CBIZ
PRIVATE EQUITY ADVISORY

Q2
2024

# M&A MARKET UPDATE

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Deals Closed (#): 2,163 (QoQ ↑ 6%) Deals Closed Value: $157.5B (QoQ ↓ 6%) PE Fundraising: $78.2B (TTM ↓ 2%)

# M&A MARKET PERSPECTIVE
## Let's Not All Rush for the Exit at Once

**Higher borrowing costs and a persistent valuation gap between buyers and sellers are contributing factors to a hindered recovery. Private equity firms remain stuck in the current reality of fewer realizations and lower returns. Most private markets firms remain significantly behind plan in terms of generating distributions and the fundraising environment is remarkably difficult. Firms are still left working through the logjam of investments made between 2014 and 2017 that are overdue for their exit events. While we're seeing some directionally promising trends through H1 2024 and the long-term outlook remains positive, working through this backlog near term is continuing to prove more challenging. This quarter, we focus on the avenues of relief as private equity continues to navigate the current environment.**

**Where are the exits?:** All-time highs in public equity markets and the industry-wide pressure on private equity to return capital to investors were presumed to force exits sooner in the year. But unlike public companies, private equity investments tend to be more leveraged with shorter term floating rate debt. With the current interest rate market, this has resulted in cash flow struggles (evident in the decline in interest coverage ratios from 2.9x in 2022 to a recent level of 2.4x, the lowest since 2008), straining the already lower margins compared to their public company counterparts. The result is fund lives at all-time highs, hitting a 7-year average median hold period for 2023 exits. Current portfolio companies are also trending longer, hitting median hold periods of 4 years and counting compared to the five-year holding period average of 3.8 years. Increased market certainty (save for the upcoming election), stable interest rates, sidelined dry powder and over-aged investments all support an impending ramp up in exit activity. However, these forces have been in place for many quarters and it's concerning (and perhaps a bit surprising) that the exit pressures have yet to come to fruition. Even the exit activity through H1 2024 isn't strong enough to cement the road to recovery. While an uptick in exits could restart the industry, what's just as likely is a continued drought in exit activity extending into a third year.

**Exit alternatives are coming up short:** While the market awaits the dam breaking, managers continue to find solutions for their aging assets through continuation funds, recapitalizations, and the secondaries market, to satiate LPs' desires for liquidity. However, these avenues aren't enough. Recapitalizations perpetuate the higher cost of debt at rates likely substantially more than original loan terms, placing more strain on cash flows. Continuation funds are reserved for the highest quality assets, large enough to support the traction needed to raise enough capital for a buyout. That leaves the secondaries market as a critical release valve, but there simply isn't enough available capital to support liquidity needs – older buyout funds are estimated to require about $316 billion in distributed capital over the next two years. However, capital from secondaries funds is only enough to cover an estimated 10-20% of what's needed to meet exit demands, which are 4x in excess of secondaries liquidity available in 2024 and an estimated 5.5x more than secondaries liquidity come 2026. Additionally, while increased secondaries activity has led to improvements in pricing and has created an opportunity for LPs buying at discounts, it's not favorable for managers selling their assets, on average at 91% of NAV. All of this to say that a recovery of traditional exit activity, i.e. buyouts and IPOs, is still the way out.

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# M&A MARKET PERSPECTIVE
## Let's Not All Rush for the Exit at Once (continued)

**Fundraising is a lagging indicator that is no longer lagging:** Distributions as a percent of invested capital are at a 25-year low (the lowest point since the Global Financial Crisis). In practice, this means it's taking longer to return capital and when it is returned, IRRs are eroded due to the longer hold periods. This slower and lower return environment means there is not enough capital to replenish the fundraising cycle, which in turn has the potential to drive the fundraising market into a multi-year recession. The fundraising environment has become so challenging that firms are pausing on fundraising altogether or taking significantly longer to raise less than their previous fund vintage. It's yet to be seen if the sidelined dry powder is enough to support investing until we're on the other side of the current fundraising slog.

Looking ahead, there are emerging signs of life through more manageable debt market conditions and better interest rate visibility (with possible rate cuts on the horizon near term). Newer vintage fund managers who have exercised greater discipline and are more operationally driven are setting themselves up for success without reliance on the tailwinds characteristic of the last decade. But many firms are still struggling with putting dry powder to work (hampered by low inventory) and could be in a position where their investment timelines are compressed because of delayed capital deployment.

Near term, all eyes are on liquidity and on when and how it happens.

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***Significant Sources:***
*Pitchbook*
*Bain & Co. 2024 Global Private Equity Report*
*Bloomberg, 'Everything Is Not Going to Be OK' in Private Equity, Apollo's Co-President Says*
*JP Morgan Asset Management, Will exit activity improve in private equity?*

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# DEAL METRICS UPDATE
# Q2 2024 By the Numbers

## Not Better But Not Worse

Deal count continued its sideways trajectory through Q2 2024 with a slight 6% increase in activity over last quarter. By comparison, deal value moved in the opposite direction, declining 6% over Q1 2024. More notably however is PE deal activity as a share of the broader M&A market. After Q1 2024's shrinking results, Q2 2024 trended back up, resulting in H1 2024 coming in 12% over H1 2023 and PE grabbing almost 37% of all M&A activity (compared to the 2022 peak of 44% market share, and up from 32.6% last quarter). While the level of activity over the last eight quarters has felt lacking compared to the highs of 2022, these trending results are higher than the "old normal" of 2017 through 2019, with a 25% increase over historical deal value and a 45% increase over historical deal count.

While there is more stability in the leveraged finance market, platform deals continue to be paralyzed by the perpetually high borrowing costs and lack of inventory. Platform deals declined to 19.3% of all PE deals in Q2 2024.

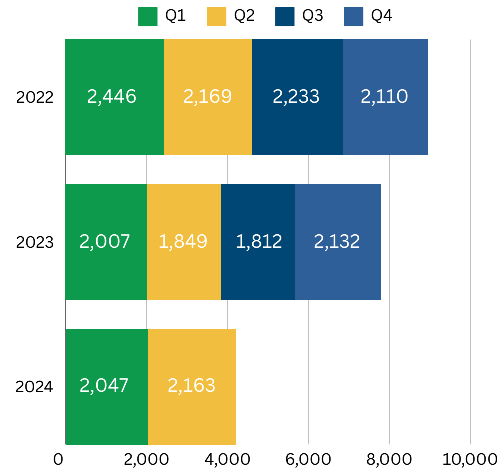
Refinancing activity within the broadly syndicated loan market continued to rise, two-to-one, over new loan issuances. Historically, the inverse was true, with new loans outpacing refinances four-to-one. The desire to lower borrowing costs and the extended hold periods resulting in sunsetting debt contributed to the flip in activity.

While add-on transactions continue to give PE firms the ability to deploy capital, pursue growth and focus on operational synergies, a decline in add-on activity may provide a signal to a broader dealmaking recovery, if/as interest rates decline, and dealmakers have room to shift to platform and carve-out strategies.

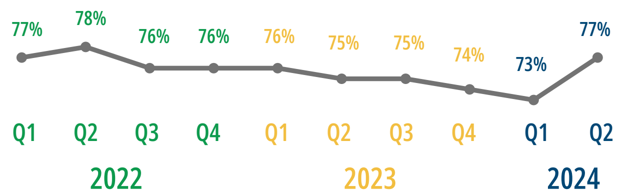
## Quarterly PE Deal Activity

### Deal Value ($B)


### Deal Count (#)




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




*Source: PitchBook Data, Inc. US PE Breakdown*



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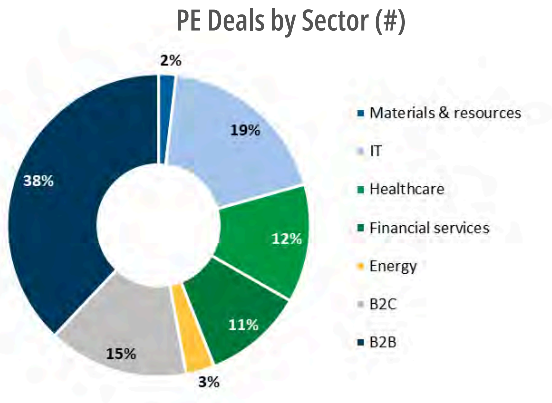
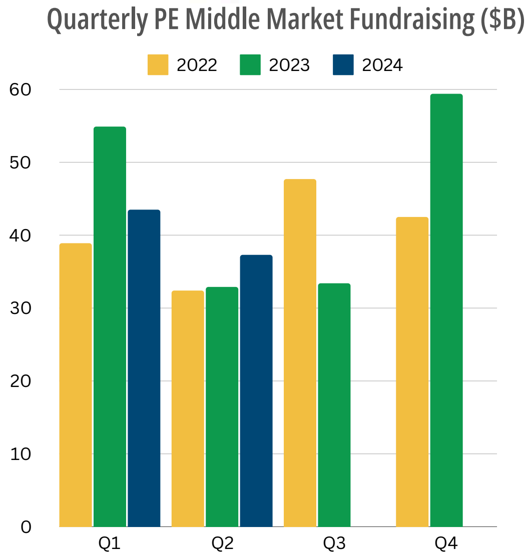
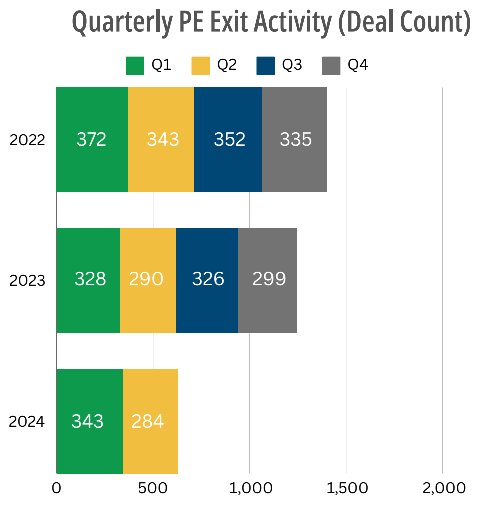
# DEAL METRICS UPDATE
## Q2 2024 By the Numbers

### Quarterly Deal Activity Breakdown




*Source: PitchBook Data, Inc. US PE Breakdown*

### The Exit Stalemate Continues

Exit activity fell short of the expected forced recovery. With funds growing older and LPs' calls for ROI getting louder, there's an expectation that the exits will be forced, regardless of the resulting metrics. While H1 2024 exit value increased to 15% over the same period in 2023, the spike is likely reflective of GPs only bringing their best-quality assets to market. Exit count remained relatively flat in H1 2024 compared to H1 2023 and declined 17% when comparing Q2 2024 to Q1 2024.

Valuation gaps continue to plague dealmaking, evident by the exit/investment ratio hitting 0.36x this quarter, a new record low. In parallel, capital calls outpaced distributions by two-to-one. These metrics reflect the chokehold the lack of exits has on the broader investment engine.

### Fundraising Catches Up to Market Challenges

Net fundraising numbers alone still show positive results, with H1 2024 tracking slightly above H1 2023 (the second-best fundraising year ever). However, minimal exit activity, low and slow distributions and portfolio rebalancing away from PE are all expected to impact fundraising. Those underlying factors are emerging through more telling metrics - fundraising rounds have increased from 11.2 months in 2022 and 14.7 in 2023 to 18.1 through H1 2024. While the period between fund raises shrunk from 3.5 years in 2023 to 3 years through H1 2024, they have trended heavily to established managers where investors feel there's a track record of success and therefore less risk; and the median step-up of about 39% is the lowest since 2015 and more than 10% below the five-year average. These metrics are the lagging indicators expected after two and a half years of struggles in the dealmaking landscape.

# STATE OF THE ECONOMY
## The Economic Seesaw: Are You Enjoying the Ride?

**The description of the American economy has suddenly shifted from "resilient" to "softening" during the second quarter of 2024. Leading the sentiment has been weaker data from labor market reports, disappointing retail sales, and increasing delinquencies in consumer credit. But sometimes bad news is good news in the marketplace. Softer economic data has been linked to higher probability of rate cuts by the Fed, and that is good news for investors and dealmakers.**

- **The jobs market surprise:** During the second quarter, cracks began to surface in the U.S. labor market. The headline unemployment rate moved incrementally from 3.8% in March to 4.1% in June. Underneath the surface, the headline job gains of 206,000 in June were mostly from noncyclical areas of the economy: government, health care, and social assistance. Supporting the pressures in the employment situation, we saw job openings fall to levels not seen since the first quarter of 2021.

- **Inflation settles and the Fed shifts its focus:** The June Consumer Price Index (CPI) came in below all consensus estimates, with the headline CPI settling at 3.0% YoY, the lowest since March of 2021. As the inflation profile closes in on the Fed's 2% inflation target, the central bank is shifting its focus away from prices to the labor market. And in the context of softer jobs market data as of late, the Fed funds futures market is pricing in a first 25-bp rate cut in September of 2024.

- **AI-related frenzy or a flight to quality?** The S&P 500 Index continued to hit record highs during Q2 2024, driven by the Magnificent Seven stocks[1]. While investors attribute the rise of a handful of tech stocks to artificial intelligence, there may be another explanation. These tech names are flush with cash, have little debt, and have accounted for more than 50% of the YoY earnings growth of the S&P 500 Index in Q1 2024. In other words, these stocks are "quality" names. As the economy shows softening signs, investors may be accomplishing two things at once: participating in the AI upside and allocating to quality balance sheets.

- **The cost of capital:** The historically tight corporate credit spreads started to unwind during Q2 2024 – investment grade option-adjusted corporate spreads (OAS) widened by 4 bps and high yield OAS by 10 bps. Such widening may seem counterintuitive as the S&P 500 Index hit new highs, but excluding the Magnificent Seven stocks, the public markets have been struggling: small cap stocks were down 3.3% for the second quarter as represented by the Russell 2000 Index. The Fed's start of the rate-cutting cycle will be important to credit investors who pay attention to the cash flow and interest coverage profiles of companies.

Is a soft landing possible for the U.S. economy? The probability of this achievement increases the earlier the Fed starts its cutting cycle. Currently[2], two rate cuts are priced into the market for 2024, and the CBIZ house view is that we will most likely get them. We also think that the Fed should start cutting rates sooner toward normalization of interest rates, so that the stressed areas of the economy (i.e. real estate, consumers) can begin to heal.

[1] The Magnificent Seven: Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla
[2] As of 7/11/2024



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## WHAT'S TRENDING

# Does Your Budgeting Process Fit Like a Glove?

**Many middle-market businesses with established budgeting processes begin to mobilize an annual budget around the start of Q4. However, if you lack a routine planning process, don't fully understand the "why" of budgeting, or seek to make significant changes to your processes, discussions should start much earlier.**

For any business, aligning the primary objectives of a budget can help guide the development of the most effective budgeting process. A well-fitting budget process balances the investment of cost and effort with the value of achieving those key objectives. Here are some of the most common key objectives for designing your company's annual budgeting process.

| BUDGETING OBJECTIVE | DOS | DON'TS |
|---|---|---|
| **COMPLIANCE:**<br>**Fulfill an external requirement (i.e., credit agreement covenant)**<br>Consider a top-down approach, leveraging a summarized financial model to minimize the number and effort of involved personnel. | Focus on key metrics important to the external party implied by the budget scenario (e.g., Net Leverage, FCCR, etc.) | Expect to provide data-driven variance analysis to the budget scenario. |
| **ACCOUNTABILITY:**<br>**Hold leaders accountable to financial performance**<br>Either invest in a uniform process for all leaders or specify metrics and granularity for each leader's planning process output. | Clearly define each leader's responsibility so that budget inputs are mutually exclusive and collectively exhaustive. | Expect limited iteration; emphasizing accountability may lead to 'sandbagged' initial budget submissions. |
| **TRANSFORMATION:**<br>**Define a plan for substantial change in the business (e.g., new product / market, extraordinary investment in OPEX, insourcing / outsourcing, etc.)**<br>Develop detailed assumptions/drivers to model business changes, emphasizing future variance analysis for performance context. | Maintain the budget scenario to clearly segment the P&L impact of core business from initiative #1 from initiative #2. | Minimize attention paid to budgeting related and unrelated changes in the core business. |
| **OPTIMIZATION:**<br>**Provide a detailed roadmap to achieve meaningful profitability improvement through either cost reduction or revenue expansion**<br>Common methods (e.g., zero-based, bottom-up, top-down) can be used to arrive at the end budget scenario, but it must be built from detailed assumptions and data attributes (e.g., customer, vendor, employee, etc. even if reverse-engineered) for actionable tracking against the improvement roadmap. | Build efficient, detailed variance analysis and reporting; invest as much into ongoing performance management processes as the creation of the budget. | Destroy the usefulness of detailed support by including material "topside" adjustments in the final budget scenario. |

Aligning on the primary objective(s) of an annual budget process provides a framework to evaluate what aspects of the planning process should be emphasized. Planning processes vary tremendously in terms of sophistication, effort, contributors, and detail; the process that "fits best" does not (and should not) maximize all aspects.


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# CBIZ PRIVATE EQUITY ADVISORY

## Deal Advisory

- 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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## CBIZ Private Equity Advisory By The Numbers

**400+** PRIVATE EQUITY CLIENTS

**2,000+** PORTFOLIO COMPANIES SERVED

**110+** PROFESSIONALS