BMO Middle Market M&A update

Private Equity Demand for Middle Market Companies Remain Strong

While M&A markets in the first three quarters of 2023 were slowed by a challenging economic backdrop of high interest rates, liquidity constraints in some regional banks, and inflationary cost pressures on businesses in the M&A pipeline, private equity demand for middle market companies under $1BN in Enterprise Value remains strong as evidenced by key indicators.

Deal Volume

Quarterly U.S. private equity total deal value and deal counts at the end of Q3 2023, while down from their peaks in 2021, are estimated to be $173B across over 1,250 transactions. These levels represent a normalization to pre-pandemic watermarks. Anecdotes from BMO Middle Market M&A's pipeline of activate engagements tell of sellers and buyers better calibrating on value expectations based on the current M&A environment and finding creative structures to help bridge any gaps.

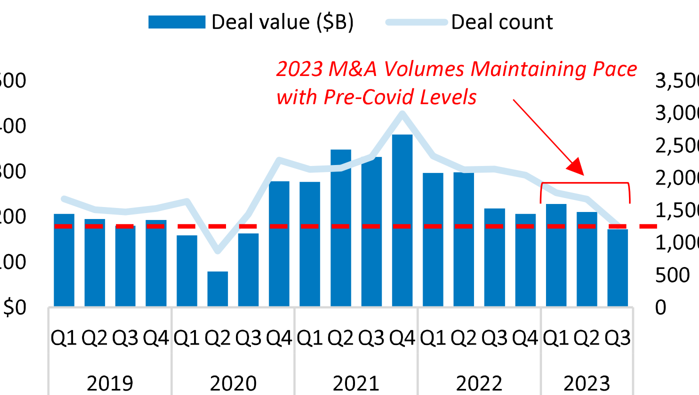
Middle Market Share

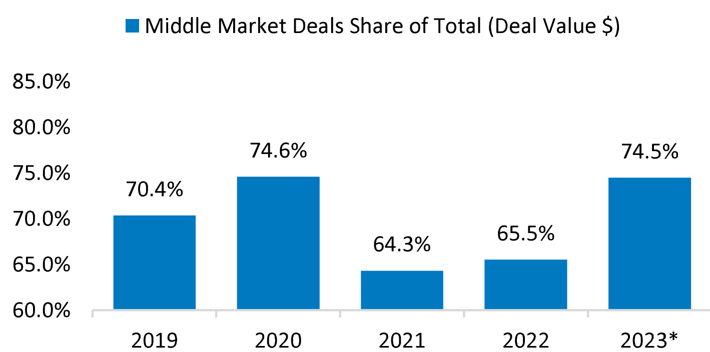
The Middle Market share of total private equity deal value (deals under $1B), are on pace to represent ~75% of all private equity transactions (over 99% based on transaction counts) in 2023. On the supply side, middle market companies are relatively less capitalized and have less access to bank capital. Faced with challenges such as labor shortages and rising input costs, they are more likely to seek non-bank capital sources and, in many instances, considering a complete exit and transition. On the demand side, financing and underwriting complexity typically increases with deal size, benefiting smaller deals when the financing environment is more constrained. Smaller deals that fit add-on criteria are also often financed using existing portfolio company balance sheets and lending facilities.

Dry Powder

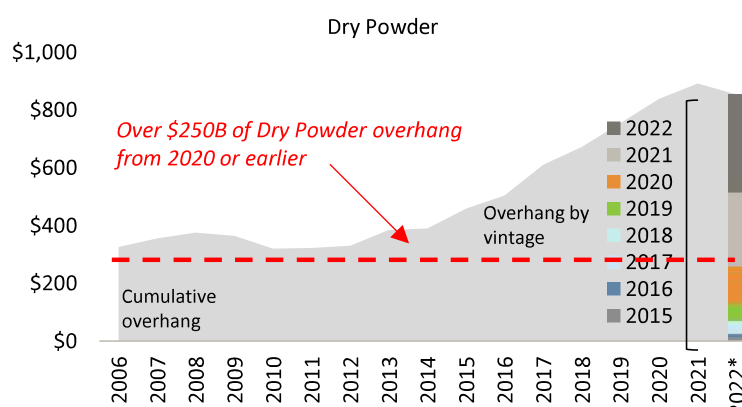
A key driver of this sustained momentum in private equity activity is the amount of private equity dry powder (committed, but unallocated capital a firm has available), which currently remains near all-time highs at over $850B. In addition to the sheer amount of capital that needs to be deployed by these firms, over $250B or 30% of the total, is overhang and raised in 2020 or earlier. As these sponsors seek to rapidly recover from progress loss during the first 3 quarters of 2023, we expect to see several key trends continue in M&A activity in Q4 2023: focus on recession resistant business models, rising popularity of growth-equity, and continued appetite for add-ons.

U.S. Private Equity Deal Activity





*Through September 2023



Source: Pitchbook

Outlook on Private Equity Acquisition Activity in Q42023

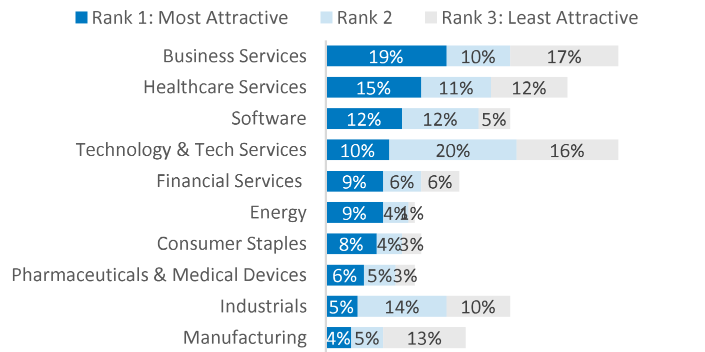
Recession Resistant Business Models

In a recent private equity research report[1], interviews of 100+ senior private equity stakeholders (managing directors and partners) at middle market sponsors found near consensus (81%) in the desire to focus on investing in recession-resilient sectors in response to the current economic & M&A environment. The report further clarifies that these sectors include "business services and healthcare services, which have demonstrated recession resiliency historically and, critically, present attractive opportunities for digital transformation". Furthermore, interest is also now increasing for "asymmetric opportunities in industries traditionally considered more cyclical, in which sponsors see valuations as having fallen far enough to present attractive opportunities to capitalize on long-term tailwinds".

Middle Market Private Equity Survey

"Over 80% of middle market private equity sponsors have started to focus on recession-resilient sectors."

"Most Attractive Sectors"

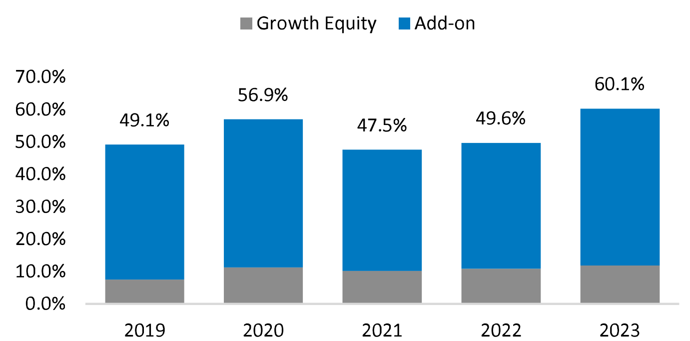


Source: Apogem. "Exploring the New Paradigm Shift". February 2023.

Growth Equity & Add-Ons

On a percentage basis, growth equity and add-on transactions are on pace to reach 10-year highs, accounting for nearly 60% of all private equity transactions. For operators of middle market companies, Growth Equity is an increasingly popular alternative capital source for bolstering balance sheets and funding growth due to the relative flexibility in structure and terms (compared to traditional bank debt), especially in complex underwriting situations or industries with challenged macro backdrops. The rise in the demand for growth equity investments is supported by comparable underlying trends driving growth in middle-market transactions over large cap deals. In the previous section, we discussed the relatively less complexity in financing and underwriting smaller transactions. Similarly, growth equity investments also typically do not rely on debt as a funding source.

Growth Equity & Add-On Transactions (as a % of All Transactions)



Source: Pitchbook.

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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1. "Exploring the New Paradigm Shift: Middle Market Private Equity Research", Apogem Capital and Coalition Greenwich, February 2023.