Q3
2024

CBIZ
PRIVATE EQUITY
ADVISORY

# M&A MARKET UPDATE

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Deals Closed (#): 2,198 (QoQ ↑ 1%) Deals Closed Value: $246.0B (QoQ ↑ 14%) PE Fundraising: $81.3B (TTM ↓ 2%)

# M&A MARKET PERSPECTIVE
## Rates Drop, Exposing Hidden Market Strains

**Private equity continues to adapt to the evolving market landscape, with uncertainty still clouding the timing of when M&A will find a more stable footing. Although year-to-date deal activity and total deal values outpaced the same period in 2023, several factors continue to weigh on dealmaking. The Fed's first 50 basis point rate cut in four years was seen as a potential spark for M&A activity. However, beneath the surface, the market continues to struggle with weaker business performance, limited exit activity, and valuation disparities, all set against a backdrop of political uncertainty. Although lower rates may provide some support, there are valid reasons to believe that other factors will temper any significant momentum in the near term. As market sentiment suggests a stronger close to 2024 than its start, we turn our attention to the key drivers shaping dealmaking right now.**

**Fed rate cut impact:** At first glance, the Fed's rate cut seems like a welcome relief from the prolonged period of elevated rates. In theory, lower rates reduce borrowing costs, improve cash flow through decreased interest payments, boost profitability, and potentially increase a company's valuation. A stronger company, paired with cheaper capital, could attract more buyers, perpetuating the cycle. However, the initial spike in rates alone didn't significantly dampen dealmaking activity, so it's unlikely that a (relatively) modest rate reduction will be the sole catalyst for a surge now. Instead, we're seeing the underlying challenges that were previously overshadowed by higher rates.

**Are portfolio companies and their managers fighting an uphill, losing battle?:** In 2021, the U.S. economy saw robust growth at 5.7%. However, according to a number of organizations, the US GDP growth forecast for 2024 is between 2.5% and 2.7%, with the potential for further decline in 2025 if a soft landing continues. Over the past two years, PE firms and their portfolio companies focused on cutting costs, streamlining operations and strengthening balance sheets to protect the bottom line against higher borrowing costs. Despite these efforts, broader economic pressures are reflected in declining EBITDA or slower growth rates. In light of these headwinds, only improved business performance can reignite deal activity.

**Resetting the goalposts:** There remains a valuation gap between buyers and sellers. Fund managers continuing to extend investment hold periods further may drag down IRR, while exiting at a discount may call into question valuation shortcomings of their entire portfolio, potentially jeopardizing a firm's ability to raise future funds. Rather than rushing to exit, GPs may opt to extend hold periods and focus on improving asset values while waiting for multiples to recover.

This new playing field calls for a new way to keep score. Traditionally, PE performance has been measured by IRR, which was meaningful when PE outperformed public markets and investment strategies could be successful in shorter hold periods. However, the rise of longer-term roll-ups coupled with investor pressure to distribute returns have shifted the focus toward DPI, the ratio measuring "distributions to paid-in capital". While DPI doesn't obscure a poor exit, it does remove the penalty for timing and therefore the incentive, or pressure, for managers to accept lower valuations for the sake of an exit.


***References:***
*Pitchbook*
*Financial Times, "Private Equity is doing badly – however you measure it"*
*Financial Times, "Buyout Executives say distributions are 'magic word' after exit slowdown"*
*Baird, "Fed Rate Cuts a Catalyst for M&A Activity"*



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# DEAL METRICS UPDATE
## Q3 2024 By the Numbers

### Momentum Headed Into Q4

Q3 2024 marks the second quarter in a row where both deal value and count improved over the prior quarter – deal value made larger strides, up 14% over last quarter and 23% over YTD 2023; while deal count (the more meaningful metric in our view) is up 1% over Q2 2024 and 13% over YTD 2023. Lower interest rates are also expected to provide a boost to dealmaking as investors intend to buy first (and sell later), with the lower cost of capital.

With the upcoming election quickly approaching, many question the impact on dealmaking headed into year-end. However, an election-year lookback by Pitchbook found that historically there were downshifts in activity in August and September, 'normal' activity in October and November and surges in December. By this account, any related decline would already be behind us.

The Broadly Syndicated Loan market continued to surge with new activity and is on pace to beat its prior all-time high of $213B from 2013. However, unlike historical trends, refinancing continued to outpace new-issue volume accounting for almost two-thirds of all activity. With hold periods still on the rise coupled with declining rates, this trend is expected to continue near term.

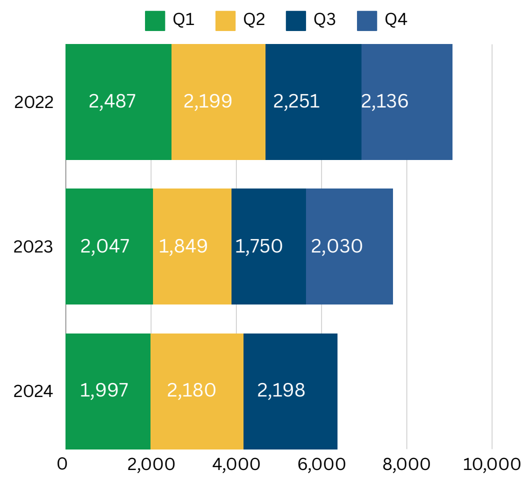
Carveouts also continued their upward trend. As a favorable option for both buyers and sellers, they accounted for almost 12% of all US PE buyouts in Q3 2024, the highest proportion since 2016.

Add-ons, which have accounted for about 75% of deal activity since Q2 2022 likely reached their high-water mark. With the rate-cut cycle underway, it's expected that LBO activity will begin to supplant add-ons as credit conditions improve.

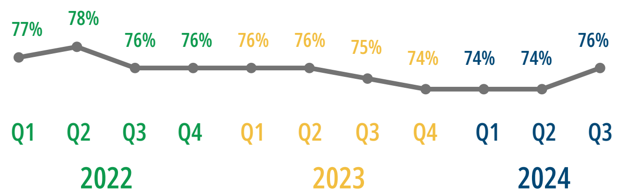
### Quarterly PE Deal Activity

Deal Value ($B)


Deal Count (#)




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




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



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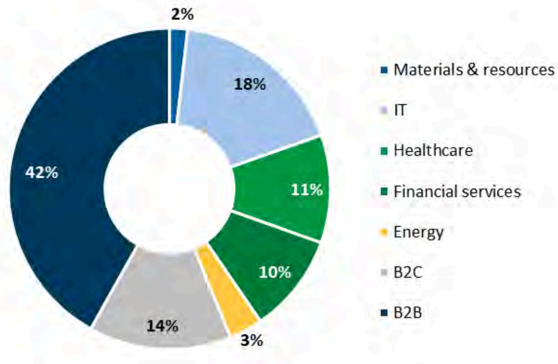
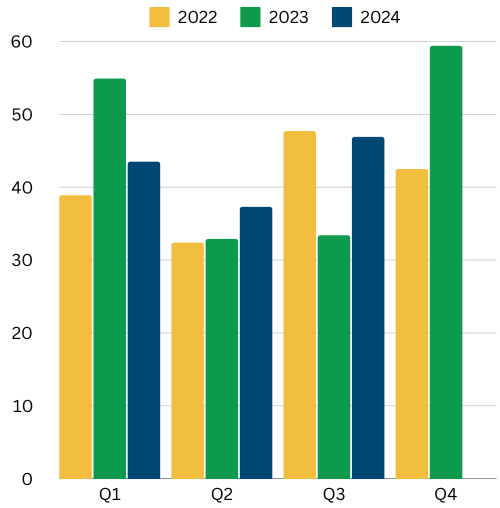
# DEAL METRICS UPDATE
# Q3 2024 By the Numbers

## Quarterly Deal Activity Breakdown

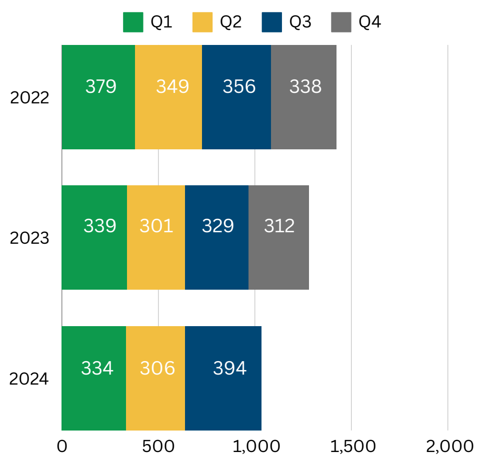
PE Deals by Sector (#)




Quarterly PE Middle Market Fundraising ($B)




Quarterly PE Exit Activity (Deal Count)




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

## The Collective Acceptance

Market and LP pressures have not forced exits like expected. Instead, managers have found different ways to satiate LPs, manage cash flows and hold onto assets. Instead of waiting for better market conditions, managers seem to be working, and waiting, for improved company performance, still stiving for desired exit values. While exits are necessary to keep the dealmaking engine moving forward, the underlying factors read more like an acceptance that managers are voluntarily riding out conditions until asset valuations improve and they can achieve successful exits.

YTD 2024 exit metrics modestly reflect this sentiment - exits are up YoY, with a 51% increase in exit value but only a 7% increase in deal count. However, the mismatch in activity underscores the selling of only the highest quality assets, while investments with less favorable valuations wait their turn.

Valuations appear to be on the mend, as expected given the recent rally in the small-cap sector, and past and future rate drops are expected to continue supporting the trend. However, to what extent?

## With Puts and Takes, Fundraising Holds

Even in the shuffling of portfolio rebalancing, PE is still raising capital at a rate in excess of pre-pandemic levels, and in line with 2023. However, those dollars continue to be harder to come by, taking an average 16.8 months to close compared to 11.2 months in 2022.

Middle-market fundraising continued to benefit from the macroeconomic landscape, with over 54% of all YTD 2024 capital raised.

# STATE OF THE ECONOMY
## An Inflection Point

**Trends, whether in fashion or in our economy, have momentum and directionality associated with them. When the economy is at an inflection point, however, momentum may falter, and directionality may become confusing. And that is where we find ourselves in the last quarter of 2024. Whether the inflection point leads upward or downward depends on a multitude of factors that are difficult to foresee, which makes the intermediate-term view of the economy murky at best.**

- **Labor market surprises:** During the third quarter, the Bureau of Labor Statistics announced that the job gains between March 2023 and March 2024 had been overstated by 818,000. The severe downward revision exposed the undercurrent of weakness in the jobs market that had already been present. Unexpectedly, the September jobs report showed a remarkable upside surprise that cast some doubt on the "softening labor market" narrative.

- **Inflation seems to settle above 2%:** The core consumer price index (CPI) has settled at around 3.3%[1] YoY, and the Fed's favorite gauge for inflation, the personal consumption expenditure deflator (PCE Index) has been hovering around 2.7%[2] YoY for the last six months. The stabilization of prices is welcome and has allowed the Fed to focus on the labor market as a guide. However, since the Fed's 2% inflation target has not changed, the interest rate environment may err on the side of being restrictive for the foreseeable future.

- **The S&P 500 Index is not the economy:** As of October 10, 2024, the S&P 500 Index had achieved its 45th record high in 2024. However, the reality on the ground may not be so rosy. In the public markets, small cap companies in the Russell 2000 Index more closely resemble the reality of most American businesses, and this index has returned 10% for the first three quarters of 2024 while the S&P 500 Index returned 21% over the same period. The lag in the small market performance is indicative of where investors believe growth and opportunities lie in this environment.

- **Plenty of liquidity, just not for everyone:** Investment grade and high yield option-adjusted spreads have compressed to historic levels, and investors can't seem to get enough new bond issuances. In addition, capital has been available through non-traditional sources like private credit, and private equity firms tapping leveraged loans through large banks. However, the actual allocation of capital has been highly selective, and M&A deal volume has remained muted through Q3 2024. Financial markets may see ample liquidity, but this tide does not lift all boats.

While many variables impact the direction of the economy, there is one factor that can move the needle: interest rates. The dearth of M&A activity, the sluggish real estate market, and other areas that are impacted by the restrictive rate environment could influence the future trend of the U.S. economy beyond this inflection point. As the Fed is data dependent, its opinion and views may be as volatile as the data can be at this juncture in the economic cycle. We believe that the Fed should continue the easing cycle it started in September because the data are backward-looking and their policy impacts the economy with a lag. This would mean two more cuts of 25 bps each, in November and December 2024.

[1] Bureau of Labor Statistics, as of September 30, 2024
[2] Bureau of Labor Statistics, as of August 31, 2024

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## WHAT'S TRENDING

# Evolving Exit Strategies: Modern Trends Shaping Deals

**Broadly speaking, what buyers have been looking for in a business has not materially changed over the past decade – strong cash flow, growth potential, synergies, etc. However, changes in technology, the interest rate environment, and continued economic uncertainty have made it imperative for business owners to shift how they prepare for an exit process.**

While these preparation considerations should be in place before the sales process starts, evaluation of these considerations occurs during the pre-LOI and due diligence phases as buyers continue to assess investments with greater scrutiny and smaller margins for acceptance. How do the latest trends in key considerations compare to traditional approaches?

| TRADITIONAL CONSIDERATIONS | | TRENDING CONSIDERATIONS |
|---|---|---|
| **Cash Flow Positive Focus:**<br>• The demonstration of upward trends and a track record of historically strong revenue and cost management.<br>• The identification of opportunities for expansion with positive cash flow potential.<br>• Working capital management (but which may be lacking in granular data visibility). | REPLACED BY: | **Cash Flow Resilient Focus:**<br>• Enhanced revenue predictability through longer-term contracts.<br>• A clear vision, and ability to strengthen market leadership in core products and services with tangible ROI.<br>• The active use of company data (including BI and AI) to drive visibility into cost levers and enhanced CAPEX management, yielding higher returns. |
| **Management Focus:**<br>• The retention of key personnel.<br>• The ability to articulate how existing management will support / transition post close. | REPLACED WITH: | **Enterprise Focus:**<br>• Clearly defined succession plans for key roles.<br>• Ability to manage company culture and offset any perceived negative impact from a sale.<br>• Effective management of remote workforces. |
| **Technology Opportunity for Improvements:**<br>• Operating with older / multiple ERPs.<br>• Some degree of cyber focus, primarily ensuring endpoint and firewall protection. | REPLACED WITH: | **Already Technology-Fluent:**<br>• Efficient and appropriate ERP / operational system(s) or a well-articulated cost / benefit plan to upgrade.<br>• Proactive cyber testing, remediation, and enhanced protection (e.g. measures to prevent, detect and remediate). |

Dry powder continues to accumulate while exit activity remains subdued. Historically, this capital will eventually need to be deployed, but with heightened buyer scrutiny, it's crucial for company and firm managers to focus proactively on what matters now. Regardless of whether a sale goes through, there's a silver lining for sellers who prioritize preparation: well-executed measures can not only enhance the sale price and streamline the transaction process but also position the business for future growth and scalability.

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## 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

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