BMO Middle Market M&A update

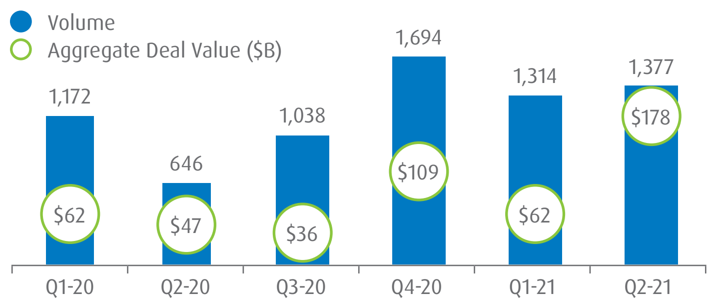
Record deal activity

Brings its own set of obstacles

The third quarter of 2021 continues to trend the same as the first two quarters with a flurry of M&A activity. The fourth quarter of 2021 is expected to see a record level of M&A volume and value ahead of potential capital gains tax changes.

The current business in the market has brought on its own challenges as third-party service providers (e.g., lenders, lawyers, market study providers, accountants, etc.) have been frequently turning down work—leading to delays or significantly higher fee quotes for work to be completed near-term. Most quality of earnings providers, a key supporting analysis for many sell-side transactions, have lead times greater than 30 days.

U.S. M&A Activity: 2020 & 2021[1]



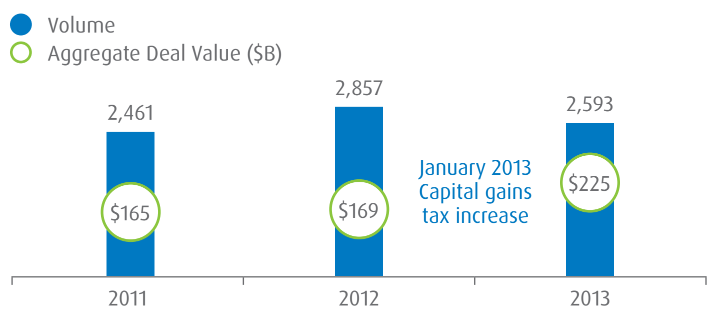
A look back at history

To years following tax policy changes

On January 1, 2013, the capital gains tax for top earners (39.6% tax bracket) was raised from 15% to 20%. Additionally, earners at and above the 33% tax bracket were subject to an additional 3.8% Medicare tax.

The fourth quarter of 2012 saw record M&A activity as sellers hoped to avoid the coming tax changes. The value of M&A deals more than doubled from the third quarter. As expected, the first quarter of 2013 saw a pullback in activity, but 2013 as a whole saw a substantial increase in deal value and multiples compared to 2012.

U.S. M&A Activity: 2011–2013[1]

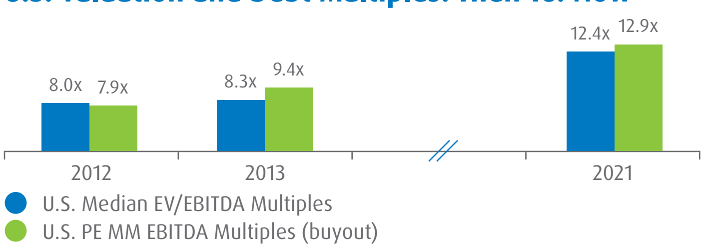


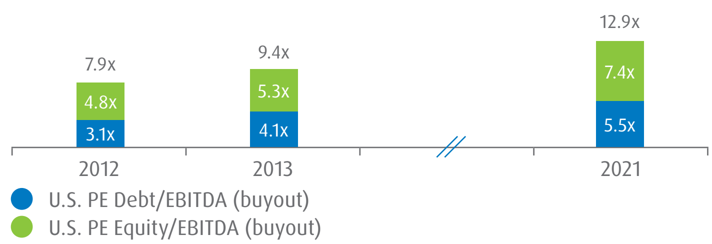
Stage is set

For a robust M&A market in 2022

If the capital gains tax changes in early 2013 and the proceeding M&A activity are any indication, 2022 is poised to be another strong year for M&A. Private equity firms are sitting on an unprecedented amount of dry powder ($704B for US PE firms at the end of 2020), debt remains readily available and at low cost, and multiples remain elevated. Transaction volumes will likely level out in the first half of 2022, giving sellers the upper hand in a less crowded market.

U.S. Valuation and Debt Multiples: Then vs. Now[1]





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Navigating the current market

Requires a strategically designed sale process that is uniquely aligned to each individual transaction

If a sale process is not currently underway, it will be very difficult to close a transaction by the end of the year. However, business owners that can be patient and launch a sale process in 2022 may see significant demand as the deals in market subside from the fourth quarter of 2021. Buyers will have significantly more capacity to dig in on deals—especially those they find unique and the most intriguing. We remain steadfast in our recommendation that process preparation, positioning, and momentum are of the utmost importance in this active deal environment.

Preparation

The time needed to prepare the documents and information required to go-to-market is currently, and expected to remain, prolonged due to service provider capacity constraints, but this window can serve as an ideal opportunity to seed the market in advance of a process launch. Raising the opportunity with buyers before it goes to market provides them advanced notice as they manage their own deal pipelines—enabling them to allocate sufficient resources to the project once launched.

Positioning

Given the expected high deal volume through 2022, it is more important than ever to effectively position a business and clearly articulate why it is differentiated and what makes it a truly compelling opportunity.

Buyers are overwhelmed with the amount of deals in the market and tailored messaging is critical in getting their attention and having them engage.

Momentum

Maintaining competitive tension throughout is a cornerstone of any successful process in any given market environment, but the current conditions require that sellers be nimble and tailor timing to successfully achieve this dynamic.

Managing various timelines across buyers can be complex to execute but setting rigid process milestones can lead to "downtime" for buyers—creating the risk that they become distracted with other opportunities and drop out of a process.

An ever-changing tax environment

Makes planning around tax changes even more challenging than in the past

During his campaign, President Biden had called for a 39.6% top federal tax rate on long-term capital gains and dividends—nearly double the current rate of 20%. Current legislation would tax capital gains and dividends at a much lower top rate of 25% (applied to single filers with at least $400,000 of income and married couples with $450,000). In addition, a 3.8% Medicare surtax would be applied for certain tax filers and an additional 3.0% for "high-income" earners (both of these surtaxes also apply to ordinary income)—making the top rate an effective 31.8%. All capital gains tax increases would be retroactive to September 13, 2021.

Although very few corporations pay taxes equal to the statutory corporate tax rate, and some manage to eschew federal income taxes altogether, the most recent House proposal would raise the top federal corporate tax rate from 21% to 26.5%. President Biden had originally suggested raising it to 28%.

While the tax environment continues to transform, we believe the M&A market will remain strong through these changes and through 2022.

Let's connect

Whether you're expanding through acquisition or are ready to transition the business, our middle-market mergers and acquisitions experts are ready to help you take your company to the next phase.

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[1] Source: Pitchbook