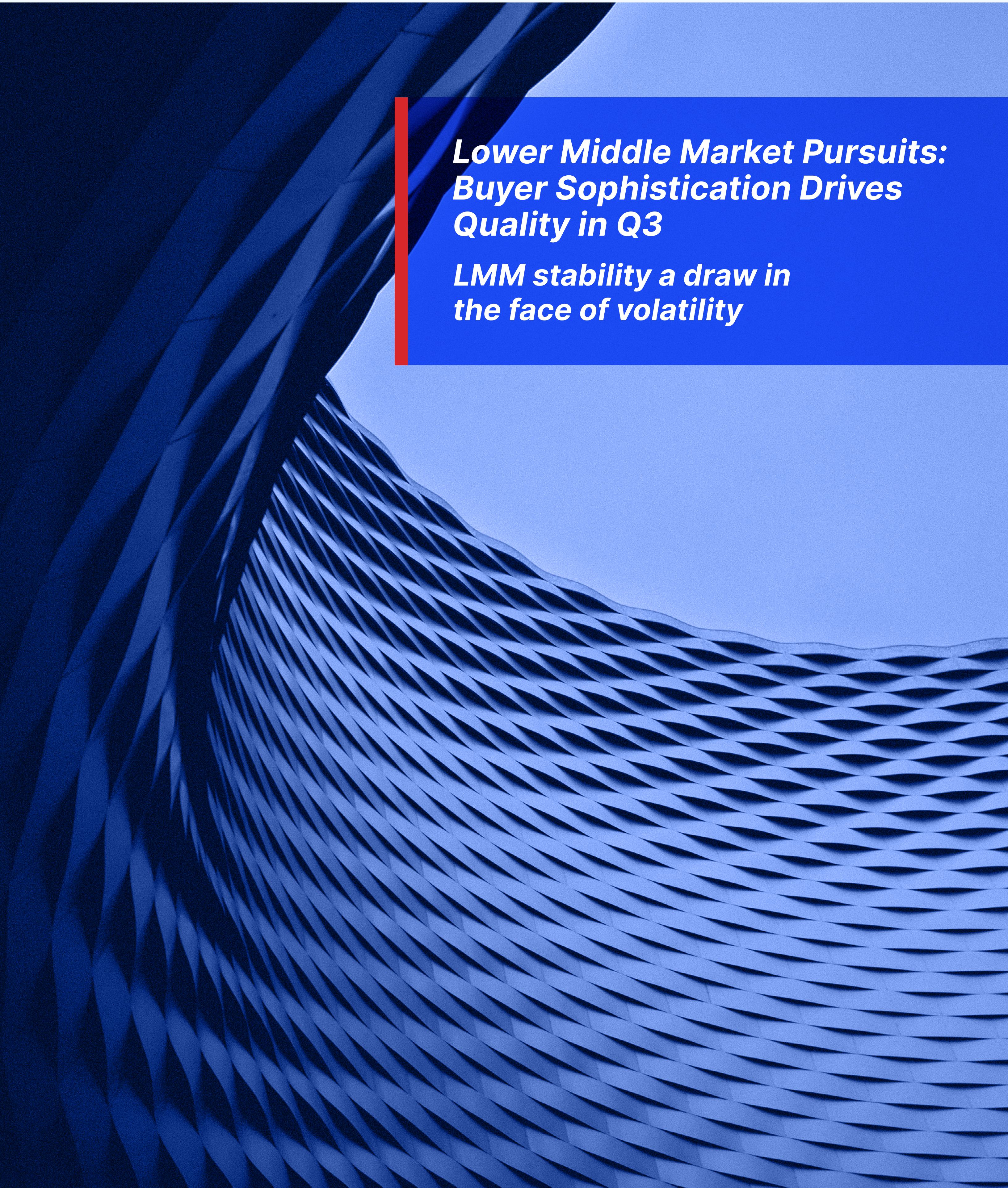
AXIAL

Fall 2022



Lower Middle Market Pursuits: Buyer Sophistication Drives Quality in Q3

LMM stability a draw in the face of volatility

Peter Lehrman
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The headline results for the past quarter, according to most measures of market performance, capture a grim picture — perhaps no more so than the volatility metric (VIX) up 38.2% year over year through September. Meanwhile, for the “real economy” grappling with inflation lodged near 40-year highs and rates poised to climb, a dilemma has emerged: consumers may spend less in the near term, despite solid household balance sheets.

As Q3 data makes clear, though, the lower middle market continues to provide a top source of quality deal flow. And as this market has matured, the buyer profile has only grown more sophisticated to match. In particular, private equity firms have been quick to take advantage of lower valuations. Moreover, the current environment may actually represent a unique opportunity for enterprising dealmakers in the lower middle market to purchase companies at a discount.

As the past quarter demonstrated, lower middle market buyers remain as discerning as ever. The data for the past quarter reveal that the additional scrutiny has meant that it takes more pursuits to reach LOI, even as pursuit rates remain elevated.

And despite persistent market volatility and increased costs of borrowing, high-quality assets continue to come to market. Across all available targets, the average profit margin reached 19.5% — a 1.2% increase over the same quarter last year. Perhaps only the widespread distribution of this performance is more impressive, with some 42% of all targets coming to market in Q3 with profit margins at or above 20%. But the propensity of prospective buyers to pursue the targets boasting the highest earnings did pull back slightly over the past quarter. In Q3, companies generating EBITDA in excess of $5 million annually had an average pursuit rate of 11.3%.

As such, the lower middle market largely does not register macro-level dislocations as acutely, nor does it reflect the same sorts of excesses that can characterize dealmaking in the public equities markets. The data in the following pages continues to support the hypothesis that lower middle market dealmaking does not stall out or shut down during periods of turbulence, and the stability of dealmaking activity across geographies and sectors will continue to be defining elements of the lower middle market going forward.

Enjoy the report!

Persistence and Resilience in the Lower Middle Market

Economic uncertainty — from a combination of entrenched inflation, persistent supply chain challenges, and continued geopolitical tensions — continues to put a damper on global dealmaking. The latest data from Refinitiv reflects a global M&A market stuck in a holding pattern. Per preliminary figures, the level of aggregate M&A transaction value globally fell 42% compared to Q2, representing the lowest Q3 figure in a decade. Moreover, the pace of last quarter's performance was the slowest since Q2 2020, when the world ground to a halt as the COVID-19 pandemic took hold. In the US, dealmaking fell last quarter at a similar rate, down to $278 billion.

And the depth of this trough captures more than just a falloff in valuations. The Consumer Price Index remains at historically elevated levels. The August print revealed a CPI of some 8.3% year over year — a "retreat" to where things stood in the spring. In its ongoing campaign to tamp down price increases, the Federal Reserve tacked on another 75 basis points to the Fed Funds Rate in September to a range between 3% and 3.25%. In addition to the hike, the central bank released median projections for the remainder of the year reflecting an anticipated target rate of 4.4%. Meanwhile, the World Trade Organization now forecasts an increase of just 1% in global exports/imports activity next year — a sharp decline from its prior prediction of 3.4% for 2023. The WTO's revised expectations follow the US trade report for August, when exports fell by 0.3%. This drawdown in trade represents a double-edged sword; on one hand, inflation could finally slow next year. On the other, a decline in trade only adds to the risk of recession.

And yet, the lower middle market in the US remains a notable bright spot. Financial sponsors such as private equity firms have expanded their presence across the lower middle market, and as a result, small businesses have increasingly been able to benefit from greater economies of scale. Additionally, lower middle market operations of all kinds have diversified their revenue streams of late, which has helped to expand the scope of operations and provide insulation from shocks to any one particular sector or region. These developments have all made the lower middle market a resilient corner of the economy — and an attractive investment target.

WHAT YOU'LL FIND INSIDE:

Top 10 Sell-Side Advisors: Highest Average Deal Pursuit Rates in Q3[1]

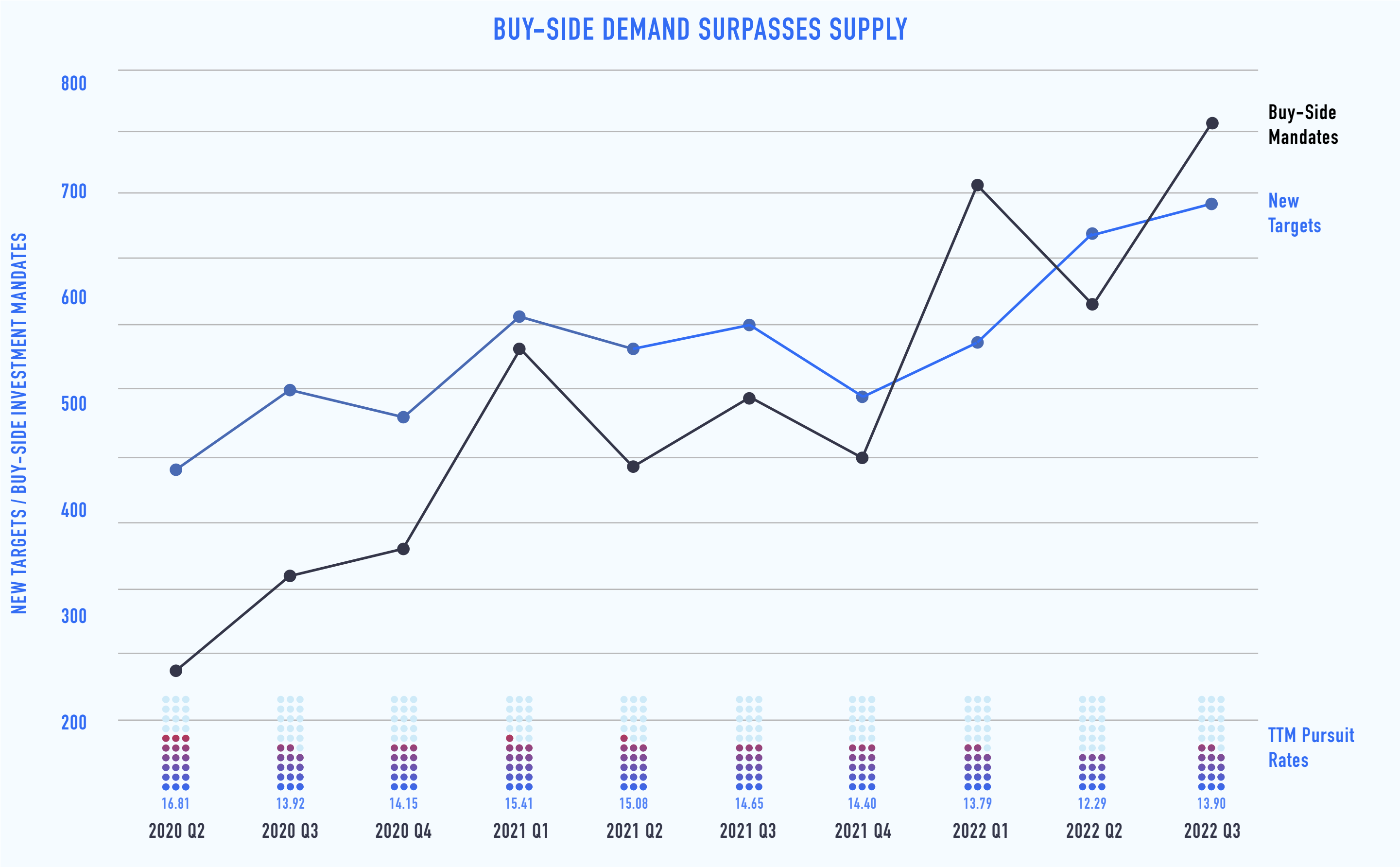
Firm Name	Average Q3 Pursuit Rate
ROI Capital Partners	31.71%
Ascend Strategic Partners	26.47%
Southard Financial	24.42%
Corum Group	24.00%
Xnergy	22.73%
Exit Partners	21.43%
Salt Creek Partners	21.08%
Mertz Taggart	20.65%
The DAK Group	20.13%
Tsalach Corporate Finance	20.00%

[1] A sell-side pursuit rate higher than 15% signals elevated interest from buyers. The above list reflects a firm's average pursuit rate from all Q3 deals shared with more than 20 recipients.

Top 10 Buyers: Highest Buy-Side Pursuit Rates in Q3[2]

Firm Name	Q3 Pursuit Rate
Westmount Ventures	105.71%
Phalanx Capital	100.00%
Technology Credit Union	96.00%
SecondGen Partners	90.91%
JRS Capital	87.50%
YRC Equities	85.88%
Libertas Funding	78.72%
Ronin Equity Partners	77.42%
Posterity Capital	76.92%
Revtek Capital	73.68%

[2] The above list reflects pursuit rates of buyers who received more than 10 deals in Q3. Higher buy-side pursuit rates reflect active & efficient sourcing and imply that Axial projects very clearly represent a firm's investment mandate.



A Continued Rise in Supply and Demand Across the Market

Sell-side deal flow remained robust in the third quarter. The number of targets brought to market via the Axial platform experienced a marginal shift quarter over quarter. However, despite remaining relatively flat, Q3 remains impressive because Q2 topped its priors, eclipsing the former record level established in the opening quarter of 2021 as sellers left the sidelines and got back to business following the early innings of the pandemic. Year over year, the level of sell-side activity in Q3 achieved a 19.6% increase over the same period last year.

On the buy-side, new mandates from prospective acquirers exploded by 24% quarter over quarter. But the year over year level of buy-side activity is truly staggering. The total number of new mandates surpassed the same period last year by a whopping 42% — comfortably the strongest performance for any quarter since the start of 2020. In September alone, buy-side activity jumped to 167 fresh mandates, an increase of 8.7% in just one month.

Our previous Pursuits Reports have highlighted how the availability of dry powder has created a stabilizing force for M&A in the lower middle market. Although the overhang of available capital has fallen over the past two years, per PitchBook data, it still stands at $3.2 trillion, an estimated $1.2 of which is held in private equity funds. Although that figure is off the highwater mark of $1.5 trillion reached in 2020, it continues to drive dealmaking.

With public equity markets in duress and so much capital seeking investable opportunities, the lower middle market looks all the more appealing to those with uncalled funds. The impact of this dynamic is particularly tangible in situations where GPs must confront increasing interest rates (i.e., more expensive leverage) and an uncertain economy with which to contend. In the near term, those servicing deals across the lower middle market should expect bidding wars for moderate returns from firms looking to place their investments in more stable corners of the economy.

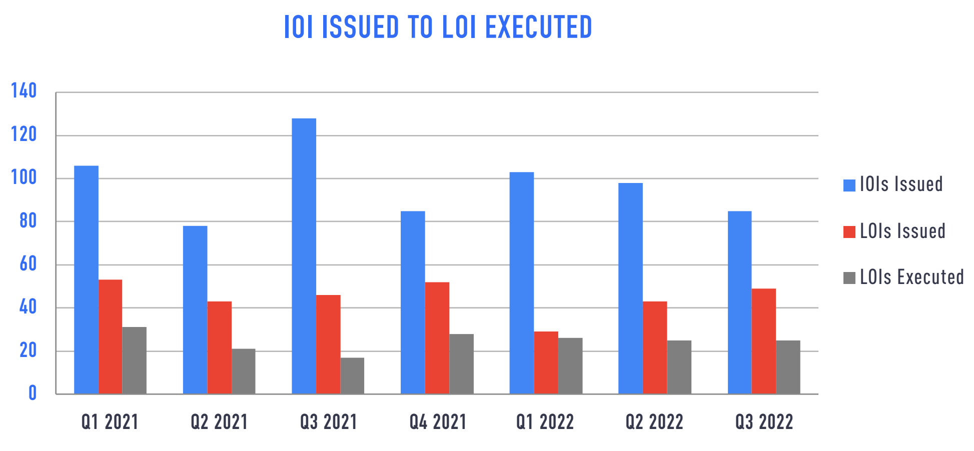
Increased Discernment Among Buyers Apparent in Decreased LOI Activity

The data informing our Pursuits Reports capture activity at the top and middle of the deal funnel. As a result, the data do not necessarily capture new sales processes or buy-side mandates that will become completed transactions further down the line. But it would appear that buyers and sellers continue to harbor somewhat divergent expectations for these sales processes. Based on the trailing 12-month pursuit rates as of the end of the third quarter, it's clear that prospective acquirers remain as discerning as ever. The average pursuit rate of 11.9% across all available targets as of the end of Q3 established a new floor as the lowest posted since the start of 2020.

The data of late suggest that it has taken more pursuits to get to LOIs.

Pursuit rates track the level of buyer interest in businesses marketed via the Axial platform. The metric for each target company rises as would-be acquirers pursue more information and show interest in specific assets. Pursuit rates above 15% tend to signal elevated interest from prospective buyers, while pursuit rates below this informal threshold track the longer-term average. Since the start of 2020, the average pursuit rate inclusive of Q3 stood at 13.9% overall. A higher volume of available companies can weigh down the index because buyers tend to gravitate towards top-quality targets while overlooking alternatives in pursuit of the best assets available.

Although many targets have generated pursuit rates at or above the 15% threshold, it's clear that prospective buyers have become even more discerning in aggregate over the past year. And the additional scrutiny has reduced the number of LOIs following suit, even as pursuits remain near historic levels. Indeed, the data of late suggest that it has taken more pursuits to get to LOIs.



Since the start of 2021, the average quarter for assets marketed via Axial has looked like roughly 98 indications of interest (IOIs) for 25 LOIs executed—effectively, a 4:1 ratio. But outliers like last year's third quarter bucked this trend, with a 7.5:1 ratio in a testament to the trend of more pursuits being required to get to LOI. For Q3 of this year, executed LOIs remained flat quarter over quarter, as buyers remain cautious, while IOIs dropped 13.3% over the same period. Fortunately for sellers, however, 29.2% of all available targets generated pursuit rates at or above the index in Q3. Over the first half of this year, that figure fell to only a fifth of all targets.

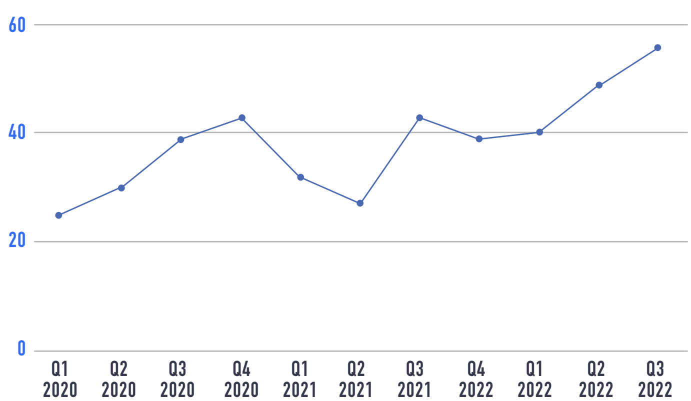
New Transaction Processes Betray Macroeconomic Trends

Over the past quarter, activity in the lower middle market has remained strong, both in terms of new deals being marketed as well as in terms of prospective buyers initiating new mandates. Pursuit rate data reveal that the assets for sale over the past quarter have been marketed by M&A advisors to 61.1% of all targets and investment banks at 27.8%. These data points suggest that buyers have taken recourse to experience — if not expertise — given market dislocations.

But many factors influence whether or not to tap an intermediary to run a traditional process versus adopting a proprietary approach in which buyers pursue prospects directly. Because deal processes can stretch past months into years, especially during periods of heightened volatility, the M&A markets make for a poor proxy of risk appetite and rarely betray the same directional sentiment from week to week or month to month of, say, public equities trading.

For example, new processes in transportation continued to pick up speed in Q3, despite stubbornly high fuel costs. This outperformance extended a trend that started to take shape back in the second half of 2021. Although the supply chain crisis represents the proximate cause here, generating greater demand for third-party logistics operators, trucking companies, and other transportation platforms, consolidation across the space is a secular development. Transportation companies have long needed to invest in new technologies and capabilities; meanwhile, the desire of private equity firms to invest in growth-oriented transportation companies has only deepened. In Q3, transportation services led the way at 42.9% of new transportation sales processes while distribution & wholesale captured an additional 26.8% of activity.

SELL-SIDE TRANSPORTATION DEALS



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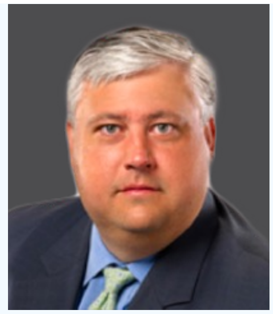

Erik Endler
Senior Managing Director,
[Three Twenty-One Capital Partners]

Q. Over the past quarter, activity in the lower middle market – both in terms of new deals being marketed as well as in terms of prospective buyers initiating new mandates – remained robust. What may explain this persistent resilience?

A. *The LMM seems to lag the overall market in terms of deal flow. Business owners in the LMM focus nearly exclusively on running their business and are typically reactive to the broader market or to specific business issues (i.e. an attractive multiple paid for a company in their industry or a personal health scare). It's at this point they explore selling, as opposed to larger companies that often evaluate the capital markets as a regular business practice and can foresee & react to market dynamics more quickly.*

Q. What are your expectations for LMM M&A for the remainder of the year?

A. *For the LMM, a lot of market dynamics are favorable. The strong dollar helps companies import products more cheaply, and because few of their sales are global, a strong dollar doesn't have an adverse effect. And although businesses are still fighting supply chain issues, there are very strong order backlogs. These dynamics have allowed businesses to raise prices and, in many cases, expand margin.*

Q. In your recent experience, are buyer and seller expectations aligned?

A. *Only time will tell. There currently appears to be alignment from a multiple perspective, however there can be a disconnect when it comes to choosing which financial period to apply the multiple. We've seen several businesses expand revenue and margins materially post-pandemic, and buyers struggle with sustainability; they'll attempt to average periods or look backwards beyond the last twelve months. As we put years between the initial pandemic and today, we start to see which elevated demand levels and margin profiles are sustainable and which are not. This type of clarity should help buyers and sellers to get more comfortable.*

Responses have been edited for clarity and brevity.

Leveling the Playing Field Across Sectors

Although pursuit rates fell on average in Q3, several sectors bucked this trend. As sell-side volume increases, as it did over the past quarter, buyers have a larger slate of potential targets to diligence. And that's really where it's most clear that no two buyers are alike. While all buyers will concentrate their attention on the best targets, just what that means will change per buyer prerogative — from a firm focused on fundamentals to managers expanding the scope of operations via an add-on acquisition.

Whatever the motive, several sectors enjoyed a great deal of attention from would-be buyers over the past quarter. But only telecom services commanded an average pursuit rate at or above the threshold of 15%. The trio of targets responsible for this outperformance over other verticals — each from information & software — came to market via an intermediary. Together, they averaged a 29.3% profit margin — a rather outsized performance compared to other sectors of the lower middle market in Q3.

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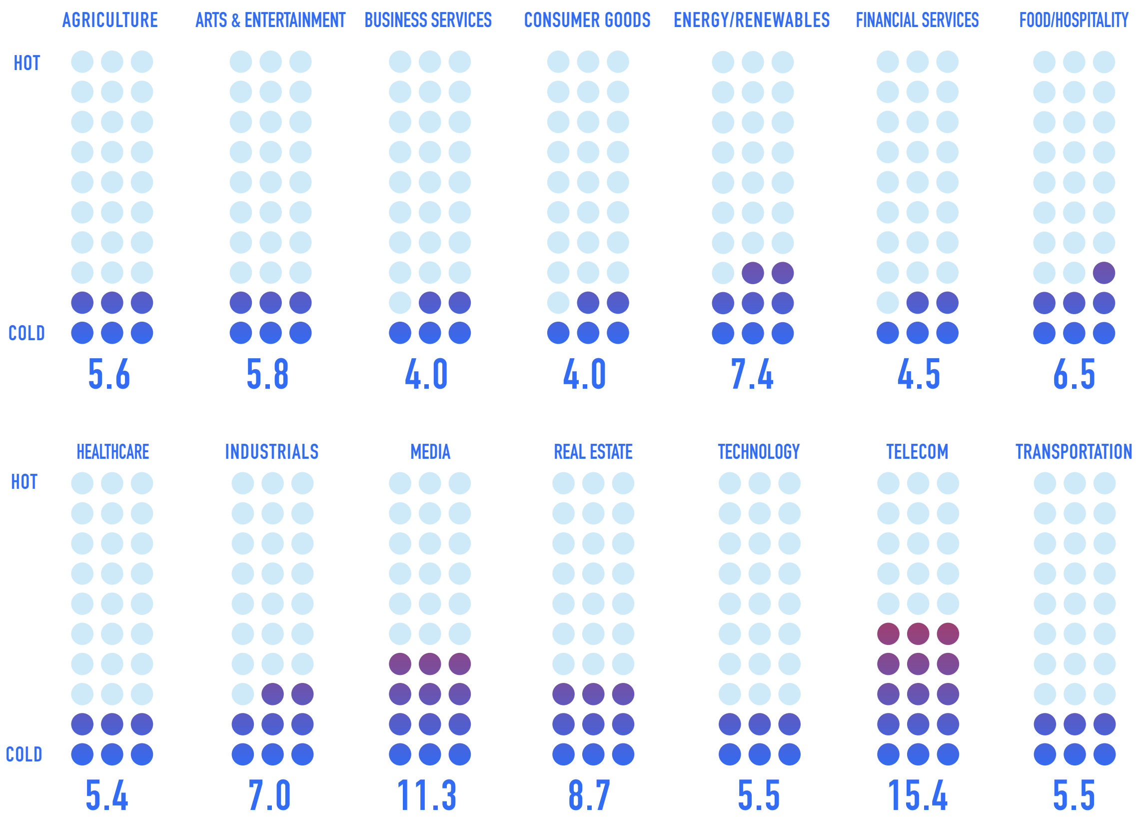
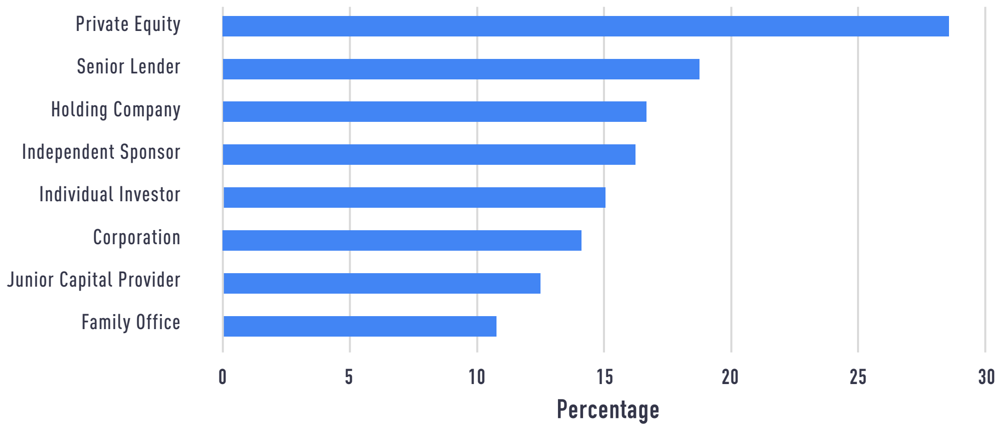
PURSUIT RATE BY SECTOR (TTM)



Buy-side activity reveals deep LMM alignment

The key to unlocking this year's resilient deal activity came thanks in no small part to one hallmark, above all, unique to the lower middle market: buyer and seller alignment. In other words, activity on the buy-side largely aligns with the sell-side's deal flow and reveals some considerable overlap in terms of geography and sector. And as the lower middle market has matured over the past several years, buyers and sellers have grown increasingly aligned and specialized across the US.

AVERAGE PURSUIT RATE BY FIRM IN Q3 2022

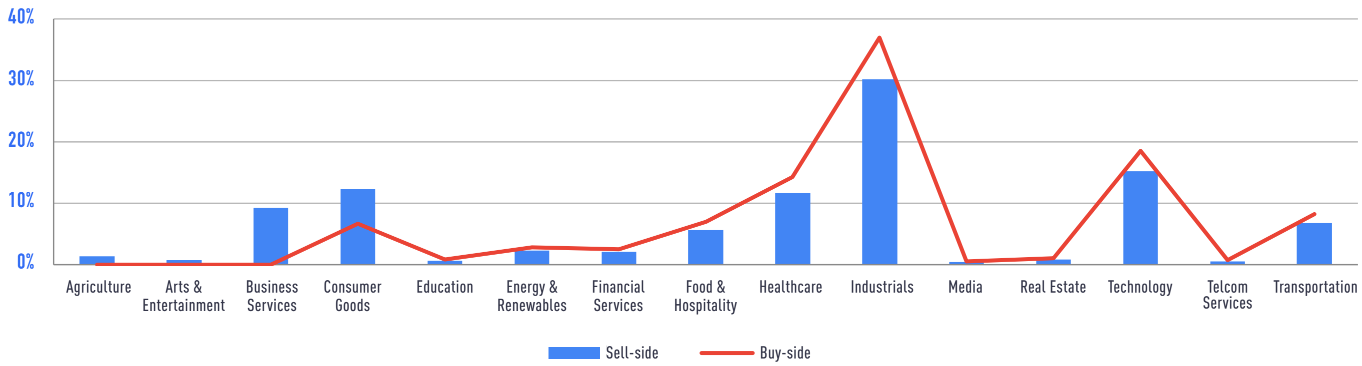


Take the case of industrials. Since the start of 2019, seller activity has originated in the greatest number from the industrials sector at nearly a third of overall supply. In turn, demand on the buy-side largely replicated these results over the same period. Industrials, including manufacturing and distribution & wholesale, led all other verticals at 33.1% in mandates over this period. As Q3 unfolded, that figure notched up slightly to 33.7% — a share perfectly replicated last quarter on the sell-side down to the tenth of a percent.

But other segments follow broader patterns of buyer-seller alignment as well. For example, since the start of 2019, seller activity originated at 12.6% by midyear for consumer goods, including retail as well as manufacturing and distribution & wholesale, and 10.8% in Q3. Meanwhile, buyer demand for consumer goods acquisition opportunities stood at 18.3% midyear and 15% in Q3. Even when divergent expectations exist by sector between sellers and buyers, supply and demand curves tend to move in line with each other across the lower middle market.

To every rule, an exception or two will always exist of course. For example, transportation's share of overall targets remained robust in Q3 at 7.9% but buy-side mandates represented just 4.2% of overall demand. Although the latter figure did expand by 1.2% quarter over quarter, the share of overall supply remained flat. Likewise, healthcare remains more misaligned even as the gap between buy-side mandates and sell-sides deals narrowed considerably in Q3. For the past quarter, demand for healthcare assets stood at 9.9% overall versus 10.6% on the supply side. This result stems at least in part from greater downward pressure quarter over quarter to bring buyer and seller expectations in line. For Q2 2022, healthcare assets represented 14.2% of all assets coming to market compared to just 7.5% of the overall share of fresh buy-side mandates.

SUPPLY VS. DEMAND BY SECTOR
Q1 2020 THRU Q3 2022



INDUSTRY DRILLDOWN

Industrials enjoy another strong quarter

The industrials space — as previously noted at 33.1% of all buy-side mandates and 33.7% of all sell-side deals in Q3 — has undergone a revitalization in interest since the start of the pandemic and enjoys perhaps the deepest level of buyer and seller alignment in all the lower middle market. What explains this resurgent activity for both buyer and seller includes the anticipation of sustained regulatory changes fueled by refreshed policy goals for infrastructure spending in the US. Although not the only driver, as a number of other factors are stoking enthusiasm in certain subsegments of the sector, the level of demand across each of them has remained remarkably persistent in recent years.

Since the start of 2020, the preponderance of buy-side mandates has concentrated on manufacturing at 45.4% of industrials followed by services at 31.5% and construction at 13%. For Q3, much remains the same here. The share of buy-side mandates has concentrated a bit more on manufacturing than recent activity at 46.1% of industrials followed by services at 30.7% and construction, again, representing an even 13% of demand. At a 7% pursuit rate for Q3, industrials sit somewhere in the middle of the pack above food & hospitality (6.5%) and behind energy & renewables (7.4%). However, within the sector, some subsegments commanded a great deal more attention than others over the past quarter — and for good reason.

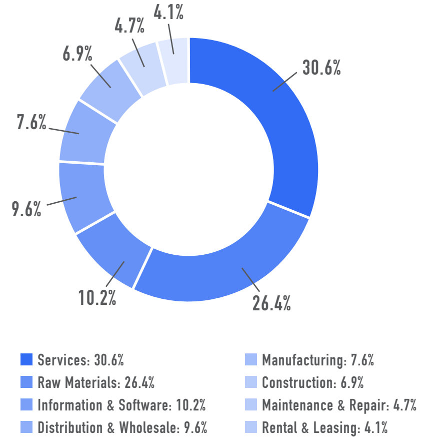
Buyers have different earnings ranges in mind when approaching the various subsegments of the industrials sector, varying from an average minimum in EBITDA of $942,938 for services to an average maximum of $26.5 million in EBITDA for information & software last quarter.

However, the sell-side cannot always supply assets that meet these targets. As a result, the distribution in pursuit rates for companies coming to market in Q3 paints a different picture of the space from the one available by reviewing the distribution of new mandates alone. Again, information & software leads where others follow with an average pursuit rate above our benchmark of 15%. But others are not far behind in garnering significant attention from buyers.

These data speak to the right-sizing of expectations from buyers assessing the assets coming to market. For example, rental & leasing may command the bottom end of average earnings expectations from buyers overall, but the target companies these buyers have reviewed would appear to more than warrant deeper scrutiny during diligence. The subsegment enjoyed a pursuit rate on average in Q3 of 14.6%. Maintenance & repair tells a similar story. Buyers in these areas have a depth of experience commensurate with their expectations for target quality, and the assets that entered their purview in Q3 did not disappoint, helping to push the subsegment's pursuit rate to 13.4%.

Industrials deal data speak to the right-sizing of expectations from buyers assessing the assets coming to market.

DISTRIBUTION OF UPPER BOUND OF EBITDA FOR INDUSTRIALS



BUYER DRILL DOWN

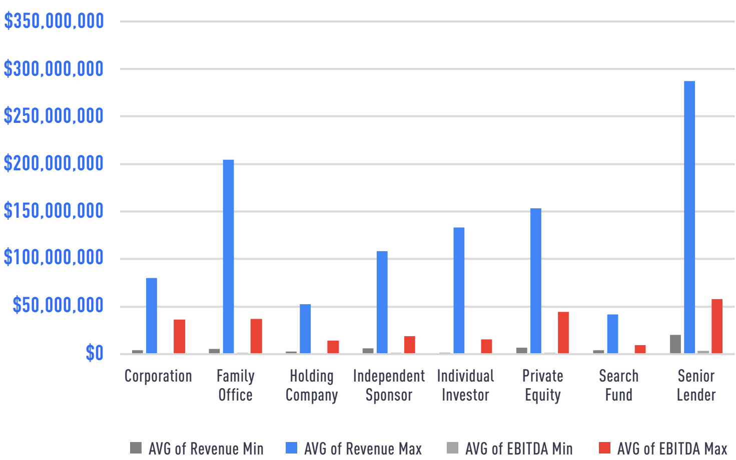
Search funds surge as PE retreats

The overall profile of buyers deviated last quarter from the norm established in recent years. Since the start of 2020, private equity funds made up 28.4% of all mandates to pursue lower middle market assets. In Q3, their share fell to just 15.4% as search funds, individual investors, and holding companies all expanded their presence — and quite considerably. Taken together, these buyers represented 29.6% of all new mandates over the past quarter.

Not only can search funds serve as a less expensive entry point for newer investors than traditional private equity funds, they also can be more flexible in their investment strategies. Furthermore, they represent a form of talent recirculation as individuals or teams of entrepreneurs with experience but limited capital resources can buy and rebuild existing businesses by playing a role in day-to-day operations.

And search funds would appear just as discerning as their larger peers while managing smaller pools of capital. In Q3, search funds pursued targets generating on average between $4.2 million and $41.9 million in revenues. Meanwhile, private equity targeted between $6.5 million in revenues on average at the low end and $153.4 million at the top.

REVENUE & EBITDA TARGET RANGES BY FIRM TYPE IN Q3



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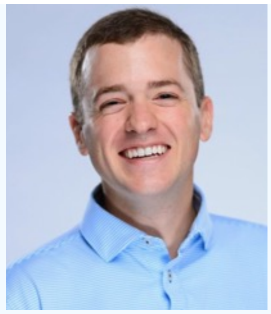


Matt Brugner,
Founder
Stewardship Partners

Q. In Q3, private equity groups pursued deals at ~10% decrease from Q2, while search funds, individual investors, and holding companies all expanded their presence; has your sourcing experience changed in recent quarters? Has competition amongst buyers changed?

A. *I haven't sensed a material change in the competition amongst buyers on high quality deals. As traditional search funds, self-funded seachers, and holdcos become more prevalent, I have noticed that brokers/bankers are more aware of the differences between each of these models and how they might impact the deal process and post-close dynamics.*

Q. Are you receiving fewer, more, or the same number of deals as past quarters?

A. *Same*

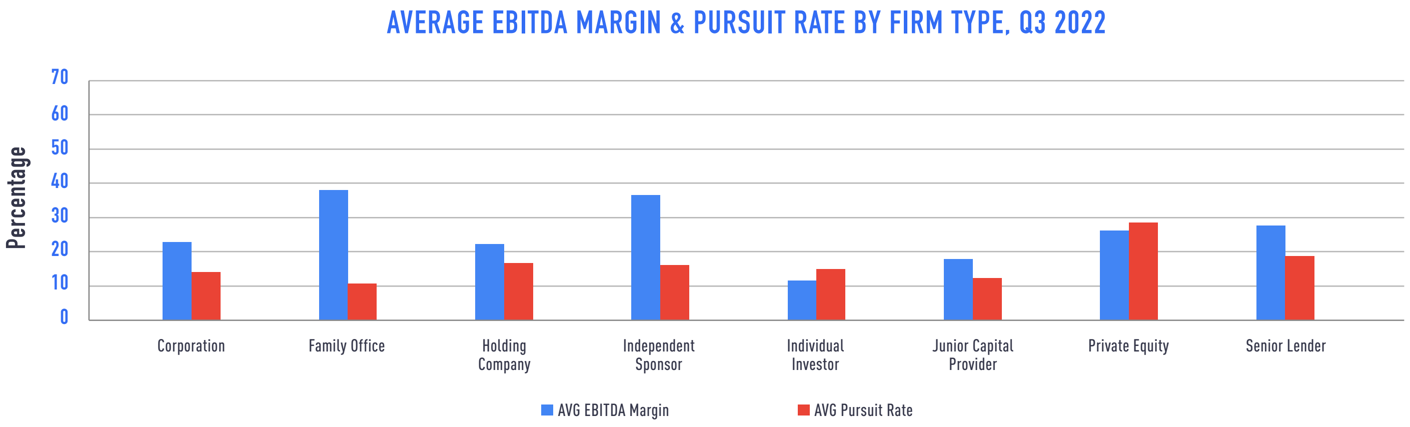
Q. What are other differentiating benefits that search funds may have versus larger private equity groups?

A. *My goal is to roll up my sleeves and run ONE business. I call it an "entrepreneurial succession plan". I'm not building a portfolio, nor do I consider myself an "investor". I'm an operator who is going to commit 100% of my career into stewarding the business I acquire into its next phase of growth. For a seller that wants to transition their leadership role, without a clear successor, a search fund allows them to build trust with their successor.*

Responses have been edited for clarity and brevity.

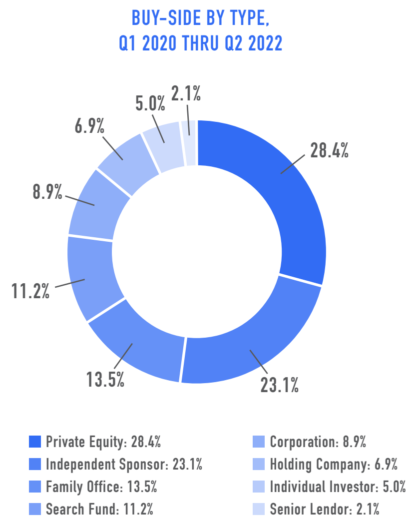
Pursuit rates reveal fit over profit

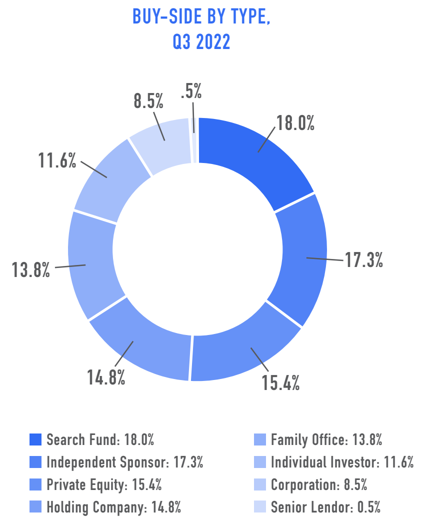
Even with pursuit rates down slightly in aggregate for the third quarter, new targets from holding companies, independent sponsors, individual investors, private equity, and senior lenders all generated an average pursuit rate at or considerably above our 15% threshold. Impressive profit margins from this cohort go some of but by no means the entire way to explaining why.



With little in the way of daylight between the profitability of the companies, the institutional profile of sellers bringing the top targets to market helps to make it all the more clear that private equity firms and senior lenders are better equipped in an increasingly complex environment to connect the keenest buyers with the best assets. As discussed above, trends taking shape on this and several other fronts suggest that buyers have also taken recourse to experience — if not expertise — given market dislocations.

Pursuits rate data reveal that the bulk of assets for sale over the past quarter have largely been marketed by M&A advisors at 61.1% of all targets and investment banks at 27.8%. However, for targets originating from advisory firms, profit margins stood at 19.5% in Q3 and captured a pursuit rate of just 9.2%. Meanwhile, investment banks brought assets to market with profit margins of 18.6% which generated a pursuit rate of 11%.





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