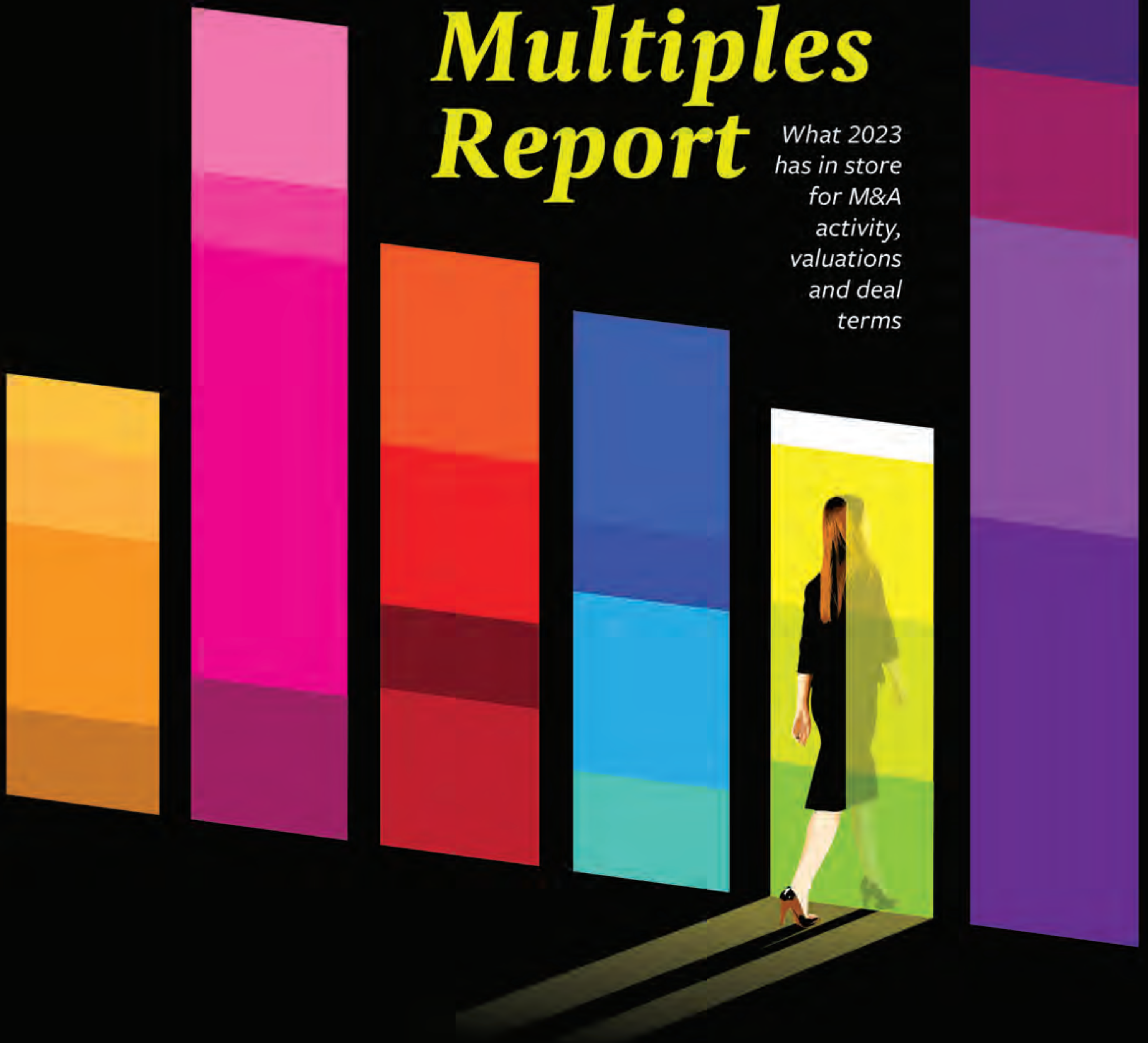
MIDDLE MARKET

Growth

// SPECIAL EDITION

Multiples Report

What 2023 has in store for M&A activity, valuations and deal terms



GF DATA
AN ACG COMPANY

ACG
Association for Corporate Growth

FORVIS

Assurance / Tax / Advisory

An Enhanced Professional Services Firm

What's going to happen tomorrow? You can't predict the future, but you can prepare for it. To thrive in an environment that moves faster every day, business leaders must be able to look ahead and be ready for what comes next.

That's where **FORVIS** can help. Driven by the desire to anticipate what's next in the economic landscape, our goal is to help our clients be ready when the future becomes the present. We're committed to using our exceptional vision to provide each of our clients with an **Unmatched Client Experience**™ that drives business forward.

FORVIS was created by the merger of equals between BKD and DHG. We aim to carry on our respective legacies of high-touch personal service delivered with remarkable integrity, care, and innovation—all now backed by the resources of a top 10 U.S. public accounting firm.

> "With national coverage and international presence, we're stronger: for our clients, our people, and the market of the future."

Tom Watson
Chief Executive Officer

Forward Vision Drives Our Unmatched Client Experiences

As a FORVIS client, you will benefit from a single organization with the enhanced capabilities of an expanded national platform, deepened industry experience, greater resources, and innovative advisory services. Our aim is to provide assurance, tax, and advisory services that help clients succeed today while preparing them to forge ahead into a clear future.

Our eye on the future isn't exclusively directed toward our clients. We want our people—at every level, in every office—to be motivated by engaging career paths that challenge and inspire them to grow personally and professionally. Our partners and staff are the foundation of the firm, and when they have the opportunity to flourish, the result is Unmatched Client Experiences.

We are FORVIS—driven by a commitment to anticipating what's ahead so our clients are ready to thrive when it arrives.

8th Largest U.S. Firm*

530+ Partners & Principals

28 States + U.K. & Cayman Islands**

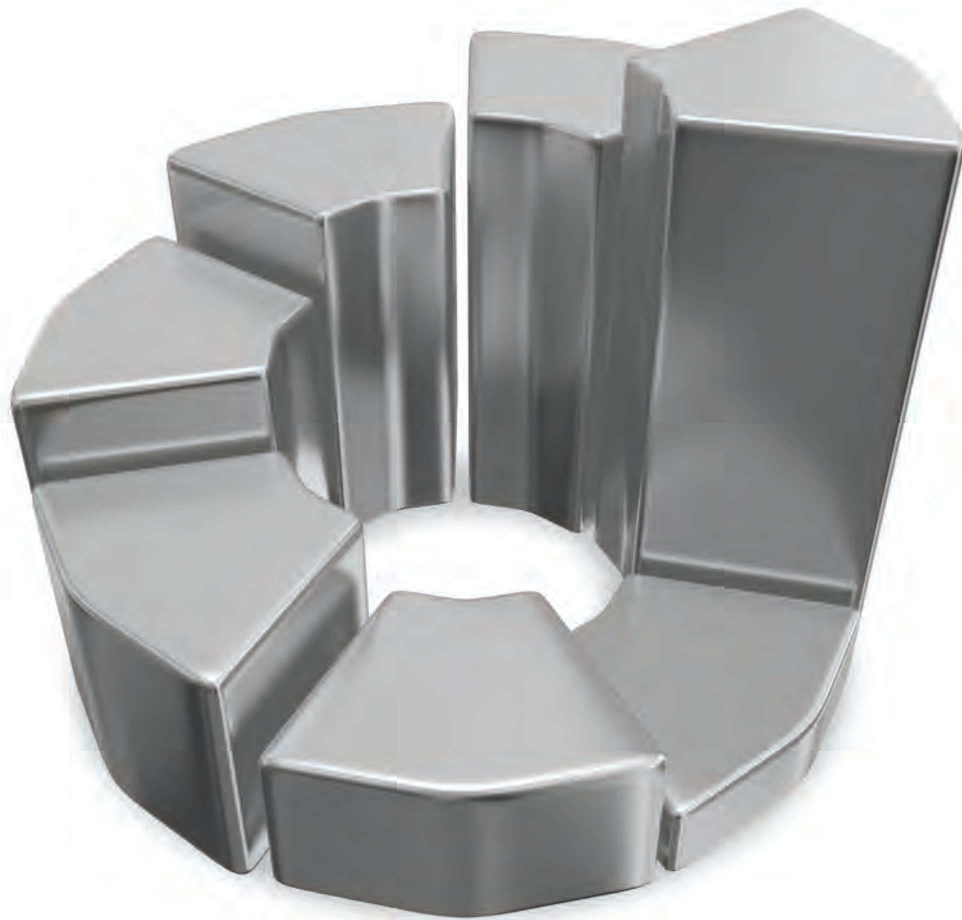
10+ Industries

5,500+ Team Members

72 Markets

PRAXITY

FOR unmatched industry insight, VISion matters



FORward VISion Invests

We applaud that the opportunities you explore begin with your vision of making an impact in the middle market. Our vision is helping make yours a reality. Whether you're looking to improve efficiencies, manage uncertainty, or create value, our forward-thinking professionals can help guide you through every stage of the investment life cycle.

FORVIS—created by the merger of equals between BKD and DHG—has the enhanced capabilities of an expanded national platform and deepened industry intelligence to help you better navigate the private equity landscape and capitalize on your vision for success with interest.

FORVIS

ASSURANCE / TAX / ADVISORY

forvis.com/private-equity

FORVIS is a trademark of FORVIS, LLP, registration of which is pending with the U.S. Patent and Trademark Office.

Twin Brook

CAPITAL PARTNERS

Twin Brook

CAPITAL PARTNERS

Tru
Fle
Rel

An ex
to last

For more i

usted relationships.
exible capital.
iable solutions.

perienced lower middle market lender committed
ing partnerships and shared success.

nformation, visit twincp.com

About Twin Brook Capital Partners

Twin Brook Capital Partners is a finance company focused on providing cash-flow based financing solutions for the middle market private equity community. The firm is managed by highly experienced, dedicated professionals who have successfully worked together throughout their careers at leading middle market lending institutions. Twin Brook's flexible product suite allows for tailored financing solutions for leveraged buyouts, recapitalizations, add-on acquisitions, growth capital, and other situations.

For more information, visit twincp.com

Connect with *MMG*

ONLINE middlemarketgrowth.org
LINKEDIN Middle Market Growth Magazine
TWITTER @ACG_MMG

ANASTASIA DONDE
Senior Editor,
Middle Market Growth
adonde@acg.org

The Devil's in the Details

Financial markets—and by extension middle-market dealmaking—have been hitting turbulence for some of 2022, and the outlook for 2023 looks no different. It's no surprise that sponsors, lenders and middle-market companies are increasingly scrutinizing their approaches to doing business.

For private equity firms, that means cherry-picking quality deals, watching out for excessive EBITDA add-backs or "pro forma" numbers, and monitoring existing portfolio companies for weaknesses and historical performance through the pandemic or past recessions. There is less debt capital available, and lenders are tightening covenants on new deals. They are also getting more diligent on forecasting downside scenarios for their portfolio companies.

Turning the screws in this way means reading more of the fine print, connecting with peers on managing through difficult times and using all available tools at investors' disposal to avoid hiccups. Our sources tell us that many proposed deals end up getting pulled or just don't launch after testing the market. Bankers have to be honest with sellers and tell them that this is not the time.

Some investors say that they're avoiding cyclical industries, like auto, building products and consumer, for now. While valuations haven't yet seen a marked decline, they're expected to start falling next year. For the time being, GF Data's November report actually shows a rise in valuation multiples to 8.1x on trailing 12 months EBITDA in the third quarter—up from a 7.4x average for all of 2021. The report from GF Data, an ACG company, which tracks private equity-sponsored deals with enterprise values of $10 million to $500 million, notes though that the multiple increase reflects marginal growth capital investments and recapitalizations and is not necessarily indicative of valuations in new buyouts. (When buyouts only are considered, the multiple was 7.5x TTM EBITDA.)

Nuances like that are important to highlight, especially when deal flow is expected to be low, investors are competing for scraps and companies newly for sale compare their potential valuations to existing deals in the market.

As you read through this special edition, you'll see more such findings from GF Data, as well as responses to our annual survey of ACG members and insight from sources, that will help you wade through the storm. //

DAVID HELLIER
Partner, Bertram Capital, and Chapter Council Chair, ACG

A Tale of Two Sentiments

For many of us in middle-market M&A, 2022 felt like a tale of two halves, as conditions worsened in the summer and dealmaking slowed down. Between Russia's invasion of Ukraine, climbing energy prices, rising interest rates and worsening inflation, the climate for investing appeared increasingly cloudy toward the end of the summer.

The outlook for next year is also something of a dichotomy. On the one hand, we're back on the road attending conferences, meetings and due diligence visits. With the worst of the pandemic in the rear-view mirror, ACG events are in full swing. It's encouraging to connect and collaborate with our clients, portfolio companies and prospective sellers in person again. On the other hand, the headwinds weighing on the market are still dampening the mood of M&A practitioners. The uncertainty is impacting the quality and pace of deal flow, and there is a cloud hanging over an otherwise robust community. The pullback on leverage and rising cost of debt are making it harder to close deals.

At a time like this, it's even more important to have a platform like ACG for sharing ideas and opportunities. ACG leaders are working hard to produce events, content and data tailored to dealmakers and provide the tools they need to succeed. The new DealMAX conference will feature tracks for operating partners and strategic acquirers with guidance to help M&A professionals navigate deal sourcing, acquisition and value creation. *Middle Market Growth*'s two titles—*Executive* and *DealMaker*—similarly offer targeted content for investors and company executives or operators.

The GF Data findings that run throughout this Multiples Report—the new incarnation of ACG's Guide to Dealmaking—also bring vital research to the middle-market ecosystem, including averages on valuation and leverage, insights on deal pacing and terms, and much more.

While the outlook for 2023 looks challenging, middle-market dealmakers will still be on the hunt for opportunities. Quality assets are expected to trade, albeit with fierce competition, and as our annual survey of ACG members shows, add-ons are expected to be a bigger source of activity. With tools available through ACG at their disposal, dealmakers can continue to make sound decisions. //

There's no time to become an HR expert when you and your portcos are focused on one thing: growth.

Insperity's instant HR infrastructure helps you navigate complex HR risks and responsibilities, so you can get your portcos to scale faster. From lightening your HR load to providing in-depth people analytics and resources to help you attract, retain and develop top talent – we give your investments the tools to level up.

Visit **insperity.com/acg** or email **alliance@insperity.com**.

ENDORSED PARTNER

Contents

MIDDLE MARKET GROWTH // MULTIPLES REPORT

FEATURES

10 WITH A RECESSION LOOMING, PE ANGLES FOR OPPORTUNITIES IN 2023

Brought to you by S&P Global

Slowing dealmaking activity and market headwinds have dampened expectations for the year ahead. Private equity investors and investment bankers discuss what that means for valuations, deal processes, due diligence and more.

17 INSIGHTS FROM S&P GLOBAL

Read more from S&P Global, a sponsor of this report, including insights on transaction activity and the capital markets.

Cover illustration by Daniel Hertzberg

MIDDLE MARKET Growth

PRESIDENT AND CEO
Thomas Bohn, CAE, MBA
tbohn@acg.org

CHIEF OPERATING OFFICER
Matthew Hickman, MBA
mhickman@acg.org

VICE PRESIDENT, ACG MEDIA
Jackie D'Antonio
jdantonio@acg.org

CONTENT DIRECTOR
Kathryn Mulligan
kmulligan@acg.org

SENIOR EDITOR
Anastasia Donde
adonde@acg.org

DIGITAL EDITOR
Carolyn Vallejo
cvallejo@acg.org

ART DIRECTOR, ACG MEDIA
Michelle McAvoy
mmcavoy@acg.org

SENIOR VICE PRESIDENT, SALES
Harry Nikpour
hnikpour@acg.org

SENIOR DIRECTOR, STRATEGIC DEVELOPMENT
Kaitlyn Gregorio
kgregorio@acg.org

ACG®
Association for Corporate Growth
membership@acg.org
www.acg.org

Copyright 2022 *Middle Market Growth*® and Association for Corporate Growth, Inc.®
All rights reserved.

Printed in the United States of America.

ISSN 2475-921X (print)
ISSN 2475-9228 (online)

Don't let your carbon footprint walk all over you.

Supply chain emissions – from manufacturers of products to transporters of goods – are roughly **11.4 times higher** than operational emissions. That's why large, public companies are building decarbonization strategies that involve the entire supply chain.

Would your small and medium-sized enterprises (SMEs) pass a carbon assessment as part of a vendor-selection process?

Accelerate your decarbonization journey with our $100 million Kickstarter Capital Program for SMEs.

Learn how: www.usa.siemens.com/kickstarter

Contents

20 LENDERS SHARPEN THEIR FORECASTING TOOLS

Direct lenders and equity investors discuss the state of the credit markets and leverage levels, and their impact on dealmaking in the months to come.

28 NO UNCERTAIN TERMS

According to market participants and research from GF Data, stricter requirements for deal insurance and changes to key deal terms are among the forces shaping the M&A playing field.

36 FUNDRAISING TRENDS AND VALUE-CREATION FOCUS WEIGH ON PRIVATE EQUITY HIRING

Brought to you by Globalization Partners

Firms that struggle to fundraise could turn to layoffs, while those that recently closed funds may need to hire new team members to deploy them, according to experts, who discuss these and other topics related to employment and compensation.

Illustrations by Daniel Hertzberg

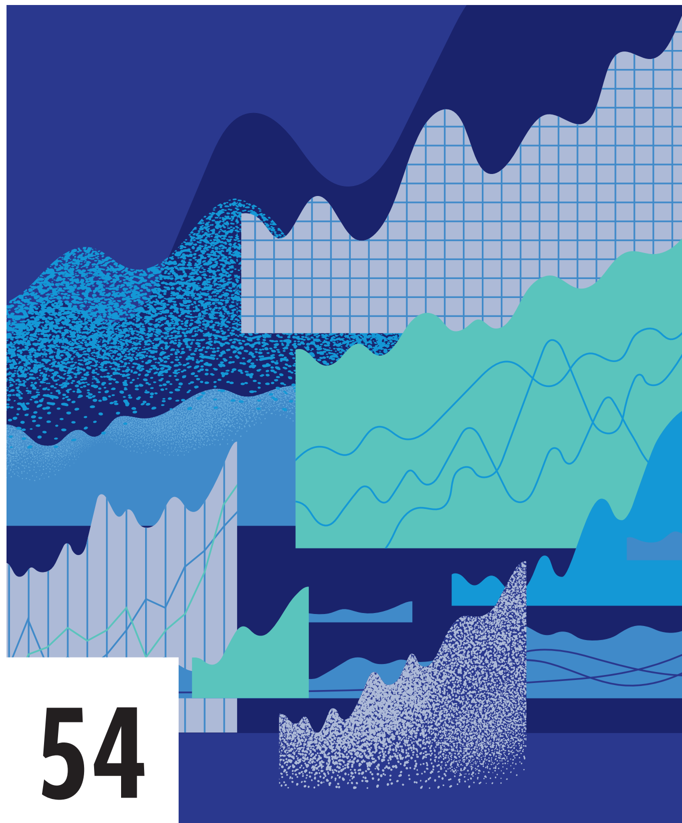
44 CONCERN ABOUT RISK DEEPENS AMONG MIDSIZE BUSINESS LEADERS

Brought to you by QBE North America

Financial, digital and business interruption risk were the three areas that topped the list of executives' concerns in 2022, according to QBE's third-annual risk survey. Here's a deep dive into the survey's findings.

51 INSIGHTS FROM QBE NORTH AMERICA

Read more from QBE, a sponsor of this report, including ways to mitigate the risk of business interruption.



54 4 DEAL SOURCING TRENDS SHAPING 2023

Brought to you by Grata

From new ways of using technology and data to more sophisticated marketing strategies, here's a look at the trends expected to shape deal sourcing next year.

Notes

Methodology

The Multiples Report looks at the state of middle-market M&A and the outlook for 2023. The reported articles in the issue draw on perspectives of industry participants, gleaned through interviews. The articles also cite data from several key sources:

ACG'S MULTIPLES SURVEY

ACG conducted a survey online between Aug. 16 and Sept. 21 for use in this report. Participants were asked about their expectations for 2023 related to M&A activity, key deal terms, leverage levels, valuations, compensation and more. Distributed via email, ACG's social media channels and on the middlemarketgrowth.org website, the survey collected input from a cross-section of middle-market M&A professionals—including accountants, attorneys, corporate strategic acquirers, family offices, investment bankers, lenders, limited partners, private equity firms and advisors. There were 171 complete responses to the survey.

GF DATA REPORTS

GF Data collects information on private M&A transactions ranging from $10 million to $500 million, as reported by more than 250 active contributing firms. The Multiples Report references various GF datasets. GF Data, an ACG company, publishes quarterly reports on middle-market trends and dynamics. Its proprietary data is submitted on a blind, no-name basis. Contributing PE firms can access GF Data for internal reporting to LPs and gain reliable market benchmarks in negotiation. Learn more at gfdata.com.

2022 MID-SIZED COMPANY RISK REPORT

Survey findings in QBE North America's 2022 Mid-Sized Company Risk Report, produced in partnership with ACG, are the basis for the article "Concern About Risk Deepens Among Midsize Business Leaders" in the Multiples Report. Now in its third year, QBE's risk report is based on an annual survey of executives in a variety of risk management roles at companies with $200 million to $3 billion in revenue from a cross-section of industries. The report discusses 12 macro and 97 micro risks that concern midsize company executives, whether companies have risk management plans in place to address these risks, and their top needs for reducing risk exposure. Learn more at qbe.com/us/risk-report.

A NOTE ABOUT OUR SPONSORS: Four of the editorial feature stories in this report are underwritten by ACG sponsors—Globalization Partners, Grata, QBE North America and S&P Global. Their sponsorship provided financial support for this report; however, they were not involved in the production of those feature stories. Content contributed directly by the sponsors follows each feature story. //

Creative Solutions. Relationship Focused.

$12.8B
Commitments Issued to Date

230+
Inception to Date Transactions

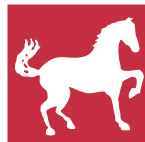
115+
Deals as Lead/Co-Lead Arranger

WhiteHorse Capital provides senior, unitranche and second lien debt for refinancing, growth capital, acquisitions, buyouts, and balance sheet recapitalizations for middle market companies in the U.S. and Canada. We offer a wide range of financing solutions across industry sectors and capital structures, serving sponsor and non-sponsor communities for more than 18 years.

BENEFITS OF WORKING WITH WHITEHORSE CAPITAL

- Relationship Oriented Mindset
- Underwrite Complex Credits
- Speed and Certainty to Close
- Flexible and Creative Solutions
- Transparent Approval Process
- Broad Investment Capabilities

To learn more, visit us at: www.whitehorse.com



WHITEHORSE CAPITAL

N
W
E
S

Brought to you by S&P Global Market Intelligence

Written by *Meghan Daniels*

Illustration by *Daniel Hertzberg*

With a ***Recession Looming,*** *PE Angles for Opportunities in 2023*

After several years of frenzied M&A, increased economic headwinds leave dealmakers wary about the 2023 outlook

2023 M&A Opportunities

Uncertainty is the name of the game when it comes to M&A expectations for 2023. Coming off a massive peak in 2021, deal activity in 2022 slowed considerably, driven by geopolitical issues, inflation, rising interest rates, supply chain instability and other factors.

GF Data, which provides data on deals from more than 250 active private equity contributors reported 129 PE-sponsored M&A deals in the first half of 2022, compared with 464 in all of 2021. (GF Data covers transactions with enterprise values of $10 million to $500 million.)

Depending on who you talk to, the market outlook for the coming year varies from slightly pessimistic to exceedingly so. According to a survey* of ACG members conducted in late summer, 66% of respondents believe deal activity will either slow or stay about the same in 2023.

"Public markets are down, IPOs are down, interest rates are up, leverage levels are down. Banks are incredibly conservative right now. It's more costly to do deals," says Brian Crosby, managing partner at private equity firm Traub Capital Partners, which invests in consumer businesses. "All these factors are weighing on private equity buyers and making us much more selective in terms of what we'll look at."

Jeffrey Stevenson, managing partner at private equity firm VSS Capital Partners, adds that the anticipation of a recession is weighing on the market. "We're beginning to hear about valuations being dropped and some processes being pulled. Banks being more conservative will of course have a knock-on effect on M&A and valuations," he says. "I expect we'll start to see a lot more cracks in the system in terms of M&A slowing down—buyers will have more apprehension about the future, and sellers may decide to put off going to market."

However, the effect may be less pronounced for well-established companies with above-average financial characteristics that serve targeted niche markets, according to GF Data's August M&A Report. These deals account for 68% of total deals tracked by GF and completed in the first half of 2022, up from 66% in 2021 and a historic norm of 57%.

"Top-tier assets with recurring revenues, high margins and limited cyclicality are still getting robust interest from private equity buyers, along with support from private lenders and sellers, and are receiving mid-teens to higher EBITDA multiples similar to 2021," says Sash Rentala, partner and head of financial sponsors at investment bank Solomon Partners.

VALUATIONS ON THE DOWNSLOPE

While top-tier businesses may be an exception, valuation expectations are trending downward across the board. Fifty-seven percent of ACG members surveyed said they expect valuations to fall, while 34% expect them to stay about the same. Only 9% said that they expect them to rise.

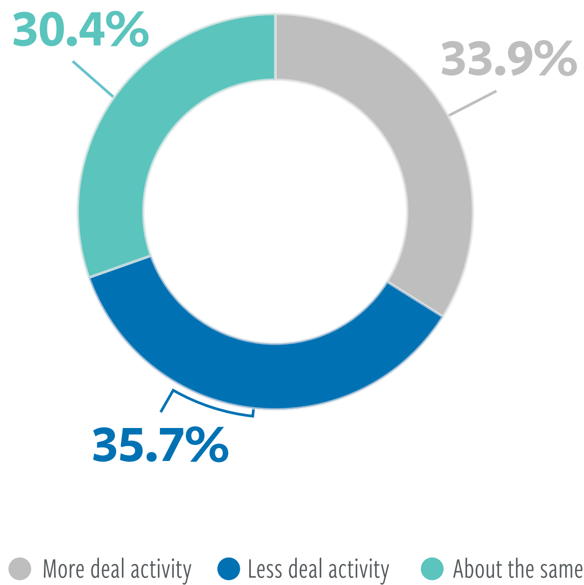
The reality of lower valuations is taking some time for sellers to get used to, after several years of sky-high multiples. Many dealmakers agree that in the summer of 2022, the market flipped from a seller's to a buyer's market. Now, "sellers are mostly looking for last year's multiple while buyers are more typically looking to pay a multiple that reflects the current economic outlook," says Doug Korn, managing partner at Victor Capital Partners.

As a result, deals are taking longer, and it can be hard for both sides to reach mutually agreeable terms. However, many expect that in the coming months, seller expectations will start to shift, creating an equilibrium and leading those who need to transact to accept lower valuations and those who are able to wait to do so.

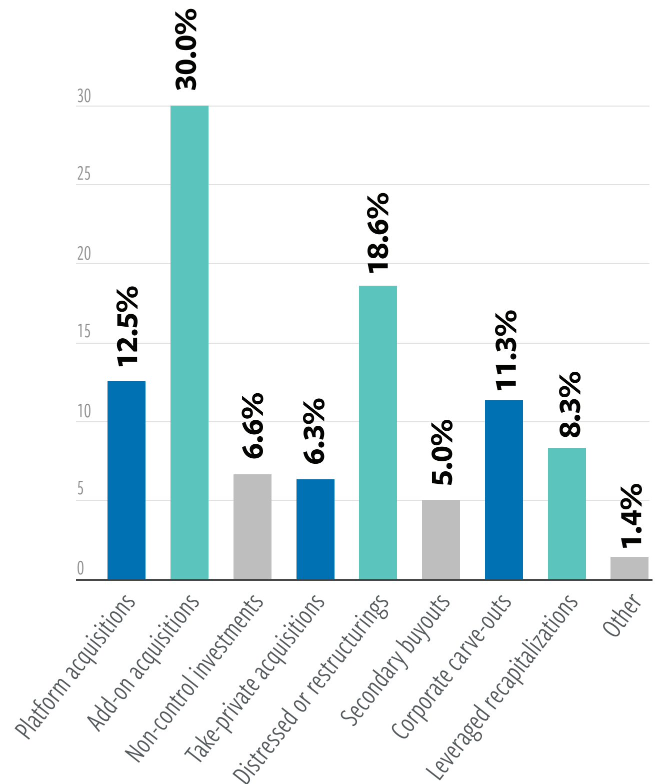
ERODING BUYER CONFIDENCE

Meanwhile, buyers' confidence in their M&A prospects in 2023 is lukewarm at best. The volatility of the public equity markets, driven by macroeconomic factors like the pandemic, the Ukraine war and increasing interest rates, "has created a host of liquidity problems for GPs and LPs who need a return of capital to enable future M&A activity," says Rentala. "I suspect these macro issues will

How do you expect middle-market M&A activity in 2023 to compare with 2022?



Which types of deals do you expect to see more of in 2023, compared with 2022? (Select all that apply.)



take a good part of 2023 to resolve and there will be a significant backlog of portfolio companies waiting for liquidity events."

Fifty-nine percent of buyers are "somewhat confident" in their ability to find high-quality investment targets to meet their M&A goals in 2023, according to the ACG survey.

At the same time, buyers do want to get deals done—and there is plenty of capital in the private equity space to back up that desire. As of August 2022, private equity still had $1.2 trillion of dry powder (down from $1.5 trillion in 2020), according to PitchBook.

"Buyers and investors *want* to be active. There are still massive amounts of capital in the market, and they want to put that capital to work. They want to be able to show that they can do transactions in whatever market environment prevails," says Dan Connolly, managing director and co-head of M&A at William Blair.

Whether they're able to make that happen remains to be seen.

CREATIVE DEALMAKING

One thing is certain: Faced with a tight financing market, buyers need to get creative with deal structure in order to complete transactions in 2023.

Previously, "sellers just wanted cash and they were by and large able to get what they asked for," says Meahgan O'Grady Martin, director of business development at private equity firm Palladium Equity Partners.

Moving forward, many transactions will be bridged through structure, as was more common prior to the pandemic, in order to meet expectations on both sides. This may include cash up front, as well as contingencies around the continued performance of the business, such as earnouts. "This helps address concerns about 'COVID bumps' and how businesses will be able to fare in the pending recession," notes O'Grady Martin.

Borrowing has also grown more costly these days. "Debt is more expensive, less plentiful and less tax-advantaged than it was a year ago," says Victor Capital's Korn.

Graph Source: ACG's Multiples Survey

2023 M&A Opportunities

The cost of debt is already impacting processes, a trend that is likely to continue in 2023. "We've had deals where leverage multiples have come down a full multiple of leverage or more from when we put in the IOI," says Traub Capital Partners' Crosby. This necessitates further communication with advisors and sellers and can put a snag in deal discussions. However, while the state of the debt markets makes pure financial engineering a much less viable strategy, it creates opportunities for PE firms that put greater emphasis on value creation through operational improvements.

In addition to complicating negotiations, the debt markets are leading some business owners to rethink sale plans. "We're seeing owners evaluate a broader set of alternatives than simply an outright sale or buyout," says William Blair's Connolly. This includes minority investments and secondary sales.

INTIMATE PROCESSES BECOME THE NORM

There are also changes underway to the sale process itself.

"Given the volatility right now, regular sell-side auctioneering is by and large not happening," says Connolly, with the exception of companies that are forced into a position where they need to transact immediately. This is a marked change from 2021 and the first part of 2022, when auction processes were large, frequent, competitive and rapid-fire.

In 2023, the expectation is that many companies that can wait to go to market will. However, dealmakers expect that deals will get done—just in a different way. "There are far fewer broad processes being launched. Creative origination—getting to know founders and CEOs at a more intimate level—is at the core of deals being done now more than ever," says O'Grady Martin.

Bankers would rather engage a targeted buyer in a lengthier proprietary process than risk a hung deal by attempting a broader process. This helps everyone save face. "If bankers have conversations with the most logical buyers and things don't work out, they can say they were just testing the market and will circle back again," says O'Grady Martin.

Though borne of necessity, these more intimate processes can be a boon for both sides. Of Traub Capital Partners' five active deals as of the time of writing, three of them have been a long courtship emerging from targeted matchmaking. "We're big believers in a culture-led approach, in finding a true partnership with owners and the management team. It's nice to be able to 'date' each other for much longer durations rather than have a 45-day shotgun marriage," says Crosby.

DOUBLING DOWN ON DUE DILIGENCE

In a volatile market, due diligence takes on increased importance as well.

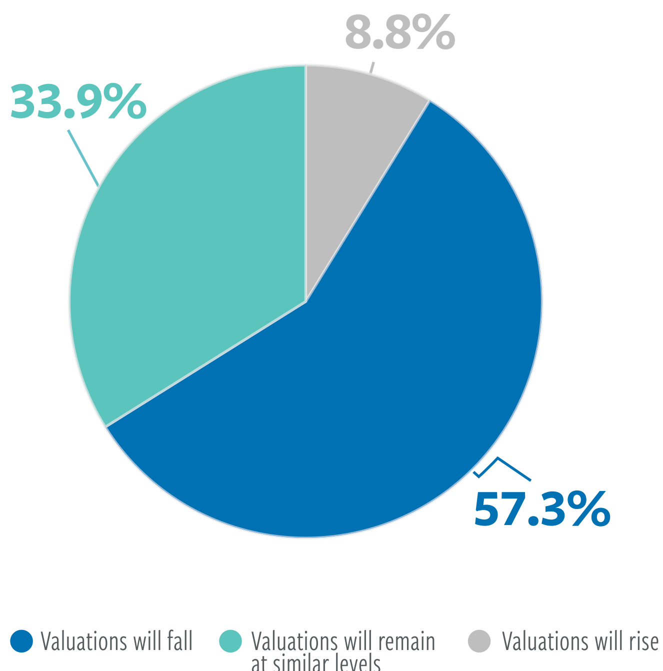
M&A processes are slowing down, driven in part by buyers taking more time to do their due diligence. "Last year, people were buying companies off projected year-end numbers and taking the sellers' word for it. This year people are much more skeptical. They want to see the results come in," says O'Grady Martin.

There are numerous factors to consider. For example, with inflation on the rise, "if you have a business that can't pass along its price increases to consumers, that's difficult to navigate," says Victor Capital Partners' Korn.

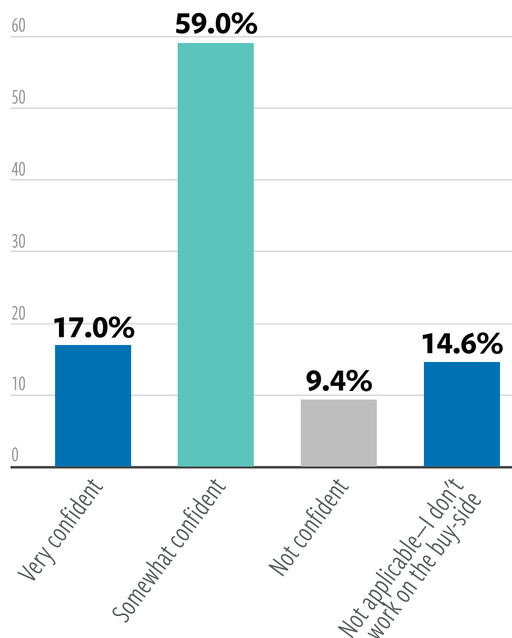
Labor costs, which have been increasing, are another big factor. "If you look at EBITDA over a 12-month period, as is typical, it's not going to capture the run rate increase of those costs," notes VSS' Stevenson. It requires a lot more work that needs to be done during due diligence to understand where the business is headed, he adds.

Ultimately, after three years of a pandemic, there's an inherent challenge in predicting how businesses will perform in a "normal" environment. Ideally, buyers would find companies where performance has been steady, but that can be difficult. Whether looking at a company that was hurt by or benefited from the pandemic, buyers need

How do you expect valuations in the middle market in 2023 to compare with 2022, on average?



As a buyer, how confident are you (or your buy-side clients) in finding high-quality investment targets to meet your M&A goals in 2023?



to put in the work to understand how changing dynamics may affect future earnings.

ADD-ONS ABOUND

In an uncertain landscape, add-on acquisitions offer opportunities for private equity firms, their platform companies and smaller businesses looking to transact. In the first half of 2022, add-on acquisitions made up nearly 80% of total deal activity by buyout funds, according to PitchBook. When ACG members were surveyed about which deal types they expected to see more of in 2023 vs. 2022, the most popular answer was add-ons (30% of respondents), followed by distressed/restructurings (19%) and platform acquisitions (13%).

"Add-ons can be less of a bet on the economic cycle and may be poised to accelerate in a challenging economic environment. A current owner may find that their business is more competitive when part of a private equity platform than to the current owner of the business, because of cost synergies, cross-selling opportunities or the multiple expansion ascribed to being part of a larger company," says Korn, who adds that Victor Capital Partners is stepping up add-on activity across its portfolio.

In addition, owners of smaller, family-owned businesses may find it hard to weather economic downturns and may be ready for a transaction.

For private equity firms eager to deploy capital, add-ons can be a less risky way to do so. "Add-ons make a lot of sense in uncertain times. You have an existing investment in the space, you know the industry, you have a management team that you know and trust," says Traub Capital Partners' Crosby, who notes his firm is also increasingly seeking out add-ons for its existing portfolio.

OPPORTUNITIES FOR PE

A down market also creates opportunities for those firms looking to provide growth capital to help build businesses.

"Firms that look to buy companies at a bargain price and drive returns while otherwise leaving it

Graph Source: ACG's Multiples Survey

2023 M&A Opportunities

Valuation Drilldown by Type of Buyer—2022 Through Q3

Total enterprise value (TEV)/EBITDA

						Buyouts Only	
TEV ($ mil)	ALL	PE Group	Family Office**	Mezz/Jr. Capital	SBIC	Platforms	Add-Ons
10-25	6.6	6.4	6.7	6.6	6.7	6.6	6.2
25-50	7.1	7.4	6.6	7.2	6.7	6.9	7.7
50-100	8.8	8.8	7.4	9.6	9.3	9.0	8.0
100-250	9.7	9.7	9.1	10.0	10.3	9.7	7.8
Total	7.7	7.7	7.0	8.1	7.9	7.8	6.9
N =	215	124	46	39	50	119	71

***Note: The Family Office grouping also includes deals done by other sponsors not organized as committed funds, e.g., independent sponsors.*

alone will struggle. Firms with sector expertise and those that can offer real value to their portfolio companies will be well-positioned to navigate this environment," says Korn.

While fewer business owners may be willing to consider an all-out sale, "in a market environment where valuations are lower, we'll find more entrepreneurs wanting to hold and raise capital," says VSS' Stevenson. GF Data found that in the first six months of 2022, "more high-performing companies are choosing to 'take chips off the table' rather than substantially exit," a trend that is likely to continue. In an atypical development, mezzanine funds/junior capital providers completed transactions at an average of 8.1x in 2022 as of Q3, while the average for PE funds was 7.7x, according to GF Data.

While there may be fewer high-quality targets to consider, the new market environment does have some advantages for buyers. "It's nice in the sense that these auction processes have moderated a bit in terms of pace, frenzy, speed to close, and certainly the valuation multiples and expectations," says Crosby.

Ultimately, most agree that a recession is on the horizon in 2023. But there remain opportunities for buyers, if they only know where to look. "Right now, we're seeing more and more deals being put on ice, with seller expectations still at 2021 levels," says O'Grady Martin. "But once those expectations converge, that will provide a very nice buying opportunity for those that still have a significant amount of dry powder left." //

MEGHAN DANIELS is a freelance writer and editor based in Brooklyn, New York.

**ACG conducted a survey between Aug. 16 and Sept. 21 in which 171 respondents from the middle-market dealmaking and corporate growth community answered questions about their outlook for 2023.*

Graph Source: GF Data's November 2022 M&A Report

S&P Global
Market Intelligence

In private markets, insight is everything.

Our data, software, and tools empower you to build a 360° view of the private markets, so you can pinpoint opportunities and **capture what's next.**

To unlock private markets, visit: **spglobal.com/PrivateMarkets**

Seek & Prosper

Insights provided by:

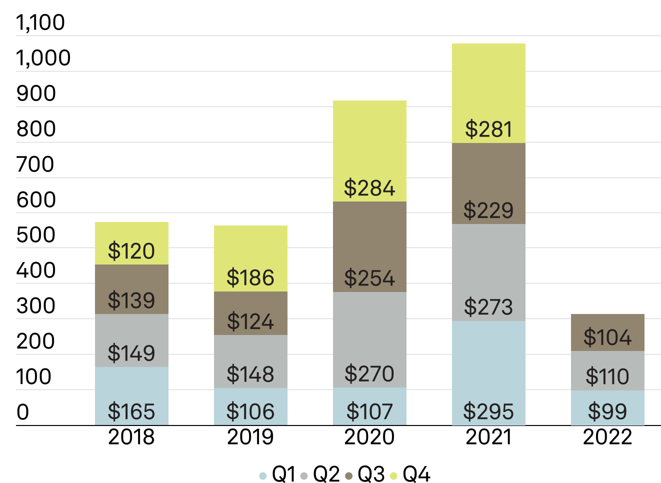
spglobal.com/marketintelligence

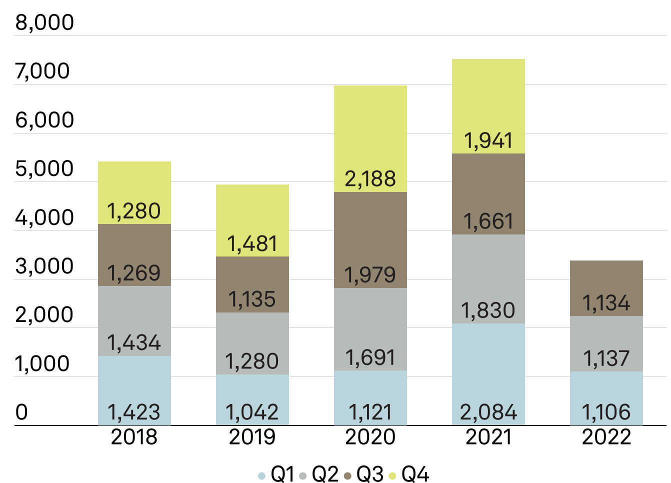
S&P Global
Market Intelligence

The Big Picture:

Visualizing the 2022 Global M&A and Capital Markets Dealscape

Global Equity Capital Markets Issuance by Quarter

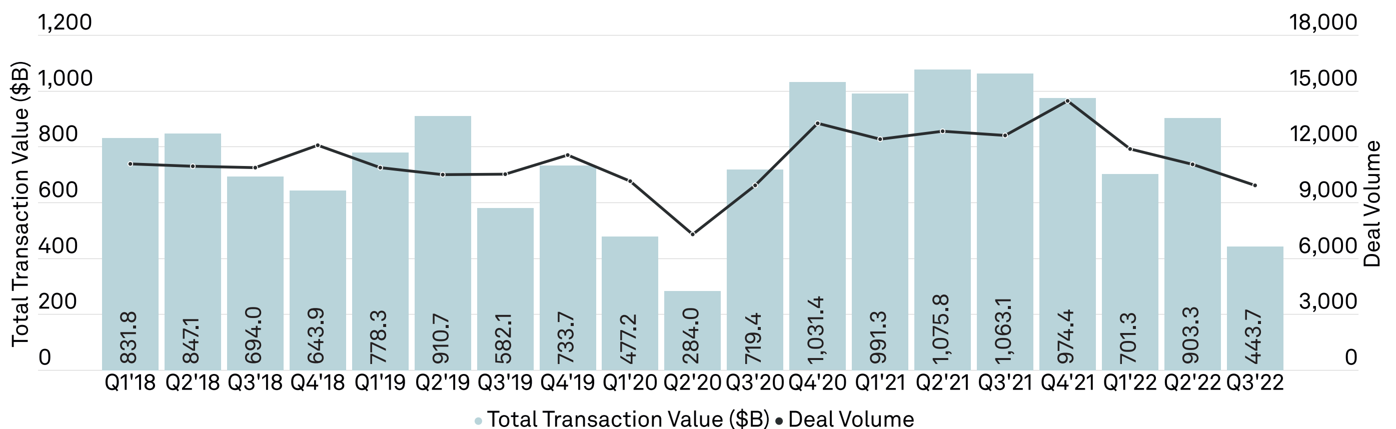




The volatile equity markets, rising interest rates, and economic uncertainty have weighed on dealmaking over the first three quarters of 2022. Lower equity valuations reduced buyers' purchasing power and the higher financing costs increased the cost of acquisition—but some opportunities still exist. Global M&A experienced its slowest quarter in Q3 since the onset of the pandemic with aggregate deal value ($443B) experiencing a 50% decline compared to Q2.

Slowing Global M&A

Quarterly Comparisons by Deal Volume and Transaction Value ($B)



Data as of Oct. 11, 2022. Analysis includes global public common and convertible preferred equity issuances completed between 1/1/18 to 9/30.22. Excludes private placements and blank-check blind pool companies. Aggregate amount offered includes overallotments. M&A data includes announced or completed deals between 1/1/2018 and 9/30/2022, where the buyer acquired a majority stake in a company or asset. Source: S&P Global Market Intelligence.

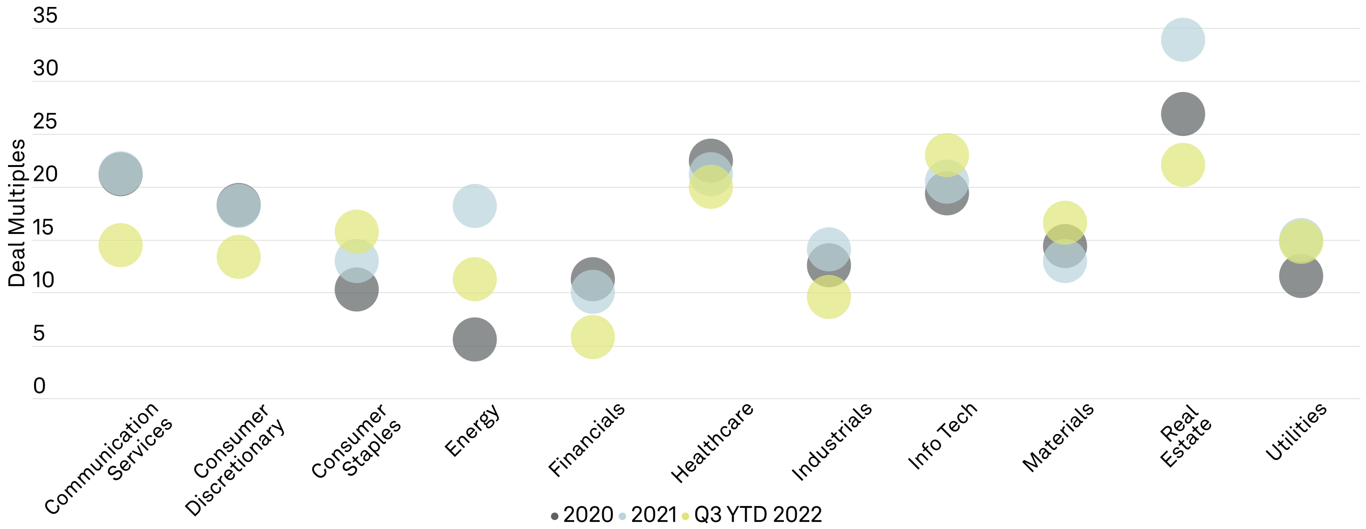
S&P Global
Market Intelligence

See the Big Picture

Read 2023 outlook reports at
spglobal.com/bigpicture >

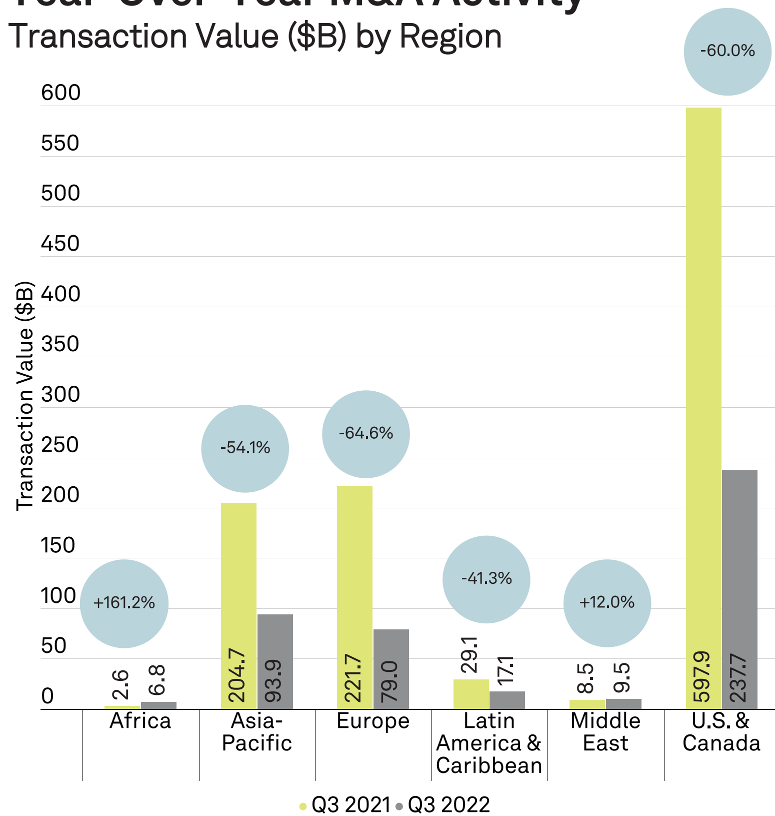
Volatility in Shifting Deal Multiples by Sector

Implied Enterprise Value/EBITDA, 2020 - YTD through Q3 2022

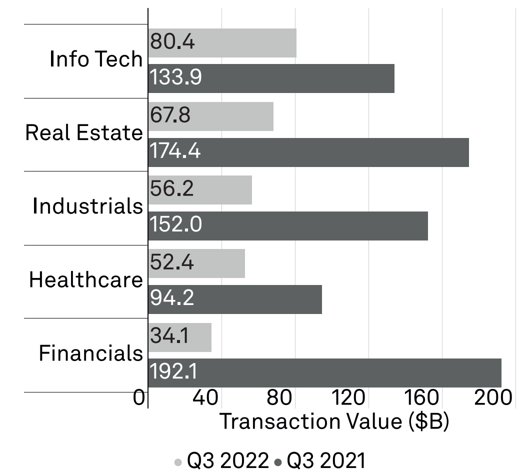


Year-Over-Year M&A Activity

Transaction Value ($B) by Region



Top Five Sectors in Q3 YTD



Turn deals undone into deals done right.
Explore M&A data solutions >

Data as of Oct. 5, 2022. Includes announced or completed deals between 1/1/2020 and 9/30/2022, where the buyer acquired a majority stake in a company or asset with the target's geographic location and primary industry disclosed. Source: S&P Global Market Intelligence.

WRITTEN BY
Anastasia Donde

ILLUSTRATION BY
Daniel Hertzberg

Lenders Sharpen Their ***Forecasting Tools***

With storm clouds rolling into financial markets, debt providers are focusing on modeling downside scenarios for their portfolio companies

Lending

Both businesses and investors are facing a number of challenges, and credit availability is becoming scarce. With slowing growth and deepening inflation, direct lenders are screening their portfolio companies and potential new investments for risk. "We're running downside scenarios in case of rising interest rates and worsening inflation," says Ted Denniston, co-head of direct lending at NXT Capital.

"We started to put more emphasis on forecasting prior to the pandemic," agrees Michael Ewald, global head of private credit at Bain Capital Credit. The firm is getting in the habit of asking, "How bad would things have to get for the company not to be able to stand a stress scenario? What's your reason for that not happening?" Ewald adds that Bain Capital likes to run several downside scenarios on what would happen to the company if macro conditions worsen. Bain Capital has a macroeconomic group that works on modeling across the firm, including the private equity and credit departments. It was formed around the start of the pandemic and staffed with new and existing employees.

Some lenders are relying on the company's sponsors to run their models. "Lenders are now spending a lot of time forecasting which companies might have trouble covering their fixed charge interest ratios," says Matt Janchar, head of capital markets at private equity firm Berkshire Partners. "They're calling us and asking for our cash flow models. A lot of the time, they will take our models and run their own scenarios to try to get ahead of where there might be problems next year."

Needless to say, lenders are being cautious around new investments. While deal valuations have held up so far, they are expected to drop next year. "Completed deal volume was down markedly in the first half of 2022, while valuations for mid-market companies acquired by private equity groups and other deal sponsors held strong at an average of 7.4x EBITDA," according to GF Data's Fall 2022 Key Deal Terms Report. GF Data tracks deals with $10 million to $500 million in enterprise value.

GF Data's third quarter report actually shows an uptick in valuation multiples to 8.1x, though the report notes that some of that represents growth equity investments and recapitalizations, not fresh buyouts.

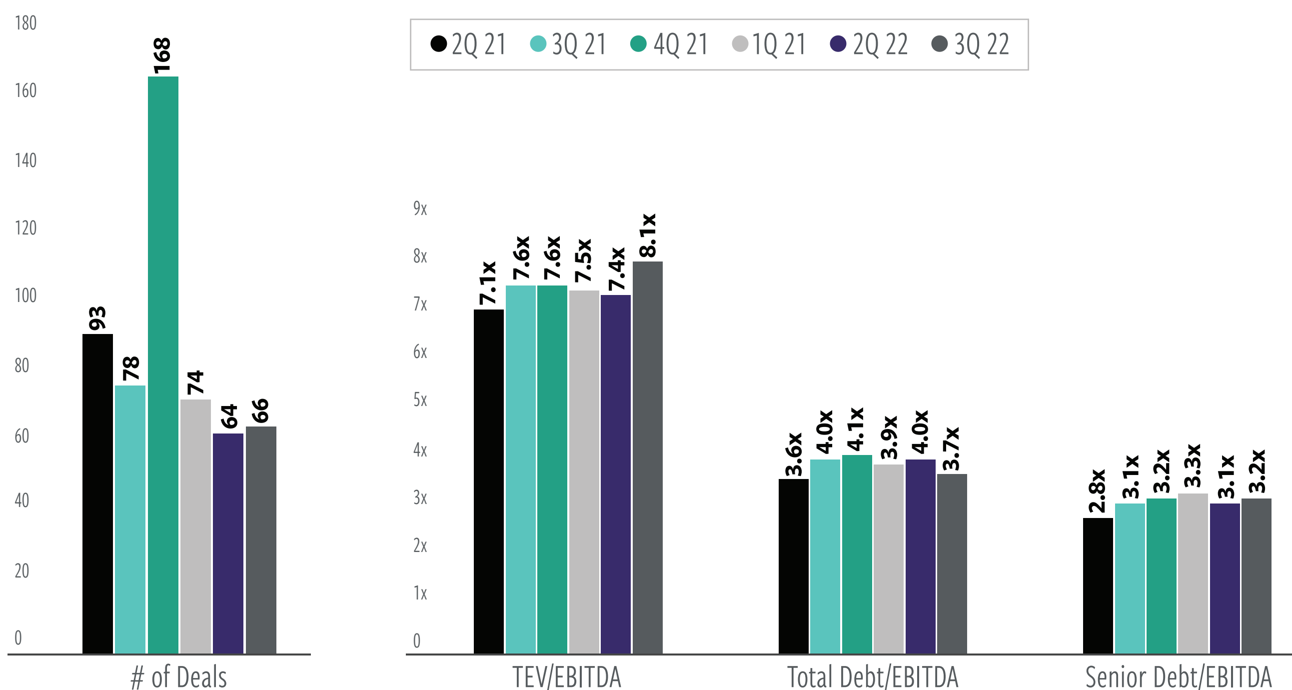
When asked how valuations in 2023 will compare to those of 2022, most respondents (57%) to an ACG survey* said they expect valuations to drop, with 34% saying they will stay the same and only 9% expecting they will rise. More than half of respondents (62%) said they don't expect debt utilization in private equity transactions to rise next year.

A TALE OF TWO HALVES

Several sources say the market's perception of 2022 was that of a "tale of two halves," with the first half of the year being busy with overflow from 2021. "In the second half, things took a bit of a turn with Russia invading Ukraine, energy costs rising and inflation worsening," Ewald says. Some companies responded by increasing prices, a move that can perpetuate inflation. The Federal Reserve then raised interest rates, which led to pessimism in the market and a slowdown in dealmaking. "There are a lot more deals being pulled by the seller because of a price expectations mismatch," Ewald says.

Janchar adds that it even looked like a "tale of two summers." In early summer, volatility was lessening and access to capital was sound. But in early to mid-August, "there was an inflection point: It became clear that interest rates were going to keep rising and inflation was going into this self-perpetuating spiral," Janchar explains.

With several large syndicate arrangements being pulled recently, including in deals involving Citrix and Brightspeed, the outlook for credit seems bleak. Weakness in the broadly syndicated market usually rolls downhill to the middle market in time, though direct lenders have some advantages. "The syndicated loan deals require ratings, meetings with investors, ongoing monitoring, whereas private credit firms can commit large amounts quickly and there is usually an intimate relationship and trust between a lender and a sponsor," Janchar says. Some direct lenders are still willing to do new deals but are being extra cautious.



**Transactions include those reported by GF Data's active private equity contributors that meet the following parameters: $10 million-$500 million TEV; and TEV/trailing 12 months adjusted EBITDA of 3x-18x

SAFETY IN NUMBERS

Multibillion dollar deals by direct lenders are becoming less common, and lenders are only willing to hold a small part of a loan. Whereas previously one firm would take on a $500 million to $1 billion loan for a single credit, they're now willing to do $100 million to $150 million in hold size, Janchar says. This is leading to a proliferation of the "club deal," where multiple direct lenders take on portions of one large loan. In times like these, there is safety in numbers. "Everyone wants a friend. They go to the investment committee and say, 'Who else is in this?'" Janchar says. This sometimes creates headaches for the sponsors because they now must get multiple lenders to agree on the structure and terms of a deal.

According to NXT's Denniston, average leverage has already dropped a turn or so to 5.5x from 6.5x last year across industries. If valuations go down next year, some say that would be a welcome change, as the sky-high multiples of 2021 shouldn't be the norm. Ewald says leverage has come down somewhat, but it also depends on the industry: Leverage multiples could average around 6x in software and around 4x in industrials. GF Data shows a decline in leverage to 3.7x in the third quarter, down from around 4x last year and in Q2.

"So far valuations have held up, but deals have to actually trade to show new valuations, and many have gotten pulled," Ewald says. With unusually high valuations in the past year or two, Denniston says he has worked on many deals that were financed with 60% equity and 40% debt. A normal deal would be the reverse of that ratio, so valuations coming down would normalize M&A metrics more. These might affect private equity returns in the long run but could also make exits easier.

Several lenders say they are avoiding cyclical industries like consumer, building products or auto in this environment. Others are looking forward to distressed and restructuring opportunities. NXT has a fully staffed work-outs group that hasn't

Graph Source: GF Data's November 2022 M&A Report

Lending

Total Debt/EBITDA by Period

TEV ($ mil)	4Q 2020	1Q 2021	2Q 2021	3Q 2021	4Q 2021	1Q 2022	2Q 2022	3Q 2022	N=
10-25	3.6	4.4	3.4	3.4	4.5	3.6	4.2	3.5	219
25-50	3.6	3.7	3.4	4.4	4.0	4.0	3.5	3.8	205
50-100	3.5	3.7	3.8	4.1	3.9	3.9	4.2	3.6	158
100-250	4.7	4.6	4.5	4.3	4.1	4.6	4.3	5.1	105
Total	3.7	4.1	3.6	4.0	4.1	3.9	4.0	3.7	
N =	114	107	83	65	142	68	53	55	687

seen a lot of activity in recent years, but the firm expects that to change now.

"There is nervousness around where the economy is headed but high-quality deals are still getting done," says Brent Kulman, managing director in business development at Five Points Capital, whose firm manages a credit strategy as well as a buyout strategy that was recently re-branded as Reynolda Equity Partners. "There is more caution and scrutiny around cyclical businesses like consumer, building products and real estate."

Sponsors are often coming to lenders earlier in a process to test the waters for leverage reads, says Kulman. Normally, sponsors would have everything buttoned up and just go to a lender once they were ready to submit a letter of intent. Now private equity investors are often going to a lender as soon as they receive marketing materials and asking what debt providers think before they submit an indication of interest.

NO NEED TO PANIC

Despite myriad industry challenges facing the market, lenders remain cautiously optimistic about the future. Some say that while many sizable new deals might not be happening, they will be working on add-ons in the interim. Kulman notes that the lower middle market is somewhat insulated from broader macroeconomic events and there are still motivations driving parties to transact, such as founders wanting to retire or platforms looking for smaller add-on investments. Indeed, 30% of respondents to ACG's survey said they expect to see more add-on investments in 2023 than 2022.

Cherry-picking companies and sectors that are still healthy in this environment is another strategy. Quality companies are still going to market, although the competition for these assets—that are few and far between—is more pronounced, sources say.

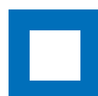
Some market participants question how direct lenders will fare through this downturn when many

Graph Source: GF Data's November 2022 Leverage Report

MEASURING SUCCESS ONE DEAL AT A TIME FOR OVER 25 YEARS

26	7	2.0	140+	70+
YEARS IN BUSINESS	INVESTMENT FUNDS RAISED	BILLION OF COMMITTED CAPITAL	PLATFORM INVESTMENTS	INDEPENDENT SPONSOR PLATFORMS

Peninsula Capital Partners provides customized debt and equity solutions to middle-market companies as either a ***control or non-control*** investor. We specialize in working with independent sponsors and directly with companies on buyout, recapitalization, growth and other leveraged capital transactions.

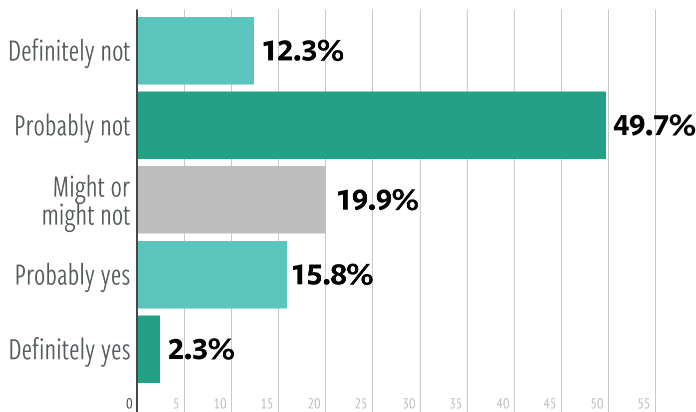


PENINSULA CAPITAL PARTNERS L.L.C.

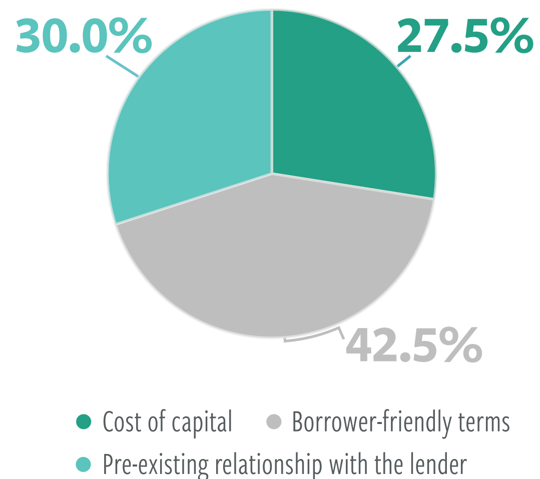
PLEASE ALLOW US TO SHARE OUR CAPITAL STRUCTURING EXPERTISE WITH YOU — 313.237.5100 | WWW.PENINSULAFUNDS.COM

Lending

Do you expect debt utilization, on average, in private equity transactions to rise in 2023 compared with 2022?



As a private capital investor or borrower, what is the most important aspect in selecting a lender in the current environment?



didn't exist during the last recession in 2008. Most of the same lenders spun out of banks following the Dodd-Frank Act at the time, so they're accustomed to managing credit, albeit at banks rather than private debt funds. The NXT team used to work together at other institutions, including Merrill Lynch. "We have the battle scars from the last recession," says Denniston.

Some of the challenges arriving at lenders' doorsteps have also been building for a time. The arrival of the COVID-19 pandemic took investors by surprise and many thought it was going to become detrimental to dealmaking. The damage wound up only affecting some businesses negatively for a short period of time, but investors were prepared to go to battle even then, says Ewald. "We thought everything would come to a screeching halt. We spent a lot of time blocking and tackling at the company level, and fixing capital structures in the face of lockdowns," he says. "That collaboration will continue," he adds, now that a recession is on the horizon.

"2008 was an existential crisis. Where we are now is a dramatic repricing of interest rate expectations," says Janchar. "For 30 years, the market has been overestimating how much interest rates will come up. Now the market is floundering to adjust." He thinks eventually things will balance out. Once interest rates level off and succeed in tamping down inflation, conditions for dealmaking should get better.

"There are a lot of reasons to be concerned and aware but not a lot of reasons to panic," says NXT's Denniston. "If there is a place between concern and panic, that's where I'd be." //

ANASTASIA DONDE is *Middle Market Growth*'s senior editor.

**ACG conducted a survey between Aug. 16 and Sept. 21 in which 171 respondents from the middle-market dealmaking and corporate growth community answered questions about their outlook for 2023.*

Graph Source: ACG's Multiples Survey

$170,000,000

Senior Credit Facilities
Left Lead Arranger
and Bookrunner

August 2022

$125,000,000

Senior Credit Facilities
Sole Lead Arranger
and Bookrunner

August 2022

School Development HC Finance II LLC et al.

$85,000,000

Incremental Term Loan
Sole Lead Arranger
and Bookrunner

July 2022

Wall Street capabilities. Main Street sensibilities.

Support to navigate your industry's ever-changing landscape.

As you work to move your business toward an even stronger financial future, Regions Securities® is here to help you turn obstacles into opportunities. Our team of executive-level bankers has specialized industry experience to help you reach your objectives in all economic cycles.

We use a relationship-oriented approach to offer capital-raising and advisory services as well as customized risk management tailored to meet your needs.

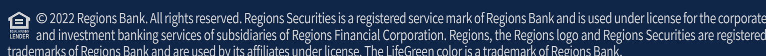
Learn how our experienced bankers can help keep your business moving forward at regions.com/SecuritiesSolutions.

Rit N. Amin | Executive Vice President
Group Managing Director
Corporate & Institutional Markets
rit.amin@regions.com

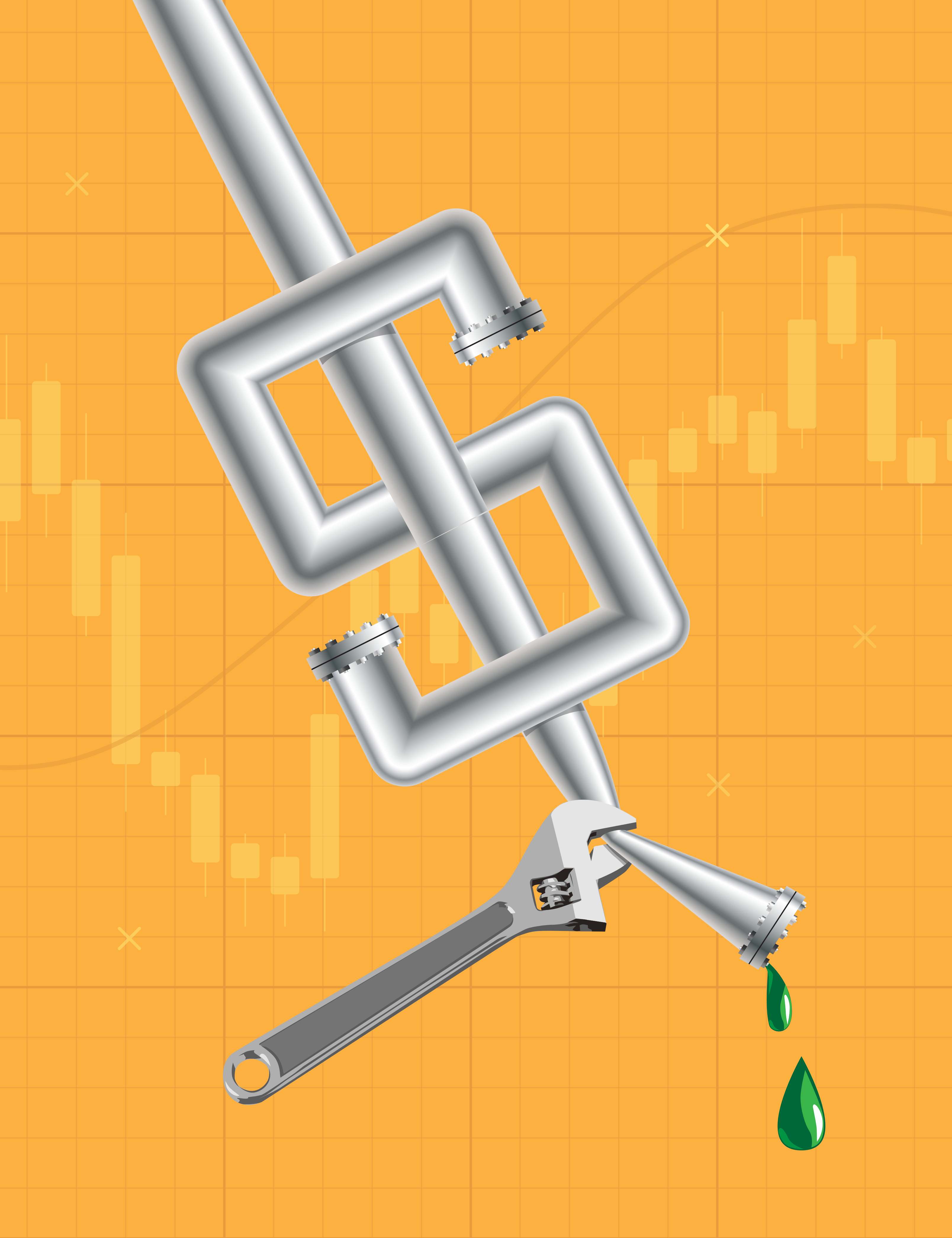
Corporate Banking | Industry Expertise | Capital Markets & Advisory Services | Comprehensive Financing Solutions

Investment, Annuities and Insurance Products
Are Not FDIC Insured | Are Not Bank Guaranteed | May Lose Value
Are Not Deposits | Are Not Insured by Any Federal Government Agency
Are Not a Condition of Any Banking Activity

Securities activities and Merger and Acquisition advisory services are provided by Regions Securities LLC, 1180 W. Peachtree St. NW, Suite 1400, Atlanta, GA 30309, 404-279-7400. Member FINRA and SIPC.


Banking products and services, including lending, financial risk management, and treasury and payment solutions, are offered by Regions Bank. Deposit products are offered by Regions Bank, Member FDIC.

© 2022 Regions Bank. All rights reserved. Regions Securities is a registered service mark of Regions Bank and is used under license for the corporate and investment banking services of subsidiaries of Regions Financial Corporation. Regions, the Regions logo and Regions Securities are registered trademarks of Regions Bank and are used by its affiliates under license. The LifeGreen color is a trademark of Regions Bank.



WRITTEN BY
Bailey McCann

ILLUSTRATION BY
Daniel Hertzberg

No *Uncertain* Terms

Tightening lending conditions, stricter requirements for deal insurance and changes to key deal terms signal where the M&A market is headed in 2023

Deal Terms

M&A activity had a slow start to the year in 2022. According to analysis from data provider GF Data, completed deal volume among its contributors was down significantly in the first three quarters of 2022. They closed only 204 deals this year as of Sept. 30, compared to 296 deals for the same time frame last year.

Both sellers and sponsors pulled back in the first half of the year as economic volatility and tightening liquidity conditions made it necessary to add another layer of due diligence to transactions to ensure that portfolio companies could ride out a potential recession.

Private equity data tends to trail by a quarter or more, but early indications from the second half of 2022 suggest that activity picked up slightly as both sellers and sponsors adjusted to new economic conditions and capital requirements—even as they contended with stricter covenants from lenders and insurance providers along with changes to key deal terms.

LESS LIQUIDITY

Sources say that the appetite for dealmaking remains robust. "There's plenty of dry powder that private equity funds have that they're looking to invest," says Brent Kulman, managing director for business development at Reynolda Equity Partners, an affiliate of Five Points Capital. "And the same holds true for credit funds that provide much of the debt capital that goes into financing these deals."

Still, it's not the same sellers' market it was in 2021. "You're certainly seeing lenders tightening up their terms," Kulman notes. "Credit spreads are moving up. Covenants are getting tighter. Leverage is declining in terms of what's available from lenders."

Steve Ruby, co-head of origination at New York-based Audax Private Debt, points out that market forces are putting pressure on how much leverage is reasonable for a deal. "We underwrite to cash flows," he says. "We do a lot of work on historical performance. If a company has been through a recession before, we're looking at how that went."

Ruby characterizes his team's underwriting process as one that's "very sensitive" to risk. "So you have that model coming alongside a rising rate environment where the cost of capital is going up and spreads are widening," he says. "Those are pretty significant changes. We're seeing leverage come down half a turn to a full turn. Pricing is going up, and in some cases yields are nearly doubling."

Tightening liquidity markets are also impacting the due diligence process and extending the time it takes to close a transaction, according to Nick Gibson, a Chicago-based partner in the private equity practice at law firm Reed Smith. He notes that he and his colleagues are seeing deal timelines increase to 45 or 60 days, up from more like 30 days in 2021. He has also observed notable changes to buyer behavior.

"Last year, there were many instances of buyers going in without exclusivity, marking up a purchase agreement, and getting representations and warranties insurance fully underwritten before being chosen as the bidder," he says. "What we're seeing now is buyers are getting exclusivity more frequently before having to fully engage every aspect involved in due diligence, and they are also increasingly thoughtful in validating those diligence fronts, which is leading to longer deal timelines."

Lengthy auctions and tighter liquidity mean companies that might have come to market in 2021 are facing more scrutiny. Kulman notes that M&A advisors are getting more candid with potential sellers about what their prospects are. "For the lower quality deals at this point, some of them are not even being brought to market right now. Advisors are telling sellers that their business might not be well received—that now is not the best time. So that's part of where the slowdown is," he says.

LOOKING FOR ALIGNMENT

Against this backdrop, sponsors have a bit more power, and it's beginning to show up on term sheets.

Senior Debt Pricing by Period

TEV ($ mil)	4Q 2020	1Q 2021	2Q 2021	3Q 2021	4Q 2021	1Q 2022	2Q 2022	3Q 2022	N=
10-25	4.3%	5.0%	4.1%	4.1%	4.4%	4.3%	3.8%	6.5%	139
25-50	5.3%	5.3%	4.3%	4.8%	4.4%	4.7%	4.2%	6.1%	153
50-100	5.2%	5.4%	4.9%	4.0%	5.1%	4.4%	5.5%	6.6%	127
100-250	6.8%	5.4%	5.7%	5.2%	4.8%	4.5%	5.7%	7.4%	76
Total	5.2%	5.3%	4.5%	4.5%	4.6%	4.5%	4.7%	6.5%	
N =	81	80	60	47	92	50	42	43	495

*All rates are as of the respective quarter end.

While the appetite for high-quality companies remains strong, those businesses aren't necessarily going to sail through a deal. Large buyouts are under the most pressure as it becomes more difficult to use the syndicated debt market to finance a transaction. In the middle and lower middle market, private credit financing is proving to be more flexible but with some caveats.

"Over the past few years, even during COVID, walkaway deals were fairly common, and we're seeing less of that now," says Matthew Simpson, a complex transactions attorney at law firm Mintz, referring to deals where sellers aren't subject to earnouts or other longer-term exit conditions. "Unless it's a very, very attractive asset, there is just more tension in the market right now, and that kind of deal is less likely."

Simpson adds that he is talking to his clients about these dynamics and the prevailing valuations in today's market, which he expects to persist into 2023. "There is still a bit of a disconnect between seller expectations and what sponsors are willing to pay," he says. "I think that's going to continue to shake out over the next year."

In its Fall 2022 Key Deal Terms Report, GF Data noted that changes to key deal terms—including representations and warranties insurance, earnouts and indemnification caps—could be another harbinger for a coming drop in valuations. According to the authors, "buyers have become less accommodating" across those three deal terms, in particular. GF's data shows a decline in use of deal insurance and earnouts in the first half of 2022.

The report concluded, "If recessionary conditions take hold and valuations recede in the fall, we will look back on this movement in deal points other than price as a leading indicator of that decline."

TERM SHEETS TIGHTEN

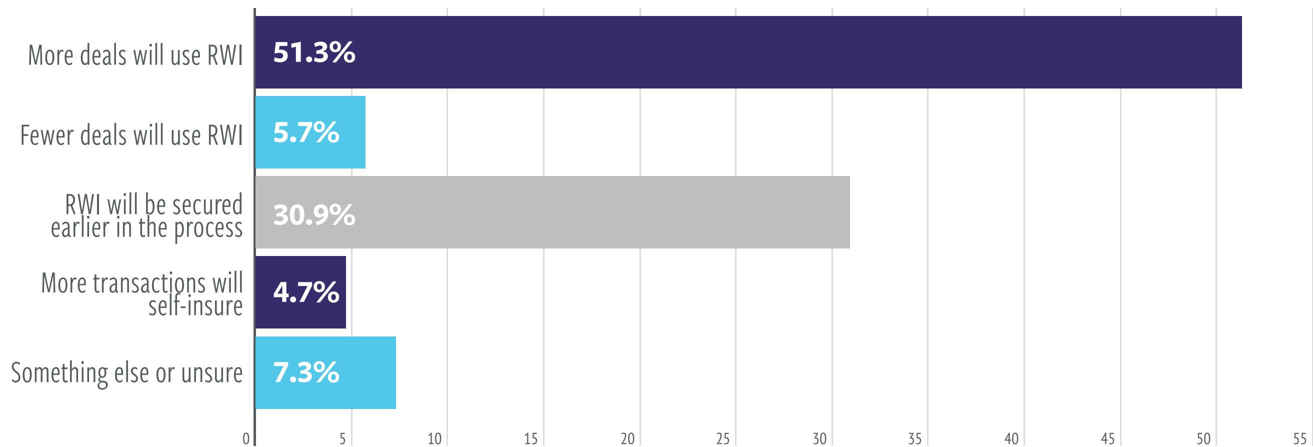
Representations and warranties, a type of breach-of-contract insurance, isn't just a foreshadowing tool for coming valuation changes; it's also having an impact on which transactions move forward.

Known as RWI, reps and warranties insurance coverage is generally a bespoke policy that will cover claims if there are unforeseen costs that arise in a deal. There are benefits for both buyers and

Graph Source: GF Data's November 2022 Leverage Report

Deal Terms

What changes do you expect to see in the use of reps and warranties insurance (RWI) in 2023 compared with 2022? (Select all that apply.)



sellers. Buyers offering this kind of policy will generally accept a smaller deal escrow, which can lead to bigger profits for a seller. However, before issuing these policies, insurers conduct independent due diligence on a transaction to make sure they agree with the deal terms under consideration. Insurers then become sort of a check on a deal—if they don't want to write a policy or the policy is very expensive, that can be an indication of risk.

Prices for these policies went up significantly in recent years because of the pandemic. They have since come down as COVID-19-related risk lessened, but insurers can still play a big role in deal flow.

"Insurance influences how we design our indemnification paradigms in a deal," says Mintz's Simpson. "Insurers are an important bellwether, and they are getting more creative with what they are willing to offer."

He adds that recently he's seen interim break coverage, as well as a greater push for intellectual property coverage, transactional tax insurance and contingent liability insurance. "To the extent that buyers and sellers can offload some of the risk via insurance, that's going to drive transaction flow," Simpson says. "But there are costs associated with it, and the due diligence has to line up."

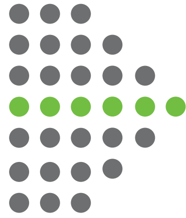
Asked about their predictions for RWI usage in 2023 in a recent ACG survey, 51% of middle-market respondents predicted more deals will use this coverage compared with 2022, while 31% said they expect it to be secured earlier in the process. Only 6% predicted that fewer deals will use reps and warranties insurance.

WORKAROUNDS

In an environment where a variety of stakeholders must sign off on a deal to get it over the finish line, some deal types are becoming more popular. There is also a greater willingness to seek bespoke solutions to help manage risk or reach an acceptable result.

Tuck-ins and bolt-ons—smaller deals that require less leverage and aren't a full-scale buyout—are likely to drive deal flow, at least over

Graph Source: ACG's Multiples Survey



GF DATA®

AN ACG COMPANY

Get Real Values from Actual Deals No Guessing. No Extrapolation.

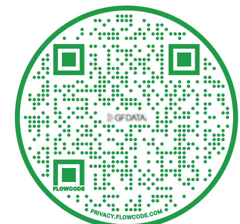
When it comes to valuing M&A transactions in the middle market, no other source provides the level of quality and granularity as GF Data.

GF Data provides the most reliable data on private-equity sponsored M&A transactions with enterprise values of $10 million – $500 million.

Uncover proprietary transactional information provided by an established pool of private equity groups on a blind and confidential basis. Obtain accurate and up-to-date information to value and assess middle-market businesses.

To learn more about subscribing or contributing, scan the code or contact bdunn@acg.org.

GFData.com



GF Data is proud to be part of the ACG family.

Deal Terms

Indemnification Cap—% of Total Enterprise Value

TEV ($ mil)	2003-2017	2018	2019	2020	2021	1H 2022	Total	N =
10-25	21.6%	21.3%	13.1%	23.0%	16.0%	20.3%	20.5%	1015
25-50	14.1%	14.2%	11.7%	13.4%	15.5%	10.0%	13.8%	715
50-100	11.6%	7.5%	11.2%	8.9%	8.9%	16.3%	10.8%	435
100-250	9.7%	4.8%	3.4%	5.8%	7.6%	5.6%	8.0%	217
Total	16.6%	14.9%	11.4%	16.2%	13.7%	15.0%	15.6%	
N =	1451	205	209	194	241	82		2382

the near term. "We're still seeing some frothiness in platform tuck-ins," says Kristian Herrmann, a partner in the M&A and private equity group at law firm Proskauer. "There is still a strong market opportunity to continue to build on platform investments with good fundamentals. The targets are out there, and it may be easier to come to terms on those deals in the current climate."

Mintz's Simpson says that more sponsors may also pivot to a growth equity-type stance because they can get a feel for a company. "We have seen deals where valuations were coming in at levels from six months ago without flexibility on the price, and sponsors aren't willing to pay," he explains. "But you can get to a deal where, instead of an 80% control stake, a sponsor might take 30%, offer a liquidity event to a seller and then that sponsor is also positioned well if there is a buyout opportunity in one to two years."

Whether it is with growth equity or some other type of solution, flexibility is likely to make both buyers and sellers more competitive when market conditions are this uncertain.

"There are a lot of dynamics at play," Herrmann says. "If you're a founder and you want to exit and you're getting offered $80 million instead of the $120 million you wanted, you might still take that deal. If you can wait, you might wait to see if conditions change in the near term."

Founders aren't the only ones thinking this way—sponsors are considering these dynamics too, he adds: "Can they wait to exit? Can they do a continuation fund? The way that pencils out is probably going to be different for everyone and depends on their own particular circumstances." //

BAILEY MCCANN is a business writer and author based in New York.

Graph Source: GF Data's Fall 2022 Key Deal Terms Report

Let's Talk Business: Your Business

Get the most out of your banking with First Bank's Private Equity Fund Banking Division

- Capital Call Line of Credit
- Working Capital Line of Credit
- Portfolio Company Financing
- Cash Management & Deposit Solutions

Ramzi Dagher, SVP/Team Leader, Adam Regnery, VP/Relationship Manger

Call Ramzi & Adam Today! 215.807.9301

FIRSTBANK

Personal Bankers. Real Relationships.

firstbanknj.com

Scan the code to learn more about our Team:

GrowthTV

Now Playing: Middle Market Trends

GrowthTV highlights top deals, covers newsworthy trends and features in-depth conversations with middle-market investors and business leaders to help foster growth and innovation.

STREAM THE LATEST AT
ACG.ORG/GROWTHTV

© 2022 Association for Corporate Growth. All Rights Reserved.

BROUGHT TO YOU BY

WRITTEN BY
Danielle Fugazy

ILLUSTRATION BY
Daniel Hertzberg

Fundraising Trends and Value-Creation Focus Weigh on **Private Equity Hiring**

Firms are seeking staff to deploy newly raised funds and fill functional roles while fine-tuning strategies for employee retention

Hiring Initiatives

Following a period of strong dealmaking activity, market conditions are shifting and middle-market private equity firms, as well as their portfolio companies, are preparing for a slowing economy. The question is, how will the looming recession and rocky market conditions impact hiring and compensation in 2023? Turns out, the impact varies greatly depending on firm size and role. Some firms and employees will experience disruption, while others are likely to remain unscathed.

In fact, according to a recent survey* of middle-market financial services executives conducted by ACG, respondents were divided on whether staff size would increase or decrease in 2023. Fifty-one percent of respondents said their headcount will most likely increase in 2023, while 28% said their staff size will either definitely not or probably not increase. The balance of the respondents remains unsure about staffing in 2023.

"I do not think we are looking at massive layoffs in the private equity industry, but I do think some firms will have a more difficult time getting to target fundraises, which will lead to indirect layoffs and less hiring," says Bill Matthews, co-founder of BraddockMatthews, an executive search firm that focuses on the private equity industry.

According to PitchBook, during the first three quarters of 2022, U.S. PE firms collectively raised $258.8 billion across 296 funds. However, the year is expected to end on a low note, with fundraising slowing considerably in the fourth quarter.

For middle-market vehicles, fundraising has slowed in each quarter of 2022. Through the first three quarters, middle-market funds raised $119 billion across 143 funds, according to PitchBook's Q3 2022 US PE Breakdown report. "With one quarter to go," the report's authors noted, "we expect that the middle-market space will fall short of the 200+ closed funds seen in each of the previous three years. The fundraising market continues to tighten, and the middle market is feeling the pinch as LPs allocate to larger funds and capital is rationed."

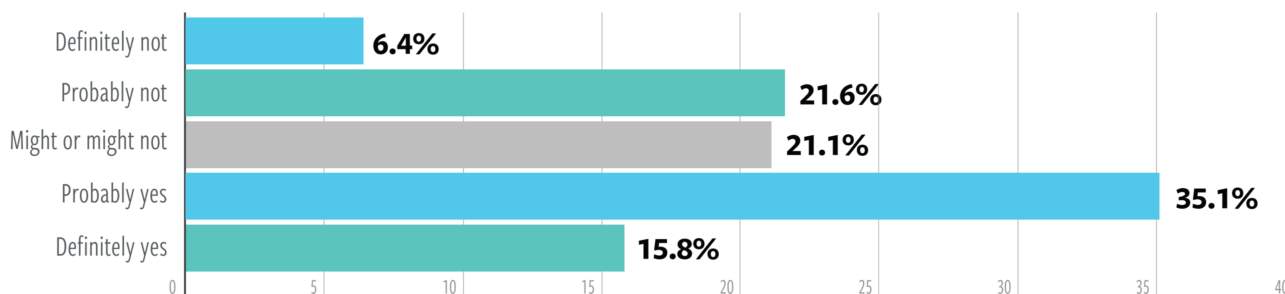
The sentiment at this year's Super Return conference was similar. According to PitchBook, the consensus at Super Return was that two of every three funds in the market today will need to push their closings into 2023. Even with the longer lead time, given the overcrowding in the fundraising space, large limited partners are prioritizing certain private equity firms over others and often putting their most trusted relationships first. Due to the extensive track records of these long-standing relationships, larger and more-established managers are likely to fare better with their fundraising efforts than emerging and middle-market managers.

"If a firm's new fund isn't going to be as big as originally anticipated, managers may look at the headcount and say, based on the size of the fund we are able to raise in this environment, we don't need as many people," says Matthews. "Reduction of staff will happen at firms that struggle to raise their next fund. Fundraising is expected to be difficult next year."

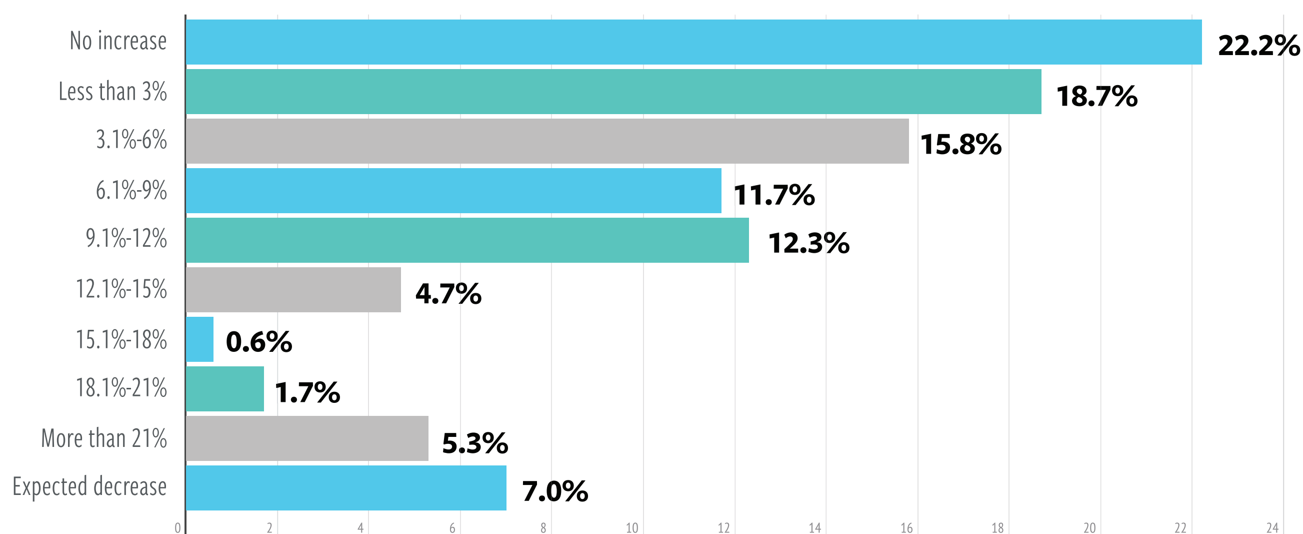
This, however, is a very different story from the firms that raised new funds over the past couple of years and are planning on actively deploying capital in 2023. According to PitchBook, 2021 saw a record amount of capital raised from a record number of funds, with 699 private equity firms raising $366.1 billion. The prior two years—2019 and 2020—were also record-breaking. In the first half of 2022, the private equity industry recorded $1.81 trillion of dry powder, according to S&P Global.

"Hiring for us is driven by our fund size," says Nathan Schray, director of talent and organizational development with Clayton, Dubilier & Rice, a New York-based private equity firm, which has raised about $10 billion for the first close of its 12th buyout fund. "If you extrapolate from that, it's fair to say many firms have been growing their fund sizes and many firms have raised new funds. If you have a bigger fund and you are deploying your fund, you need a bigger team to deploy those funds."

Do you expect your firm to increase its staff size in 2023?



How much do you expect the value of your total compensation package to increase in 2023?



FUNCTIONAL ROLES MATTER

In addition to hiring traditional investment professionals to deploy funds, many private equity firms have created nontraditional positions over the last few years to strengthen firm resources. "We have seen an overall increase in hiring over the past couple of years. Private equity firms have always recruited traditional investment or deal professionals, but they are now also hiring in other functional areas," says Dan Ellis, a managing director at Townsend Search Group, an executive search firm that caters to the private equity industry. "They are recruiting in-house operating partners, finance, accounting, business development and marketing professionals," adds Ellis. "As firms grew their funds, they were able to expand their resources and functional expertise, which ultimately creates value and saves on outside consultants."

The outlook for these roles will likely remain steady, as a downturn could create a greater need for different skill sets. "Hiring may slow on the dealmaking side if the market declines, but then firms may need more turnaround-type people or operating partners to make sure portfolio companies are performing under more stressful conditions. These functional people come with a

Graph Source: ACG's Multiples Survey

Hiring Initiatives

The number of non-investment professionals working in the larger, more established private equity firms has grown significantly. It's the luxury of getting larger—you have the capital to add these roles and they have the potential to bring tremendous value to the firm.

NATHAN SCHRAY
Director of Talent and Organizational Development, Clayton, Dubilier & Rice

different skill set that is useful in a down market," says Ellis.

All functional roles have been growing. For example, in 2016, approximately 25% of first-time funds with $250 million or more established a dedicated business development effort within the first year of, or before, closing their inaugural fund, according to research from PitchBook and BraddockMatthews. That number steadily increased in the following years. In 2020, approximately 83% of first-time funds with upward of $250 million established a dedicated business development effort within the first year of, or before, closing their inaugural fund.

Other titles, such as operating partner, chief financial officer, chief compliance officer and chief diversity officer, to name a few, have seen growth as well. "The number of non-investment professionals working in the larger, more established private equity firms has grown significantly. It's the luxury of getting larger—you have the capital to add these roles and they have the potential to bring tremendous value to the firm," says Schray.

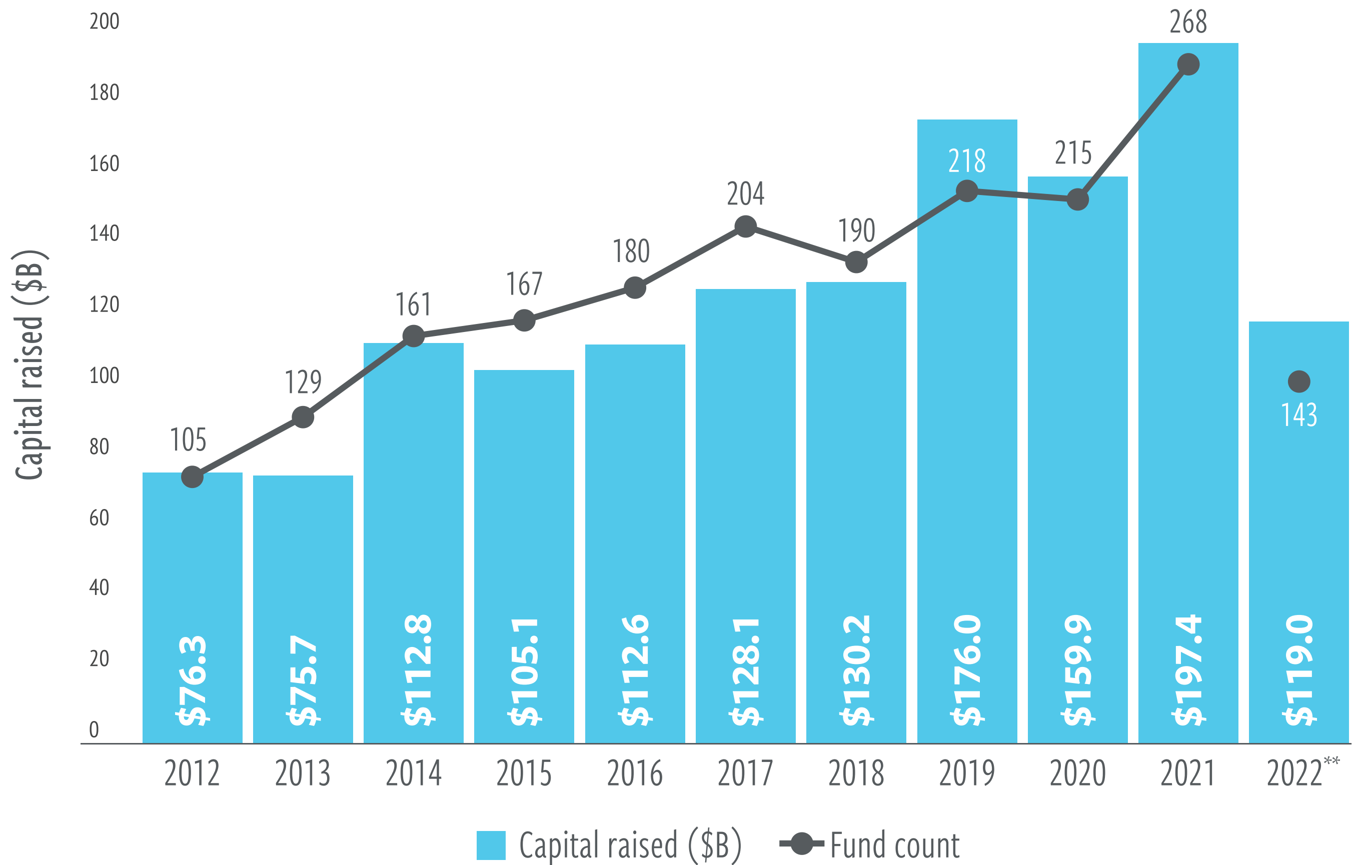
RETAINING TALENT

Cash compensation has grown significantly at private equity firms over the past few years; however, most respondents to the ACG survey do not expect that to continue in a significant way. According to the survey, more than 40% of respondents—who represent private equity as well as other financial services firms—expect no increase or a less than 3% increase to employee compensation in 2023. That said, only 7% of respondents believe that total compensation will decrease.

According to Ellis, not only has cash compensation increased over the years but so have offers of equity participation to junior employees at firms. "We are now seeing firms attract talent at a lower level by offering them equity and letting them grow with the firm. It's harder and more complex to leave a firm when you have that equity," he says. "Also, by giving equity earlier on, you are telling employees they are a part of the value-creation process, which matters to employees today."

These factors have made positions at private equity firms more attractive to prospective employees, compared with family offices or private companies that cannot offer carry, Ellis adds.

Additionally, employers are being more thoughtful about work-life balance, and giving employees thoughtful benefits is leading to better retention. For example, Clayton, Dubilier & Rice introduced fertility benefits for its employees. "It's fair to say, the employee value proposition has evolved. Cash will always matter, but there is growing recognition that other important intangibles need to be considered as well," says Schray. "Flexible work arrangements are one way to strengthen the value proposition, but there are so many more."



WORKING FROM HOME

During the past couple of years, working remotely became synonymous with work-life balance, but this is changing and likely will continue to evolve throughout 2023. Many private equity firms have asked their employees to come back to the office at least four days per week. AEA Investors, New Heritage Capital and The Blackstone Group all have employees coming into the office, and other firms are starting to follow suit.

"If you want to be developed and mentored, you have to be there for the impromptu water-cooler moments. Remote work is a deterrent because you have to be so deliberate about every conversation that it sometimes means you simply don't have the conversation because it requires scheduling a meeting," says Ellis. "The pendulum is swinging back, and employers want people back in the office at least a couple of days a week. You have to be present or else you will plateau."

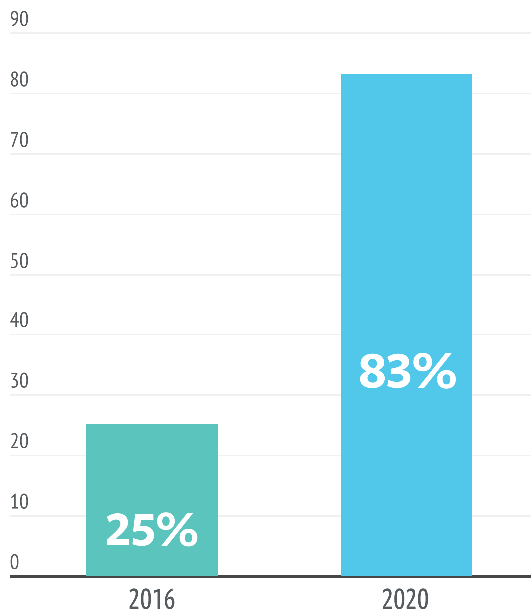
Matthews agrees and says he is seeing less work from home options being offered. "Firms were trying to be flexible, but now we are out of COVID, and they are setting policies; it's less fluid. I wouldn't be surprised if it gets back to a more normal four or five days in the office," he says.

Graph Source: PitchBook's Q3 2022 US PE Breakdown

Hiring Initiatives

Business Development Roles on the Rise

First-time funds ($250 million+) with a dedicated business development effort established before or within a year of closing their inaugural fund



"The more we talk with people, the more we hear that employers are preferring more in-office time," Matthews continues, adding that softer market conditions could lead to employees having less power to make demands of employers in general. "This dynamic of working anywhere will change in the next couple of years and employees will have less leverage," he says.

AT THE PORTFOLIO LEVEL

Compensation and hiring at the portfolio company level vary greatly depending on industry and role. However, C-suite talent is expected to remain in high demand. A lot of companies that private equity firms buy are owned or led by founders. Private equity firms are tasked with professionalizing these organizations. "These companies are putting in their first CFOs and operational leaders. I do not see that slowing down as private equity firms continue to make acquisitions," says Ellis.

Employees below the C-suite level may have a different experience in 2023 if the market softens. Still, private equity firms and portfolio company managers must be very thoughtful about how they engage with and develop employees either way.

"If we go into a full recession, the employers will gain the upper hand, but that's not where we are right now in the market. Right now, every employer must be in tune with employees' aspirations, otherwise they will leave to find an employer who is," says Ellis. "For the private equity firm, to be in tune with employees creates a good transformation story for them to share. People want to feel included and part of something."

Even if the economy enters a recession and employers gain some leverage, they'll still need to tread carefully to protect their reputation.

"If the market turns and employers do gain the upper hand, they will have more flexibility, but either way employees will share their experiences with the world," Ellis says. "Positive and negative actions will have an impact on a company's brand." //

DANIELLE FUGAZY is a freelancer writer covering private equity for more than 20 years. She is based in Glen Cove, New York.

**ACG conducted a survey between Aug. 16 and Sept. 21 in which 171 respondents from the middle-market dealmaking and corporate growth community answered questions about their outlook for 2023.*

Graph Source: PitchBook and BraddockMatthews

G-P

Global Made Possible

The everywhere workforce is here.

Let’s get you there faster.

BROUGHT TO YOU BY

WRITTEN BY
Katie Mulligan

ILLUSTRATION BY
Daniel Hertzberg

Concern About Risk **Deepens** Among Midsize Business Leaders

QBE survey shows financial, digital and business interruption risks continue to weigh on executives

Assessing and Managing Risk

There is no rest for the weary, as they say.

Even after several years of uncertainty and disruption, business leaders' concern about risks to their organizations rose significantly in 2022, according to a report from QBE North America and the Association for Corporate Growth.

Like its findings last year, the 2022 Mid-Sized Company Risk Report showed that middle-market business leaders continue to rank financial, digital and business interruption as the top-three "macro" risk areas for their organizations. More than 300 decision-makers at U.S. midsize businesses with revenue between $200 million and $3 billion responded to the survey, which HawkPartners conducted in the summer on behalf of QBE for the third year in a row.

Meanwhile, organizational risk crept into the fourth spot, up from seventh a year ago. The change reflects growing concern over factors like M&A risk and hiring, retention and teamwork challenges.

Respondents were asked about 12 macro risks in total, and their level of concern across all of them rose significantly from 2021 to 2022.

Christopher McGrath, head of middle-market property and casualty insurance at QBE North America, attributes the increased sense of anxiety to a variety of factors, including labor shortages, competition for talent, supply chain issues and hybrid work. "And when these are coupled with cyclical kinds of geopolitical and economic issues that typically follow a large-scale event like the pandemic, we see greater concern about things like pending recessions and increased inflation, and the impact those can have on their businesses," he says.

On top of that is the widespread push toward digitization, which exposes companies to greater cyber risks and the potential for data and intellectual property theft. "That adds up to quite a lot for companies to be considering and protecting themselves against," McGrath says.

THE DIGITAL DILEMMA

In QBE's survey, cyberattacks or breaches ranked as the most concerning "micro" risk overall for respondents, while 44% indicated that it's a top digital risk for their business.

Although cyber incidents at middle-market companies tend not to make headlines, these businesses have become a focus for bad actors seeking targets with less robust security infrastructure, according to a report published by RSM in June. It noted that the number of breaches in the midmarket has declined slightly; still, 22% of middle-market executives surveyed for RSM's report said their company experienced a data breach in the last year.

Yet only 56% of executives in QBE's survey reported having a mitigation strategy for digital risk, a category that encompasses cyberattacks and breaches, corporate espionage and data integrity, among others.

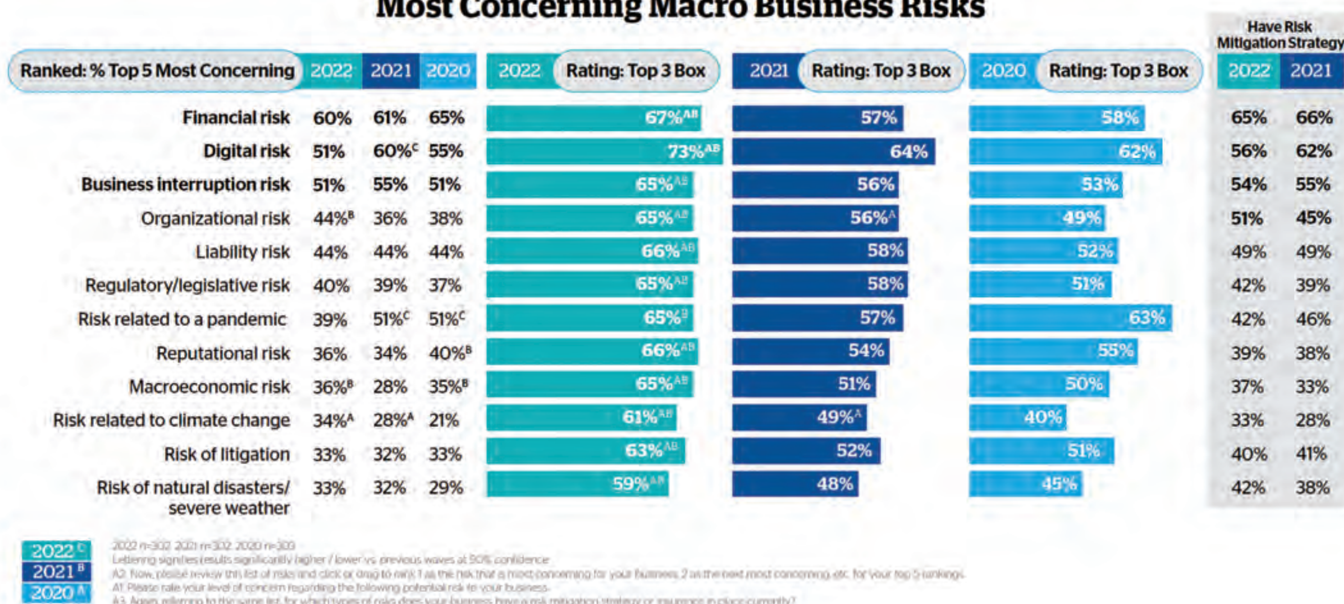
One explanation is that midsize businesses tend not to have a dedicated chief information security officer to focus on cyberthreats and enforce good cyber hygiene practices, says Bill Neuman, an operating partner at private equity firm Lovell Minnick Partners, which invests in financial services businesses.

Plus, limited bandwidth often forces midsize business leaders to prioritize the most visible issues, sometimes at the expense of equally serious threats. "If you have a 10- or 15-person open headcount that you're trying to fill, that's a current, pressing problem," Neuman says, "whereas cybersecurity investments are sometimes viewed as insurance against an unlikely future event with few advocates."

In an effort to outsource some of the security responsibility, many companies are shifting their digital assets to the cloud. InterCool, a Carrollton, Texas-based provider of industrial refrigeration services and solutions, took that step in 2019 to capitalize on the security infrastructure of a third party.

Patrick Riggio, a director at lower middle-market investment firm RF Partners, which made its initial investment in InterCool in June 2019, points to the "strength in numbers" that comes with cloud-based platforms whose services are used by numerous companies. "It behooves us as a partner to work with high-end providers so that we can benefit from the investment security they've made and that they provide their customers," he says.

A complicating factor for businesses looking



to protect themselves from cyber risk involves changes to cyber insurance coverage. Many are having difficulty obtaining or renewing cyber insurance policies as carriers become stricter in their requirements and raise the cost of coverage.

Neuman sees a silver lining in the stringent requirements from carriers, such as mandates for multifactor authentication.

"The good news is, when that occurs, it's driving companies to improve their cybersecurity posture," he says. "Cyber insurance may have created a false sense of security for some leaders; the tightening of cyber requirements is helping to close the gap between that perception and reality."

ORGANIZATIONAL RISK

Organizational risk didn't rank as high as digital risk in QBE's survey, but it did show the sharpest increase, jumping three spots to become the fourth most-concerning macro risk for executives in 2022.

That risk encompasses micro risks such as attracting and retaining talent, the impact of demographic changes to the talent pool and an inability to innovate, among others. It also includes risk around M&A and a failure to realize synergies after a transaction. More than a quarter of executives surveyed said they're concerned about M&A as an organizational micro risk to their business, while 19% cited it as their most concerning organizational risk.

Whether a deal delivers on its promise hinges heavily on successful integration, a process that many organizations get wrong. "What I see is a lack of focus, deployment of resources and leadership's interest in integrations," says Galina Wolinetz, managing director at advisory firm Virtas Partners, where she focuses on M&A integration and separation advisory. "Everybody's very excited about getting the deal done, and then somebody has to run the combined company, but the focus and resources are gone."

One misstep she points to is not focusing enough on value creation. Ahead of a deal, the buyer has likely developed a strategic rationale and a financial forecast, Wolinetz notes, but those are often not followed through on after the transaction closes. "A lot of times I see people assume, 'Well, we just acquired this company, so all this stuff we think was going to happen is just going to happen,'" she says. Instead, she recommends that leadership teams identify owners and specific initiatives related to all aspects of the desired outcomes of the deal, to make sure they're achieved.

Wolinetz regularly sees poor communication after an acquisition, where employees of the acquired entity are left in the dark about what the transaction means for the business and them personally. That

Graph Source: QBE's 2022 Mid-Sized Company Risk Report

lack of transparency and the uncertainty it creates can result in valuable talent walking out the door. If those employees' contributions were factored into financial forecasts, the synergies the acquirer was counting on could be compromised.

SAFETY FIRST

Liability risk continues to weigh on employers' minds, including through associated micro risks like accidents, health issues and workers' compensation. Liability was cited as a top-five macro risk by 44% of respondents to QBE's survey for the third year in a row.

In some cases, that risk can manifest in dangers encountered on the job. Technicians at InterCool, for example, regularly encounter chemicals like ammonia. Riggio points to a rigorous safety program and ongoing training as key components of the company's risk mitigation strategy.

The company's training extends beyond safety, too. According to InterCool Executive Vice President Clay Hill, the company strives to promote from within. He adds that it has "appropriate levels of redundancy throughout the management team" as a means of mitigating the risk of a key employee leaving the organization.

Proper safety and training initiatives not only protect employees from injuries and keep them on the job; they can also reduce financial losses stemming from workers' compensation claims. QBE's McGrath notes that workers' compensation coverage is often the costliest component of a property and casualty insurance program.

He recalls a loss control survey that QBE performed for a coffee manufacturer, which revealed that workers were engaged in manual lifting tasks—loading tall plastic silos in a tight space using heavy equipment and moving 150-pound bags of coffee beans—that were a leading cause of sprains and strains among workers.

According to a case study published in 2021 in *Middle Market Growth*, QBE conducted onsite Job Hazard Analysis supervisory training in response to its findings. The program included a safe lifting program, online courses and ergonomic risk assessments on a variety of tasks. Within about two years, the program cut the coffee manufacturer's workers' compensation loss ratio roughly in half, according to QBE.

RIDING A DOWNTURN

The risk of a recession or economic downturn emerged as the fourth most-concerning micro risk in QBE's survey, tied with cash flow and liquidity risk and the loss of a critical supplier or subcontractor.

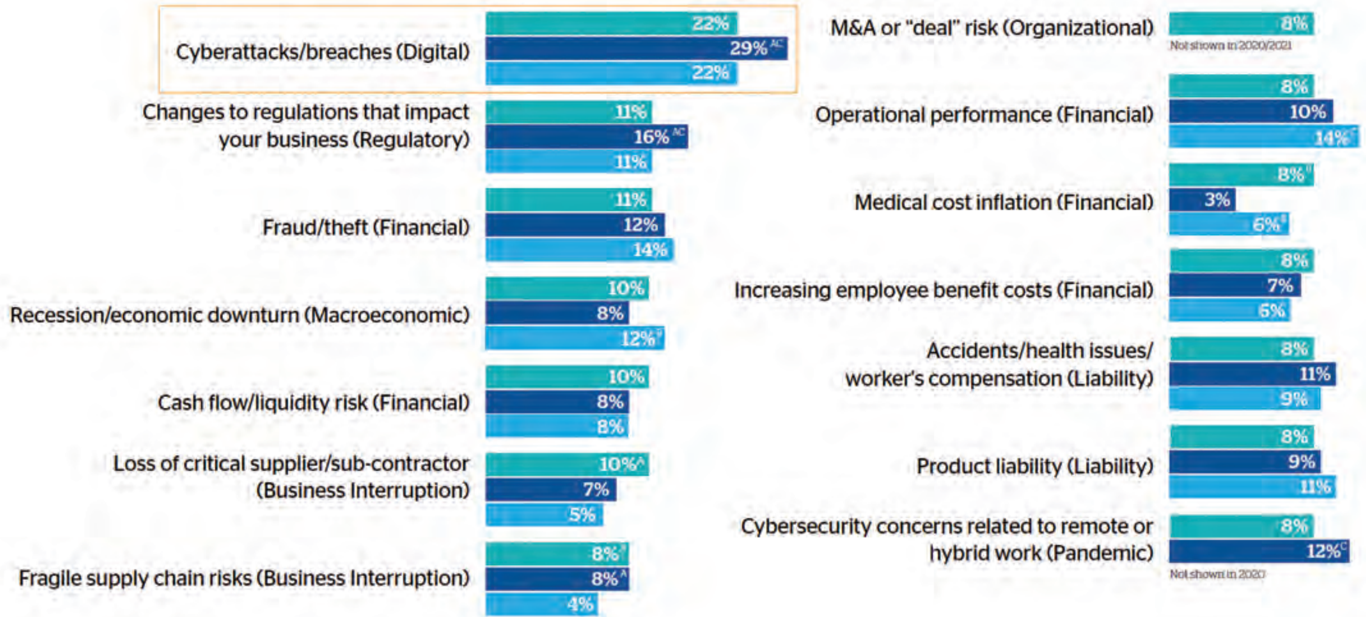
An economic downturn will likely impact industries differently—some B2B businesses will probably feel the effects less acutely than those that serve end consumers, notes Neuman of Lovell Minnick Partners.

Meanwhile, inflation and rising interest rates are expected to dampen M&A volume and prompt additional scrutiny on borrowing. "Businesses, as far as I can see, are going to be forced to work more on the cash that they can generate," he says.

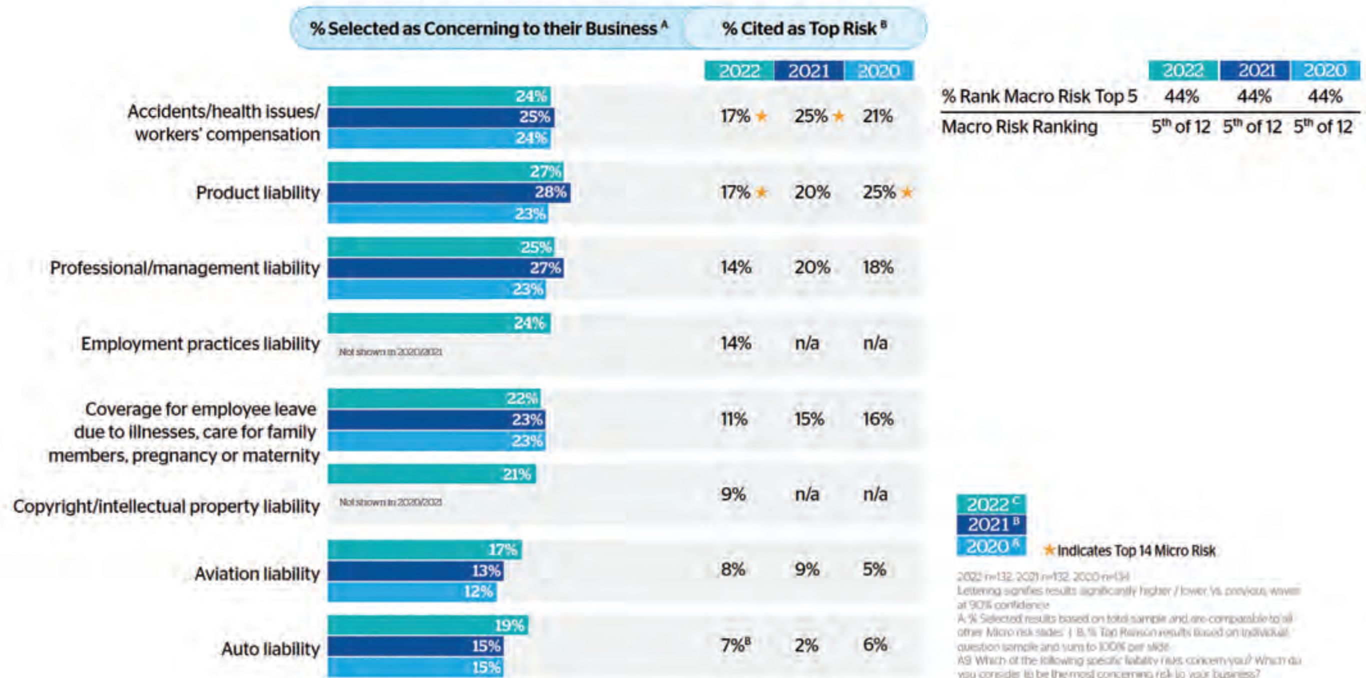
Slowing economic growth and rising prices will also influence which M&A transactions move forward. "We always underwrite to a recession case. But at the end of the day, when something is looming over the course of the next 24 months, you really start focusing much more clearly on deals that you think could be resilient," says Dean D'Angelo, founding partner of Stellus Capital Management, a private credit manager that invests in middle-market companies.

That means focusing on companies that are not selling discretionary, durable goods and services that could be affected by a downturn, he adds. Businesses with a variable cost structure versus one that's fixed are also likely to become more attractive investment targets in this environment.

In recent years, labor and supply issues posed the greatest challenges to businesses, but D'Angelo expects that will shift. "I think we're working in an environment where demand is going to be a bigger issue. What you really start thinking about and focusing on is that top-line pressure and margin pressure," he says. If the cash coming in starts to slow, a business will have a revenue issue, he adds, "so you're going to try to be as competitive as you can and cut costs."

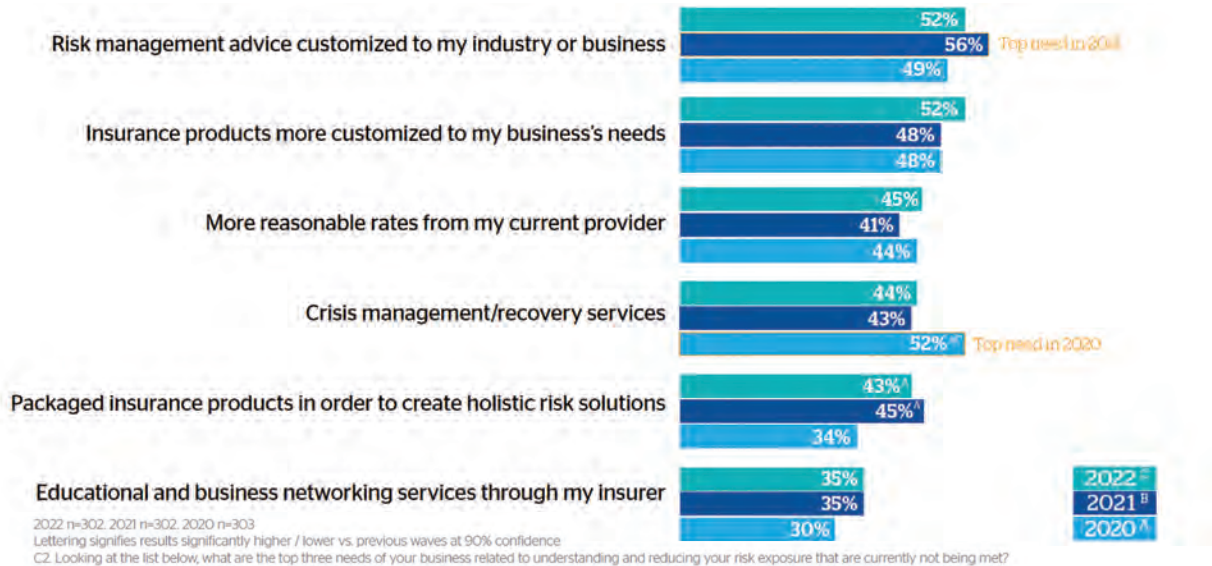


Most Concerning Micro Risks
% risk ranked in top 5
Cyberattacks/breaches (Digital)
22%
29% AC
22%
Changes to regulations that impact your business (Regulatory)
11%
16% AC
11%
Fraud/theft (Financial)
11%
12%
14%
Recession/economic downturn (Macroeconomic)
10%
8%
12% B
Cash flow/liquidity risk (Financial)
10%
8%
8%
Loss of critical supplier/sub-contractor (Business Interruption)
10% A
7%
5%
Fragile supply chain risks (Business Interruption)
8% A
8% A
4%
M&A or "deal" risk (Organizational)
8%
Not shown in 2020/2021
Operational performance (Financial)
8%
10%
14% C
Medical cost inflation (Financial)
8% B
3%
6% B
Increasing employee benefit costs (Financial)
8%
7%
6%
Accidents/health issues/ worker's compensation (Liability)
8%
11%
9%
Product liability (Liability)
8%
9%
11%
Cybersecurity concerns related to remote or hybrid work (Pandemic)
8%
12% C
Not shown in 2020
2022 n=302 2021 n=302 2020 n=303
Results showing top answers for 2022 only (10% or greater). Full results can be found in crosstabs
Lettering signifies results significantly higher / lower vs. previous waves at 90% confidence
2022 C
2021 B
2020 A



Liability Micro Risks
% Selected as Concerning to their Business A
% Cited as Top Risk B
2022 2021 2020
Accidents/health issues/ workers' compensation — 24% 25% 24% — 17% ★ 25% ★ 21%
Product liability — 27% 28% 23% — 17% ★ 20% 25% ★
Professional/management liability — 25% 27% 23% — 14% 20% 18%
Employment practices liability — 24% Not shown in 2020/2021 — 14% n/a n/a
Coverage for employee leave due to illnesses, care for family members, pregnancy or maternity — 22% 23% 23% — 11% 15% 16%
Copyright/intellectual property liability — 21% Not shown in 2020/2021 — 9% n/a n/a
Aviation liability — 17% 13% 12% — 8% 9% 5%
Auto liability — 19% 15% 15% — 7% B 2% 6%
2022 2021 2020
% Rank Macro Risk Top 5 44% 44% 44%
Macro Risk Ranking 5th of 12 5th of 12 5th of 12
2022 C
2021 B
2020 A
★ Indicates Top 14 Micro Risk

Assessing and Managing Risk



TOO MANY HATS

QBE's survey revealed that, unsurprisingly, executives tend to be most prepared for risks with the highest level of concern; but aside from the top four macro risks, fewer than half of the respondents' companies have a risk mitigation plan in place.

QBE's McGrath attributes this to a lack of capacity and expertise. Midsize companies typically don't have a dedicated risk management department. In the middle market, it's likely that the chief financial officer also wears the risk manager hat. Or if there is a dedicated risk manager, they're often a team of one. As for expertise, they may not have the knowledge for navigating risks in particular areas, or for identifying an insurance solution. Financial resources also tend to be a barrier; midsize companies don't have the same risk management budgets as their Fortune 100 counterparts.

Regardless of the set of risks facing their organizations, business leaders need not go it alone.

Businesses that have received institutional capital have an extra set of eyes to identify risks, starting with due diligence, and a partner to help manage them.

"It's very rare that we will close a deal recognizing there's a risk without a plan already in place to manage that risk post-close," D'Angelo says. For example, Stellus might close a deal where the business needs to diversify its supplier base, but the firm will want to know what concrete steps will be taken post-close to address this issue, he adds.

Another resource for companies looking for help mitigating risk is their insurance carrier.

QBE's McGrath notes how a loss control specialist can help businesses address risks, including those tied to inflation. Property loss coverage is one example. As property values rise, failing to update the building's valuation with the insurance carrier can lead to insufficient insurance coverage in the case of a loss.

Midsize business leaders often find themselves drinking from a firehose and doing as much as they can with limited resources. McGrath sees the role of an insurance partner as someone who can say, "'Hey, I understand your exposure and I understand where you're coming from,' because insurance is something that no one wants until they need it," he adds. "Understanding is the first step, and then working together in partnership to come up with the right solution is that critical second step." //

KATIE MULLIGAN is ACG's content director, based in Chicago.

Graph Source: QBE's 2022 Mid-Sized Company Risk Report

Property and Casualty Middle Market

We'll take care of risk, so you can take care of *customers*

Customize the solution you need to run your business with confidence.

In today's uncertain world, mid-sized businesses need to know that they're working with an insurer that understands the unique and emerging risks they face — and, most importantly, can tailor solutions to address them.

Discover a range of products to protect your business:

- **Property**
- **Workers' Compensation**
- **Commercial Auto**
- **Commercial General Liability**
- **Umbrella**
- **Excess Casualty**
- **Foreign Package**

Together, we'll create a solution that fits your needs — so no matter what, you can stay focused on your future.

Premiums4Good

When you choose QBE, you choose to give back — with a portion of all customer premiums committed to investments with social and environmental objectives.

For more information, visit us at qbe.com/us

Commercial **Crop** **Specialty**

QBE and the links logo are registered service marks of QBE Insurance Group Limited. ©2022 QBE Holdings, Inc. 457310 (11-22)
This literature is descriptive only. Actual coverage is subject to the terms, conditions, limitations and exclusions of the policy as issued.

QBE

Why Concerns Over Business Interruption Exposures Are Increasing

Natural disasters, fragile supply chains, and other factors call for more attention to business continuity planning

By Charles Greer, Monique McQueen and James Vachon

A fire, water leak or windstorm that severely damages a commercial building is a terrible event made worse by a lengthy disruption in normal business activities and revenue caused by the disaster. This one-two punch is fast becoming a worrisome prospect for more mid-sized companies.

For the third year in a row, QBE's Mid-Sized Company Risk Report, produced in partnership with the Association for Corporate Growth, reveals that the possibility of a significant interruption in business income is the third most concerning macro risk for mid-sized organizations, just behind financial risk and digital risk. Moreover, concern about business interruption has risen each year, with 65 percent of executives expressing a high level of concern in 2022, up significantly from 56 percent in 2021 and 53 percent in 2020.

This concern stems not just from potential property damage to company locations but a host of factors, as well. For instance, the survey revealed that the loss of a critical supplier/subcontractor and a fragile supply chain are among the most concerning micro risks overall, with the level of concern up significantly since 2020 as global trade relationships have grown more tenuous. Critical infrastructure breakdown also ranks highly as a concern.

The survey findings were published just a few weeks before Hurricane Ian, considered to be one of the most damaging and destructive weather events in U.S. history.[1] It is anticipated that the hurricane will produce total economic losses possibly exceeding $100 billion, a figure representing direct physical damage losses, non-physical financial loss and net-loss business interruption, according to a recent study.[2]

> "... the possibility of a significant interruption in business income is the **third most concerning** macro risk for mid-sized organizations"

The impact of Ian will likely increase costs that were already up sharply for building materials like lumber, steel and gypsum, as well as construction labor. Moreover, the replacement of machinery and equipment is more expensive since a significant and prolonged restriction in supply during a period of high demand produces a ripple effect that increases the price of all goods and services.

Added up, a combination of inflation-fueled price increases, more frequent and destructive natural disasters, and a slowdown in supplies is resulting in longer and costlier business disruptions. What used to take three months to remediate a property can now take six months and more.

Although mid-sized company risk professionals have no control over the changing weather, infrastructure breakdowns and spiraling inflation, they can take prescriptive actions to mitigate the duration and related cost of a business interruption.

Planning for Disaster

Chief among these actions is the drafting of a business continuity plan led, managed and governed by an internal team composed of senior management, IT professionals, Legal and front-line employees. A typical plan is divided into three stages—disaster preparation, response and restoration.

The first stage entails the evaluation of current business processes, such as how products are received through the supply chain and what might happen to the flow of these goods during a disaster that results in the discontinuation of normal operations. The assessment also should account for potential damage to critical equipment, impairment, loss of power or other utility-provided services, and disruptions in freight transportation and employee access. Once completed, identify possible backup plans to fill in gaps in supplies and services like transportation, gas and electricity.

A related concern is the need to expeditiously rebuild damaged structures to restore normal operations. Following Hurricane Ian, the length and cost of business disruptions has increased due to unprecedented demand for building materials and skilled labor, which were already in short supply before the storm.[3] To get to the front of the line, consider securing legally reviewed agreements in advance with licensed restoration contractors.

Similar agreements may be useful to secure alternate suppliers and qualified providers of equipment, construction materials and transportation. Cultivate relationships with all these parties and weigh the value of contractually incentivizing them with step-level payments based on their prompt delivery of goods and performed services.

The second stage of a well-crafted business continuity plan concerns the actions needed to put it in motion. Alert regular suppliers and other vendors of the event and its potential repercussions. If for some reason they cannot

provide service in customary timeframes, activate the aforementioned agreements with the alternate suppliers and services providers. At the same time, contact the building restoration contractors to repair the damage.

The plan's third stage entails the need to report the extent of the property damage and interrupted income flow to the insurance broker and/or carrier. Retain all invoices and receipts involved in the restoration of the property and the related impact on normal business activities. Up-to-date and accurate records of financial operations are critical to support the stated income lost in the claim.

Other Insurance Considerations

Aside from a thorough and regularly updated business continuity plan, it is important for mid-sized company risk professionals to carefully review the business interruption elements of the property insurance policy. Business interruption coverage typically applies to income lost due to covered damage to insured company property. A key consideration is the period of indemnity, as some insurers limit indemnity to two years while others have no time limitations.

Like many other insurance policies, business interruption insurance includes a deductible giving buyers the opportunity to self-insure a portion of the loss, in return for a lower premium. Whereas the deductible in automobile insurance is the financial amount paid by the policyholder before the insurance covers the remainder of the loss, with business interruption insurance the deductible could be a specified number of days before the insurance kicks in.

In addition to lost income, many business interruption policies cover a range of so-called "extra expenses," such as the added cost for a supplier to expedite a shipment or the need to shift production elsewhere. These financial records also must be accurate and available to the insurance broker and/or carrier in the filed claim following a loss.

Another valuable insurance coverage to consider is contingent business interruption insurance. Offered as optional coverage in a commercial property policy, it typically covers lost income as a result of damage to a supplier's or recipient's property that impairs delivery of the promised product. It is important to understand specifically what perils are covered by the policy. In most cases, the coverage is an extension of the perils that are covered in the company's property insurance protections. But what if the perils at the supplier's location are very different from those at the company's location? For instance, the company may have decided to forgo flood or earthquake insurance because those risks are extremely low at their locations. The supplier, however, may be in an area highly exposed to floods or earthquakes. Power outages and labor strikes are other risks often overlooked in the policy terms.

Contingent business interruption policies are frequently limited to named locations of the suppliers. While coverage can extend to unnamed locations, insurance companies are understandably much more selective about assuming risks for locations they cannot inspect. To secure the best coverage and rates, risk professionals at mid-sized companies may find it is well worth the effort to understand and document all the locations of their suppliers for inclusion on the policy – and to keep the information up to date.

Contingent business interruption insurance has wide applicability, depending on the insurer and the policy features. A case in point is a mid-sized company that derives the lion's share of income from its nearby proximity to a theme park or other major attraction. If the theme park is sidelined by covered property damage, the insurance would compensate for the reduction in the mid-sized company's normal flow of income. In some cases, the insurance also would cover lost revenue caused by a key customer no longer able to purchase a company's goods or services.

In all such cases, it is prudent for all risk professionals to discuss their organization's exposure to property losses and both the risk mitigation and risk transfer opportunities presented by carriers.

[1] Hurricane Ian's Damages Are Forecast to Be Worse Than 1992's Andrew, Bloomberg, 9/27/22
[2] Gallagher Re's assessment of damage caused by Hurricane Ian, 10/18/22
[3] Post-Ian Reconstruction Needs, Tight Construction Labor Market Add Up To Delays Nationwide, Biznow National, 10/25/22

Charles Greer
VP, Large Property Underwriting Leader
QBE North America

Monique McQueen
VP, Property Claims
QBE North America

James Vachon
VP, Risk Solutions
QBE North America

BROUGHT TO YOU BY

WRITTEN BY
Carolyn Vallejo, Anastasia Donde, Katie Mulligan and Sue Ter Maat

4 Deal Sourcing Trends Shaping 2023

From the types of deals in demand to how they're sourced, here are four themes to watch in the coming year

Deal Sourcing Trends

The coming year is unlikely to see a marked departure from the deal sourcing tactics of 2022. Instead, private equity business development professionals and other industry participants point to trends that they expect to gain greater traction in 2023, including creative approaches to marketing, new technology applications, increased enthusiasm for smaller deals and an earlier start to relationship-building.

TAKING TECH IN NEW DIRECTIONS

Technology is a must-have in dealmaking, but when it comes to deal sourcing tech, not all acquirers find themselves in the same place on the adoption curve. In a shifting M&A landscape, corporates and financial investors may have significantly different tech adoption experiences in 2023.

Nevin Raj, chief operating officer and co-founder of private company intelligence engine Grata, says a growing disparity between corporates and PE firms may lead to one of the most poignant trends in tech adoption next year.

"What we see is that (PE) investors, especially early-stage tech investors, tend to be some of the first adopters of technology," notes Raj. As a result, those investors tend to embrace technology within their deal sourcing workflows, too. In contrast, corporates are "actually the furthest behind" in the adoption curve, he adds.

But 2023 could see that gap narrow, as high interest rates offer an opportunity for corporates to gain a competitive advantage over PE buyers. "To get up to speed, (corporates) are going to make the biggest changes in their use of technology," Raj predicts. This may first begin with laying the foundations of a more digital operation, using technology to manage M&A processes and funnels. Eventually, however, corporates could leapfrog financial buyers. "You're going to see more AI and ML (machine learning) bleed into that world, because they need to be a step ahead of the financial sponsors, who are pretty much eating their lunch now in terms of deals," he adds.

While corporates are ready to hit the gas on deal sourcing technology adoption, for PE investors, the outlook is more about refining and bolstering existing digitization strategies to maintain the dealmaking momentum of the last few years.

Stephen Madsen, director of the Business Development and Capital Markets team at private equity firm Monomoy Capital, says this is particularly true when it comes to wielding data to support a more strategic approach to deal sourcing. Data quality, he says, "is the biggest hurdle to a lot of us," but an often-overlooked obstacle is the quantity of information financial acquirers can use.

"Data quality, everybody complains about," says Madsen. "But people don't talk often enough about just how little relevant data there is for most of the problems that we, in the private markets, want to address."

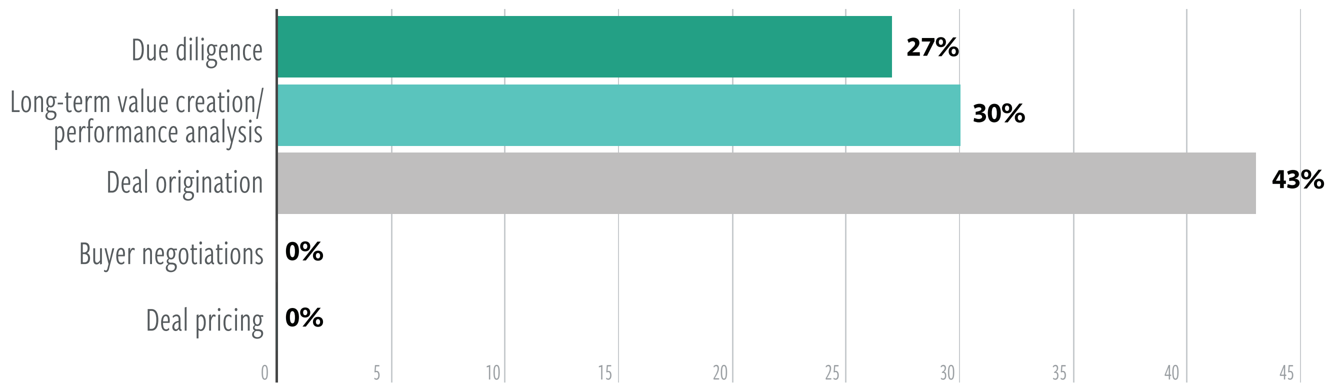
A lack of both data quality and quantity prevents acquirers from strengthening their deal sourcing workflows. Recent IHS Markit research released in October found this to be particularly true for PE investors. While 43% of survey respondents agreed that advanced analytics can benefit deal sourcing more than any other stage in the dealmaking process, only 3% say they actually leverage it.

Whether it's enhancing existing systems with machine learning or using private market databases for the first time, corporates and financial acquirers alike will have to take a tactical approach when deploying deal sourcing technology to remain competitive in a challenging M&A market.

BUILDING RELATIONSHIPS EARLY

Private equity sponsors like to tout their "proprietary deal flow," and in the current competitive environment that's become even more important. Although deal activity is slowing down because of market headwinds, sources say quality assets will still trade in 2023 and the competition for these few deals will be more intense. As such, private equity firms want first dibs on prospective sellers—often ahead of a formal auction or bank hiring.

In which part of the investment process do you believe the increased use of data analytics could have the most positive impact?



For some firms that means leaning more on different types of advisors, engaging with the independent sponsor community, using data tools to narrow down targets or partnering with seasoned executives in different industries to find investment opportunities.

At Trivest Partners, business development professionals will be attending more industry conferences to connect with dealmakers and advisors now that travel is back in full swing. Tony Hill, a principal in business development at Trivest, is particularly keen on independent sponsors as a source of deals.

"We spend a lot of time engaging with the independent sponsor community—they have their own networks and can find businesses that we don't have access to," he says, adding that Trivest has done seven deals in partnership with independent sponsors over the last four to five years. These sponsors find investment opportunities first, negotiate a purchase price and then get the funding together via private equity groups, high-net-worth individuals, family offices and other investors.

Trivest splits its business development team regionally—across its Miami headquarters, and in Chicago, Los Angeles, Charlotte, Philadelphia and Toronto. The team also engages with various advisors, service providers, data providers and external buy-side search firms to scout for opportunities. "A core pillar of our sourcing strategy is covering the 'long tail,' a network of thousands of smaller business brokerages, accounting and valuation providers, law firms, wealth management advisors and more," Hill says. Often, these are trusted advisors to founders that can loop Trivest into conversations with business owners before an investment banker gets involved.

Meanwhile, Huron Capital plans to concentrate its efforts in the coming year around its ExecFactor strategy, where the Detroit-based firm partners with executives to work on an investment thesis and search for deals.

To get up to speed, (corporates) are going to make the biggest changes in their use of technology.

NEVIN RAJ
Chief Operating Officer and Co-Founder, Grata

Graph Source: Survey of senior PE executives by IHS Markit, October 2022

Deal Sourcing Trends

"We partner with a seasoned industry executive and together we develop a thesis and plan to buy and build a platform in a growing, fragmented sector," says Heather Madland, partner in business development at Huron. "These executives have deep networks and relationships that we can leverage to make warm introductions to founders and management teams."

Having a well-developed investment thesis, experienced industry resources and a repeatable playbook to build and professionalize scalable businesses quickly enables Huron to target smaller companies that competitive acquirers might overlook. "We can start smaller and scale more rapidly because a critical component of our thesis development is building a pipeline of actionable acquisition opportunities," Madland says. The two platform investments that Huron made in 2022, ExperiGreen and Exigent, are part of the firm's ExecFactor strategy.

Starting with an executive and a thesis enables Huron to buy a smaller business to build into a platform for add-ons or to name a new business first and acquire two or more companies to create a foundation for the platform.

The firm keeps relationships with investment bankers who often make introductions to companies that are too small for the bankers to pursue from an advisory standpoint but could be a fit for Huron's strategy.

Huron primarily invests in services companies across 10 subsectors and is currently working on a thesis around industrial automation systems integration. The firm plans to find CEOs in the space in 2023.

THE YEAR OF THE ADD-ON

Buy-and-build strategies have long been favored by private firms, and 2023 looks to be no different, albeit with a greater emphasis on add-on acquisitions relative to platform investments, thanks to rising interest rates, slowing economic growth and eager sellers.

"I think M&A activity will continue to be soft from a platform point of view," says Russell Greenberg, founder and managing partner of private equity firm Altus Capital Partners, which invests in U.S. middle-market manufacturing businesses. His firm has seen an uptick in the number of add-on deals and is spending more time working on those engagements relative to larger platform investments.

We spend a lot of time engaging with the independent sponsor community—they have their own networks and can find businesses that we don't have access to.

TONY HILL
Principal, Business Development, Trivest Partners

"In the past six months, we have a longer list of add-on opportunities for our portfolio companies than we do for new platform investments," he says. Altus is currently devoting more than half of its time working on add-ons for its portfolio companies—significantly higher than in past years, when add-ons accounted for about 25% of the Altus team's time, Greenberg estimates.

James Andersen, founder and managing partner at lower middle-market private investment firm Clearview Capital, attributes the relative uptick in add-on acquisitions in part to difficulty finding platforms at reasonable valuations, given the uncertain economic outlook for the coming year. Even as prices have come down for public equities, the private markets have been slower to adjust. "The valuations in our part of the market haven't really moved much at all, so there's kind of a disconnect," he says.

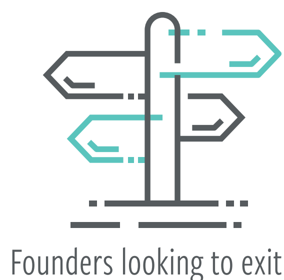
Add-on deals are having a moment, thanks to:

High valuations for platforms

Rising cost of capital

Uncertain economic outlook

Corporations wanting to divest assets



Founders looking to exit

In uncertain environments, "capital tends to flow down to the lower middle market," to businesses with $100 million in enterprise value or less, says Phil Pizzurro, senior managing director of mergers and acquisitions at Generational Capital Markets. "They're easier to finance. They're easier to integrate. We've seen a lot of private equity groups do smaller bolt-on transactions," he notes.

The trend toward smaller deals doesn't stem solely from demand; the supply of lower middle-market businesses coming to market is also a contributor. Greenberg expects that there will be an increase in sellers looking to exit their businesses, including founders who want to step away, or large corporations that need to divest non-performing assets to raise cash. "I think there'll be more seller motivation to get liquidity, and that'll allow buyers opportunities that weren't so available in the prior few years," he says.

Even as their numbers dwindle in 2023, the platform investments that do close are likely to follow the traditional buy-and-build playbook, yet with greater emphasis on organic growth potential.

"While we don't expect that fundamental strategy to dissipate anytime soon, we are seeing a shift toward buyers prioritizing organic growth and placing a premium on businesses that can meet performance expectations regardless of their acquisition pipeline," wrote Guggenheim Securities Managing Director Chris Macios in the fall edition of *Middle Market DealMaker*.

Greenberg agrees that a company's ability to grow organically is paramount. "I always put a higher priority on internal growth than on trying to find add-ons," he says. "Let's understand that the business itself can grow and the add-ons are a nice to have, but you still have to have a business that has some inherent growth to it."

Andersen notes that both aspects are important to Clearview's strategy and will continue to be, irrespective of the economic environment. "We haven't really changed the way we think about businesses," he says. "We like companies that can grow organically but that we can supplement with add-on acquisitions."

PE MARKETING GETS PERSONAL

As digital marketing continues to evolve, private equity firms must keep up with new trends that set them apart from the competition.

Deal Sourcing Trends

Over the last decade, PE firms upped their marketing efforts to stand out. They've realized that marketing is a potent business development tool, not just a nice-to-have addition to the firm.

"The private equity industry is evolving from mainly having one-to-one business development activities to incorporating marketing, which is a one-to-many activity that supplements and enhances business development and brand building," says Farrah Holder, managing director of business development at Bethesda, Maryland-based IMB Partners.

One of the newer frontiers in digital marketing for private equity is the use of video and podcasts to build a firm's brand and cement its thought leadership, says Ryan Parker, chief marketing officer and head of brand at Trivest Partners. While a lot of other businesses pushed into video and audio content marketing, private equity firms would do well to consider moving in this direction, he says.

Holder agrees, saying that video, especially on social media platforms like LinkedIn, can help personalize private equity firms. It also helps with initial meetings, since people feel like they know someone a little more when they've seen them on video, she says.

"Incorporating video content on your website or within your LinkedIn tends to elicit higher engagement," Holder says. "Both written posts and video posts can perform well, but people enjoy the imagery of videos where they can see a personality in action versus imagining who or what it is."

For private equity firms, LinkedIn is the prime social media channel. While many firms have company pages, they might want to encourage employees to post about the firm on their LinkedIn profiles, Holder says, adding that people will be more inclined to interact with the company information if it's tied to a person on the platform.

Another opportunity for private equity is to install a chat widget, Parker says. About two years ago, he began using a website pop-up window that lets people contact him, so he can reply in real time.

Incorporating video content on your website or within your LinkedIn tends to elicit higher engagement. Both written posts and video posts can perform well, but people enjoy the imagery of videos where they can see a personality in action versus imagining who or what it is.

FARRAH HOLDER
Managing Director of Business Development, IMB Partners

"From June 2020, I've had more than 1,500 conversations on our website through the chat widget," Parker says. "The message comes directly to me."

Another growing trend that private equity should consider is aggressive branding, a subset of marketing that's particularly important for the asset class. When firms define themselves, they are positioned to receive the right kind of deals instead of less-relevant inquiries, Parker says.

"What we found is that building a brand, having a personality for the firm and creating that kind of rapport with people works because you're sharing your value proposition," Parker says.

Many private equity firms also employ email marketing, but one of the next frontiers is the use of highly segmented email lists. Whatever private equity firms do, sending emails consistently and frequently is critical, according to Parker. Trivest sends at least two emails a week to its network, but he acknowledges that each firm is different and should find the channel and frequency that best fit its needs.

"The key is finding things you can do consistently in an effort to build the brand," Parker says. //

InterGrowth is now

DEALMAX

MAY 8-10, 2023 | ARIA RESORT & CASINO | LAS VEGAS, NV

Same mission.
Now with maximum potential.

InterGrowth connected our community in ways that would generate seismic outcomes. In 2022, attendees made nearly **10 new meaningful connections on average with 3+ deals sourced per person.**

With DealMAX, we're taking this mission to the nth degree and maximizing your opportunity even further.

By bringing together the whole M&A community, and giving you focused and powerful opportunities to connect, DealMAX was constructed to catapult your growth – all in one convenient trip.

The bottom line:
Expect DealMAX to be even bigger and even better than InterGrowth.

Visit DealMAX.org to learn more about what this means for you.

PRESENTED BY ACG

IB INVESTMENT BANKERS

PE PRIVATE EQUITY INVESTORS

OP OPERATING PARTNERS

SA STRATEGIC ACQUIRERS

AL ADVISORS & LENDERS

Hilco Corporate Finance (HCF) has re-imagined how best to provide investment banking services to the middle market. Our practice is designed from the client's point of view — delivering a customized, solutions-based approach to every transaction. HCF's seasoned team of professionals have decades of experience providing M&A advisory, private capital markets, and special situations/restructuring advisory services across a broad range of industries. As an affiliate of Hilco Global, HCF clients also benefit from the expertise and relationships of the global leader in asset valuation, monetization, and related business advisory services. **For more information on how Hilco Corporate Finance can assist you, please contact Geoff Frankel at 847.504.3263 or gfrankel@hilcocf.com.**

VALUATION + MONETIZATION + ADVISORY + CAPITAL SOLUTIONS

Hilco™
Corporate Finance