FIRMEX

Deal Flow Bulletin

Q3 2022

Partnered with:

divestopedia

Contents

Bulletin Highlights

- Overall, **48% of advisors said they felt positive about the market for the coming quarter,** and 18% said they were feeling negative.
- Buyers and sellers are actively pursuing middle-market M&A transactions, as measured by a rise in data room openings in the third quarter of 2022.
- While plenty of diligence is taking place, amid political and economic uncertainty, fewer deals are closing and taking longer to do so. Success rates show that the number of firms that close at least three-fifths of the deals they start fell to 52% from 68% in January.
- A majority of advisors say that a **recession is likely within the next year.**
- **Advisors report that deal volume over the last three months has mostly stayed constant,** although one-third of advisors in Europe report slowing activity.
- **Asked to forecast volume over the next three months, advisors are split,** with 32% predicting an increase, 21% a decrease and 39% no change. Six months ago, advisors overwhelmingly were predicting they would do more business in 2022 than 2021.
- Deal valuations are coming down from their peaks. **Prices, most advisors say, have fallen to “above average” from “very high” six months ago.** Most think they will fall further.
- **One-third of advisers said there is less debt financing available,** and one-fifth said there was less equity capital.
- **Renewable energy is the sector seeing the greatest increase in activity.** The biggest decline is in real estate.

Introduction

Each quarter, the Firmex Deal Flow Bulletin not only provides a prediction for what's coming next, but also allows us to evaluate the previous quarter against expectations. Did the market respond how we and advisors anticipated? Why or why not? What can we learn from it as we look ahead? It's with that in mind that we present our Q3 2022 report, to help you analyze the M&A landscape in the face of an uncertain market, so you can be better informed with data and anecdotes to help you respond to this quarter's shifts. We are happy to once again partner with John Carvahlo of Divestopedia, whose network and expertise help us interpret this quarter's activity. As always, the 155 advisors we surveyed provided invaluable observations that illustrate what the trends we read about in headlines look like from the experts' perspectives. What advisors have to report is this: diligence is still happening at healthy levels, but that economic and political unknowns are affecting the process. Advisors remain optimistic, but how dealmakers continue to adjust remains to be seen.

—Mark Wright, General Manager at Firmex

It appears that the velocity of M&A transactions across most industry sectors and regions is slowing from the record pace experienced in 2021. The perfect storm that created a robust M&A environment (low interest, abundance of capital, growing economic activity) has shifted in 2022 and continues to worsen in Q3. In the first half of 2022, some factors driving M&A activity included the fear of increasing interest rates and attempts to gain access to labor and supply in the presence of shortages. Now, rising interest rates have materialized, and global inflationary pressures are building. For acquirers, using M&A to resolve labor and supply chain issues is less relevant in the face of a slowing global economy. Layer on geopolitical risks and difficulty in assessing normal earning levels after the pandemic to the risk bucket. The winds of change are now blowing and in Q3, it brings a slowdown in the M&A market. Batten down the hatches.

—John Carvalho, Founder of Divestopedia and President of Stone Oak Capital

Overview

Middle-market mergers and acquisitions have entered an era of uncertainty.

Activity is still strong. Prices are well above average. What is gone is the giddy feeling among investment bankers and other merger advisors that the pace of deals will keep accelerating.

Just six months ago, two-thirds of advisors told us that they expected their deal volume would be greater in 2022 than in 2021. Now, half as many are predicting an increase. While there's still plenty of diligence happening, fewer deals are closing and taking longer to do so, because of uncertainty.

In January, most advisors said valuations were "very high" and one-third predicted they would go even higher in 2022. By June, prices have fallen to "above average," and most advisors think they will fall.

The changing perceptions, of course, reflect the uncertain state of the economy in mid-2022, with inflation, energy prices and interest rates rising, all in the shadow of what may be a protracted war in Ukraine. Now, most advisors predict a recession in the next year.

"Our view of the future keeps shifting," said Steve N. Economou, a principal at Grassi & Co, in the United States. **"We are still struggling to understand what normal earnings are after the pandemic, with all the volatility in the supply chain, energy costs, wages and interest rates."**

This struggle can be seen in an anomaly in the Firmex Deal Flow Forecast. Our model sees an increase in the number of virtual data rooms being opened. Accordingly, it assumes that more prospective deals have moved into the due diligence phase and thus predicts an increase in transactions.

Deal announcements, however, have been falling, confirming that a lot of action is being postponed until economic conditions become clear.

"We are feeling nervous at this time," said Aaron Solganick, CEO of Solganick & Co., in the United States. **"Things are slowing down very quickly."**

Observations

The industry needs to have balance. The uncertainty of the markets and volatility of market sectors creates a sense of doubt to both seller and buyers which in turn complicates the deal process. ***—Edwin Zelaya, Principal at Gamani Group, Canada***

I expect valuations will decrease due to rapidly rising interest rates, stock market declines and economic uncertainty. ***—Christopher Picone, President of Picone Advisory Group, United States***

Covid took its toll on owners. They are burnt out and want to exit. ***—Betty Schnaufer, Broker at Murphy Business & Financial, United States***

Private Equity dry powder is at very high levels, so deals need to be done. But the funds expect to buy at lower prices. ***—Colin Marson, Managing Partner of Lisergy Consulting, United Kingdom***

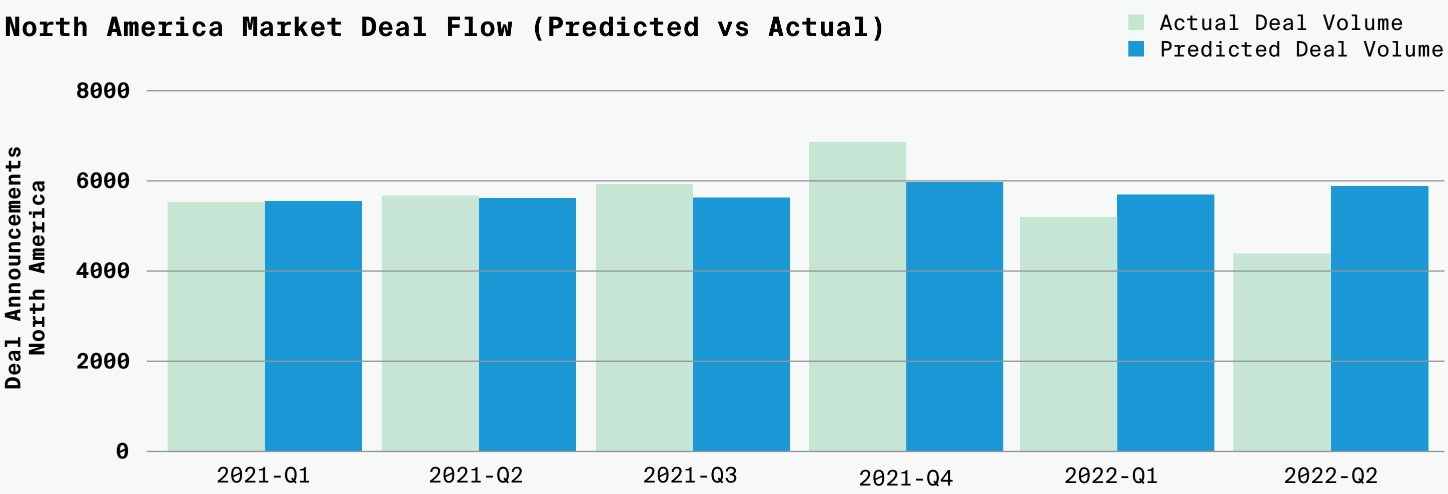
I've now begun to see differences in deal volume between transactions in the lower middle market (below $50M EV) and the middle market (above $50M EV.) Momentum in the LMM has remained consistent in 2022, while the volume of deals in the middle market has decreased from 2021.
—Jim Friesen, Founder of Portage M&A Advisory, Canada

Buyer sentiment has been impacted a little because of a range of factors. But in reality, we are coming off all-time highs for deals, and the market is generally performing well. ***—Investment banker, Australia***

Recession plus higher interest rates leads to lower valuations. ***—Federico R. Cuevas Delint, Partner at ONEtoONE Corporate Finance, Mexico***

About the Deal Projections

The forecasts of third-quarter 2022 deal volume are based on activity on the Firmex Platform, one of the most widely used virtual data room providers. Each year, more than 20,000 rooms are created on Firmex for prospective buyers and sellers to exchange confidential information during due diligence. The level of deal room creation has proven to be a reliable indicator of future M&A activity. In times of economic uncertainty, however, the measure becomes more of a trailing indicator, because the time it takes for deals to close extends. See the discussion of the North American and European forecasts.



About the Survey

The insights about market dynamics are drawn from an online survey in June 2022 of 155 investment bankers, business brokers, and other professionals involved in middle-market mergers and acquisitions. Firmex has conducted quarterly surveys with similar methodologies since 2021.

About the Respondents:

- The most common respondent was an investment banker working in the United States who is the head of a firm with five or fewer employees that typically handles deals between $6 million and $50 million, mostly for sellers.
- Half the respondents described themselves as generalists. The most common industry specialty was "manufacturing, construction, and transportation."
- Two out of three respondents were based in North America, with another quarter in Europe.
- There was quite a diversity of job functions among the respondents. Lawyers, business development executives, and others not directly doing deals made up 15% of respondents.
- Three quarters of them work in firms with 20 or fewer employees. Their firms typically complete fewer than 10 deals a year.
- Advisors at firms with more than 100 people made up 14% of respondents. And 15% regularly handle deals valued at $100 million and up.
- Three-fifths work primarily with companies for sale. One-fifth work mostly with buyers, and the remaining fifth work with both.

See the appendix for detailed information on respondents.

The Firmex Deal Flow Forecast: North America

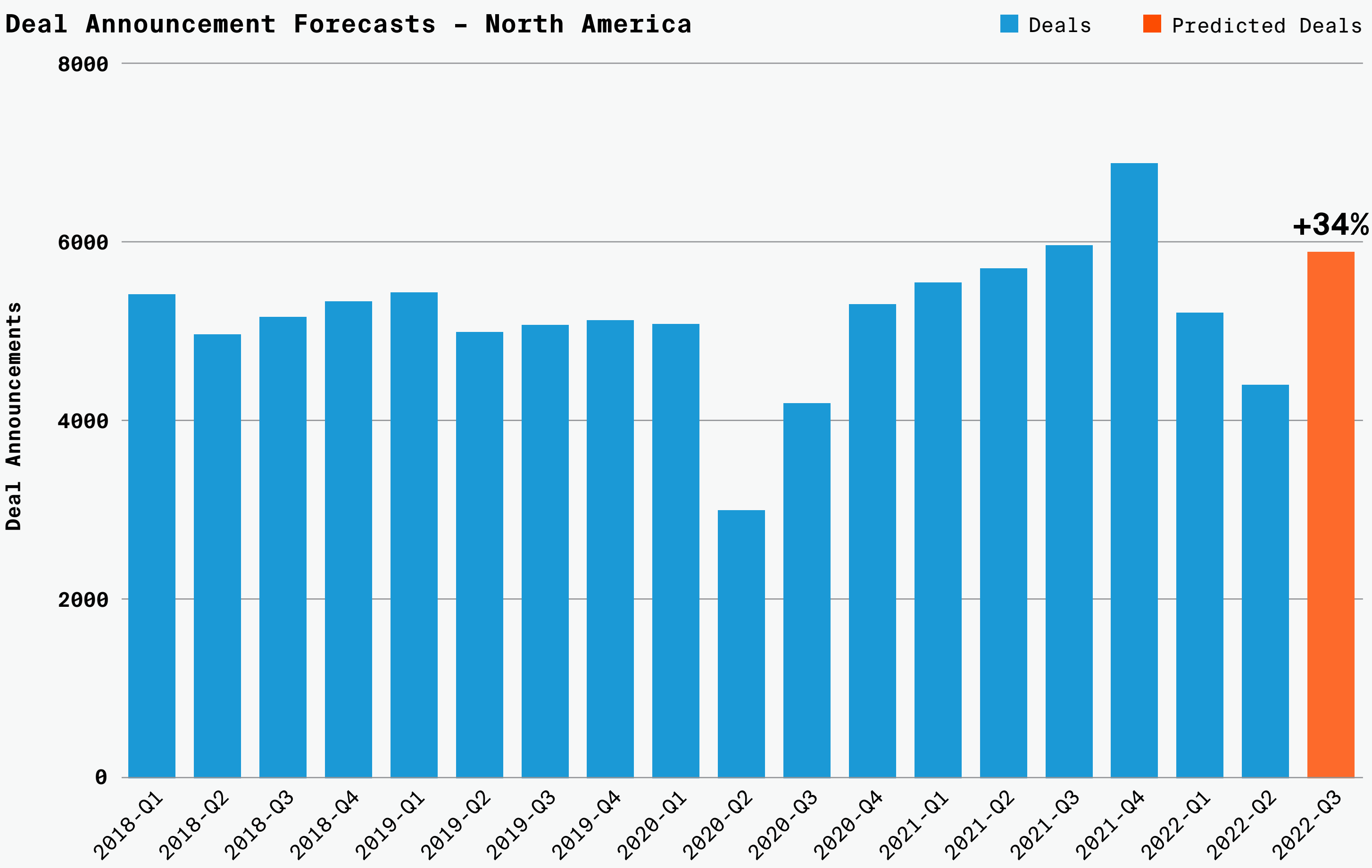
There are still a lot of buyers and sellers actively negotiating deals, and those talks are getting serious enough that they are conducting due diligence. With questions growing about the future of the economy, negotiations are dragging out longer, and fewer deals are closing. That's the clear message of our survey of advisors, and it's evident in our projection of future deal activity, which is based on the number of virtual deal rooms created.

The Firmex forecast predicts that the number of deals in North America will increase by 34% from the second quarter to the third quarter of 2022. That would put deal activity in the third quarter about even with the same period in 2021.

That forecast, almost certainly, is too optimistic. Our algorithm only takes into account the trend and seasonality of data-room creation to predict future deals. It does not consider the economic, market, or socio-political factors that are likely to have a large impact on deal activity in the current environment.

Indeed, in the second quarter, this model overestimated deal announcements. We predicted deal volume would increase by 11% over the first quarter of 2022. In fact, deal volume, as tracked by Capital IQ, fell by 16%.

It's worth repeating that the Firmex forecast is based on the number of companies that commit to serious due diligence and document exchange. In the current environment, fewer of those deals are moving to completion. As soon as the economic and political conditions clarify, buyers and sellers may quickly move for the backlog of deals they started but have not yet completed.



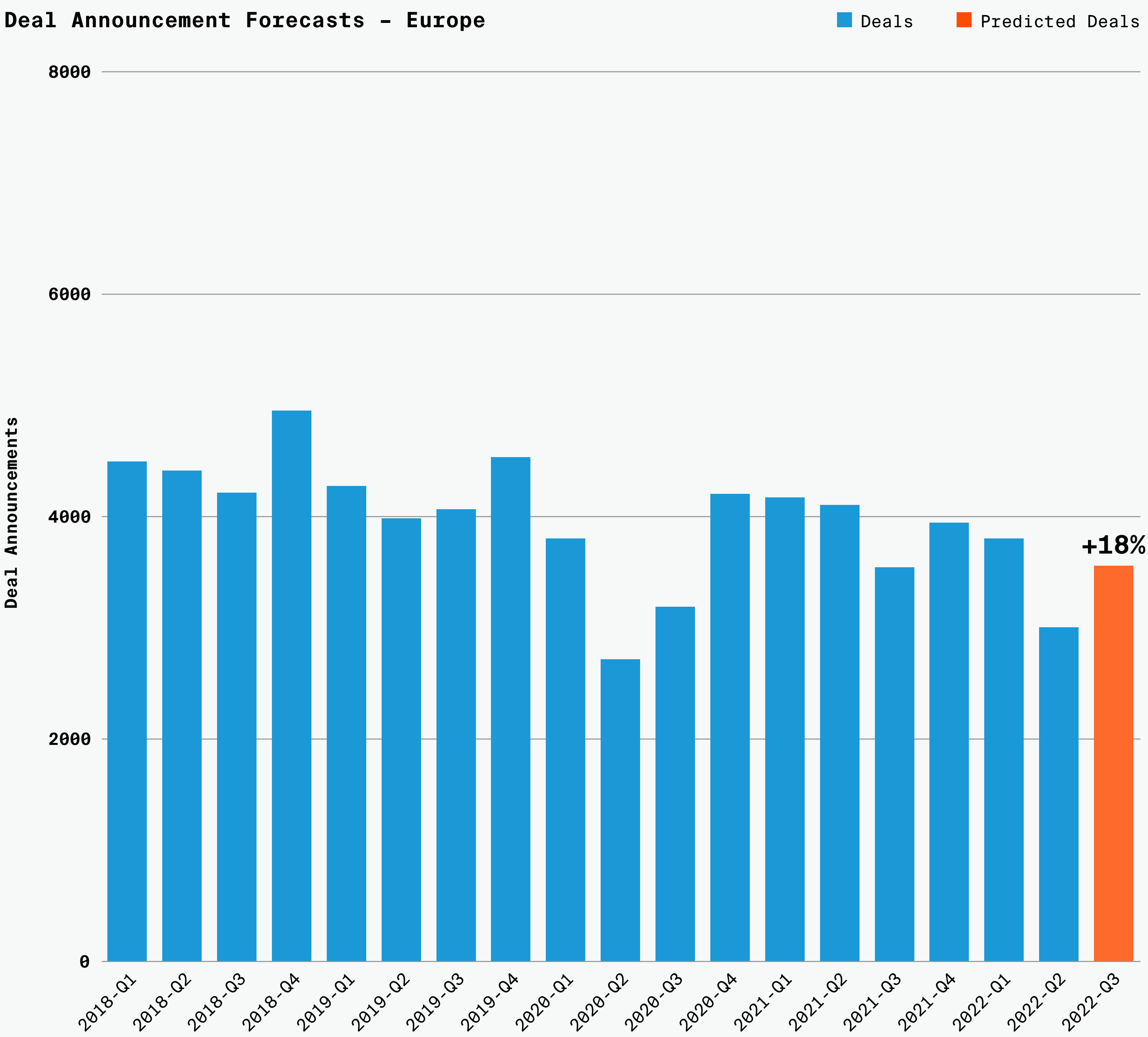
Source: S&P Capital IQ (2018 - 2022 Q2), Firmex analysis Q3 2022

The Firmex Deal Flow Forecast: Europe

The third-quarter Firmex deal forecast for Europe is very likely significantly too high for the same reasons we discussed in the North American projection.

The model, based on deal-room creation, predicts deal announcements in Europe will increase by 18% in the third quarter of 2022 from the second quarter. That would make deal activity even with a year ago.

In the second quarter, deal activity fell at a more rapid pace in Europe than North America. European deal announcements were 21% below those in the first quarter and down 27% from the second quarter of 2021.



Source: S&P Capital IQ (2018 - 2022 Q2), Firmex analysis Q3 2022

Likelihood of Recession

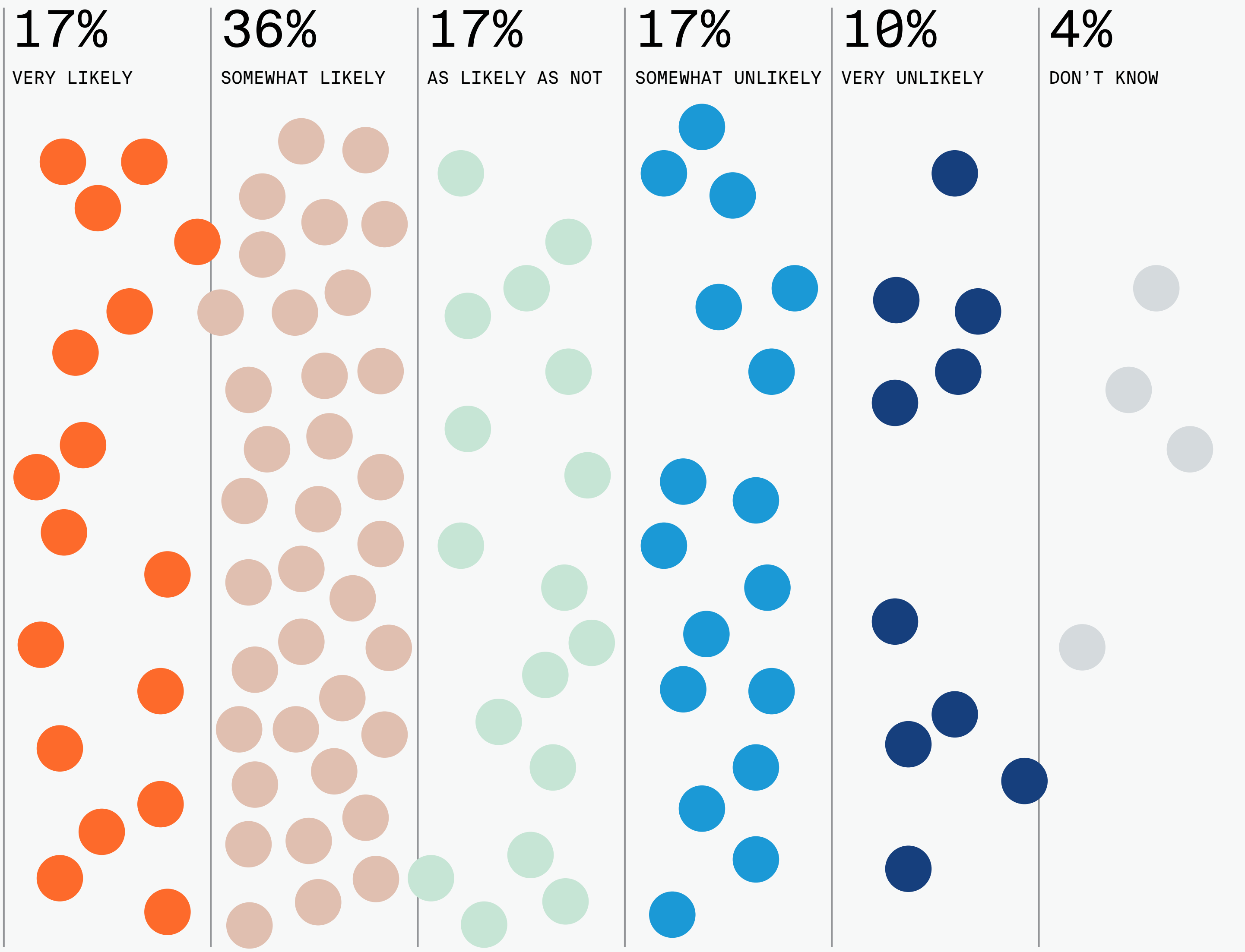
A recession is coming, according to a majority of the advisors. Specifically, 36% said a recession is somewhat likely in the next year and 17% said it is very likely. Just a quarter thought a recession was unlikely, but only 4% had the conviction to say it was very unlikely.

Interestingly, significantly fewer advisors that primarily work with buyers (41%) predict a recession than those that work with sellers (56%).

Many advisors said that the prospect of a recession is casting a pall over their business. **"The rate of macroeconomic change is spooking private equity investors,"** said Trever Acers, managing director at Objective Capital Partners in the United States.

One British investor, however, suggested market sentiment, in fact, may be influencing the economy. **"We're talking ourselves into a recession,"** she said.

What is the likelihood of a recession in the industries you serve over the next year?



Deal Volume

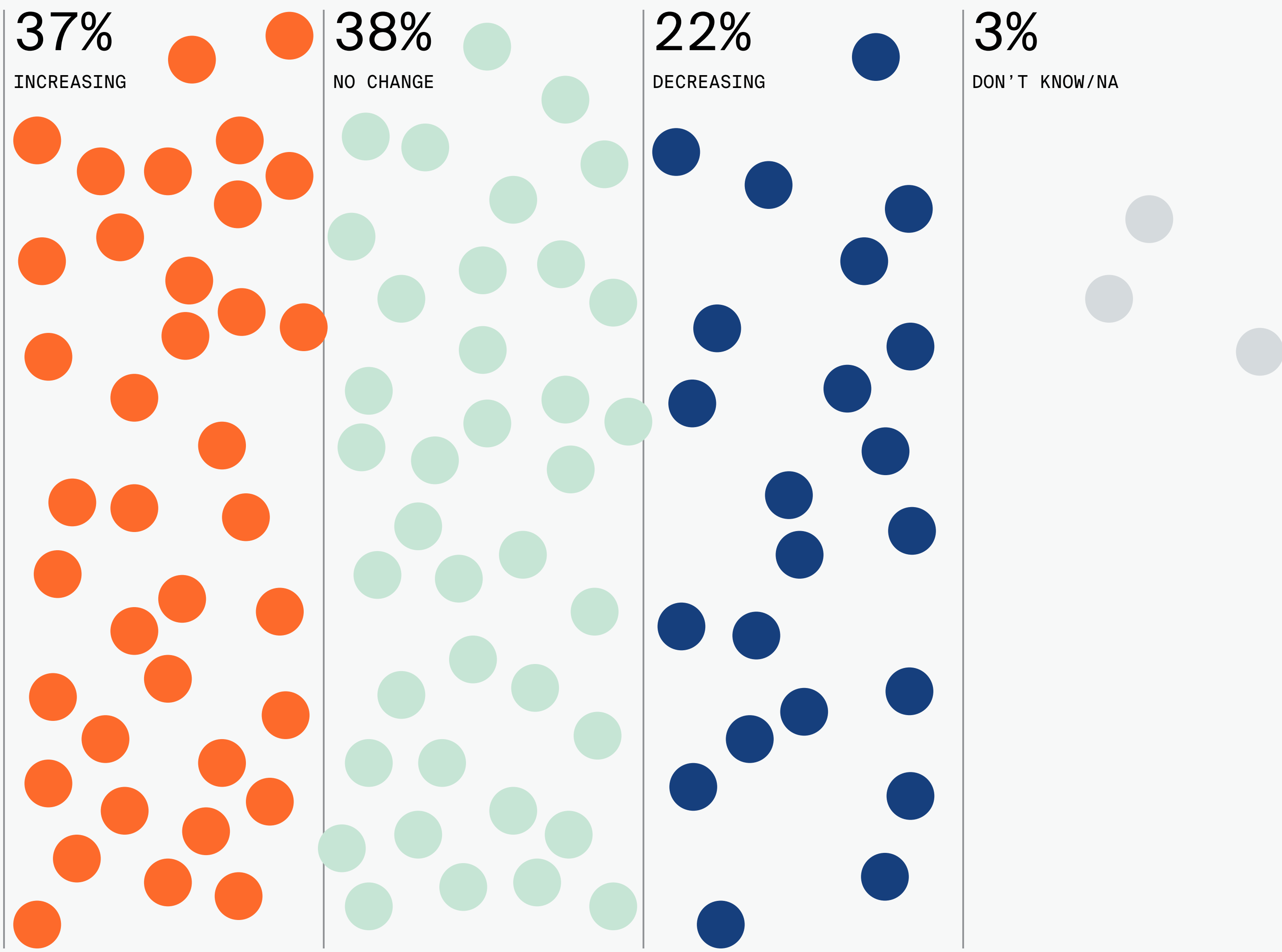
The frenetic increase in deal volume is ending, but more advisors now expect business to stay even than to fall.

This is a dramatic change from our survey in January, when 68% of respondents said volume in 2022 would increase over 2021, and only 15% said it would fall. In the June survey, asking about the coming three months, 32% of advisors expect an increase, 21% see a decrease, and 39% say things won't change.

Few investment bankers have seen business slow down so far. Only about one in five advisors said their volume in the past three months had fallen, while more than one-third said they got even busier in the second quarter. The advisors in our survey have experienced less of a reduction in deal flow than the market as a whole, perhaps because they focus on the lower middle market.

Interestingly, the experience over the last three months was much worse in Europe, which of course is confronting the war in Ukraine and the resulting surge in energy prices. Some 35% of European advisors said deal volume fell in the quarter, compared to only 17% in North America. The outlook for the future is about the same for European and North American advisors.

Over the past three months, how has your deal volume changed?

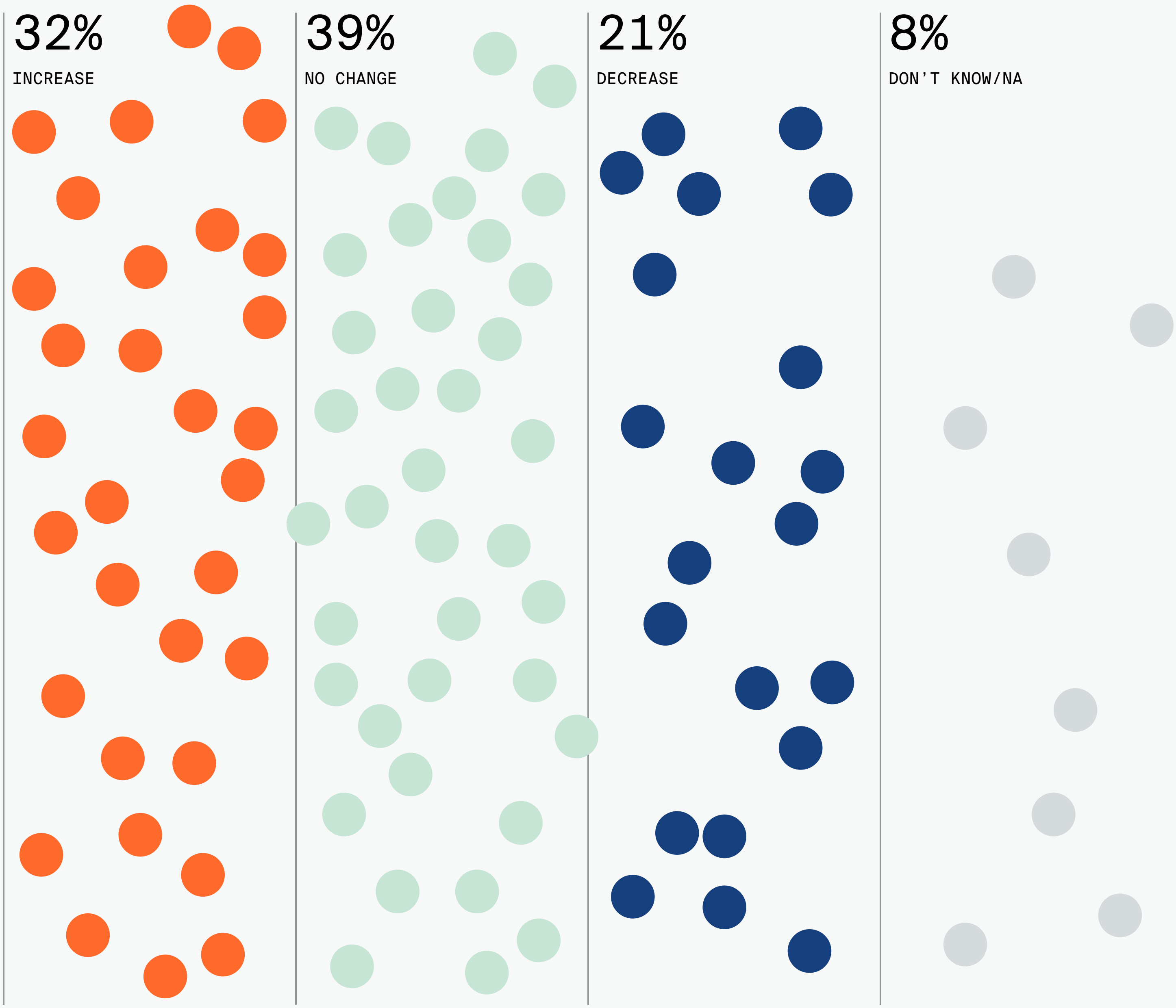


Deal Volume *CONTINUED*

"Uncertainty" was the most common word when advisors were asked an open-ended question about the factors most affecting deal volume. **"Rising interest rates, stock market chaos, and economic uncertainty"** was how one banker who sees business slowing, described the forces driving deal volume. Some wrote of "buyer paralysis" and the resistance of sellers to lowering price expectations. Others, however, saw an increase in the **"interest of potential buyers to enter a deal."**

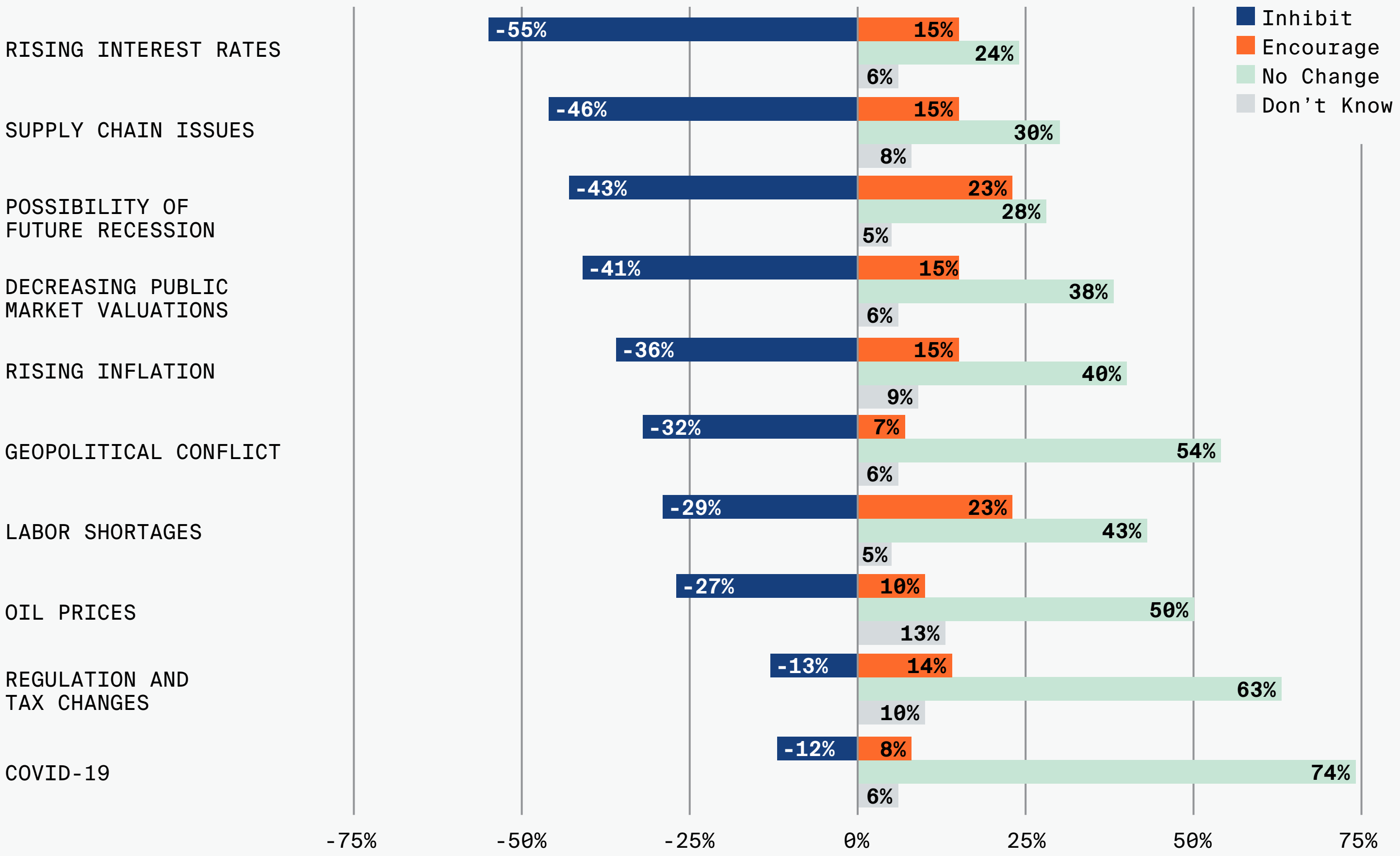
When asked about specific factors that are affecting deal flow, the biggest drags were rising interest rates and supply chain issues. Compared to three months ago, the biggest change was for views of public market valuations. In June, 41% of advisors said the falling stock market inhibited deal making compared to only 15% in March.

How do you anticipate your deal volume to change over the next three months?



Deal Volume *CONTINUED*

How are the following factors influencing current deal volume?



Observations

There are far fewer deals due to current company performance, more costly capital, lower profits, and insecurity in the stock markets. ***—Head of firm in the United States***

There is a pricing gap between buyers and sellers, given the robust environment that existed in 2020 and 2021. ***—Kevan Holroyd, Associate Partner at EY, Canada***

Second-generation family companies are not prepared for this economic situation, and shareholders are willing to sell the company. ***—Jose Tardeli Filho, CEO of Terra Boa M&A, Brazil***

It's too difficult to untangle and define what influences deal volume. We don't look at it that way. For a small investment bank, there are always deals to be done, just depends how hard we choose to work. ***—Banker in Australia***

The intense level of M&A activity makes it hard to get buyers' attention. ***—Greg Carpenter, Managing Partner at M&A Business Advisors, United States***

Valuations

While the advisors in our survey haven't seen much change in deal volume, their perception of valuations have shifted sharply. Only 7% of the advisors now say company prices are "very high," down from 45% in January. Now, 48% describe prices as "above average," compared to 30% in January. Still, only 9% say prices are "below average" or "very low."

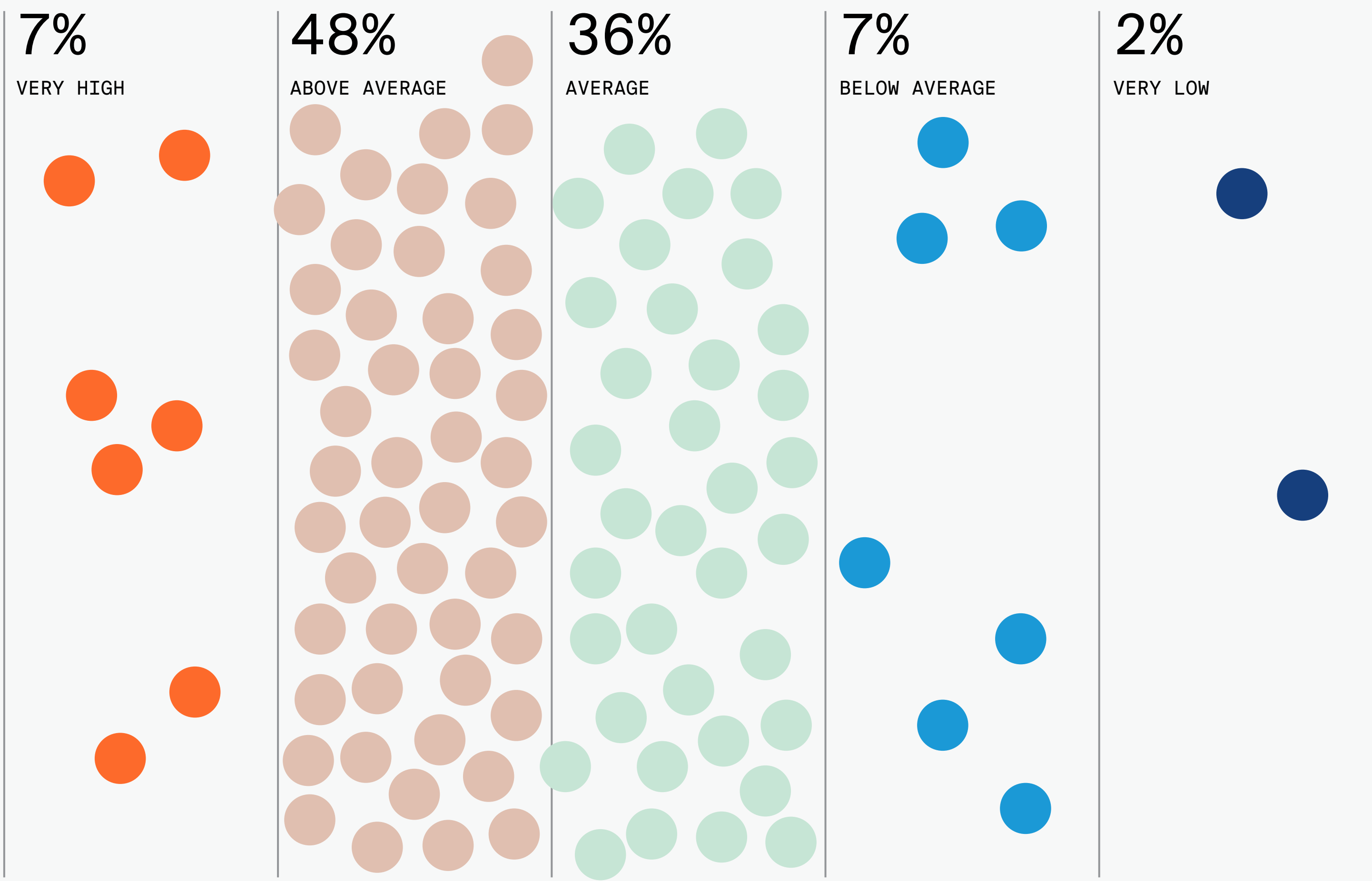
"Valuations have already adjusted down from recent highs to levels that are more in line with historical norms," said Trever Acers.

The outlook for prices in the future is also getting gloomier. Only 5% of respondents predicted valuations will head up, and 54% said prices will fall. Six months ago, optimism reigned, with 35% predicting further increases in valuations and only 23% (correctly as it turned out) expecting a decline.

"There are fewer buyers now and they are being more careful," said Jarmo Kuusivuori, founder and CEO at Wolfcorner in Finland.

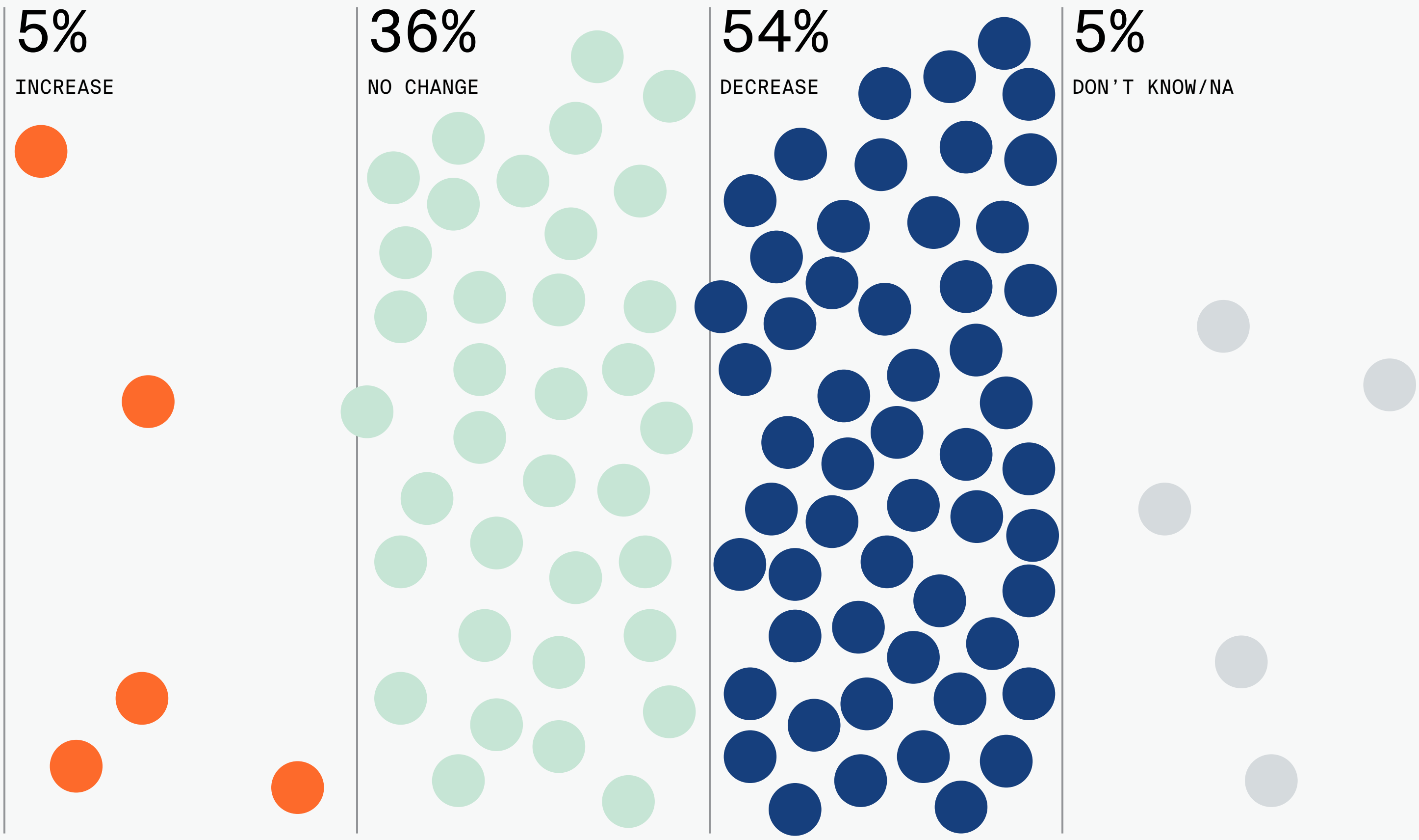
Some advisors, however, said they expect even larger drops in prices, as the economy adjusts to the new reality. **"Valuations will rationalize once capital becomes too expensive,"** said Sven Kins, managing director of Cook M&A Advisory Services in the United States. **"We're not there yet."**

Over the past three months, how would you describe the valuation of companies in deals your firm was involved in?



Valuations *CONTINUED*

Over the next three months, how do you expect company valuations to change for deals your firm is involved in?



Observations

Valuations are decreasing due to the tightening of capital markets and lower investors' risk tolerance. ***—Chandler Kohn, VP of investment banking at Capstone Financial Group, United States***

More transactions will compete for less funds. So it will become a buyers' market. ***—Oscar R. Diaz-Flores, Partner and Director at DIESTRO, Mexico***

Fear of recession is making sellers more sober about their valuations. ***—Nick Nardi, Managing Partner at WTA Technology Mergers & Acquisitions, North America***

Private equity has been driving valuations higher, but higher borrowing costs will limit leverage and valuations. ***—Bryan Ducharme, Managing Partner at Venture 7 Advisors, United States***

When there is increased uncertainty, the deal structure changes, but not always the sale price or valuation. ***—Jim Friesen, Founder of Portage M&A Advisory, Canada***

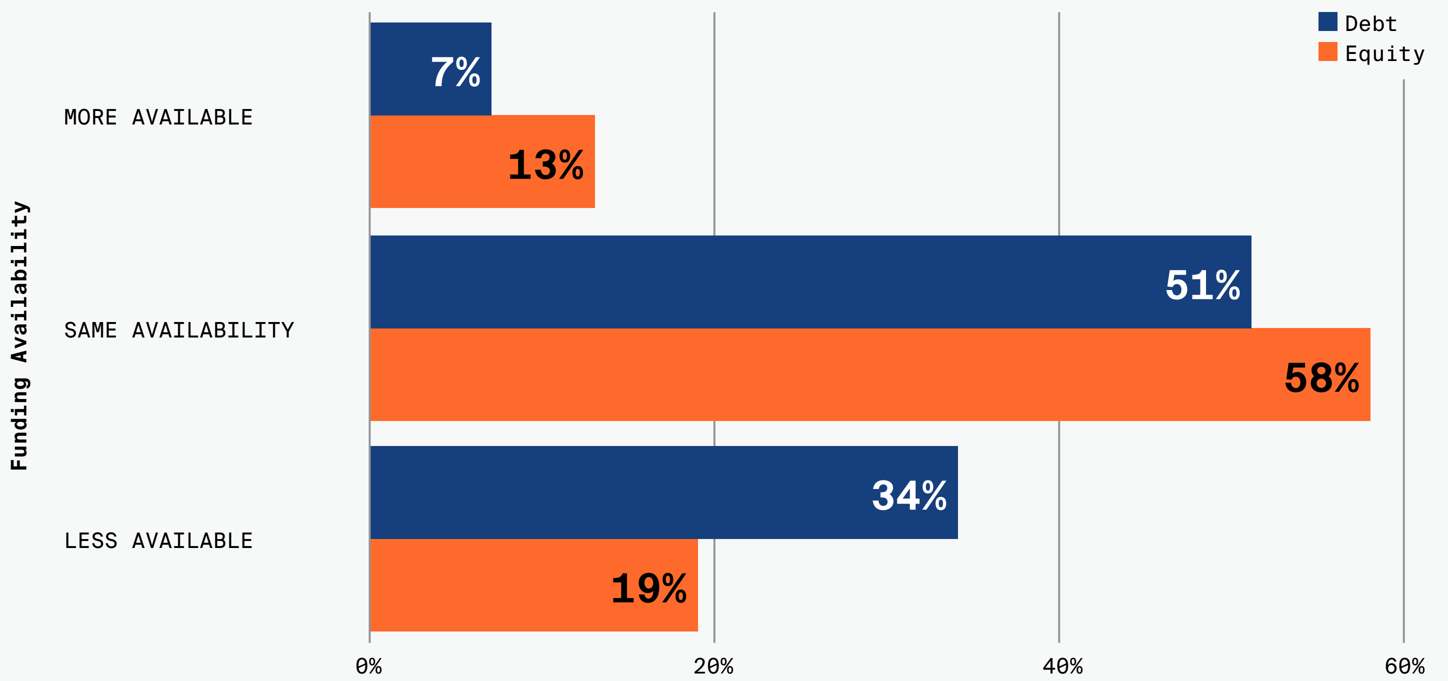
Valuations will probably remain high as long as funding for deals is readily available. There may be some decrease in 6-12 months. ***—Larry Willis, President, The Independence Group, United States***

Financing Availability

It's getting harder to finance deals. One-third of advisers said there is less debt financing available, and one-fifth said there was less equity capital. Debt capital is particularly difficult to find in Europe, where 46% of advisors said there is less available. In North America, only 29% saw cutbacks in debt financing.

The advisors say that they see lenders with more "recessionary caution" becoming increasingly wary of leverage. Moreover, as the head of one advisory firm in the U.S. put it: **"Lenders are pulling back because they see falling public market valuations affecting private company valuations. That means weakened exit possibilities."**

How is the availability of financing changing for companies in your market currently?



Observations

For debt, we're facing higher interest rates and more conservative criteria. For equity, many investors have a 'wait and see' strategy. ***—Tomas Kozubek, Partner, TARPAN Partners, Czech Republic***

Equity markets are tightening up. Strategic buyers are becoming more particular. So are financial investors, even if they have already raised funds. ***—Chandler Kohn, VP of investment banking at Capstone Financial Group, United States***

There are so many opportunities for grade A deals that it is making it difficult to finance deals with risks. ***—Greg Carpenter, Managing Partner at M&A Business Advisors, United States***

We seek our money from a pool of investors who generally see opportunity in volatile markets. ***—Investment banker in Australia***

We are expecting the risk-aversion to increase later this year. ***—Jose Tardeli Filho, CEO of Terra Boa M&A, Brazil***

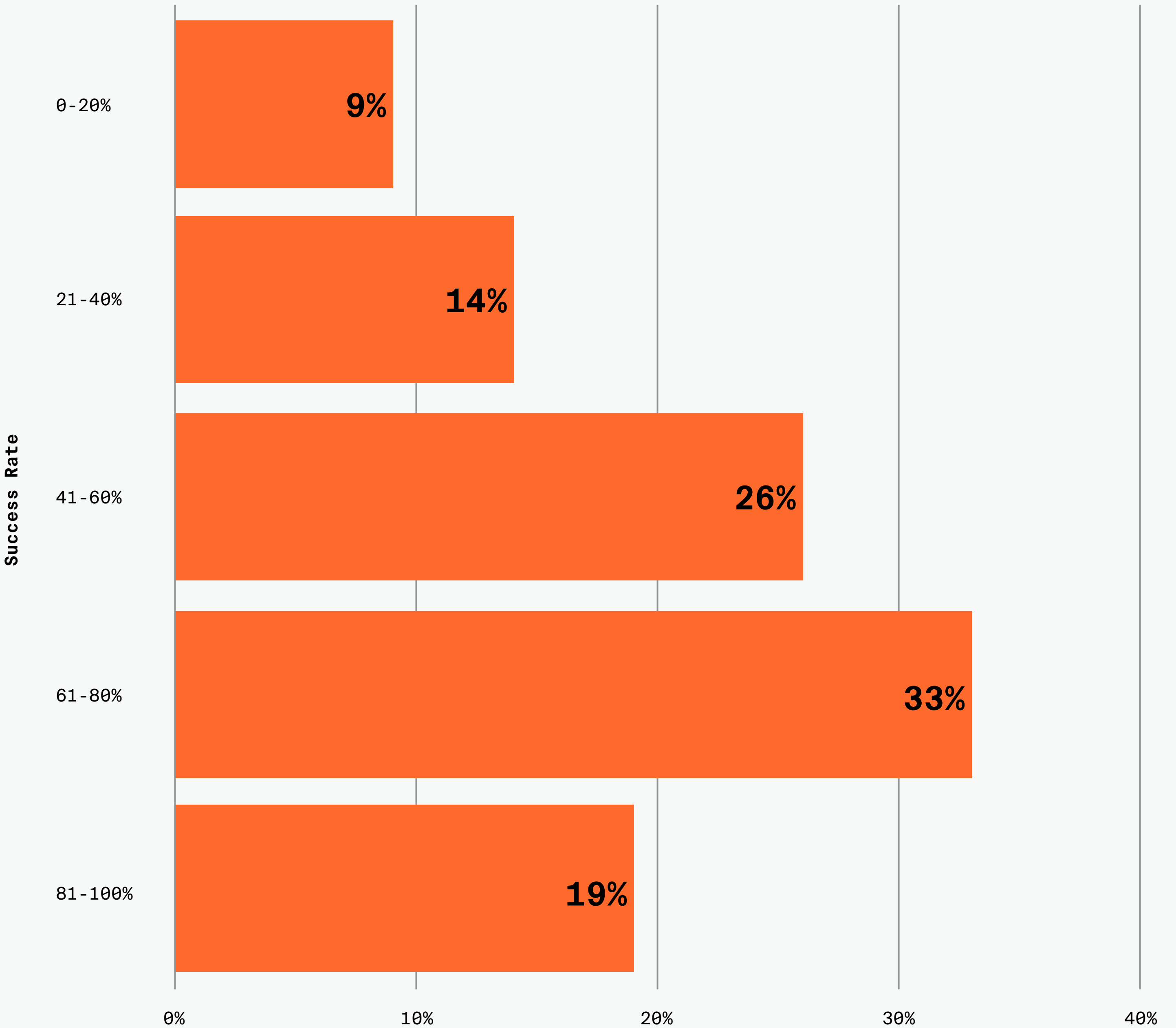
Success Rate and Time to Close

Fewer deals that enter negotiations are closing. In the June survey, 52% of advisors said they completed at least three-fifths of the transactions they started work on. That's down from 68% in January.

That decline in success rate is likely to be a surprise to many in the market. In January, half of the advisors predicted their success rate would increase in 2022. Only one-in-ten predicted the decline.

As for their new predictions, most advisors in June said their success rate will remain unchanged over the next three months. Only 14% said they will close fewer deals, while 21% said their success rate will increase.

As a percentage, what do you estimate your firm's success rate (deals started vs. completed) has been over the last quarter?



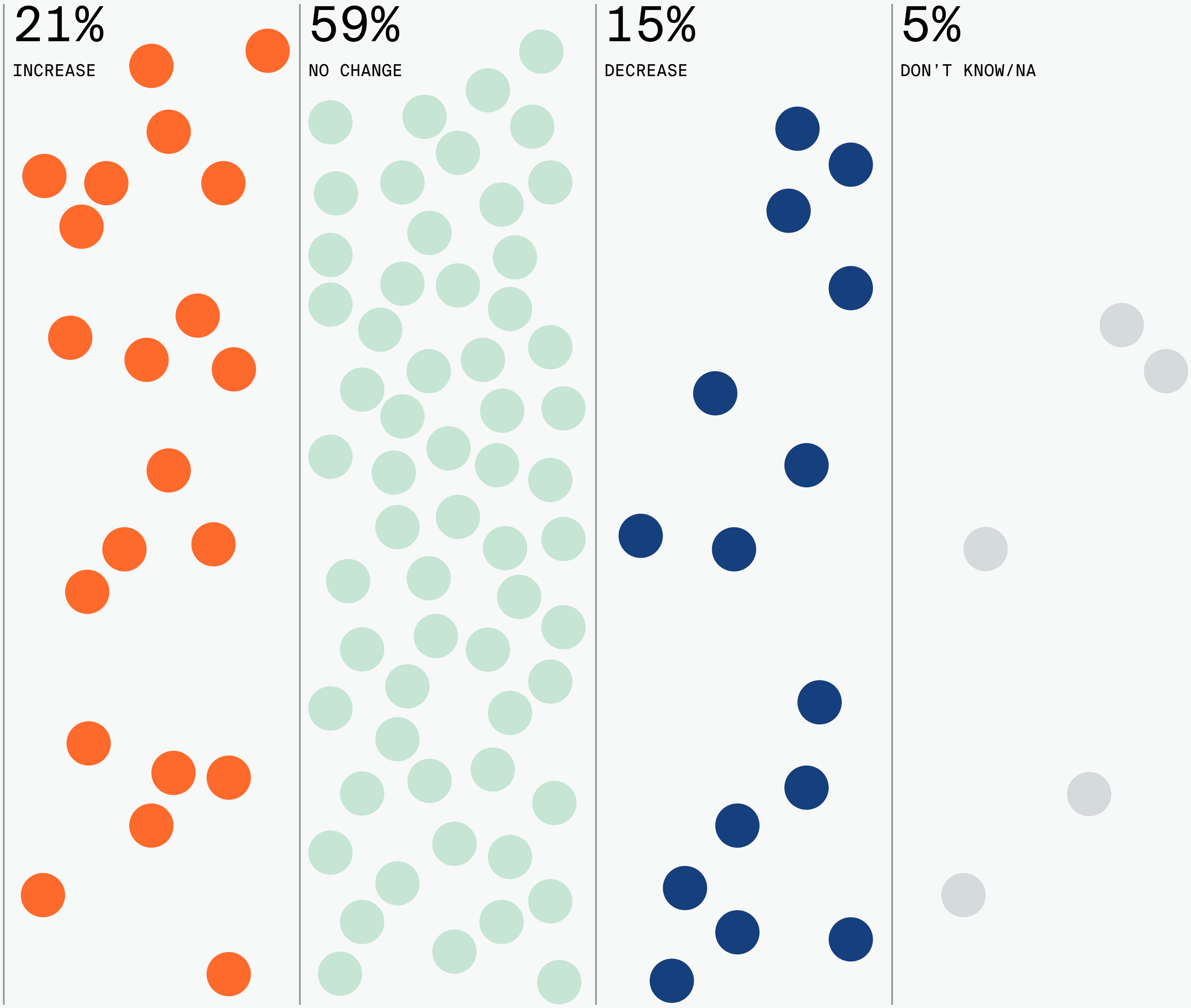
Success Rate and Time to Close *CONTINUED*

Worsening economic conditions may actually accelerate deal making, at least for a while, suggests Kevin O'Donnell, founder and managing partner at Liquidity Capital in the United States. **"Enterprise owners have a sense of urgency to beat the economic downturn and their lower profitability,"** he said.

Advisors are working longer on the deals that are completed. More than half said the time it takes to close a deal is increasing. Only 4% said they are getting deals done faster than in the past.

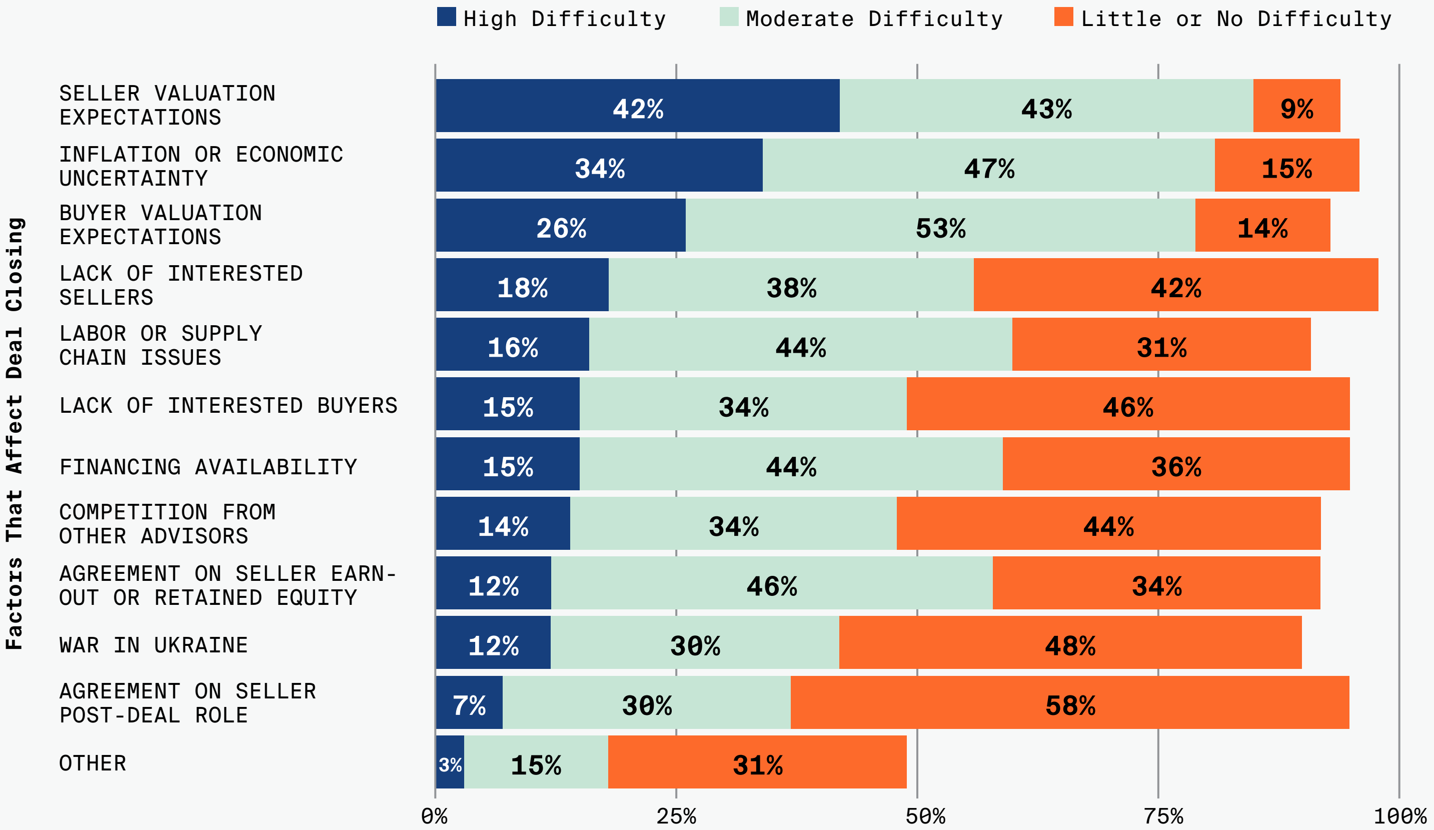
When asked about factors that make it harder to close deals, "seller valuation expectations" topped the list, followed by "inflation or economic uncertainty" and "buyer valuation expectations." The least problematic of the options offered was "agreement on seller post-deal role."

How do you anticipate your firm's success rate to change over the next three months?



Success Rate and Time to Close *CONTINUED*

How much do the following factors increase the difficulty of closing deals in the current market?



Observations

Buyers are distracted. They have too many other transactions under LOI to focus on our deals, so our deals are being delayed. ***—Vicki Fox, Founder and Managing Director of EisenFox Mergers & Acquisitions, United States***

Business owners have stepped back on any intentions to sell their company right now. ***—Mark Smock, CEO of Business Buyer Directory, United States***

Acquirers significantly reducing acquisition interest due to economic change. ***—Trever Acers, Managing Director at Objective Capital Partners, United States***

The tightening of financial markets is resulting in greater scrutiny on financing transactions. ***—Christopher Picone, President of Picone Advisory Group, United States***

The sellers' price expectations are still too high. ***—Colin Marson, Managing Partner of Lisergy Consulting, United Kingdom***

Buyers need to be willing to deal with market uncertainties in order to complete a transaction. ***—Steve Gaudreau, Manager of Financial Advisory Service at Mazars, Canada***

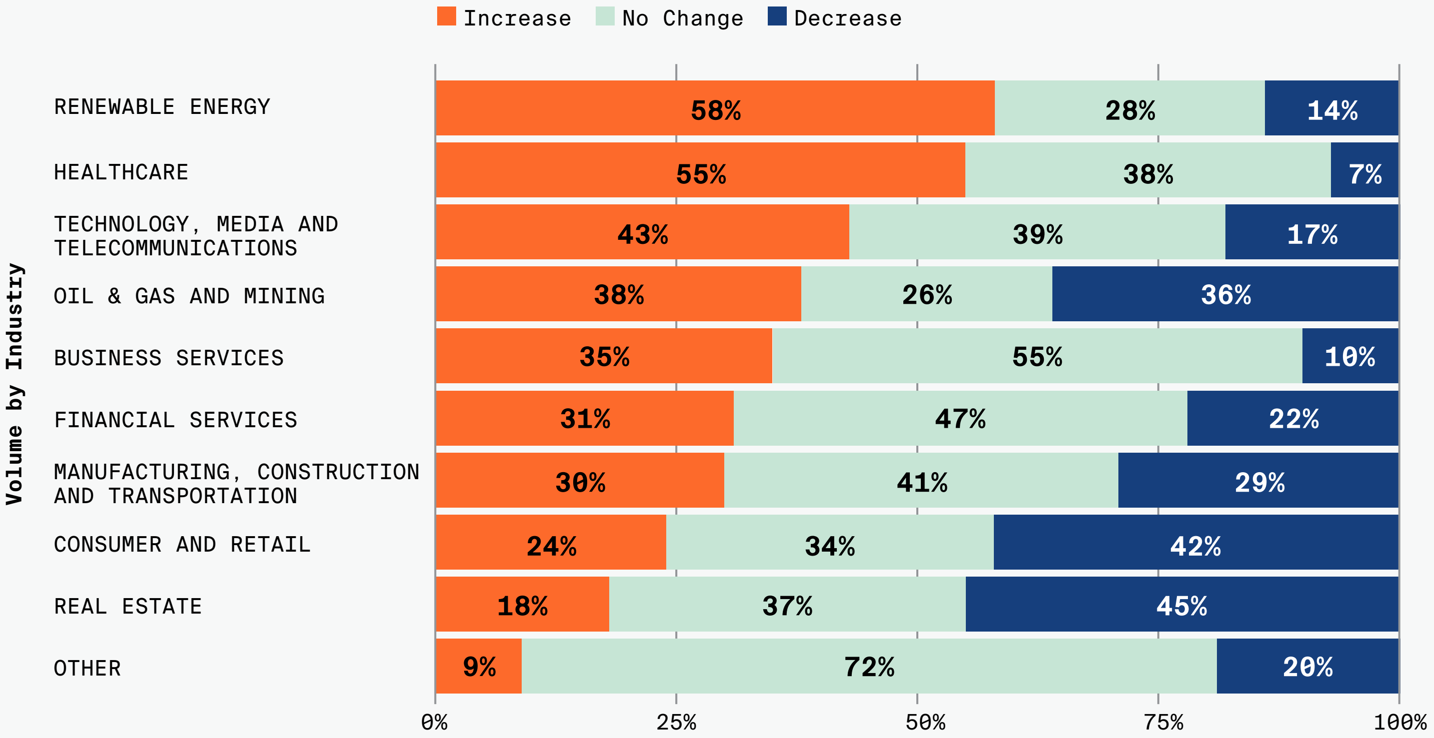
Volume by Sector

With oil prices surging, it's probably no surprise that "renewable energy" is the industry sector seeing the greatest increase in deal volume. As for conventional "oil, gas and mining" companies, about as many advisors say volume is increasing as decreasing.

"Higher oil prices make renewables more attractive and more needed," said Joeri Engelfriet, managing partner at Del Canho & Engelfriet, in the Netherlands. **"This may drive an increase in activity."**

Other sectors seen as growing include "healthcare" and "technology, media, and telecommunications." The sectors seen as declining most frequently were "real estate" and "consumer and retail."

How do you see deal volume changing in these sectors over the next three months?



Observations

Deep tech funding for technology scale-ups from private sector institutions is almost non-existent in the European Union. ***—Chandler Kohn, VP of investment banking at Capstone Financial Group, United States***

I see increased demand in renewables and pressure towards reducing carbon emissions. ***—Vuyo Klaas, Manager of Project Management Unit, Central Energy Fund, South Africa***

Buyers in the tech space are becoming more hyperfocused on quality assets, which seem to remain relatively immune to declining valuations in the broader market. ***—Investment Banker, United. States***

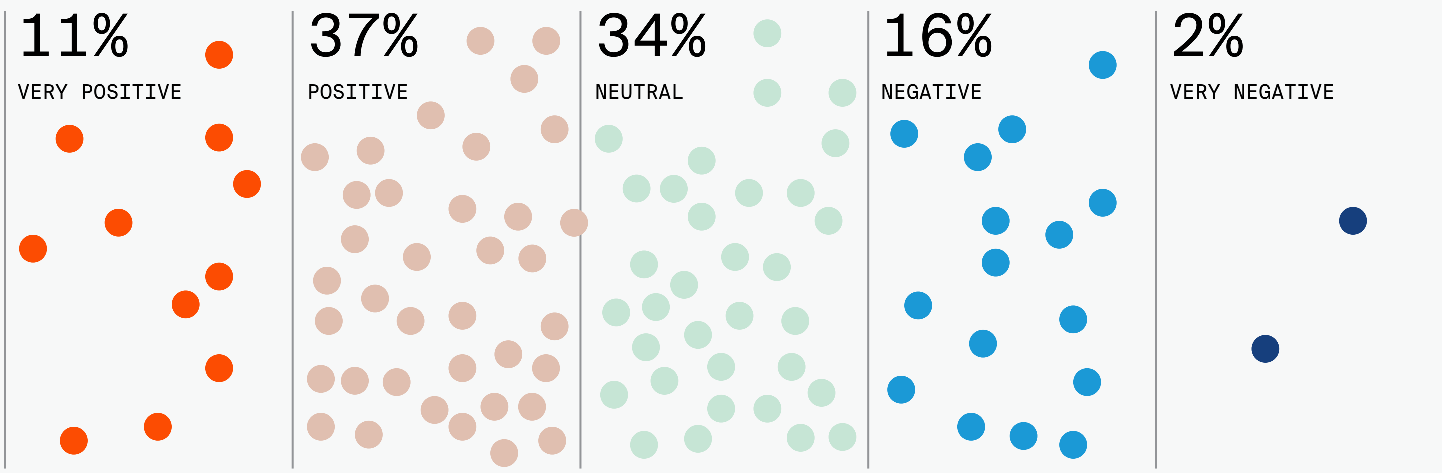
Overall Mood

Middle-market merger advisors are still upbeat about the M&A market, but they are less optimistic than they've been in the last two years. When asked to summarize their feelings about the M&A market for the next three months, 48% of advisors said they were positive and 18% said they were feeling negative.

We've asked the same question regularly since starting this survey in April 2021. Advisors were most upbeat in October 2021, when 79% said they had positive feelings, and nobody said they were feeling negative.

In the June survey, the view was somewhat grimmer in Europe, where only 41% of advisors were feeling positive and 25% were feeling negative.

As a whole, how are you feeling about the M&A market over the next three months?



Observations

I think we are trending towards increasing negative pressure on the market in general. Increasing interest rates will eventually have a negative impact. General increasing negative market news will have a negative impact on low-end deals. Strong companies will continue to trade for the near future. ***—Terry Altman, Broker at Florida Business Exchange, United States***

It's going to turn into a buyers' market, and the transition will be ugly. ***—Michael Vann, President of The Vann Group, United States***

More companies will be offered for sale, but there are fewer buyers willing to acquire them. ***—Oscar R. Diaz-Flores, Partner and Director at DIESTRO, Mexico***

The market will remain buoyant, but for different reasons than in the past three years. Before, deals were driven by excess cash in the market. The next three years will be driven by the fear and uncertainty of the markets. ***—Nick Nardi, Managing Partner at WTA Technology Mergers & Acquisitions, North America***

Many owners are wanting to exit due to uncertainty. I think the window for being able to sell their businesses is shortening because of the uncertainty. That said, many owners I have spoken with want to hold out and grow their companies for a higher value, but I wonder if they may have to wait longer than they would like if we enter into a recession.
—Betty Schnaufer, Broker at Murphy Business & Financial, United States

Conclusions

In the summer of 2022, it's clear that the M&A market has reached a crossroads and is slowing a bit, as participants take stock of which path the future will take. Some fear the road will be much rougher from here. High cost of capital and an economic slowdown will erode the liquidity of buyers, while making sellers less attractive.

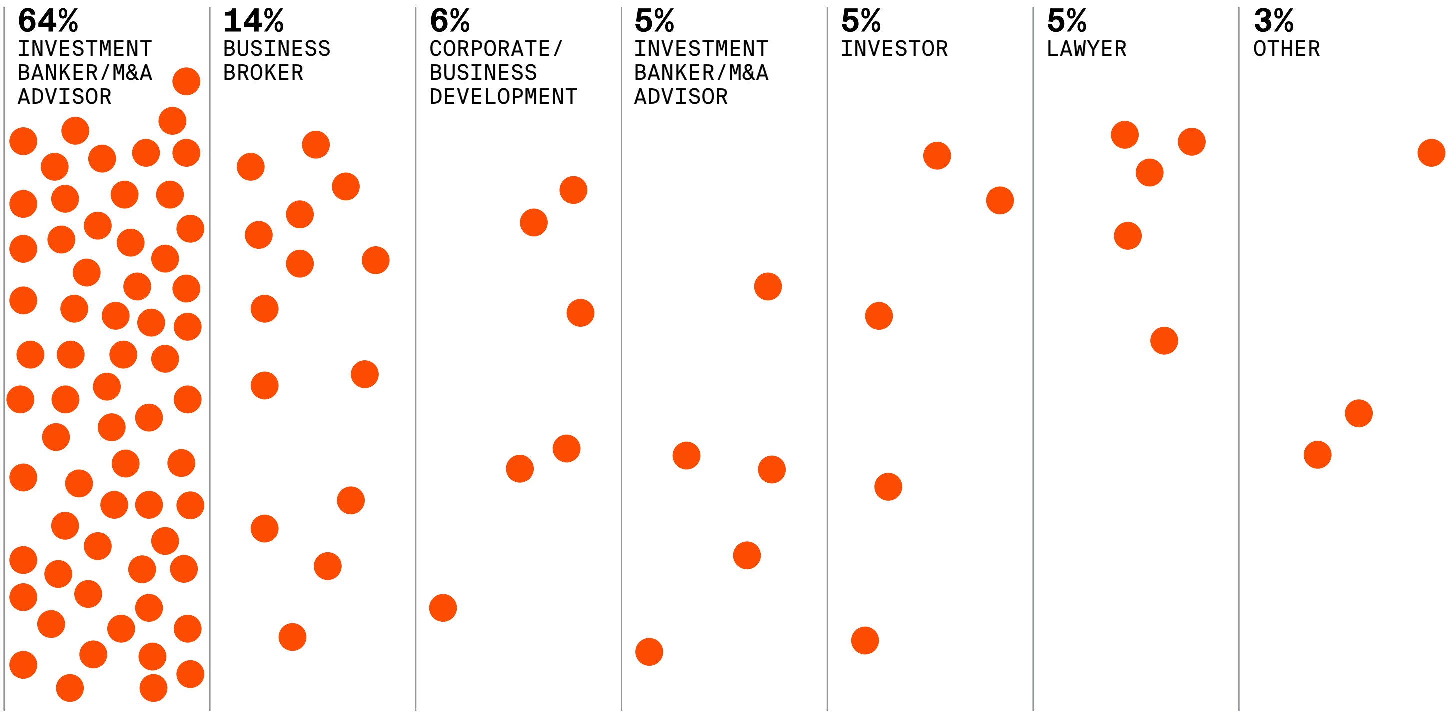
"A fundamental market reset is underway," said one investment banker in the United States. **"Much more to come."**

To others, the current economy is little more than a speedbump that will do little to slow the massive wave of consolidation of recent years. A generation of entrepreneurs, after all, is still reaching retirement. And an enormous pool of private equity capital has already been raised to buy their businesses.

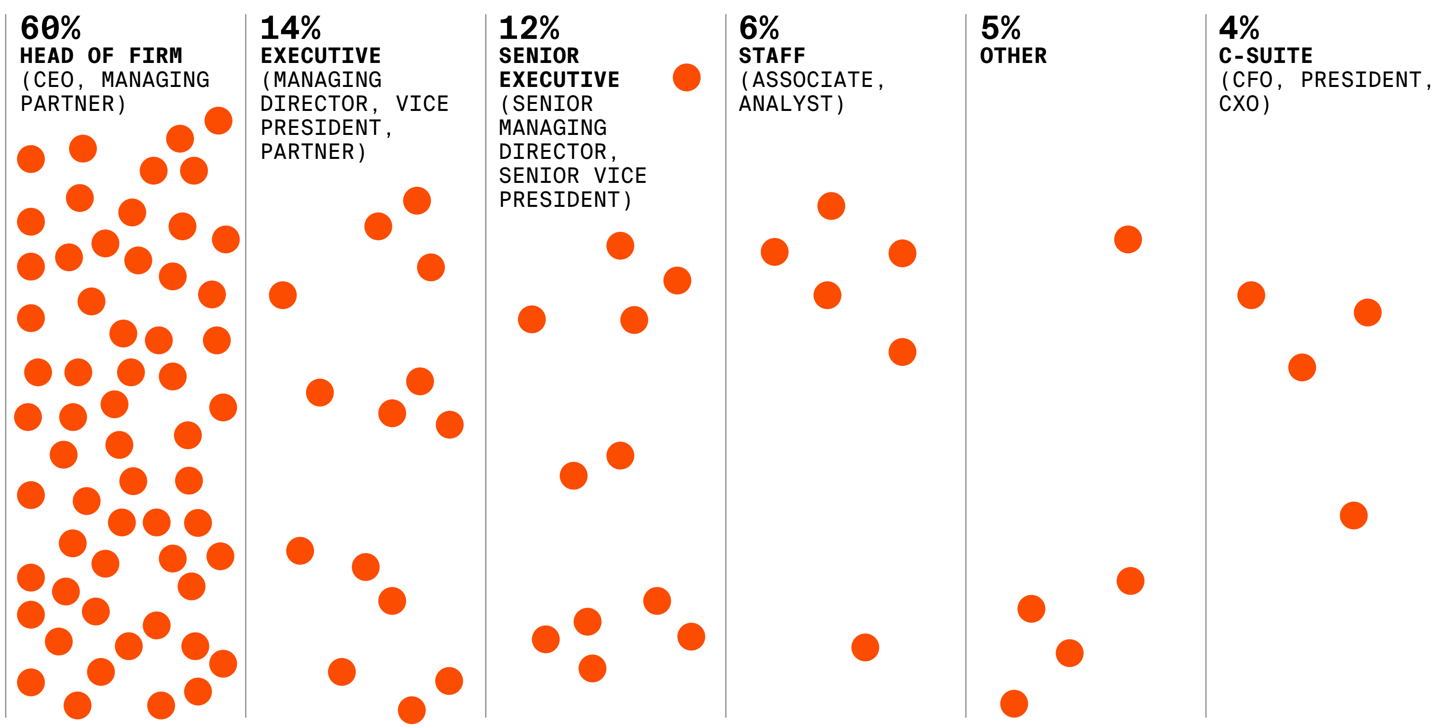
As Larry Willis, president of The Independence Group in the United States put it, **"In spite of inflation, stock market and recession discussion, the market liquidity will continue to drive deal volume in a positive way."**

Appendix: Respondent Demographics

Which of the following best describes your current occupation?

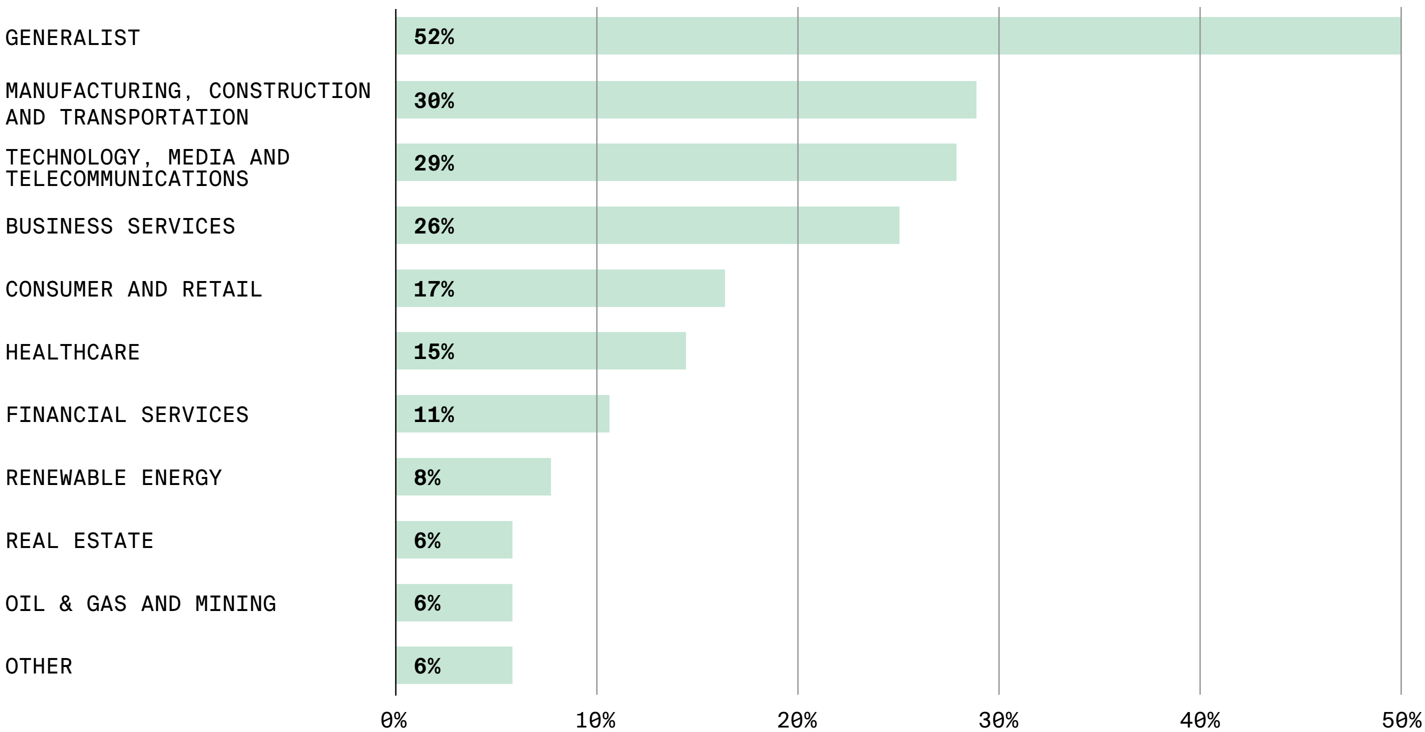


Which of the following best describes your job title?

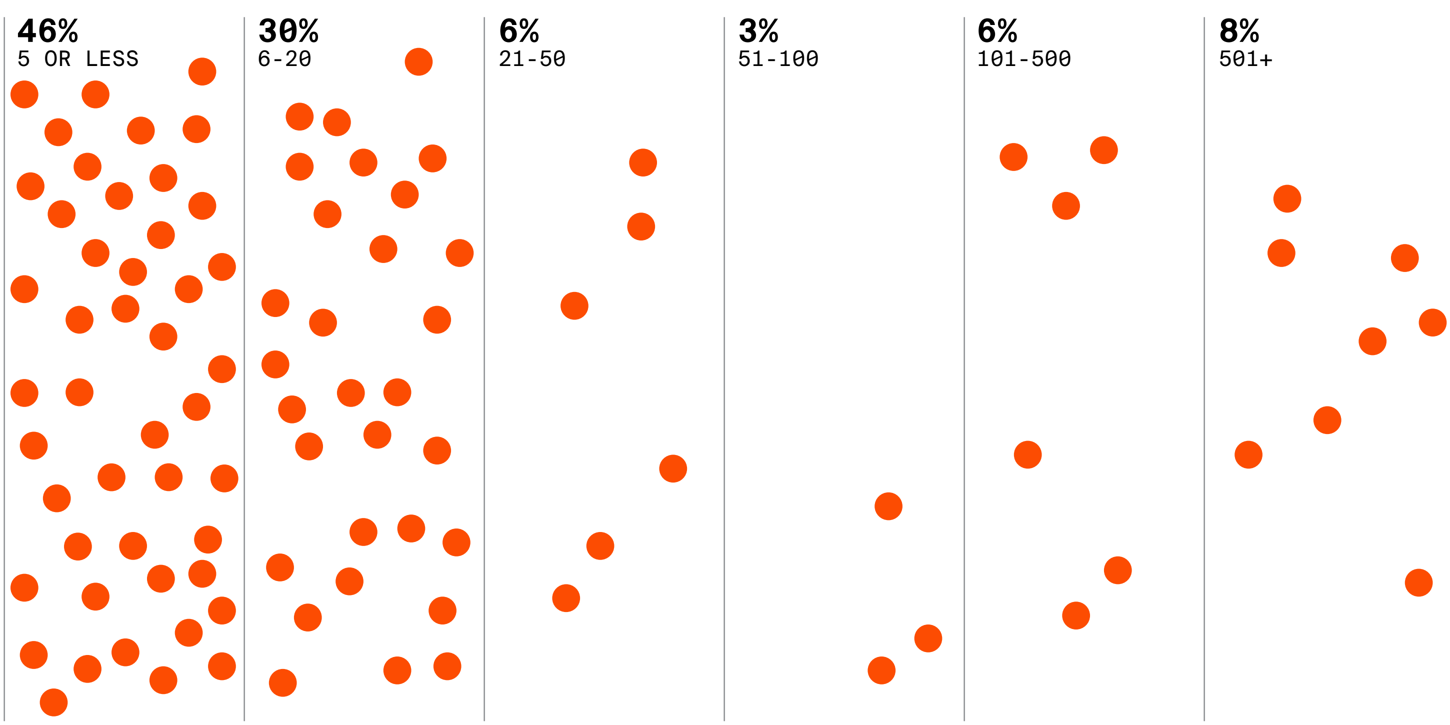


Appendix: Respondent Demographics *CONTINUED*

Do you specialize in any of the following industries? (Select all that apply.)

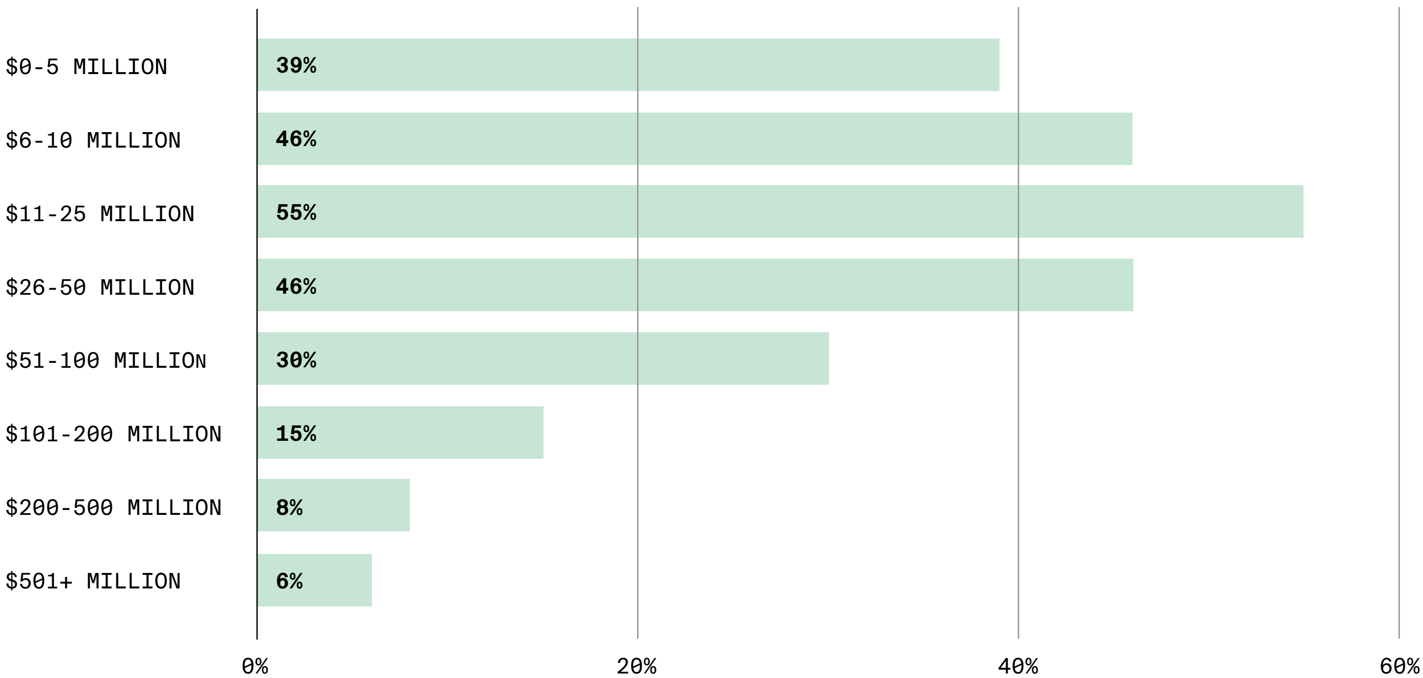


How many total employees does your firm have?

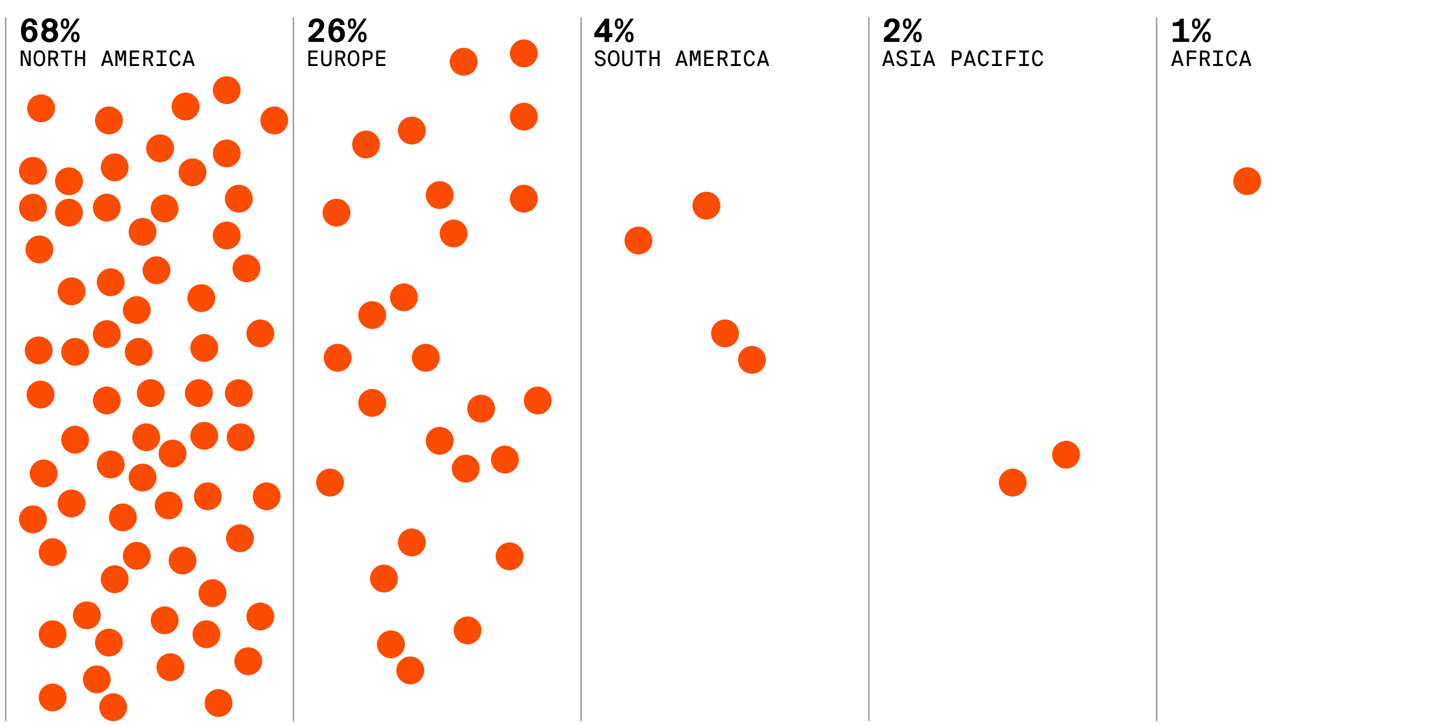


Appendix: Respondent Demographics *CONTINUED*

What size deals is your firm typically involved in? (Select all that apply.)

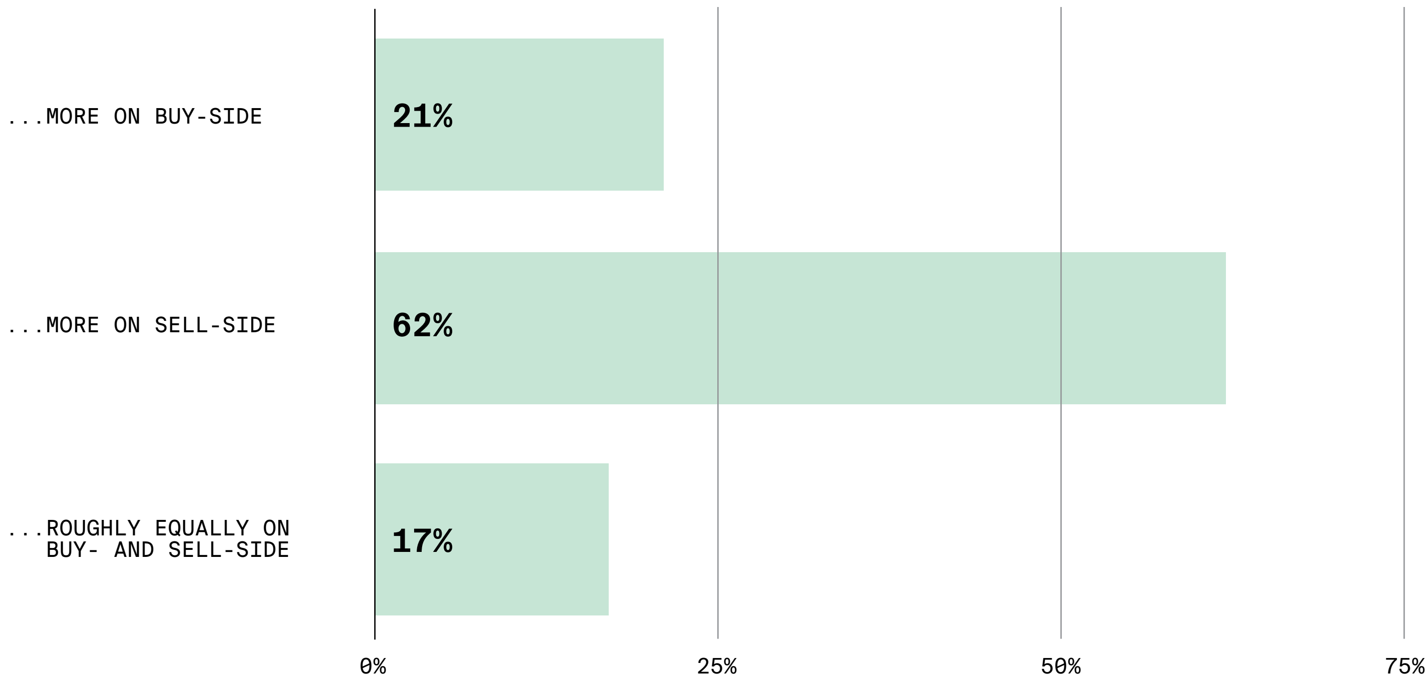


What region do you primarily work in?

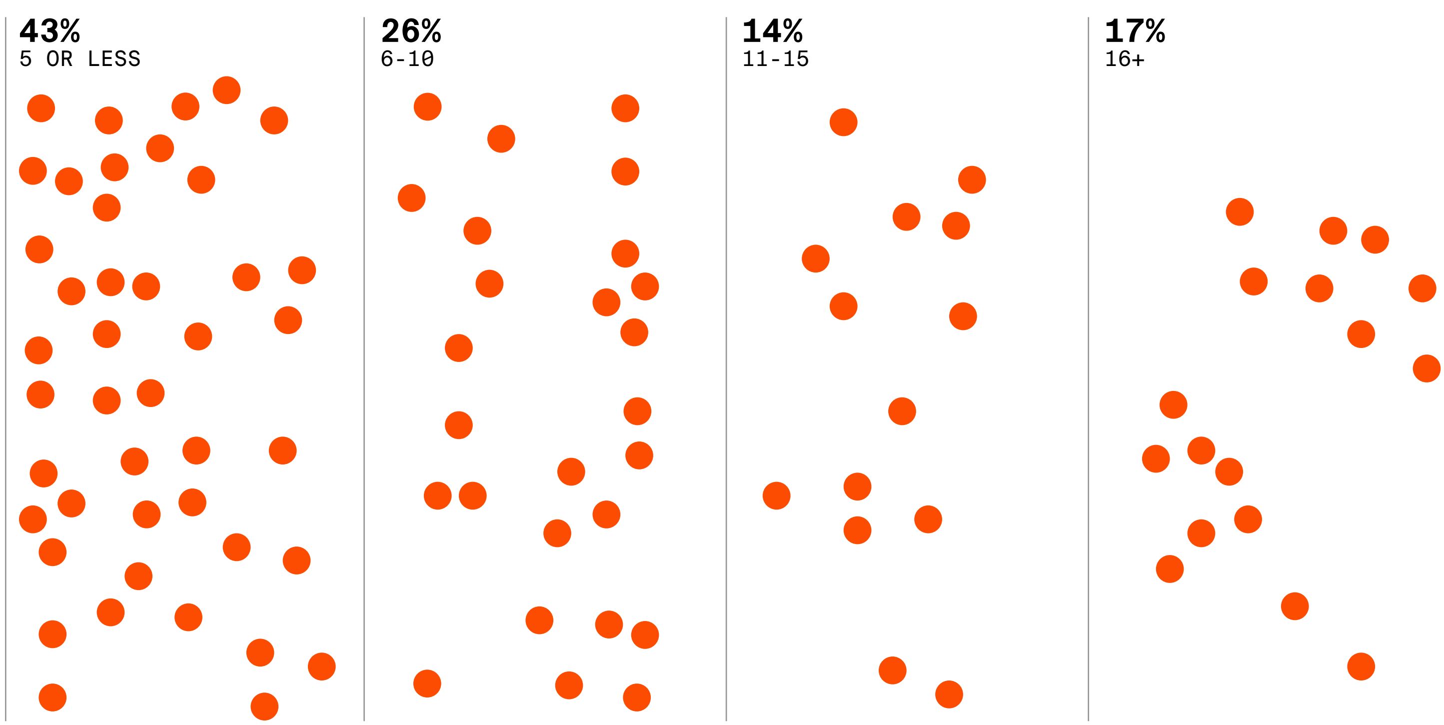


Appendix: Respondent Demographics *CONTINUED*

Are your clients...?



How many M&A engagements did your firm work on in the most recent year?



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