BMO Middle Market M&A update

The Push and Pull Dynamics of Current M&A Volume Drivers

While the U.S. economy has experienced the fastest tightening of credit conditions since the 1980s, uncertainty still lingers around how long the Federal Reserve will continue to delay rate cuts. Following the notable rate hikes of 2022-2023, M&A deal volumes have declined to some of the lowest levels in a decade and squeezed the most critical exit channel for sponsor-backed assets – strategic buyers. Despite this challenging backdrop for M&A deals, available funds of private equity firms have continued to grow to record levels (~$4.4T in 2023), and the mounting pressure on sponsors to deploy ageing dry powder could likely soon fuel the prevailing trend to reverse course.

Strategic Buyer Activity Fell for the Second Year in a Row…

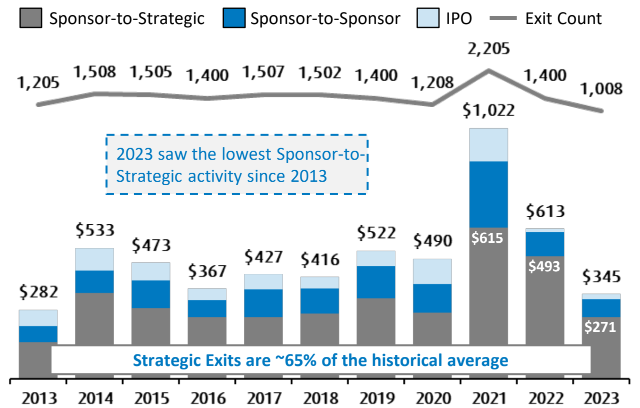
Platform sales to strategic buyers have been a primary exit channel for private equity sponsors in the past decade, accounting for ~65% of enterprise value sold. The overhang of corporate debt issued during the post-COVID recovery period has left strategic buyers with a considerable interest burden, while at the same time, coverage ratios for levered US portfolio companies fell to 2.4x in 2023 versus 3.9x in 2022 (-38%). With interest expenses consuming a larger portion of cash flows, strategic buyers have become more selective with their acquisitions. Sponsor-to-strategic exit values totaled $271B in 2023 versus $493B in 2022 (-45%) and $615B in 2021 (-20%). This recent decline in strategic activity has driven buyout-backed exits to the lowest levels in a decade.

…Causing a Significant Buildup of Aging Sponsor Assets…

Over 28,000 companies worldwide have some element of buyout fund backing (e.g., owned by PE companies), worth an estimated $3.2T today. Examining this asset class by hold period shows that buyout-backed companies are also being held for longer. The relative portion of assets held for 4+ years grew by more than 12% in 2023, accounting for ~46% of sponsor portfolios. Companies aged 3 years or less accounted for ~54% of portfolios in 2023, which represents a 4% *decline* versus the prior year. The relative proportion of longer-hold companies in buyout portfolios has not been this high since 2012 and is a function of the decline in private equity exit transactions.

Global Buyout-Backed Exit Value

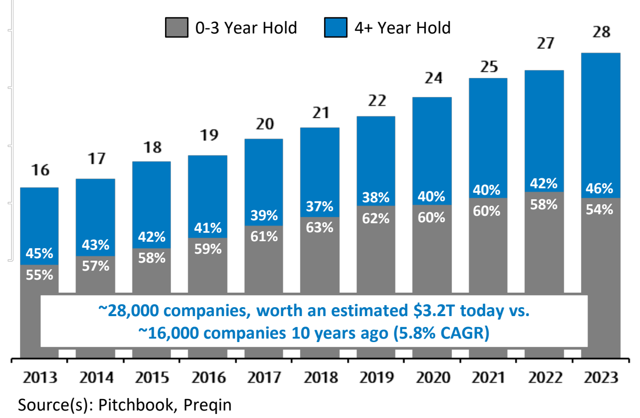
(Dollars in Billions)



Source(s): Pitchbook, Preqin

Global Buyout-Backed Companies by Hold

(Companies in Thousands)



Source(s): Pitchbook, Preqin

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Source(s): Bain - "Global Private Equity Report 2024"
Factset – S&P 500 trading closes of December 2023
MSCI – Private Capital Indexes (as of Q4 2023)
Pitchbook – "2023 Annual Global M&A Report"
Preqin – "Buyouts in the US 2023"

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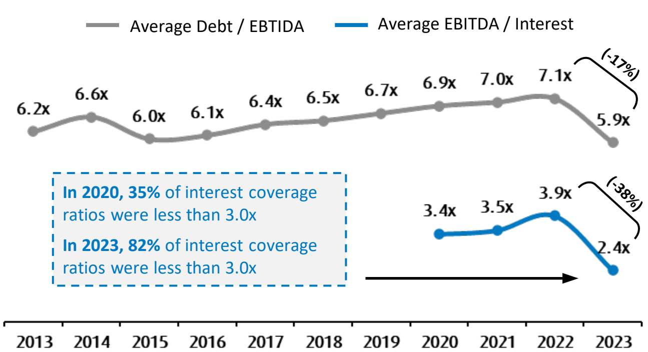
The Push and Pull Dynamics of Current M&A Volume Drivers (cont'd)

…and Depressing Overall Valuation Levels

Higher rates during the past 12 months suggest that any buyer will either spend more in interest or borrow less as a multiple of EBITDA, likely impacting returns in both cases. In 2023, debt to EBITDA ratios for LBO loans fell to 5.9x, from 7.1x (-17%) the year prior. This suggests buyers may be applying less leverage than the seller did when buying a company, which significantly changes the deal economics for the same asset. The market has seen wider valuation gaps as a result, forcing many exit processes to go "on pause". As we wrote about previously, most deals getting done today are small add-ons.

LBO Debt to EBITDA & LBO Coverage Ratios

(Deals Completed by Year)



Source(s): Pitchbook (LCD)

When will Push Become Shove?

The "Buy and Build" Strategy May not be Enough…

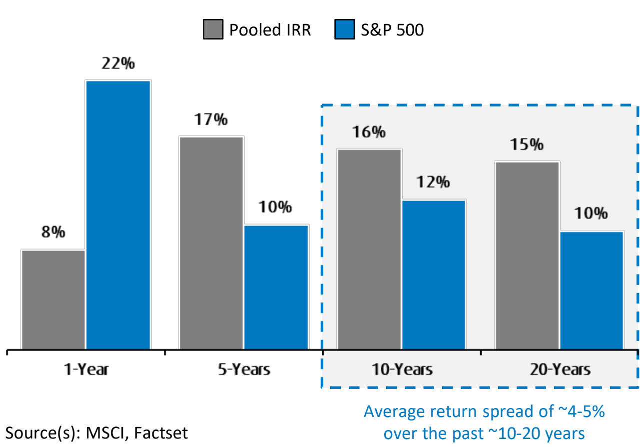
In the first half of 2023, we explored both the growing prevalence of add-on acquisitions and sponsor tendencies to move "down-market" ("The Current State of Add-On Acquisitions"; "Private Equity Investors Migrate Down Market"). In the first half of 2024, early indications suggest add-on activity will account for even more than 80% of total deal volume. In a world where the exit valuation bid-ask is still fairly wide, add-ons have been a significant means for longer-held platforms to continue "buying down" the average multiples before exit. Perhaps more importantly, they also allow private equity investors to deploy their near-record levels of dry powder.

…to Offset the Prevailing PE Push-Pull Fund Dynamics

Here's the push – With general partners sitting on a backup of $3.2T in unsold buyout assets and strategic exit channels at a standstill, the return of investor capital has also been delayed in many cases. This has put a great deal of pressure on GPs to return capital by exiting their investments, roll the proceeds, and/or inject fresh capital into new platforms. These timing delays have come at the expense of pooled IRRs, as the gap between buyout fund returns and public market returns continues to narrow. In 2023, the 10-year average pooled IRR for US buyout funds was ~16% compared to the S&P 500's 10-year average run of ~12%. This has caused private equity investors to reassess how much additional risk and illiquidity premium is enough to justify committing to new PE funds.

Historical End-to-End Pooled IRR

(All US Portfolio Companies)



Source(s): MSCI, Factset

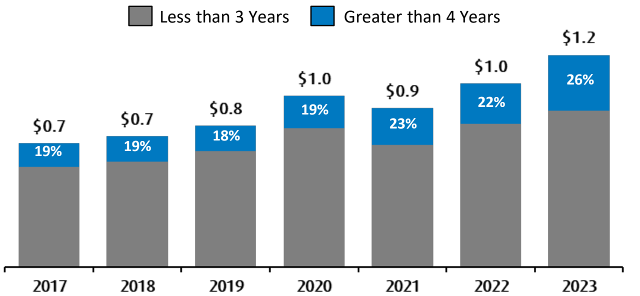
Source(s): Bain - "Global Private Equity Report 2024"
Factset – S&P 500 trading closes of December 2023
MSCI – Private Capital Indexes (as of Q4 2023)
Pitchbook – "2023 Annual Global M&A Report"
Preqin – "Buyouts in the US 2023"

When will Push Become Shove? (cont'd)

Here's the pull – Despite the recent returns crunch, the industry continues to raise record amounts of capital. Last year, buyout funds raised 18% more than in 2022, bringing in ~$448B. This left levels of buyout fund dry powder sitting at a multi-decade record of ~$1.2T. 2023 also saw 38% *fewer* buyout funds close, which drove the average closed fund size to increase 83% to ~$1.2B. This suggests "mega-funds" were the primary beneficiary of fresh capital and smaller funds faced fierce competition for investor dollars. In the wake of competition, it is easy to overlook that 26% of the total dry powder available was raised more than 4 years ago and has yet to be deployed.

PE Dry Powder by Years Since Raised

(Dollars in Trillions)

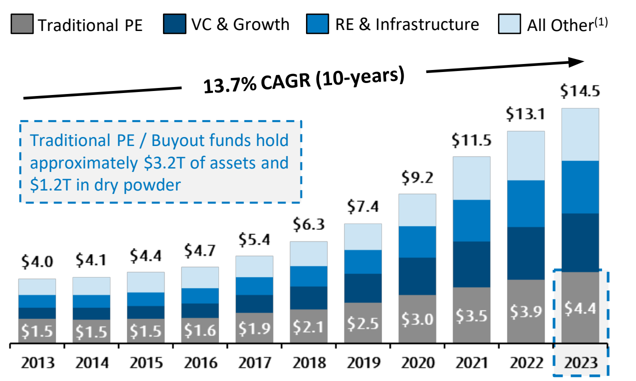


Source(s): Preqin, Bain & Co.

And here's the shove – While it has been a nice change of pace for capital on the sidelines to earn an above-inflation interest rate, it does not eliminate the pressure GPs face as undeployed capital gets older. Combined with the fact that nearly half (~46%) of the $3.2T buyout-backed assets have been held for more than 4 years, it is logical to expect a sharp rebound in M&A volumes when the Fed begins easing interest rates and exit conditions improve. We expect the industry to see a significant expansion cycle as legacy platforms are exited and replaced with new platforms, funded by redeployed sale proceeds *plus* the additional injection of sidelined dry powder. Private equity ownership will continue to reach new records and (most importantly) continue its natural expansion even further into the middle market.

Global Assets & Dry Powder by Fund Type

(Dollars in Trillions)



Source(s): Preqin, Bain & Co.

(1) "All Other" includes Secondaries, Direct Lending, Fund-of-funds, and Mezzanine Capital

It's Never Been More Important to Make Your Company "Move-in Ready"

Last quarter, we discussed the prevailing strength of M&A activity in the middle market and today's action items to consider as an owner ("Are You Prepared When a Buyer Comes Knocking?"). Preparation is key to a successful outcome for any business, and if you have been considering a sale, now is the time to get started. BMO Middle Market M&A and your Commercial Banking Relationship Managers are here to support your success in various capacities when the time comes.

Let's connect

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

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