CORNERSTONE
BUSINESS SERVICES

MARKET UPDATE

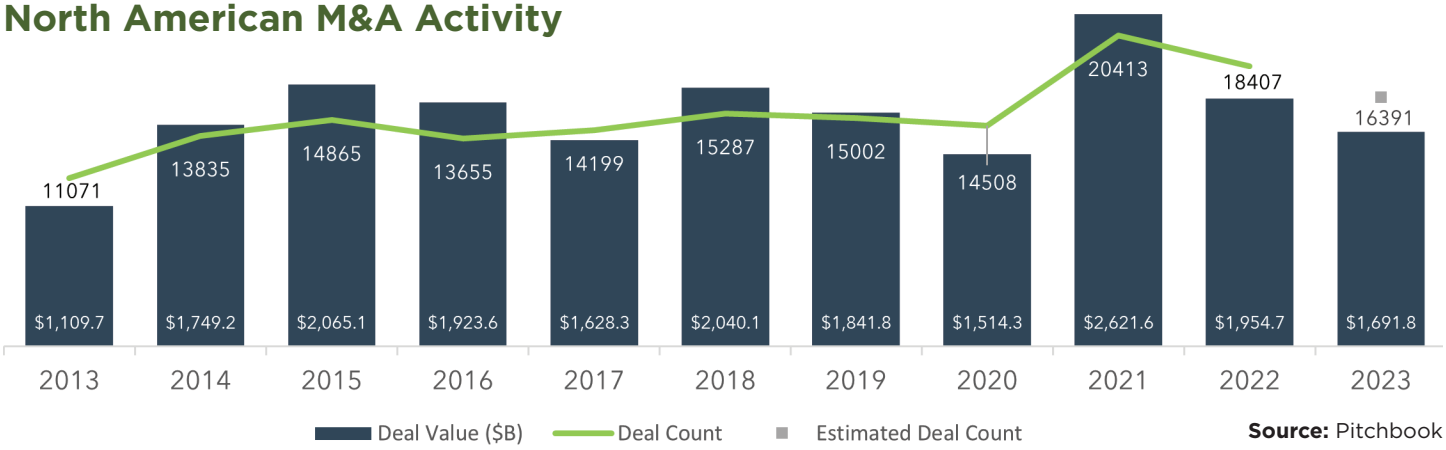
Q4 2023

LOWER MIDDLE MARKET MERGERS & ACQUISITIONS

M&A ACTIVITY DAMPENED BY MARKET HEADWINDS

North American M&A activity in 2023 continued a downward trend amid ongoing macroeconomic challenges. This downturn, observed for the second consecutive year, can be attributed to several factors, including tighter monetary policies leading to higher interest rates, a widening gap in valuation expectations between buyers and sellers, and heightened geopolitical tensions. Despite these challenges, the headwinds appear to be moderating somewhat as inflation fades and interest rates are expected by many to fall in 2024, offering a glimmer of optimism for better deal activity in the coming quarters.

North American M&A Activity



Source: Pitchbook

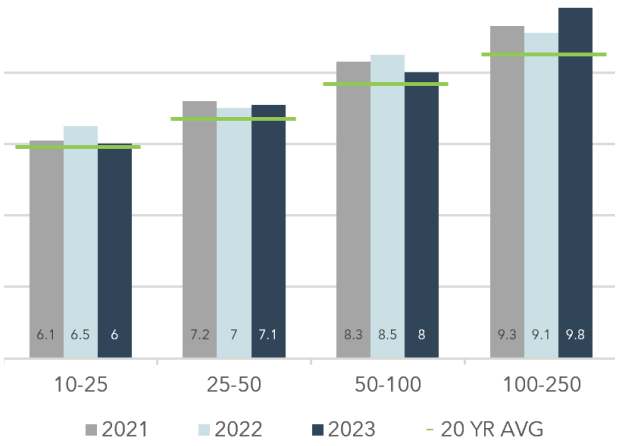
TEV/EBITDA MULTIPLES

Despite a challenging year marked by a significant drop in deal flow, average deal prices in many size tiers saw a modest increase during the third and fourth quarters.

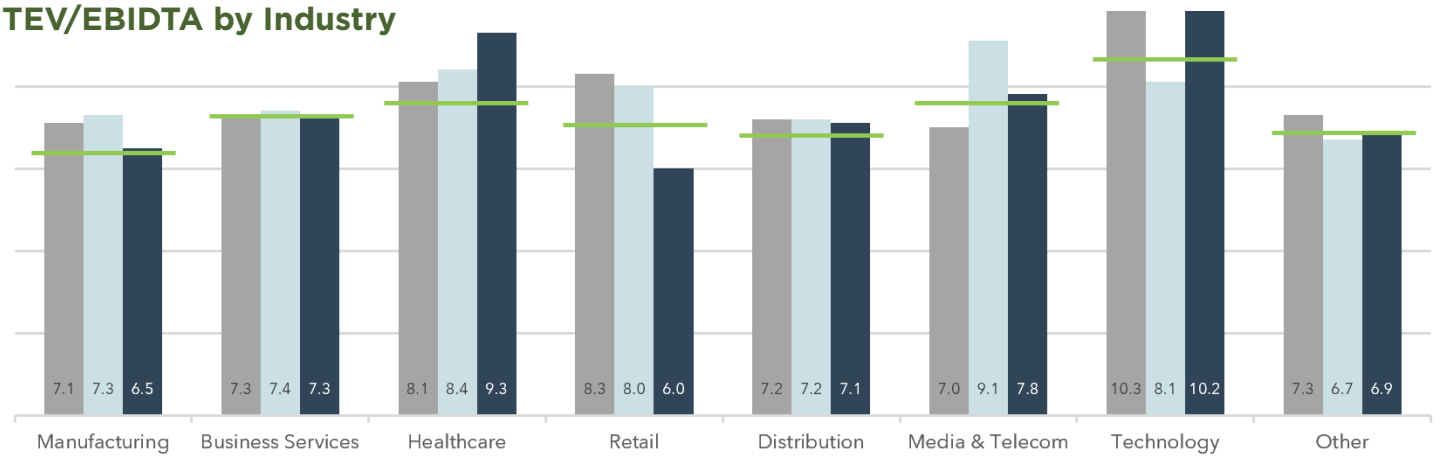
For transactions between $10M-$50M, valuations saw a more significant increase. There's also an observed quality premium for above-average financial performers, with these businesses commanding an average of 8.2x compared to 6.5x for other buyouts. This suggests a continued appreciation for stronger companies, potentially indicating a future uptick in deal volume.

The rebound in valuation is not seen across all sectors; as industries which are less impacted by inflationary pressures are those seeing the increases in TEV/EBITDA multiples.

TEV/EBIDTA by total enterprise value ($M)



TEV/EBIDTA by Industry

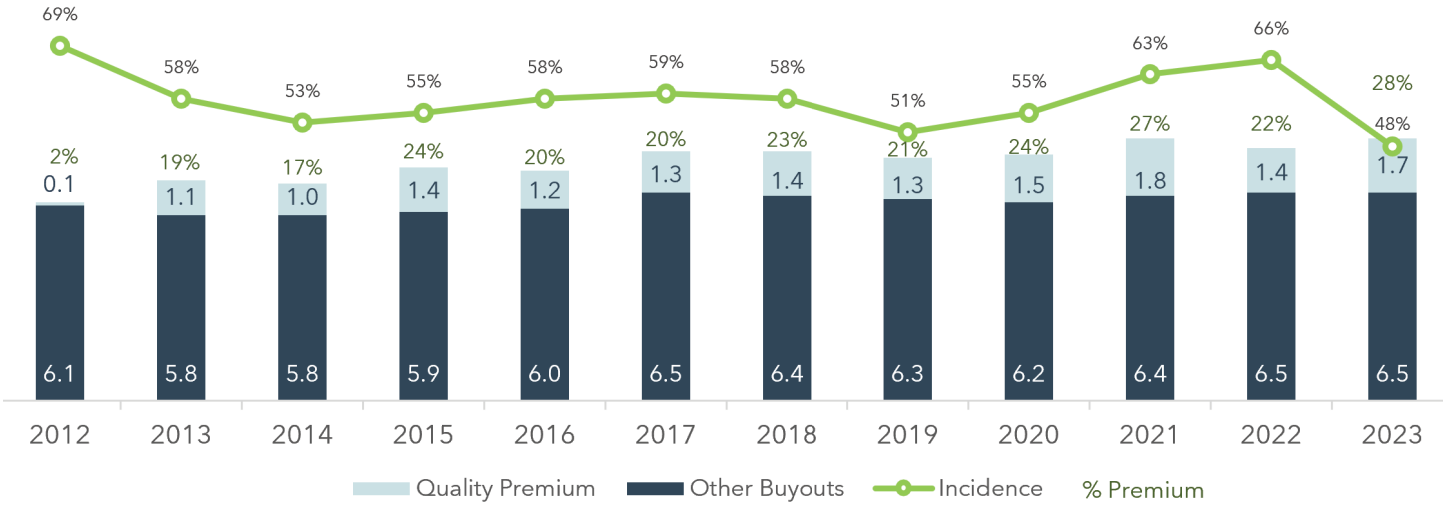


Source: GF Data®

QUALITY DEMANDS A PREMIUM

The quality of a business's financial performance had a significant impact in 2023 with businesses demonstrating above-average financial metrics receiving higher valuation multiples, highlighting a premium for quality in the M&A market. Valuations improved notably for smaller transactions, with deals valued between $10 million and $25 million seeing a substantial increase in average valuation, evidencing a trend where quality and size played crucial roles in deal structuring. The use of rollover equity also increased across all deal sizes, particularly in response to the high interest rate environment, showcasing the market's adaptation strategies to maintain deal flow and value realization.

TEV/EBIDTA Quality Premium—Buyouts Only

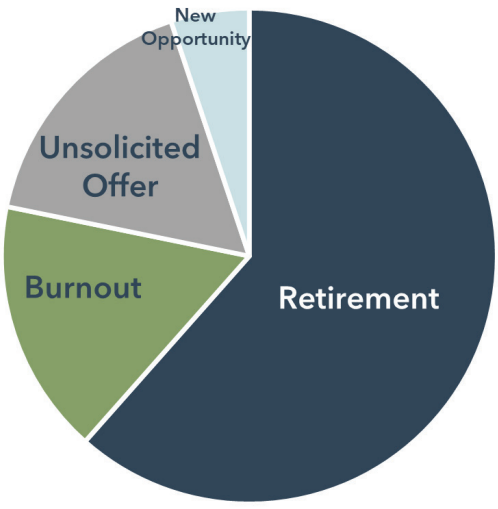


Source: GF Data®

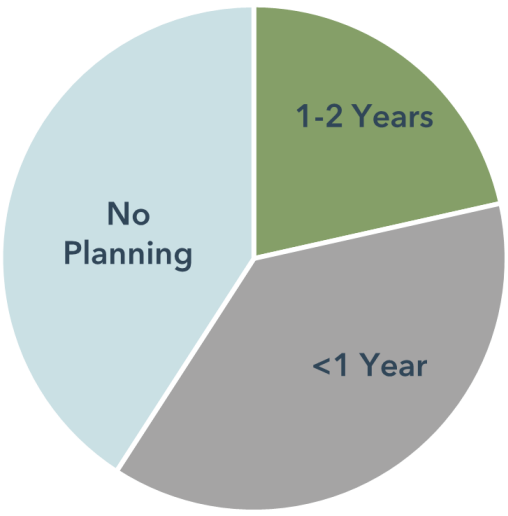
PLANNED BUSINESS EXITS

In 2023, retirement served as the primary motivator for business owners initiating the sale of their companies, followed by burnout and unsolicited offers. Surprisingly, with retirement being a foreseeable event, there remains a lack of proactive exit planning. The trend suggests that smaller businesses are less inclined to engage in pre-sale preparation. Despite the predictability of retirement, many business owners delay exit planning, with some navigating the process rapidly, often less than a year between initial consultation and going to market. This observation underscores the importance of strategic foresight in maximizing business value upon exit. Sellers who do engage in exit planning often see their deals move at a faster pace, illustrating the need for better awareness and engagement in comprehensive exit strategies to ensure optimal outcomes

Reason Seller Went to Market (TEV 5M-50M)



Exit Planning Prior to Sale (TEV 5M-50M)



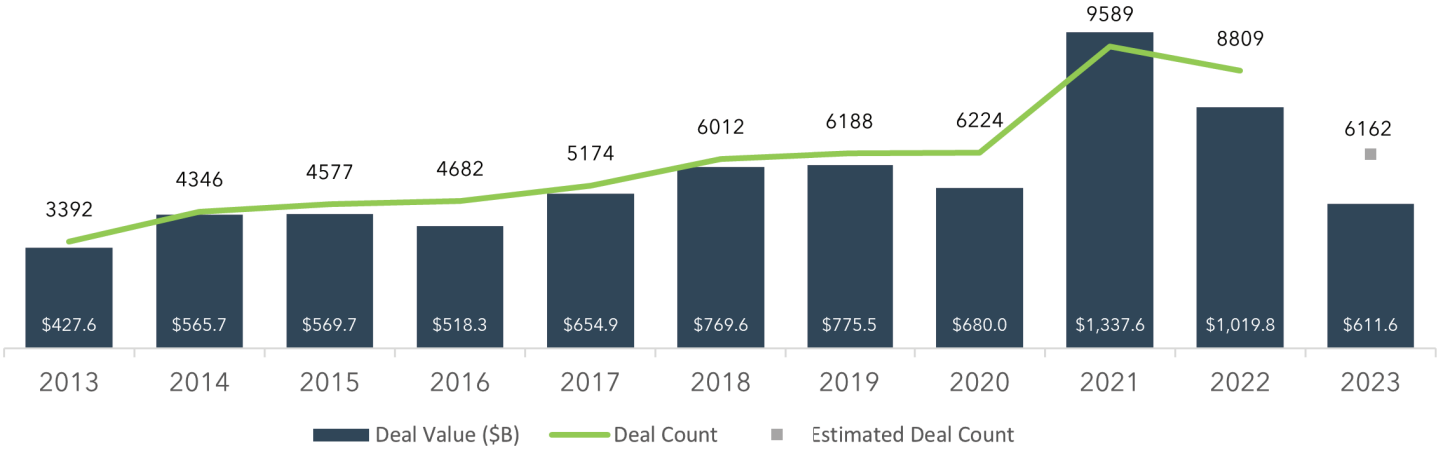
Source: M&A Source and IBBA Market Pulse

PRIVATE EQUITY ACTIVITY

Q4 2023 saw a significant decrease in deal volumes, marking a stark contrast to the market peak in 2021. This shift indicates a cooling off from the pandemic-induced surge in activity, aligning PE fund returns closer to expectations set by fundamental market factors. Infrastructure emerged as a focal point, buoyed by major legislative support, spotlighting its role in both fundraising and returns.

With the continued high cost of debt, it continues a downward trend overall in deal structure, with rollover equity being used in more cases to help acheive overall valuation expectations.

US PE Deal Activity

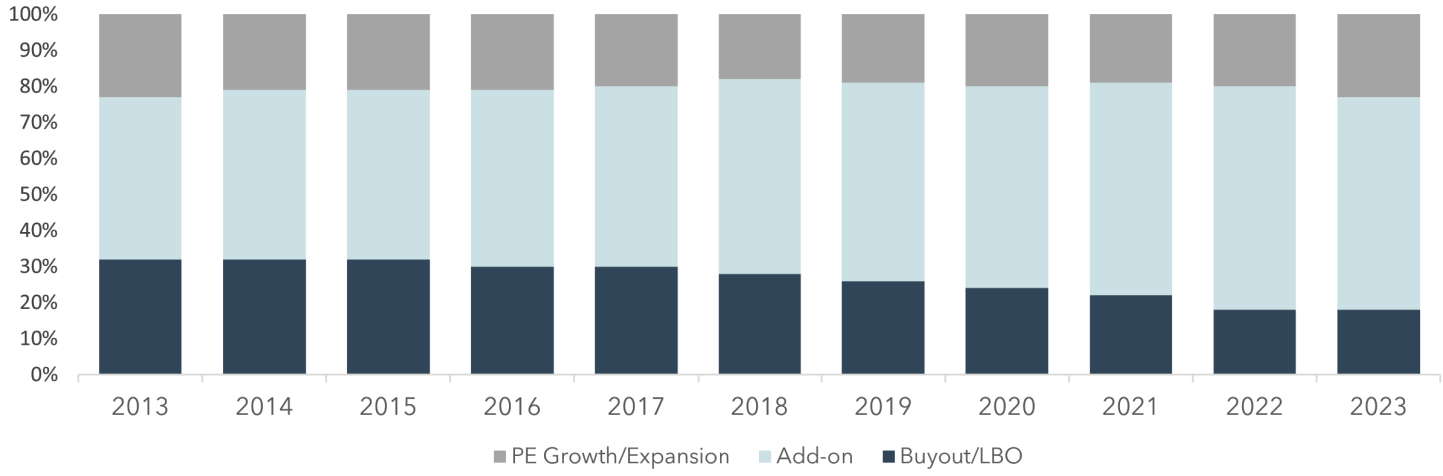


Source: Pitchbook

Add-ons

Add-ons are playing an increasingly pivotal role in the private equity playbook, reflecting a strategic shift towards leveraging these transactions to build value within portfolio companies. The incidence of add-on investments tracked by Pitchbook for the entire last year has risen to 76.1% of total buyouts, and nearly two-thirds of all US PE deal activity, indicating a continuing preference for add-ons as a growth strategy. This trend suggests that add-ons are not only more prevalent but also potentially offer a more cost-effective path for portfolio expansion. The shifting focus towards add-ons suggests that targets for buyouts in these deals are likely to be more strategic, targeting only those companies which can offer specific value to existing platforms, whether through geographic expansion, product line extension, or achieving operational synergies.

Share of PE Deal Count by Type

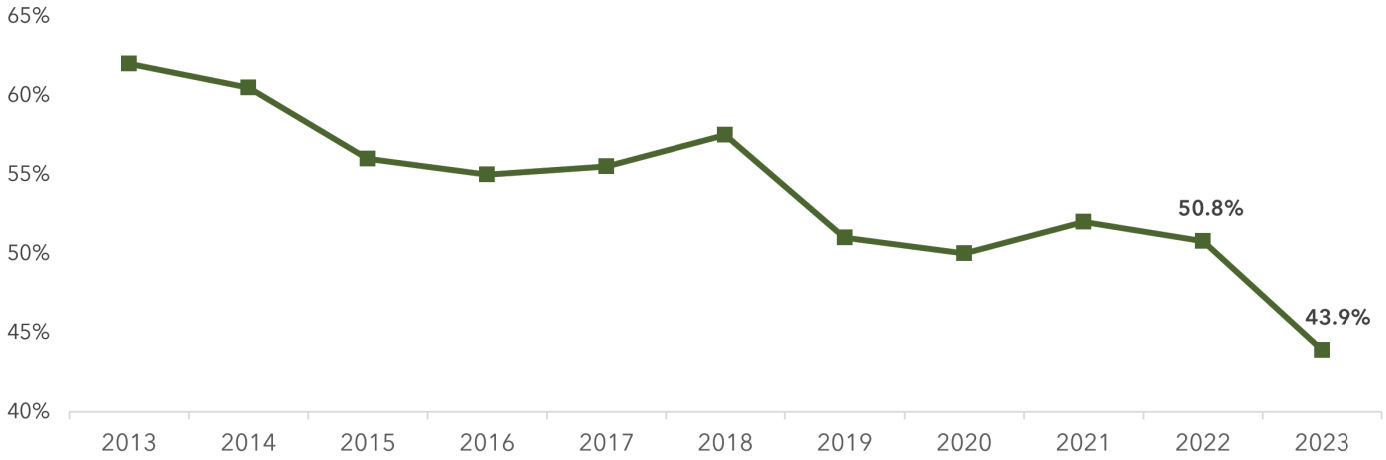


Source: Pitchbook

DEBT MARKET

Debt multiples in the M&A market have continued to retract with the increased cost of debt. The upward pressure on debt pricing, with higher interest rates impacting borrowing costs, has pushed buyers towards structures with more equity and increased rollover equity for sellers.

US PE Share of LBO Debt to EV

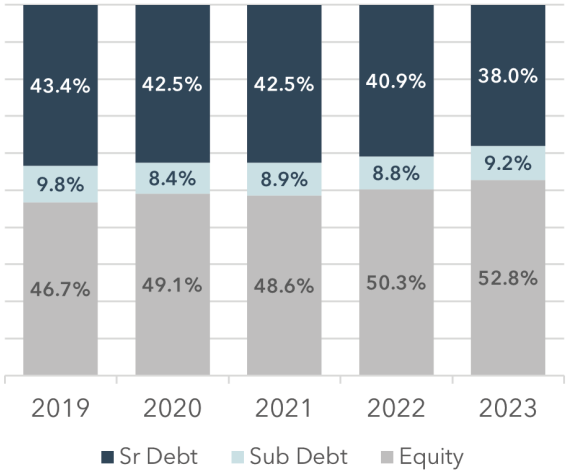


Source: Pitchbook

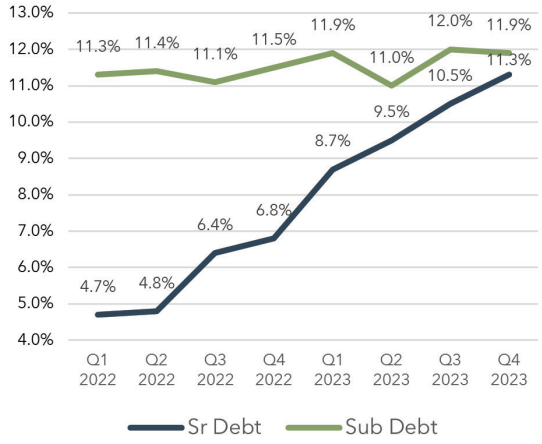
In 2023, debt pricing in leveraged buyout (LBO) transactions experienced significant shifts in senior debt and subordinated debt segments, reflecting a broader trend of rising debt costs across all deal sizes. This escalation was attributed to a variety of factors, including tightening monetary policies and market volatility. The trends show a pronounced surge in debt pricing, particularly for senior debt in deals valued at less than $100 million, underscoring the impact of broader economic conditions on financing costs.

If interest rates begin to drop in 2024, the impact on debt pricing could be significant, particularly in the context of leveraged buyouts and other private equity transactions that rely heavily on debt financing. The market is already pricing in substantial cuts to policy rates, even though the Federal Reserve has attempted to temper expectations. A reduction in interest rates would likely lead to lower debt financing costs, making leveraged transactions more attractive by reducing the cost of borrowing. This could lead to an increase in deal activity as cheaper debt enhances the potential returns on investment.

Equity and Debt Contributions
(TEV 10M-250M)



Debt Pricing Splits by Period
(TEV 10M-250M)



Source: GF Data®

FIRM OVERVIEW

Cornerstone Business Services is a boutique investment bank serving the lower middle market with M&A services since 2001. We're based in the Midwest but work throughout North America. We create value through acquisition searches, company sales, and valuations, with a focus on businesses with revenues of $5M-$150M and/or EBITDA of $1M-$15M.

Cornerstone uses a team approach on each transaction along with our proprietary Assurance 360™ process which typically generates multiple offers, a high likelihood to close and maximizes value. We work well with first time sellers who value an advisor's role and want to ensure the largest financial transaction of their life is done right.

As a founding member of the Cornerstone International Alliance, we are able to leverage a global network of M&A advisors focused exclusively on dealmaking in the lower middle market.

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