debt profile leaves the household balance sheet fragile for future challenges.

- **Inflation is a complex beast:** The path of inflation from 9% to 4% has been swift. The journey from 4% to 2% is proving to be asymptotic. The price momentum is expected to persist in Q1, and the geopolitical tensions do not help the fight against inflation. The war-related risks in the Suez Canal and the drought in the Panama Canal disrupted the route of global commerce and threatened the Fed's goal of 2%.

- **Public market euphoria:** Fueled by the "soft landing" narrative and an unexpected dovish position of the Fed, the public equity markets soared to finish 2023. The price movement has been divorced from the underlying corporate fundamentals, leaving the equity markets vulnerable to negative surprises.

Public and private markets are anticipating rate cuts in 2024 and looser financial conditions. Reducing borrowing costs certainly would help businesses maintain liquidity and spur M&A activity. It would also help to breathe life back into the housing market for American consumers. Inflation and the labor market are the most important factors driving the rate trajectory. For Q1 2024, both variables point to a "higher for longer" scenario and may disappoint the markets' dovish stance.

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1 As of 1/9/2024
2 Bureau of Labor Statistics
3 As of November 2023, The Federal Reserve

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WHAT'S TRENDING

The Shifting Terrain of Alternative Financing

In the world of corporate financing, the landscape is witnessing a significant transformation, particularly in the realms of Collateralized Loan Obligations (CLOs), LBOs, and private debt funding.

Many companies, already having spent 2023 navigating a turbulent market, are now facing heightened challenges to refinance debts in a market characterized by significantly higher costs of borrowing, which, in turn, puts further strain on their financial stability. In parallel, the pace of middle-market CLO issuance has slowed as the market contends with an uptick in credit estimate downgrades, higher interest rates, and a reevaluation of risk by investors. US PE LBOs, which accounted for over $640 billion in 2021 and $485 billion in 2022, finished 2023 at $310 billion, a 37% decline from 2022.[1]

As the landscape evolves, the refinancing needs of companies within CLO and LBO pools, particularly those with speculative credit ratings, have become a focal point of concern. The market has responded with increased private debt offerings, making up for the reduction in CLOs and LBOs in 2022 and 2023.

The Role of Business Development Companies (BDCs) and Private Debt Funds. A significant aspect of the private debt market is the emergence of Business Development Companies (BDCs) and Private Debt Funds. These alternatives have credit stipulations and may come with higher financing costs, but they offer distinct avenues for investors and companies seeking financial solutions. BDCs, subject to certain regulatory requirements, ensure a level of transparency through capital maintenance against loans and detailed reporting of loan portfolios.

Complementing the role of BDCs are Private Debt Funds, which have become increasingly prominent in facilitating refinancing deals and offer an alternative route for companies to access capital for refinancing.

Post-financial crisis regulatory changes have redirected the flow of lending from traditional financial institutions to the private debt sector. Unlike the banking industry, private debt funding, largely unregulated, has grown exponentially, from about $500 billion in 2012 to an estimated $1.75 trillion through Q2 2023.[2] This growth raises concerns due to the sector's vulnerability to higher interest rates, economic slowdowns, and risk-averse investment climates. The private debt sector, primarily funded by lending to firms owned by private equity funds, has been a major contributor to this expansion as LPs shift their allocations to situations that may offer a better combination of risk and reward in the current environment.

Systemic Concerns and Future Outlook. The growth of the private debt market and the shifting dynamics of CLOs and LBOs reflect a broader trend in corporate financing. However, the lack of regulatory oversight for a significant portion of the private debt market and the economic headwinds raise systemic concerns. In our high-interest rate environment, the credit quality of companies who have relied on private loans is at risk of deterioration, with potential overarching impacts on employment and the broader economy.

The commercial CLO, LBO, and private debt funding markets are at a pivotal juncture, navigating through regulatory changes, economic shifts, and investor recalibration. Stakeholders must act with a higher sense of awareness about the inherent risks and opportunities, which will be imperative as they continue to adapt to this evolving financial terrain.

[1] PitchBook Data, Inc. US PE Breakdown [2] PitchBook Data, Inc. H1 2023 Global Private Debt Report

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CBIZ PRIVATE EQUITY ADVISORY

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- Transaction Due Diligence
- Tax Due Diligence
- Tax Planning & Structuring
- Merger Integration
- Preparation for Exit

Performance Enhancement

- FORWARD™ Program for Post-Transaction Finance
- Accounting & Finance Optimization
- Transaction Accounting & Valuation Services
- Budgeting & Strategic Planning
- Financial, Operational & Cash Forecasting
- Performance Reporting & BI Solutions
- Profitability Improvement
- Executive Search
- Interim Talent

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