BMO Middle Market M&A update

M&A Markets Show Precursors to Rising Volume in Late 2024 and Early 2025

Recent and accumulating tailwinds are spurring M&A markets upward. The Federal Reserve's 50 basis point (bps) interest rate cut on September 18th, and the overall expectation of continued gradual cuts, will likely have a significant impact on M&A volume through the remainder of 2024 and into 2025. Despite recent challenges in the M&A markets, we anticipate that reduced borrowing costs, pent-up private equity ("PE") holding periods, concerns over potential tax policy changes, and the need for succession planning in family / founder-owned businesses will drive M&A transaction volumes and overall deal valuations in the foreseeable future.

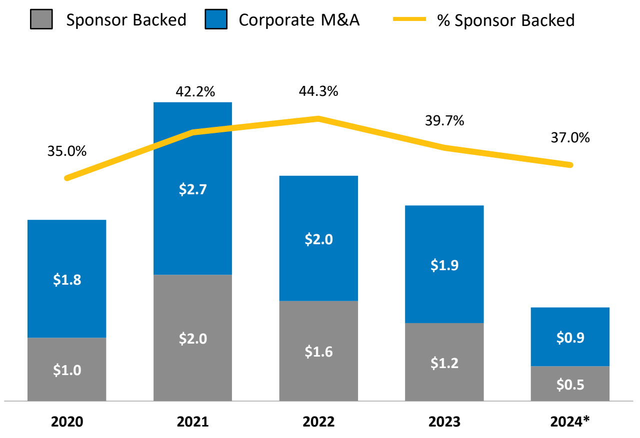
Interest Rate Relief to Spark M&A Activity…

Historical data shows that M&A activity tends to accelerate following periods of significant rate reductions. For example, M&A market volumes grew by ~21% and ~8% in the two years following the rate cuts after the dot-com bubble and the 2008 financial crisis, bottoming in 2002 and 2009, respectively. The reduction in borrowing costs should benefit all types of buyers, especially private equity firms, as they keep looking for platform investments in various industries. Strategic buyers, on the other hand, have taken advantage of a less crowded environment to be more selective with acquisitions and become more nimble in their integration processes, especially for frequent acquirers with a programmatic M&A strategy.

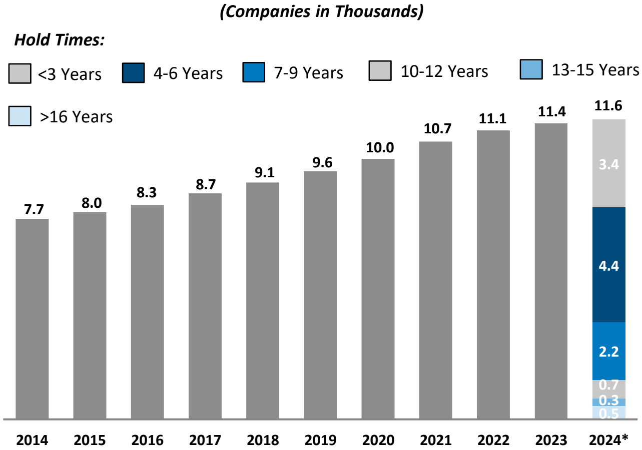
…Pent Up PE Holdings to Fuel the Increase in Exits…

Pressure is mounting for realizations as a growing portion of PE portfolio companies are at or past the five-year average hold time of ~3.8 years. Many of those funds that have sat on the sidelines waiting for "ideal market conditions" are now considering starting the process for liquidity events in late 2024. There may also be opportunities for PE owned companies to refinance existing debt deals and free up capital as an alternative solution. Increasing liquidity and returns pressure from LPs may be forcing certain GPs to consider premature exit timelines and strategies, sometimes before value creation plans have been fully completed. Fundraising plays a significant role in the strongarming of GPs to exit companies at a suboptimal return or compressed valuation. Ultimately, the increasing inventory of PE companies and demand for return of capital from LPs will likely increase M&A activity.

Deal Value by Purchaser
($Trillions)



Private Equity Portfolio Company Inventory
(Companies in Thousands)



*As of 6/30/2024
Note: "GPs" are General Partners. "LPs" are Limited Partners
Sources: Pitchbook – "Q2 2024 Global M&A Report"
Pitchbook – "Q2 2024 US PE Report"

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M&A Markets Show Precursors to Rising Volume in Late 2024 and Early 2025 (cont'd)

…Conducive Environment for Families / Founders to Exit Businesses…

The current five-year average for founder-owned businesses as a proportion of total deals is ~53.5%. There has been a recent uptick in this proportion to ~54.2% of total deal volume, as private equity sellers increase the holding time on assets. Although we expect the proportion of family / founder-owned companies to decrease as a percentage of total deal volume, we expect these businesses to remain strong in the market, especially as interest rates decline. Not only do we foresee continued valuation strength for family / founder-owned businesses, but also expect more of these family / founder-owned businesses to enter the market looking to take advantage of a more favorable lending environment, along with an expanded buyer pool looking to deploy capital, ultimately improving overall deal terms and valuations.

…and Potential for Tax Rate Changes Looming in 2025 if Democrats Make Gains

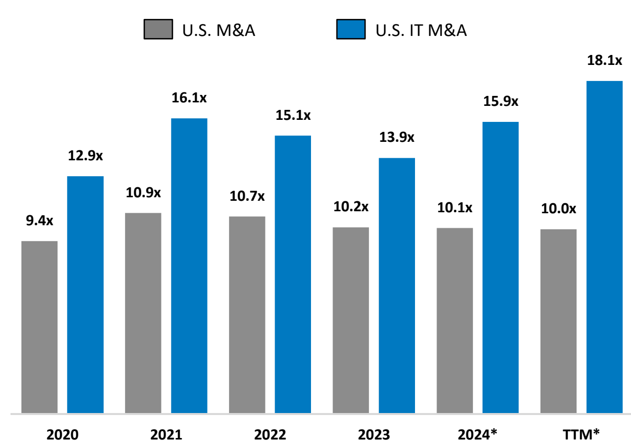
Another key driver of M&A deal activity is the perceived risk of changing tax policy in early 2025. The Trump-era tax cuts, introduced under the Tax Cuts and Jobs Act (TCJA) of 2017, are set to expire on December 31, 2025. The next White House administration will have considerable influence over the future of these policies. The outcome of this fall's election could have an impact on tax regimes for both corporations and individuals, potentially affecting deal timelines and / or the need for additional financial and tax structuring to minimize tax liabilities.

Demand is Coming – How Will Valuations Respond?

…Valuations Have Stayed Strong for Tech-Enabled Businesses and High-Quality Assets

Despite the industry headwinds that have been affecting M&A markets, tech-enabled businesses and high-quality assets have maintained strong valuations. The IT sector alone accounted for 17.5% of deal volumes and 21.2% of deal values in H1 2024. Notably, 'AI' was mentioned 199 times in Q1 earnings calls this year, explicating the corporate initiative to expand AI usage internally. This focus has contributed to the strong valuations for IT and tech-enabled businesses, while valuations in other sectors have contracted from 2021 through the trailing twelve months.

M&A EV / EBITDA Multiples



*As of 6/30/2024

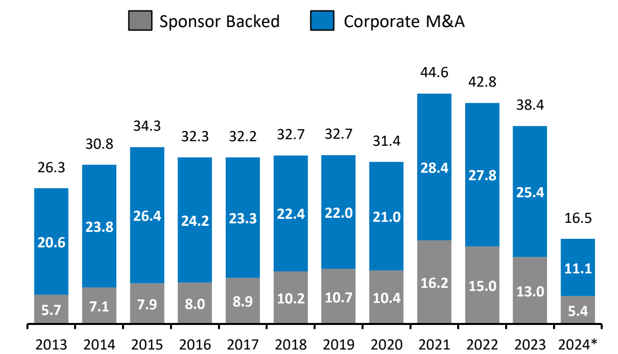
Sources: Factset – Earnings Insight
Pitchbook – "Q2 2024 Global M&A Report"
Pitchbook – "Q2 2024 US PE Middle Market Report"

Strategic and Financial Buyer Considerations

Strategic Buyers Getting Better at Scalability Through M&A, Especially for Frequent Acquirers… In a high-rate environment, having a long-term horizon has given strategic buyers an edge, as they are typically less impacted by interest rate volatility relative to institutional investors. Among dealmakers, those who consistently succeed tend to adopt a more proactive and systematic approach to M&A. Strategic Buyers are proving to have developed sophisticated systems and processes for integrating new businesses, enabling faster scaling processes through M&A. Over time, these buyers accumulate valuable knowledge and refine their M&A strategies based on past experiences. This continuous improvement allows them to address scaling challenges more effectively.

Deal Count by Acquirer Type

(Deals in Thousands)



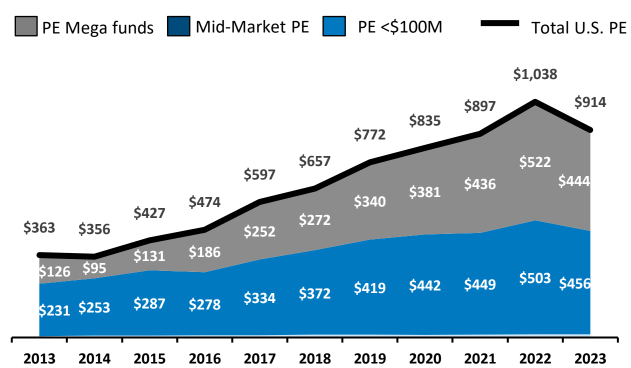
*As of 6/30/2024

Source: PitchBook

…Private Equity Pressured to Deploy Capital as Rates Normalize Dry powder remains historically elevated within the North American PE community. The 25 PE firms with the largest overhang account for ~22% of the dry powder readily available for deployment, while the broader PE landscape holds unprecedented sums of committed capital. With ~$976B of dry powder from U.S. PE funds, market multiples are expected to increase as more capital is competing for a limited pool of quality assets. As rates decline, private equity groups are incentivized to deploy more capital, benefitting from a lower cost of debt, which in turn enhances their returns. However, other institutional investors will also aid in the macro lending environment, helping sustain competitive buyer tension in the M&A market.

Dry Powder by Fund Type

($Billions)



Source: Pitchbook

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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