MERCER CAPITAL

Middle Market Transaction Update

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MERCER CAPITAL

BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

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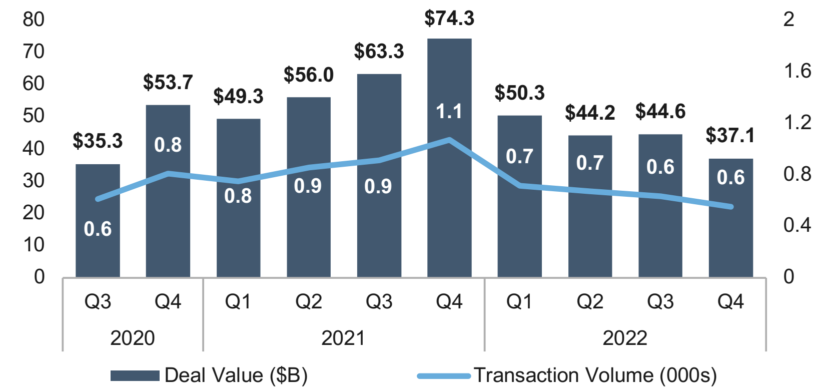
Introduction

Transaction activity in the middle market, measured both in terms of deal value and deal volume, fell in the fourth quarter of 2022, continuing a year-long skid in deal activity realized in 2022 against the backdrop of rising interest rates and looming economic threats.

Through the first three quarters of 2022, deal multiples held steady at levels seen in the more active quarters of 2021. This trend reversed itself in the final quarter of 2022, as multiples across all tranches of deal sizes fell. Multiples on deals valued in the $100 to $250 million range fell to 7.6x in the fourth quarter from an unusually high multiple of 12.8x in the third quarter and just over 9x in the prior six quarters per GF Data. While short-term fluctuations in median deal multiples could have many explanations, one could view the reduced pricing metrics during Q4 as a response to the looming economic clouds that appear to be on the horizon. Many industries have experienced record high levels of profitability during 2021 and 2022, which, paired with both higher interest rates and expectations of slowed growth or even decline in the short-term, creates an obvious negative pressure on transaction multiples.

U.S. Deal Value & Volume

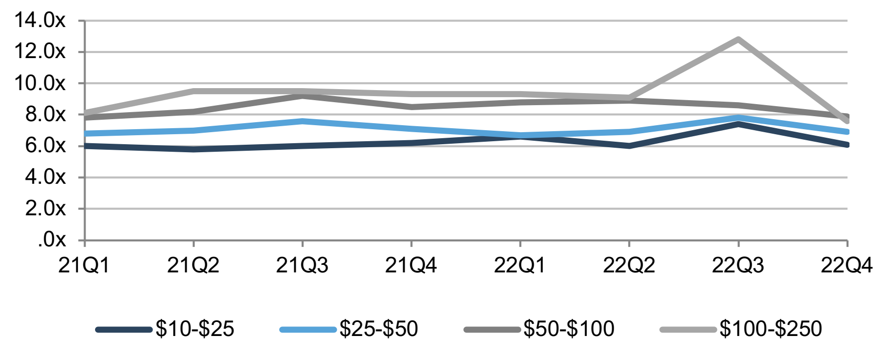
Q3-2020 to Q4-2022



Source: Capital IQ

TEV/EBITDA Multiples

Financial Buyers | Last 8 Quarters



Source: GF Data®

Illustrative Case

Although deal activity slowed in 2022 and the overall macro picture continues to look uncertain, it is important to remember that deals have continued to get done. As we have said before, quality businesses are still coming to market, and there are always going to be willing buyers in the middle market who are able and ready to pay reasonable values for these businesses. The obvious counterpoint to that argument is that the decline in deal multiples may scare off would-be sellers from bringing their business to market.

While this may well be true, we will take a look at an illustrative case showing that despite the recent decline in multiples, current conditions could still make this a good time to pursue liquidity options. We preface this illustration by urging would-be sellers to remember that investment decisions should be considered within the context of other available alternative investments. The value of a business (and hence the multiple it could be expected to generate in a sale) may be lower today than it was a year ago, but it is important to keep in mind that this is a common theme affecting both privately-held companies and certainly many publicly-traded companies.

In our example, let's consider two business owners. We'll call them Owner A and Owner B. Owner A and Owner B each own 100% interests in identical companies that have generated remarkably stable EBITDA of $10 million in each of the past three years. On January 1, 2022, a buyer approaches both Owner A and Owner B, offering to purchase their companies for 9.0x EBITDA payable in cash.

Owner A has been looking to cash in for some time and gladly takes his $90 million in transaction proceeds (for the sake of simplicity, we are going to assume that taxes do not exist in our hypothetical transaction). With his newfound pile of cash, Owner A, having already built his dream homes, funded his children's educations, and made considerable charitable contributions to a number of organizations over the years, decides to invest all $90 million of his transaction proceeds into an index fund that tracks the performance of the S&P 500. While this strategy is obviously ill-advised from a diversification standpoint, Owner A has ultimately decided that active management is not efficient over the long-run and decides on this course.

Meanwhile, Owner B has elected not to take the offer made to him on January 1, 2022 and continues to operate his company through 2022. Coincidentally, his company once again generates $10 million in EBITDA in 2022, and the same buyer returns on January 1, 2023 looking to purchase Owner B's company. However, the potential buyer is also an informed buyer, and only offers Owner B 7.5x EBITDA in his most recent offer. Still, Owner B agrees to sell this time, taking 7.5x EBITDA and total transaction proceeds of $75 million. Owner B, like Owner A, has also already accomplished all of his financial goals and is similarly unconvinced of the merits of active trading, so he too decides to invest all of his transaction proceeds into an index fund that tracks the S&P 500.

Now, let's examine the performance of both Owner A and Owner B's transaction proceeds as of March 2023. Owner A and Owner B both still hold all of the proceeds from their transactions in an index fund that tracks the S&P 500. However, this fund, whose returns are identical to those of the S&P 500, is down approximately 15% from the time Owner A invested in early 2022. On the other hand, Owner B has benefited from an approximately 6% YTD gain in the S&P 500 thus far in 2023.

Illustrative Case (cont.)

As shown in the chart below, Owner B is actually better off today in our simple example than Owner A, despite having taken a whole turn and a half less of multiple in his transaction, which also yielded $15 million less in proceeds than Owner A's transaction. In short, Owner B was able to take advantage of an opportune time to have ample liquidity by selling his business for a "cheap" price relative to recent multiples and reinvesting the proceeds even "cheaper," which, in the long-run, may well make up for the discounted multiple he took in the sale.

Hypothetical Transaction Outcomes

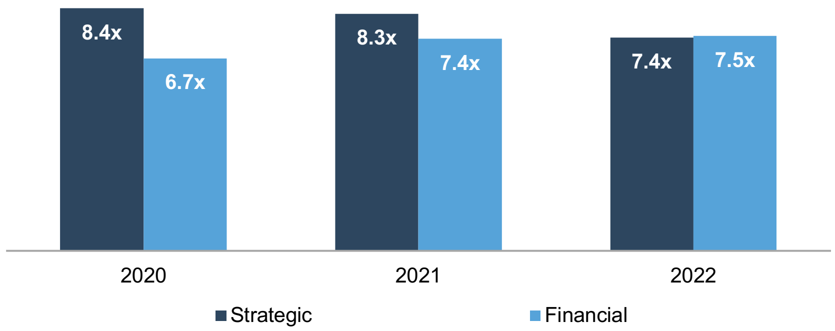
	Owner A	Owner B
Transaction Date	January 1, 2022	January 1, 2023
LTM EBITDA	$10,000,000	$10,000,000
EBITDA Multiple	9.0x	7.5x
Transaction Proceeds	$90,000,000	$75,000,000
Return on S&P 500 Index	-15.1%	5.9%
Total Net Worth Today	**$76,451,414**	**$79,403,735**

The hypothetical outcomes in this simple example were obviously created by our assumptions (and, arguably, the questionable investment decisions of Owner A), but hopefully, the point still stands. While acquisition multiples in the middle market are trending downwards, valuations in nearly all other asset classes are as well. This should present favorable investment opportunities for owners looking to sell their businesses. Selling at what is a lower multiple (relative to recent history) is not always a terrible option when you can reinvest at similarly reduced pricing levels.

Obviously, owners should not bury their heads in the sand regarding the current environment – one of the most important facets of a successful transaction is that sellers have reasonable and informed expectations of what their business may command in the market. Absent a solid understanding of current market conditions for privately-held businesses, these reasonable and informed expectations are difficult to develop.

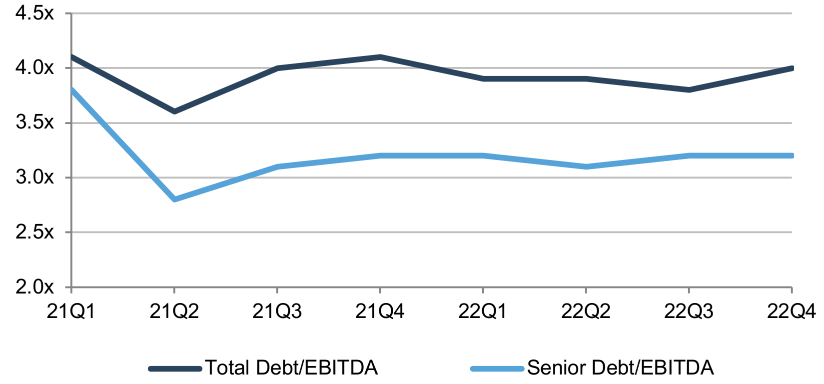
Mercer Capital has a deep bench of seasoned transaction professionals who can help you understand what your business may command in the market and lead your transaction process all the way to closing. If you are looking for an experienced team of professionals to assist in any and all phases of the transaction process, please reach out to one of our Transaction Advisory Group members to assist.

EBITDA Multiples by Buyer Type
2020 to 2022



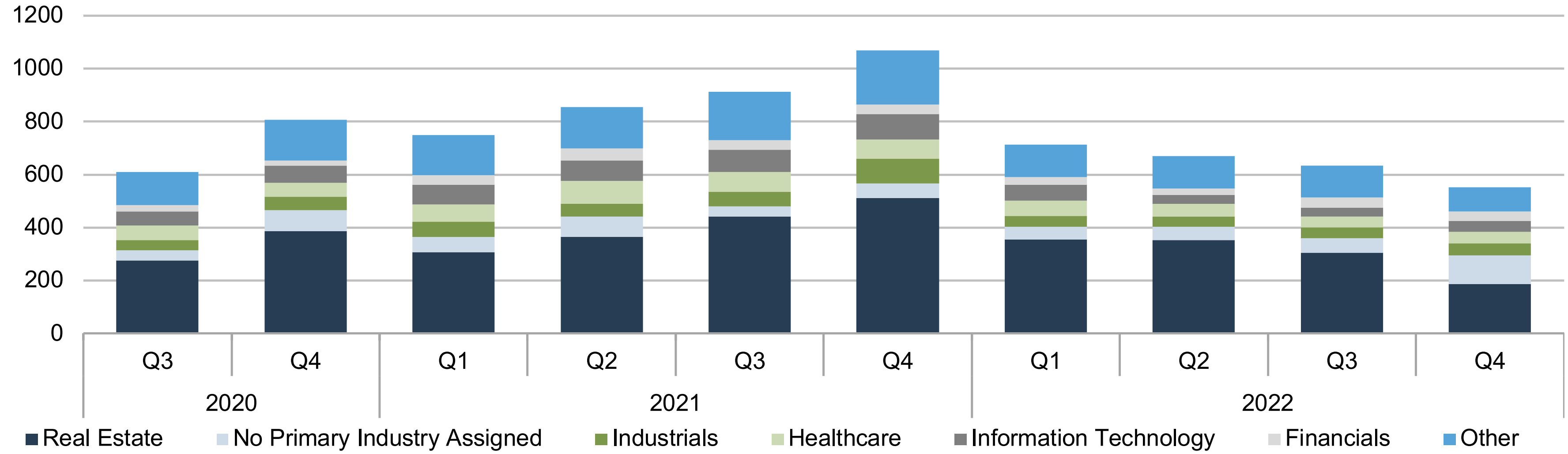
Source: Capital IQ (strategic) and GF Data (financial)
Strategic multiples exclude outliers (defined as EBITDA multiple > 18x)

Debt Multiples
Financial Buyers | Through Q4-2022



Source: GF Data®

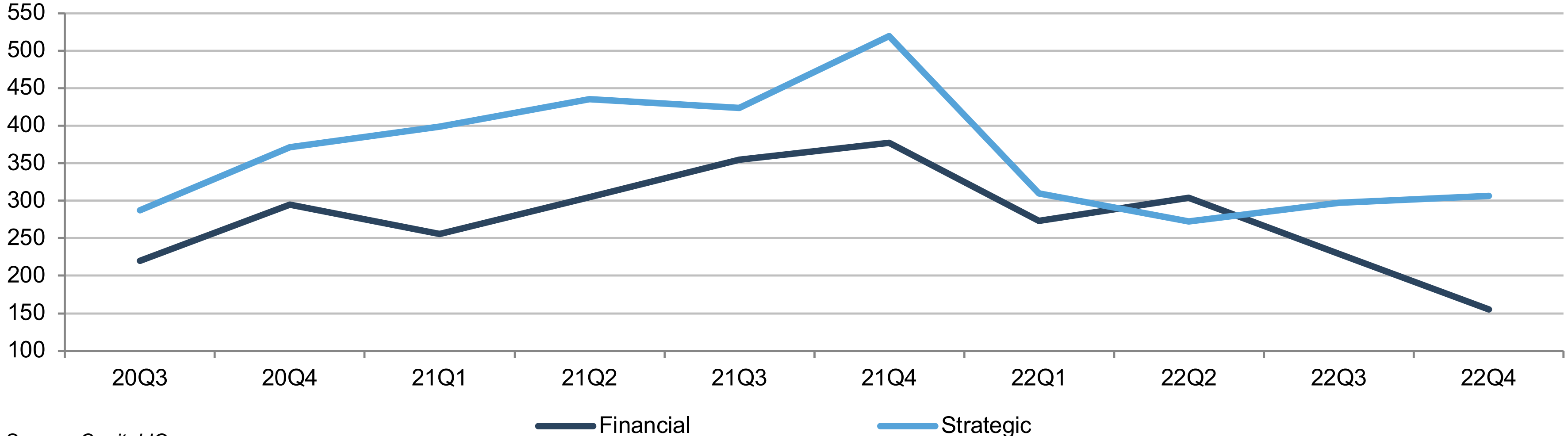
U.S. Deal Volume by Industry
Q3-2020 to Q4-2022



Source: Capital IQ

Number of Deals by Buyer Type

32-2020 to Q4-2022



Source: Capital IQ

Check Out This Video!

What do you do if your business is approached by a potential acquirer? In this video, Nick Heinz presents four broad steps you should undertake to determine if the potential acquisition makes sense.

>> Watch the Video

Thinking About Acquiring?

Before you do, check out our recent series on Buy-Side Considerations

1. Identifying Acquisition Targets and Assessing Strategic Fit
2. How to Approach a Target and Perform Initial Due Diligence
3. Strategic Premiums: Can 2+2 Equal 5?
4. Considerations in Merger Transactions
5. The Importance of a Quality of Earnings Study
6. Negotiating Working Capital Targets in a Transaction
7. Considering Contingent Consideration
8. Buy-Side Fairness Opinions: Fair Today, Foul Tomorrow?
9. Buy-Side Solvency Opinions
10. The Importance of Purchase Price Allocations to Acquirers

MERCER CAPITAL

Transaction Advisory Services

In addition to our corporate valuation services, Mercer Capital provides investment banking and transaction advisory services to a broad range of public and private companies and financial institutions.

Mercer Capital has been successfully executing mergers & acquisitions for a broad spectrum of middle-market companies since the mid-1980s.

We specialize in providing merger & acquisition services to sellers or buyers of private businesses or public companies divesting divisions and subsidiaries. In addition, Mercer Capital assists clients in industry consolidations, roll-ups, and refinancings.

Mercer Capital leverages its historical valuation and investment banking experience to help clients navigate a critical transaction, providing timely, accurate and reliable results. We have significant experience advising boards of directors, management, trustees, and other fiduciaries of middle-market public and private companies in a wide range of industries. Our independent advice withstands scrutiny from shareholders, bondholders, the SEC, IRS, and other interested parties to a transaction, and we are well-versed in the new industry standards.

The professionals of Mercer Capital can guide you through the uncharted waters of selling your business, acquiring another business or division, mergers, valuations, fairness opinions, and other transaction advisory needs. Rely on the experience, independence, and transaction know-how of Mercer Capital.

Transaction Advisory Services

- M&A Representation
- ESOP Installation, Termination, and Transactions
- Squeeze-Out Transactions
- Fairness and Solvency Opinions
- Minority Shareholder Stock Repurchases
- Corporate or Partnership Recapitalizations

Advantages We Offer

- Maximize Net Proceeds
- Negotiate the Best Possible Terms
- Speed Up the Deal Process
- Ensure Transaction Closure
- Help Ensure Confidentiality
- Minimize Burden on the Ownership

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