BMO Middle Market M&A update

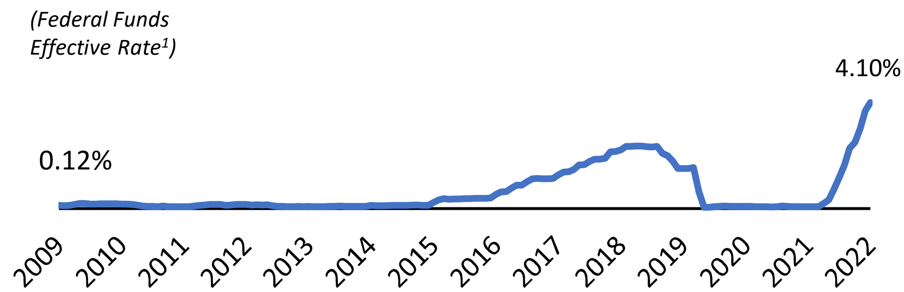
The Economic Cycle and Impact on Middle-Market Deal Financing

While access to debt financing has been favorable to borrowers in recent years, lenders have become increasingly cautious as companies continue to grapple with rising interest rates and financing costs, an inflationary environment, slowing economic growth, and a general decline in investor confidence. As a result, institutional loan volume has decreased to levels not yet seen during the current economic cycle, and lenders are typically offering lower leverage levels, higher pricing and more restrictive covenants.

These dynamics caused M&A deal volume to decrease in late-2022, and near-term expectations signal additional tightening in early 2023, albeit significantly less than the rate increases experienced in 2022. Similarly, investors may also be signaling a preference for less risk, evidenced by the share of larger enterprise value deal volume within the middle market shrinking to unprecedented lows. Acquirors have become more cautious with respect to valuation, and sellers have put more focus on buyers' ability to follow through on purchase commitments.

Despite pending interest rate increases and lingering recession concerns, there is room for optimism. The consensus is that rates will stabilize in 2023 and with near-record dry powder on hand, private equity firms are armed for a robust recovery if macro risks are alleviated as economic conditions begin to improve.

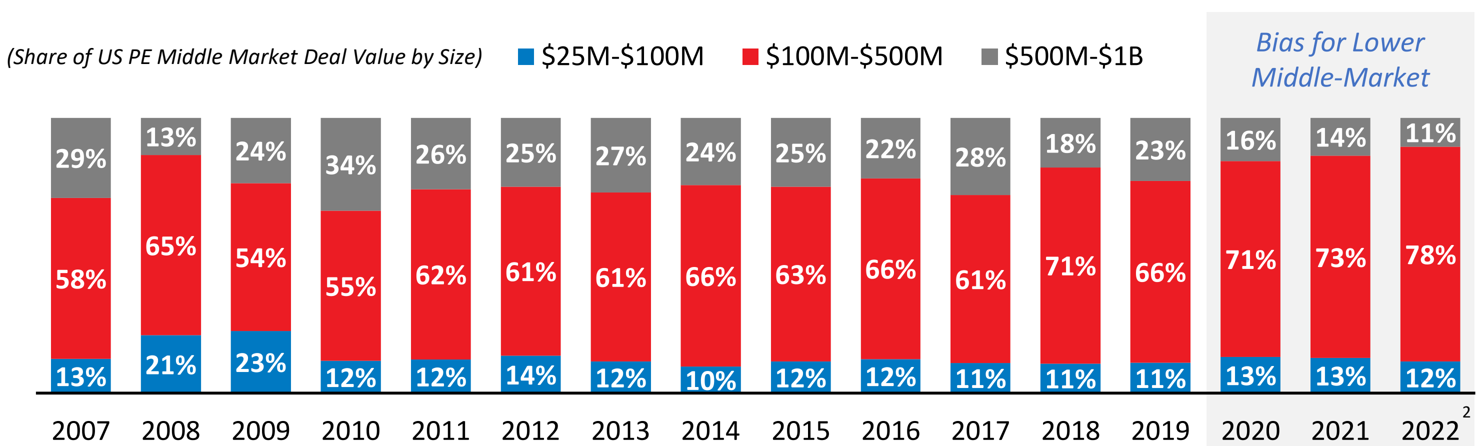
Federal Funds Rate



Private Equity Investors Migrate Down Market

Appetite for larger deals within the middle market has softened significantly, reflected by the share of deals in the $500M - $1B enterprise value range reaching a 15+ year low while activity in the $100M - $500M space achieves record levels.

Middle Market Transaction Size Trends



Less Debt and More Conservative Deal Terms

Lenders have become increasingly selective with their capital allocation and have begun to pull various levers to set downside protection measures in place as market conditions have become less stable. Notably, leverage multiples attached to deals has tightened markedly in the last 12 months, with typical total debt / EBITDA ratios being reduced 0.5-1.0x turns of EBITDA, or more in some cases.

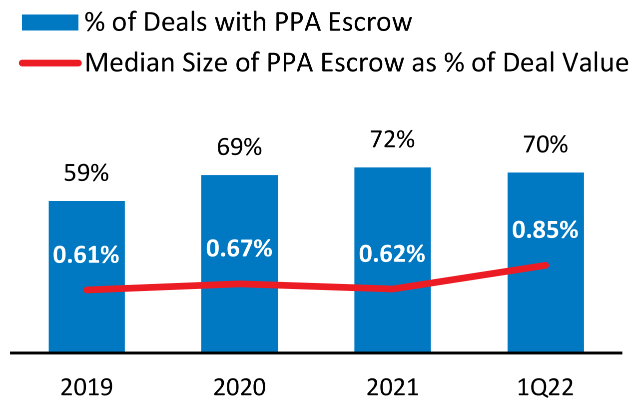
Lenders and sponsors alike are commonly finding themselves more focused on coverage ratios when evaluating new transactions. They are particularly aware of fixed charge coverage calculations when structuring deals, particularly for borrowers with ongoing capital expenditure and tax liability requirements.

BMO has witnessed a focus on quality by both sponsors and lenders, where scaled and recession-resistant assets continue to command strong lender interest as in past quarters.

The use of purchase price adjustment (PPA) escrow accounts saw a notable increase in 2020, likely coinciding with heightened uncertainty associated with the COVID-19 pandemic and has remained elevated since then. These accounts ensure funds are set aside in the case that a seller's financial condition at closing has changed from the time of purchase agreement.

In today's environment, the key difference is that the median amount required to be placed in escrow has noticeably increased, suggesting a higher expectation for sudden material shifts in a target's condition, along with a M&A market that has become more favorable to buyer terms.

Purchase Price Agreement Escrow

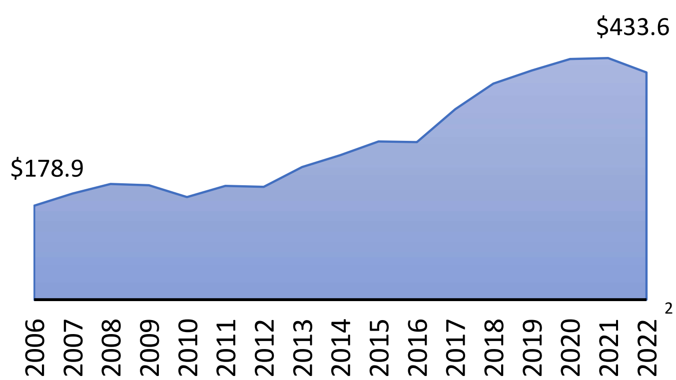


Excess Dry Powder

While fundraising slowed in 2022, lower deal volume has kept private equity dry powder hovering around near-record levels. Despite a deal environment that is significantly more challenging than investors have become accustomed to, in some cases they can only be so patient with deployment.

As conditions stabilize, investors could support a meaningful increase in M&A deal flow in the relatively near future.

Private Equity Dry Powder



Source: BMO proprietary data, FRED, PitchBook, SRS Acquiom

1 Data labels reflect 12/1/2009 and 12/1/2022

2 As of 9/30/2022

Let's connect

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

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