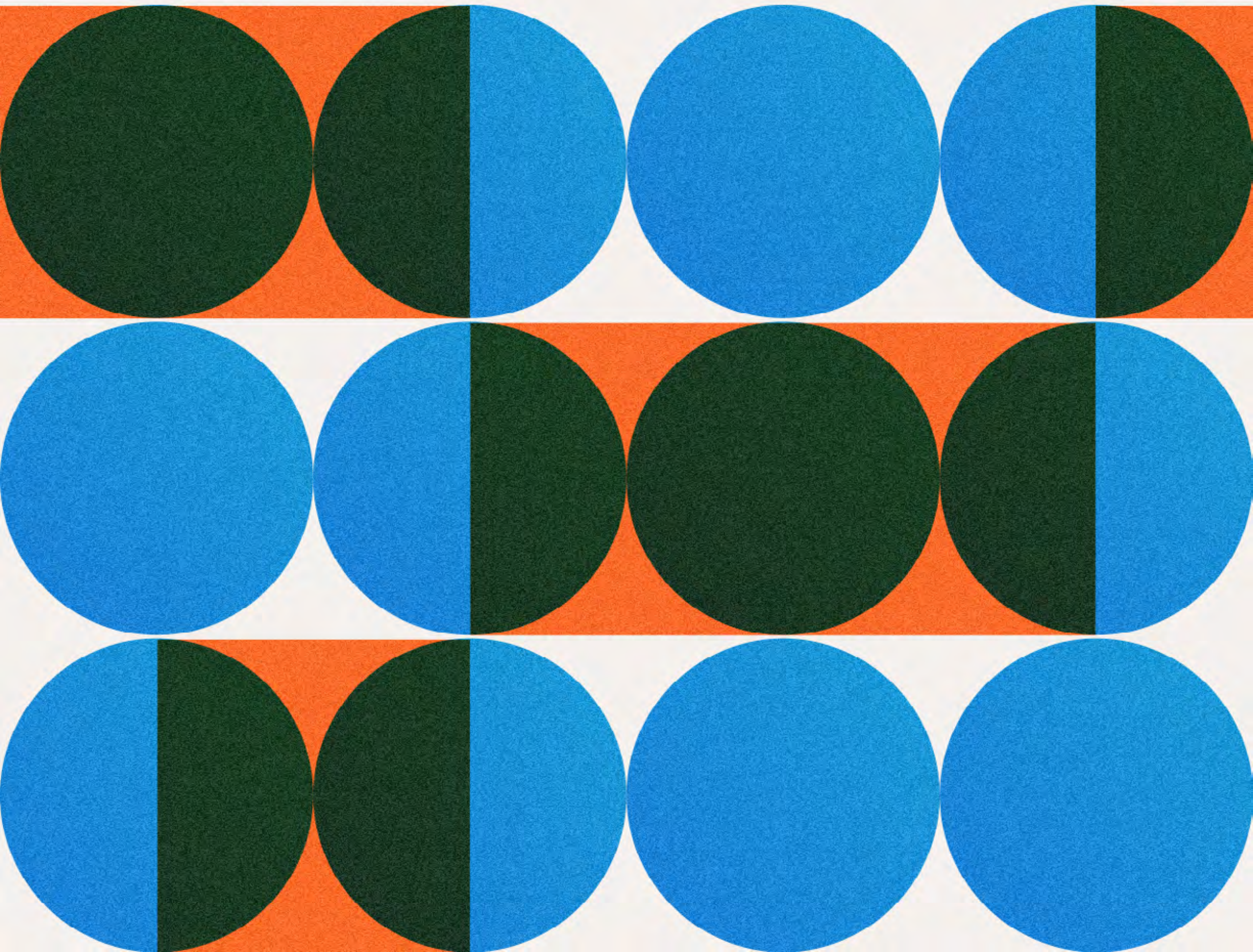
FIRMEX

Deal Flow Bulletin

Q1 2023



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Bulletin Highlights

- **Firmex projects that North American deal announcements in the first quarter of 2023 will be 17% higher than in the final quarter of 2022.** This year's forecast uses a new multi-factor, machine-learning-based model.
- **Deals in Europe will rise by 2%** from the fourth quarter, according to the new model.
- Looking back at 2022, **middle-market merger advisors said they had a good year** but not quite as good as in 2021. Four in ten of them said their volume last year was better than average, while only three in ten said it was below average.
- Looking forward, **58% of advisors expect volume to increase in 2023,** with only 17% saying it will fall.
- Overall, advisor sentiments are favorable. **Just over half of the advisors (53%) describe their feeling about the market as positive.** Only 13% expressed negative feelings.
- **For 2023, twice as many advisors say valuations will fall (43%) as say they will rise (21%).**
- **Healthcare deals will increase in 2023,** according to 60% of advisors active in the sector. Last year, only 23% expected more healthcare activity.
- Three out of five advisors said the **number of sellers in the market would increase in 2023.** A year ago, only a quarter of advisors said more companies would put themselves on the block.
- **Merger advisors completed 63% of the deals they started working on in 2022,** up slightly from 61% in 2021. Most say their success rate will increase in 2023.
- Half of the advisors said that **access to financing would be a significant challenge** as they try to close deals this year, a sharp rise from last year.

Introduction

Firmex began surveying M&A practitioners in 2021 to find out where, how, and why deals were flowing each quarter. Since then, no two quarters have been alike, and the data each time has revealed useful, and sometimes surprising, information on the status of middle market M&A. Alongside survey data and advisor commentary, Firmex has offered a prediction on deal volume generated by proprietary information on the number of data rooms opened on the Firmex platform. This prediction proved to be a reliable indicator of deal flow and matched what advisors were noticing in their practice. We are pleased that the Firmex Deal Flow Bulletins have now become anticipated and valued reports by the M&A community, and that we have advisors who routinely volunteer to fill out our surveys, helping to populate an accurate and credible view of the deal landscape over time.

Here we are one month into 2023, again encountering a unique market, influenced by complex factors and unknowns. This quarter, we are excited to implement a new deal flow prediction model that reflects this complexity. We've utilized machine-learning, expanding the model to include a total of 19 indicators that our research has shown to be correlated with deal creation. The enhanced model represents our continued interest in and commitment to conducting sophisticated and relevant research and reporting for the middle market advisory community. And this quarter, we're happy to report that overall that community is feeling positive, expecting good things for dealmaking in 2023.

—Mark Wright, General Manager at Firmex

Overview

It's back to business time for the people who advise mid-sized companies on mergers and acquisitions.

A majority of them say they are feeling positive about the market heading into 2023. And nearly six out of ten say they expect to handle more deals this year than they did in 2022.

The data confirms their optimism. Firmex has developed a new artificial intelligence-based model to forecast future deal flow based on the creation and use of virtual deal rooms, combined with other macroeconomic data. The result: M&A deal announcements will increase by 17% in the first quarter of 2023, compared to the last quarter of 2022.

Bulge bracket firms, meanwhile, are preparing for lean times. Global merger volume fell by 36% in 2022, according to Refinativ. And giant banks, including Goldman Sachs, Morgan Stanley, Credit Suisse, and Bank of New York Mellon, have announced more than 15,000 job cuts.

It's not that smaller companies are immune from forces rattling the bulge bracket. In our quarterly surveys of merger advisors in 2022, they told us it was taking longer to close deals. Buyers and sellers were pausing to understand the implications of inflation, rising interest rates, and the war in Ukraine.

The pause is over, and the market has adjusted to the new reality. Interest rates will continue to rise, advisors say, and that will lower the prices buyers can pay. All the forces behind the surge in M&A activity in recent years are again driving deals, albeit using the new valuation formula. Aging baby boomers still want to sell the companies they started. Private equity firms still have a lot of dry powder to invest. And the economies of scale still apply.

"Lower middle market M&A is not dramatically impacted by external market conditions," said John Slater, a managing director and advanced manufacturing team leader with FOCUS Investment Banking in Memphis. "More impact comes from factors personal to sellers and their businesses."

Observations

The year started with plenty of buyers, but rising interest rates slowed the volume and reduced the quality of the buyers.

—Charles Morningstar, Business Broker, United States

We are currently seeing a decrease in the volume of buyers coming to the table. I would expect this is a result of increasing interest rates, resulting in buyers' higher sensitivity to risk. Banks are also deploying risk reduction strategies, such as standby notes. All of this gets interpreted by sellers as 'maybe this is not the right time to sell!' Conversely, buyers think this is a time for 'cash preservation.' All these factors create greater disparity in value perceptions amongst sellers, buyers, and financing sources.

—Charles Morningstar, Business Broker, United States

A lot of companies will come for sale, but their valuation expectations are on too high a level.

—Jarmo Kuusivuori, Investment Banker/ M&A Advisor, Finland

There has been a decline in willing buyers due to uncertainties caused by energy prices, inflation, and rising interest rates. Valuation gaps decrease the prospects of successful transactions.

—Gregor Pajek, Lawyer, Slovenia

Volatility from COVID remains. The PPP boost artificially propped up many who would have been sellers, delaying their exits. Many are now running on fumes and will be exiting at decreased multiples.

—Dino Lucarelli, Investment Banker/ M&A Advisor, United States

About the Deal Projections

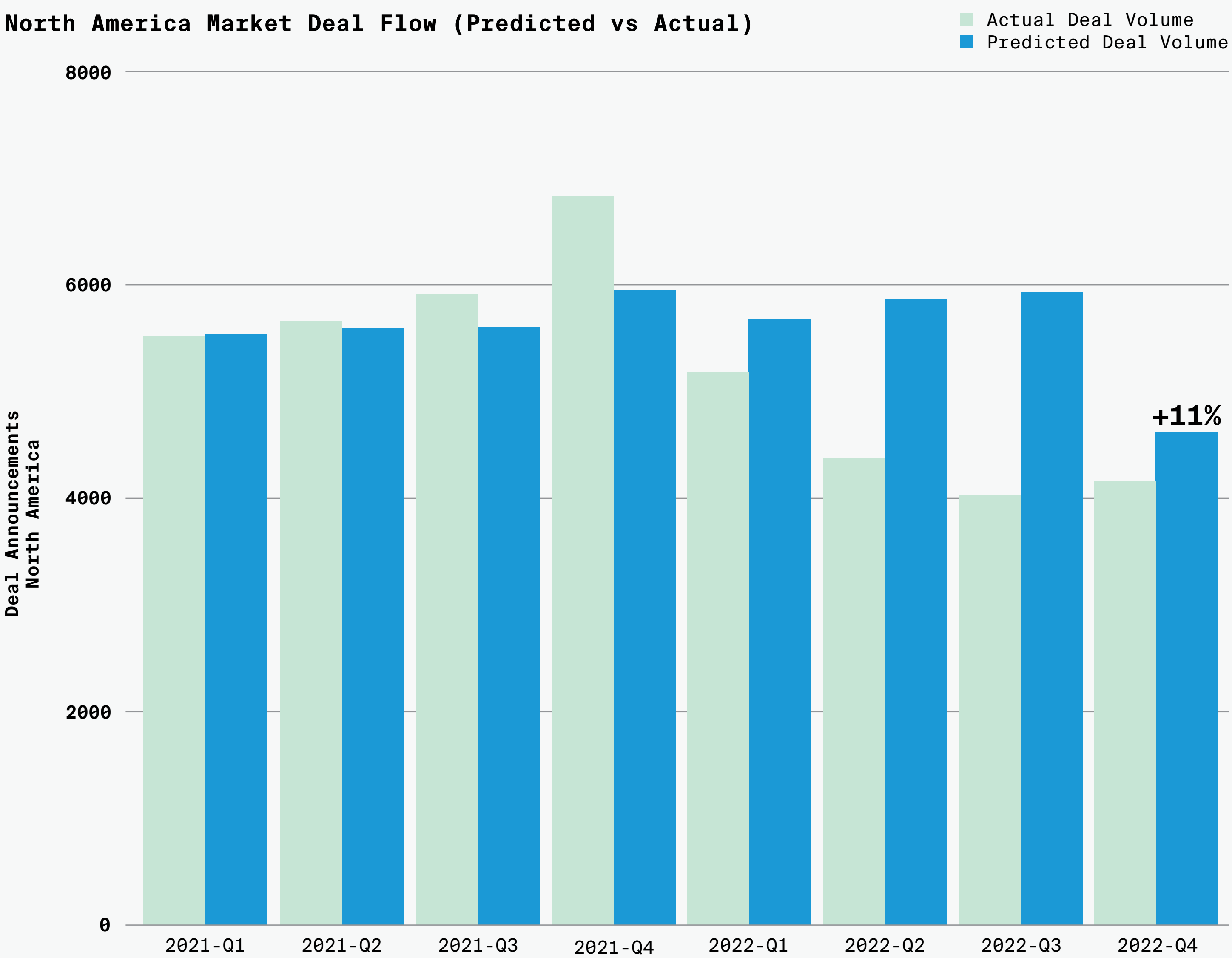
With this edition of the Deal Flow Bulletin, we introduce a revised version of the model we use to forecast future deal volume. As before, the model is based on activity on the Firmex Platform, one of the most widely used virtual data room providers. Each year, more than 20,000 rooms are created on Firmex 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.

The new model incorporates measures of the activity in a deal room, such as the frequency of logins and the number of documents uploaded. This helps identify which deals are likely to be completed. The model also uses results from the quarterly Deal Flow Bulletin survey of merger advisors and several indicators of economic activity and market sentiment.

This approach should be better able to predict volume in periods when a lot of companies start merger negotiations but don't complete them. The previous model relied largely on the number of deal rooms that were opened.

Our count of actual deals is provided by S&P Capital IQ.

North America Market Deal Flow (Predicted vs Actual)



About the Survey

The insights about market dynamics are drawn from an online survey conducted between late December 2022 and mid-January 2023. The 115 respondents were 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 "Technology, Media, and Telecommunications" followed by "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 25% of respondents.
- Three-quarters of them work in firms with 20 or fewer employees. Their firms typically complete fewer than ten deals a year.
- Advisors at firms with more than 100 people made up 24% of respondents. And 29% regularly handle deals valued at $100 million and up.

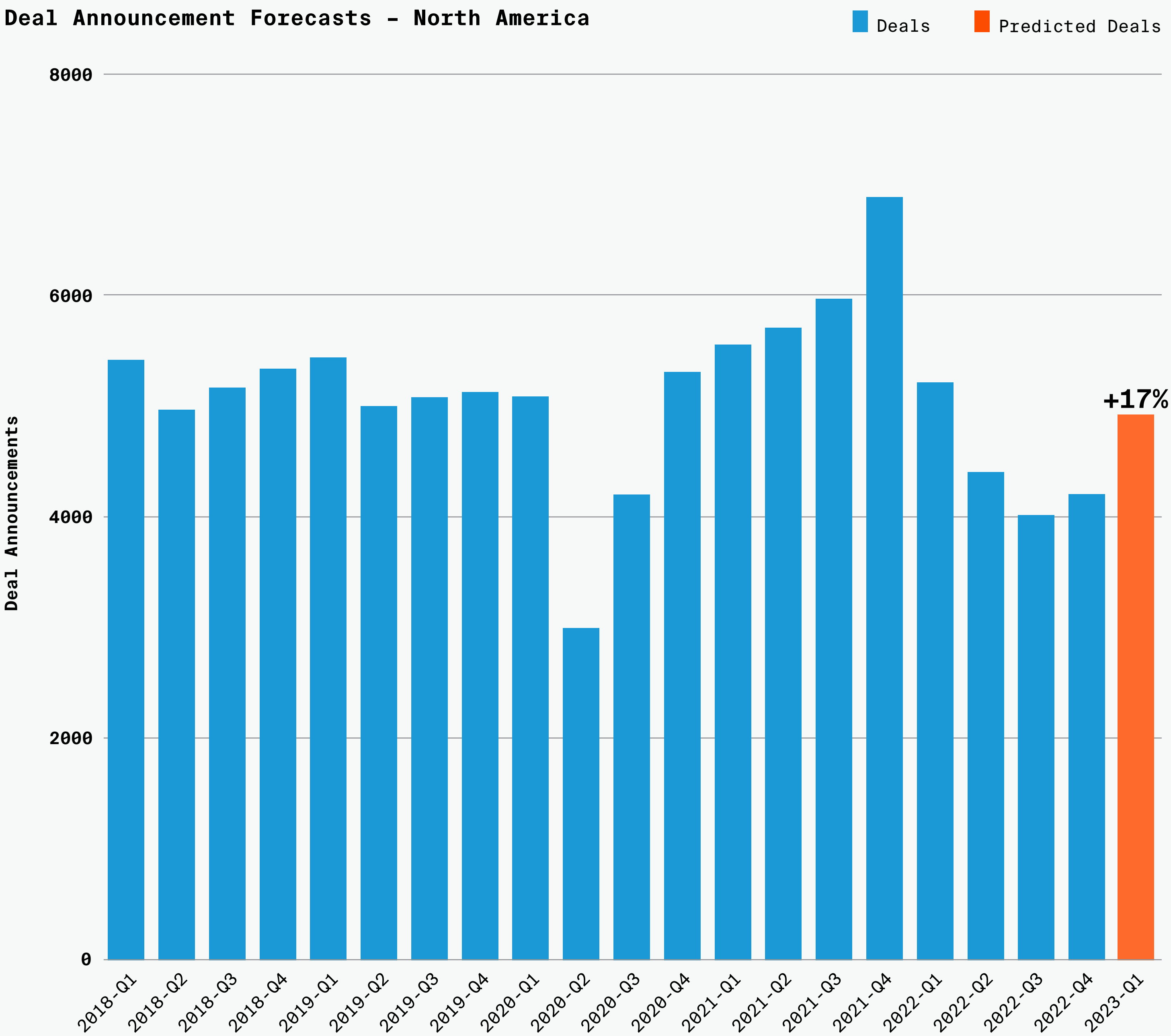
See the appendix for detailed information on respondents.

The Firmex Deal Flow Forecast: North America

Deal volume in the United States is starting to pick up.

Firmex projects that deal announcements in the first quarter of 2023 will be 17% higher than in the final quarter of 2022. That still will put the announcement level 11% below the first quarter of 2022.

For all of last year, deal volume fell by 25% from the very busy 2021. Indeed, the number of deals was 2% lower in 2022 than in 2020, when the pandemic froze nearly all activity in the spring.



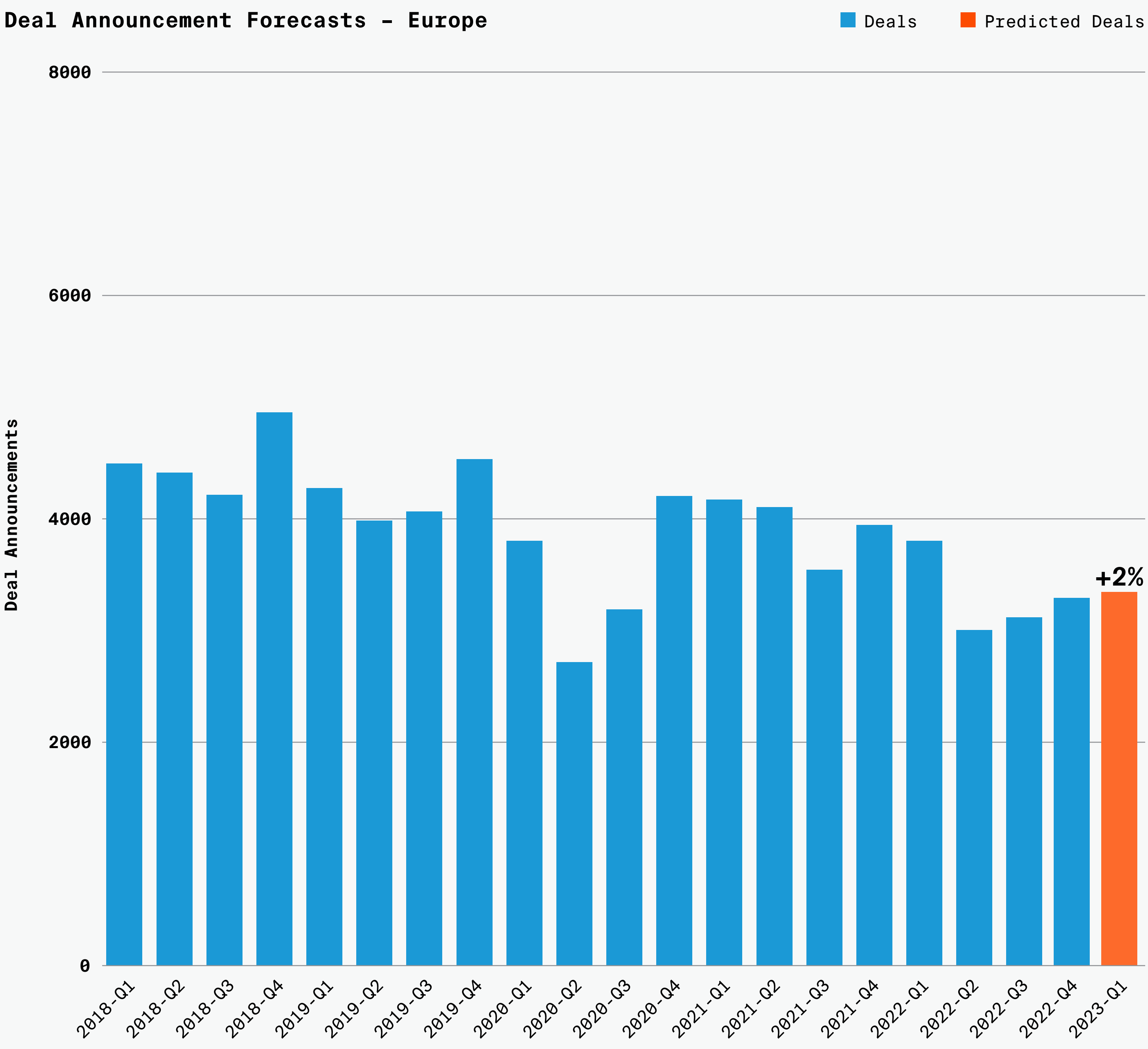
Source: S&P Capital IQ (2018 - 2023 Q1), Firmex analysis Q1 2023

The Firmex Deal Flow Forecast: Europe

The volume in Europe over the past few years has been less volatile than in the United States, and that trend continues with the Firmex forecast for the first quarter of 2023.

Deal volume will be 2% higher in the first quarter of this year than it was in the last quarter of 2022. That also represents a 14% drop from the first quarter of last year.

For all of 2022, volume was 13% lower than in 2021.



Source: S&P Capital IQ (2018 - 2023 Q1), Firmex analysis Q1 2023

Deal Volume in 2022

The advisors had a better year than the overall market.

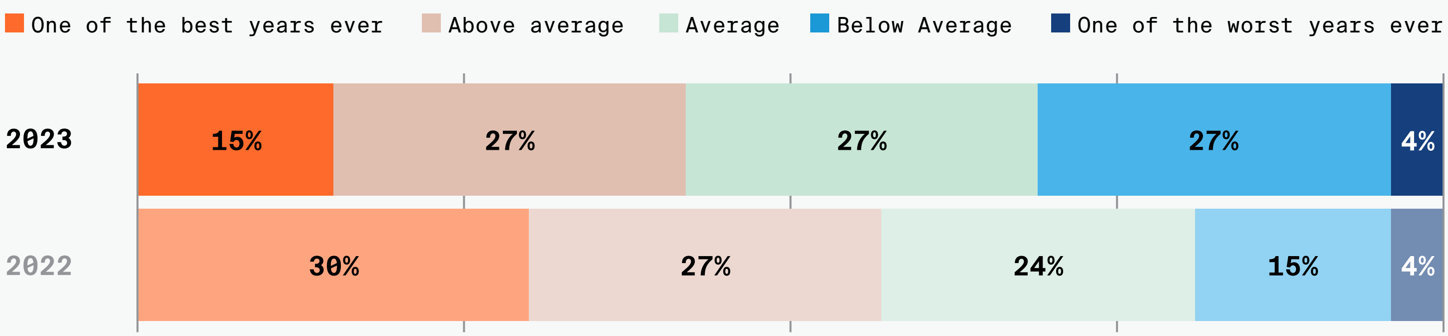
Only three in ten said their volume was below average in 2022. Four in ten said they did more deals than average. Indeed, 15% of them said 2022 was their best year ever.

Last year, 57% said their volume had been above average in 2021, compared to only 19% who said it was below average.

Advisors said that they were busy working on deals all last year, but both buyers and sellers were buffeted by political and economic events. Rising interest rates had the most direct drag. And participants had to react to the impact of the war in Europe on energy prices and a supply chain still not recovered from the Covid shutdowns. Just the uncertainty of events can delay a deal.

At the same time, advisors said the turmoil also spurred more dealmaking. Sellers wanted to lock in a price before values fell further, and buyers wanted to arrange financing before rates went up more. For a lot of longtime business owners, it was simply time to relax after several very stressful years.

Looking back at last year, how would you characterize overall deal volume at your firm?



Observations

What were the major factors influencing your firm's deal volume in 2022?

2022 might have been the best year ever if not for the fear of war and the instability which spread after the invasion of Ukraine.
—Giancarlo Attolini, M&A Advisor, Italy

Owners now seeking an exit after enduring a rough two years of restrictions on economic activities.
—Gerry Robitaille, Investment Banker/ M&A Advisor, Canada

The rocky economic environment has increased the appetite of buyers for acquiring good companies.
—Business Broker, Belgium

There was a reset of expectations in the first half of the year with a decrease in pricing that made for two slow quarters. Since then, volume has been good, even though deal size and pricing have been slightly lower. ***—Gary Ackerman, Business Broker, United States***

Fears surrounding COVID and lockdowns have declined greatly.
—Blair Bondar, Investment Banker/M&A Advisor, Canada

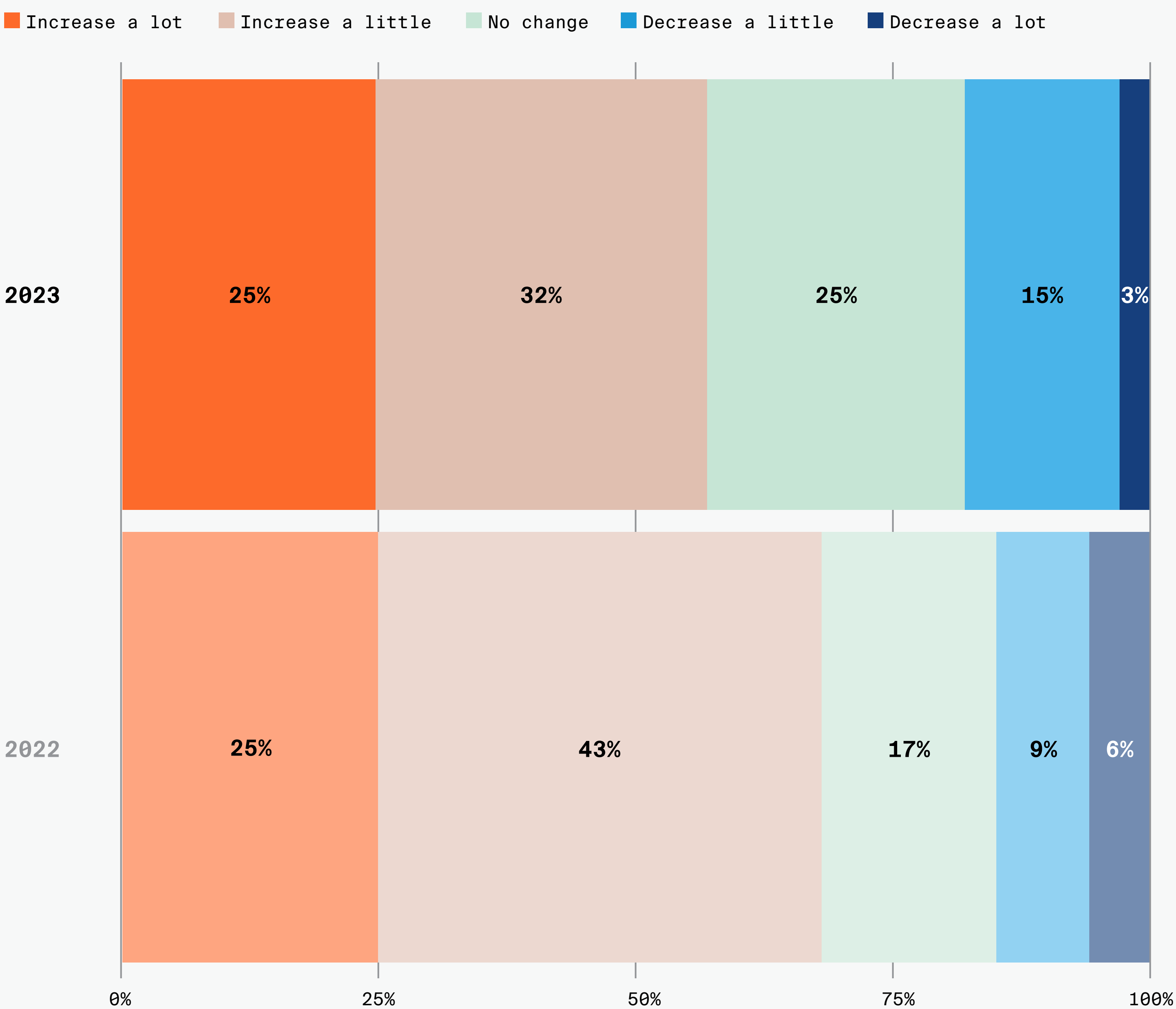
Deal Volume in 2023

Advisors are expecting a great year in 2023. Nearly three out of five (57%) expect their volume to increase. Only 18% of them say they are preparing for a slowdown in volume.

A year ago, the advisors were even more bullish, coming off of a record 2021. In our survey last January, before war broke out in Ukraine, 68% of the advisors were expecting 2022 to be an above-average year.

When we traced advisors' assessment of business throughout 2022, we asked them to predict their volume over the coming three months. On that basis, their bleakest outlook was in our June survey, when only 35% saw volume increasing. By September, 45% saw business getting better.

Looking ahead, how do you expect your firm's deal volume this year to compare to last year?

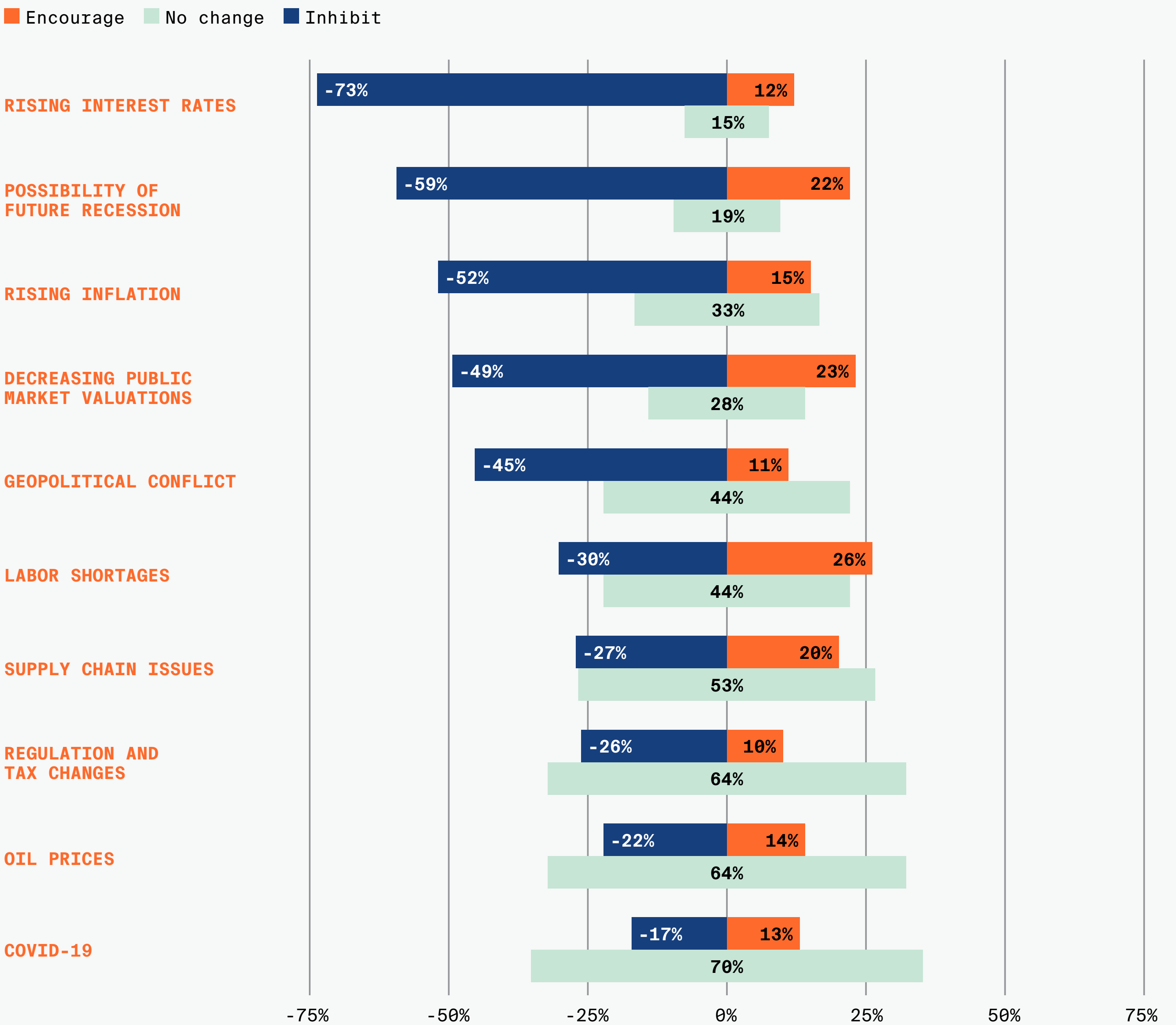


Deal Volume in 2023 *CONTINUED*

The advisors are no Pollyannas. They readily admit the bumps in the road ahead, but they are confident they can navigate around them. Four out of five of them said that rising interest rates are depressing deal volume. More than half also cited the “Possibility of Future Recession” and “Rising Inflation” as inhibiting deals.

None of the factors we listed were cited by more than one-quarter of the advisors as encouraging deals. The most cited encouragement was “Labor Shortages,” which was named by 26% of advisors. Interestingly, “Supply Chain Issues” has fallen sharply as a deal downer, with only 27% of advisors citing it in the recent survey compared to 43% six months earlier.

In 2023, how do you anticipate the following factors influencing deal volume?



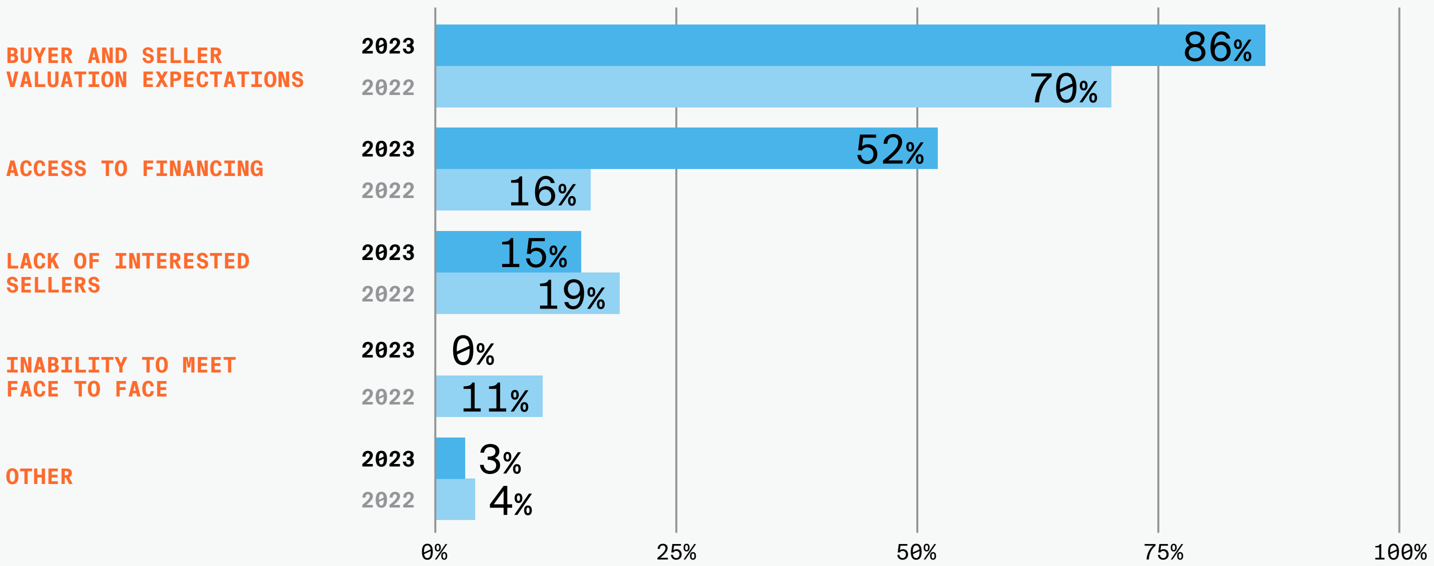
Deal Volume in 2023 *CONTINUED*

In another question probing the challenges to getting deals done in 2023, 86% of advisors named "Buyer and seller valuation expectations," up from 70% last year.

The biggest change was concern about access to financing, which 52% of advisors cited as a potential challenge. Last year, only 16% of advisors expected access to financing to be a concern.

In January 2022, 11% of the advisors identified the "Inability to meet face to face" as a challenge to closing deals. This year nobody saw pandemic travel restrictions as a concern.

What do you see as the biggest challenge for completing deals this year?



Observations

In 2023, what factors will most influence your deal volume?

The looming recession and the fatigue of business owners (as a result of supply chain issues and labor shortages) are certainly the most significant factors driving increased deal volume for our firm. ***—Jim Friesen, Investment Banker/M&A Advisor, Canada***

Owners are reluctant to sell because of recession concerns. ***—Greg Carpenter, Investment Banker/ M&A Advisor, United States***

There is a continued investor focus on roll-up consolidation. ***—John Slater, Investment Banker/ M&A Advisor, United States***

For us, there is a year-over-year increase in buyer enthusiasm for technology and digital companies, even as the current economy has led to valuation flexibility on the sell-side. ***—Ali Khader Ouattara, Investment Banker/M&A Advisor, Canada***

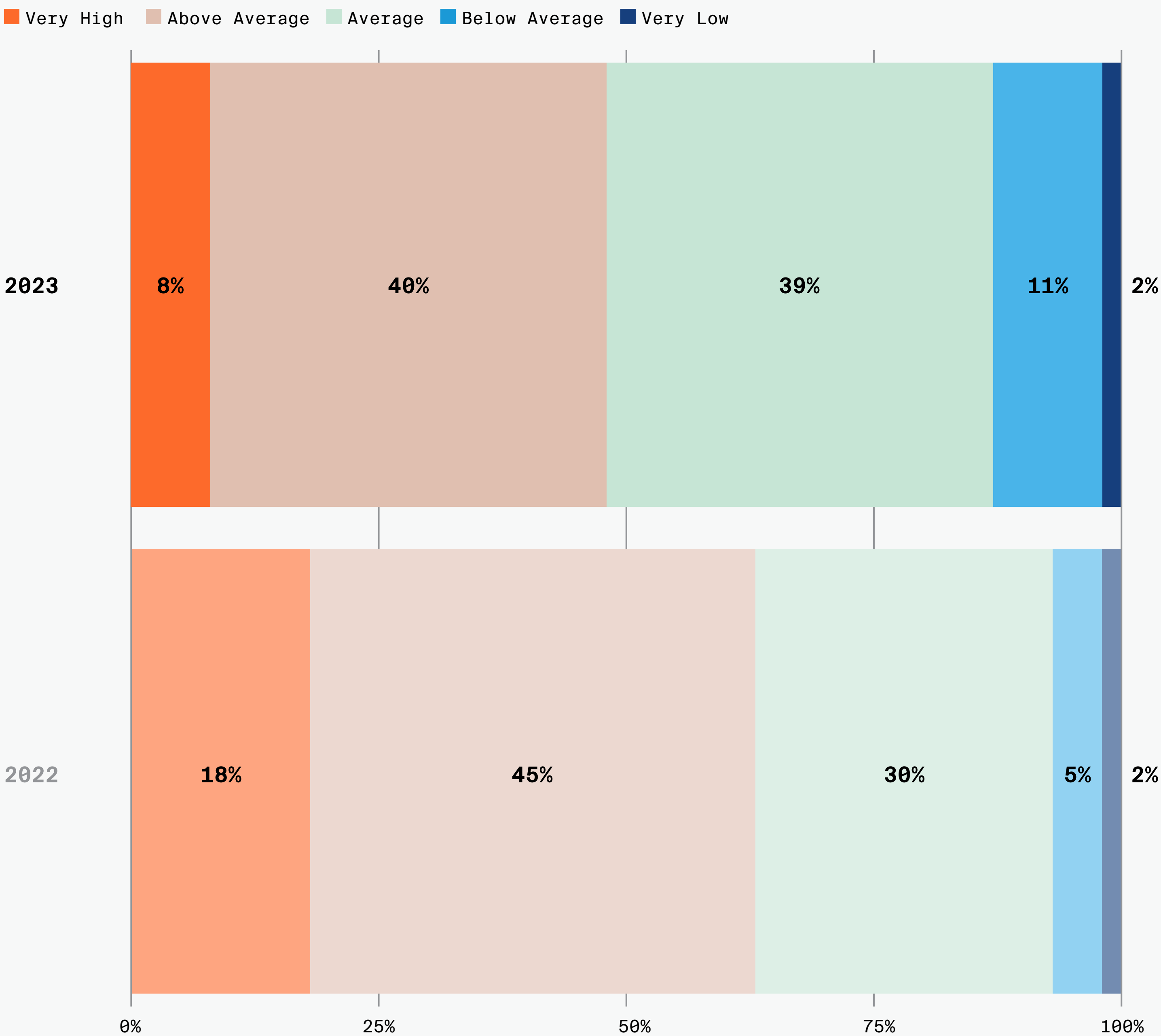
Green energy projects are booming. So are roll-up strategies in key markets, such as education and health. ***—Bruno Silva, Investment Banker/M&A Advisor, Brazil***

Valuations

There's no getting around the effect of rising interest rates on business valuations. If a buyer pays more to service its debt, there's less available to pay the sellers. The falling public market reduces a buyer's estimated exit value.

Still, as we've seen, the lower middle market is somewhat insulated from these forces. Just under half of the advisors (48%) described deal values in 2022 as above average. By comparison, a year ago, 63% told us that 2021 values were above average. This year, 13% said values have fallen below average, up from 7% who said that about 2021 deals.

Last year, how would you describe the valuation of companies in deals your firm was involved in?



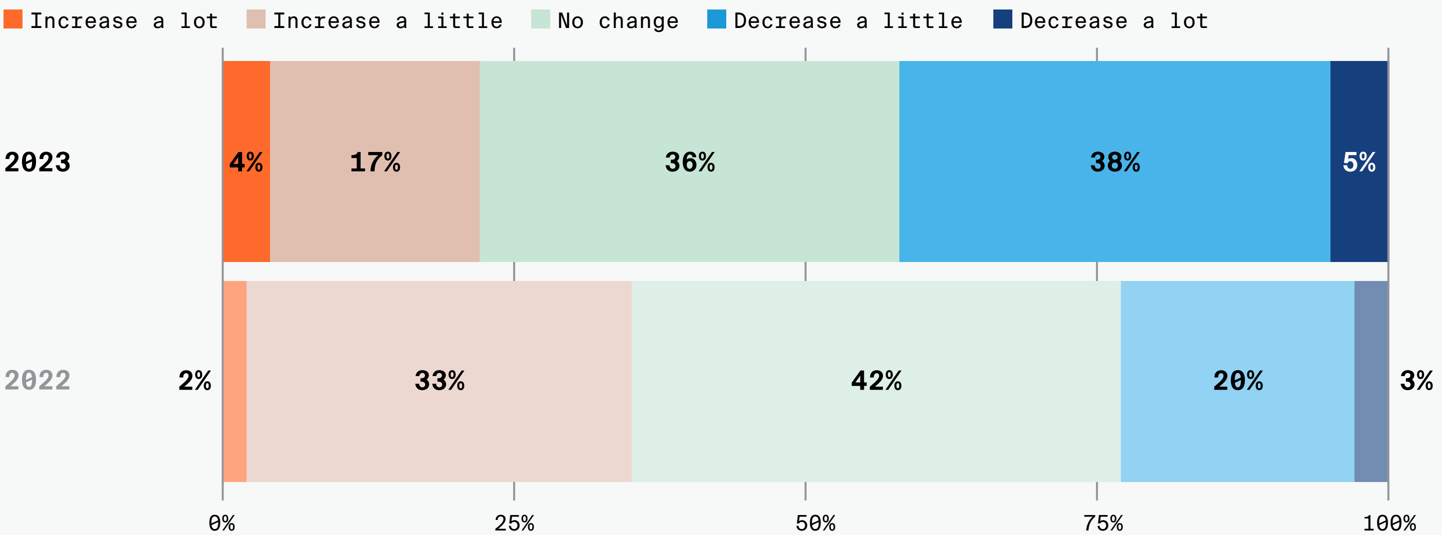
Valuations *CONTINUED*

Many advisors said that values were propped up in 2022 by aggressive buyers with capital they were eager to invest. Many smaller companies, moreover, were attractive, as they were experiencing profitable growth despite, or in some cases because of, the inflationary economy.

The consensus is that valuations have more to fall. Twice as many advisors say valuations will go down further in 2023 (43%) as say they will rise (21%). A year earlier, more foresaw an increase in value (35%) than a decrease (23%).

Nonetheless, the view in January is less pessimistic than in September, when 52% expected values to fall in the fourth quarter and only 11% expected a rise.

This year, how do you expect company valuation to change for deals your firm is involved in?



Observations

What was the biggest contributor to valuation levels in 2022?

Valuations can rise in the competitive bidding environments we create for our clients' businesses. ***—Mark Carmichael, Investment Banker/ M&A Advisor, Canada***

The current economy has led to valuation flexibility on the sell-side. ***—Ali Khader Ouattara, Investment Banker/ M&A Advisor, Canada***

Very good businesses being sold to buyers that wanted the businesses for strategic reasons. ***—Arthur Nathan, Lawyer, United States***

There is a low supply of high-quality assets at scale. Meanwhile, the continuous innovation cycle requires strategic buyers to fill gaps. ***—Andreas Roell, Investment Banker/M&A Advisor, United States***

Valuation levels were relatively unchanged in 2022, when compared to prior years. We've found that buyers tend to adjust deal structure components (for example, earnouts, VTBs, etc.) as opposed to reducing the face value of their offers. That's especially true in deals where the enterprise value is less than $10 million. ***—Jim Friesen, Investment Banker/ M&A Advisor, Canada***

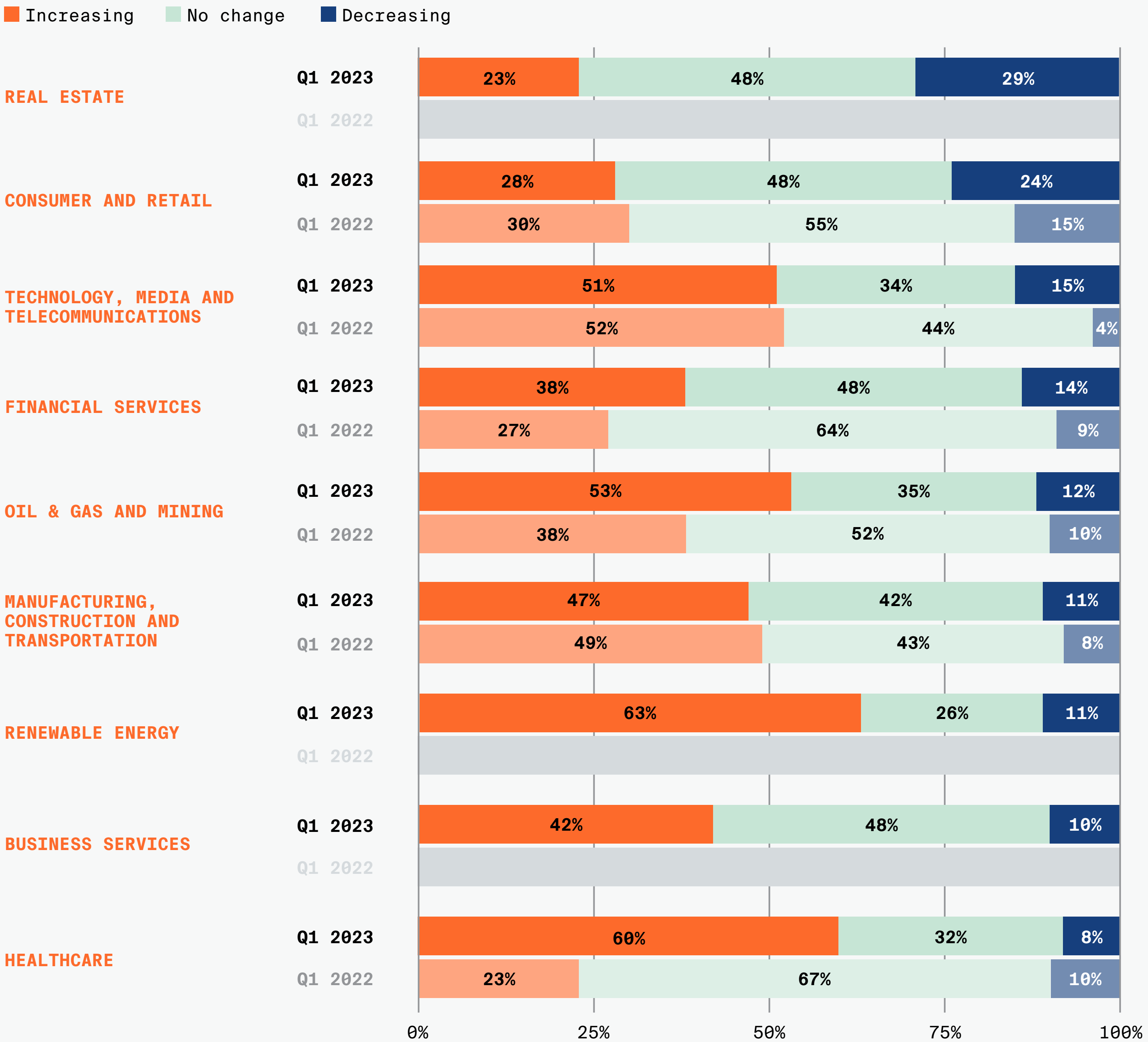
By Industry

Healthcare deals have made a dramatic rebound. A year ago, only 23% of advisors saw an increase in healthcare M&A. In the current survey, 60% say healthcare deal volume is going up.

Renewable Energy remains the hottest sector, with 63% of advisors reporting an increase in deals.

The only industry where deal volume was more likely to be seen as declining than increasing was Real Estate, which, of course, is very sensitive to interest rates.

This year, do you expect the volume of deals your firm handles in the following industries to increase, stay the same, or decrease?



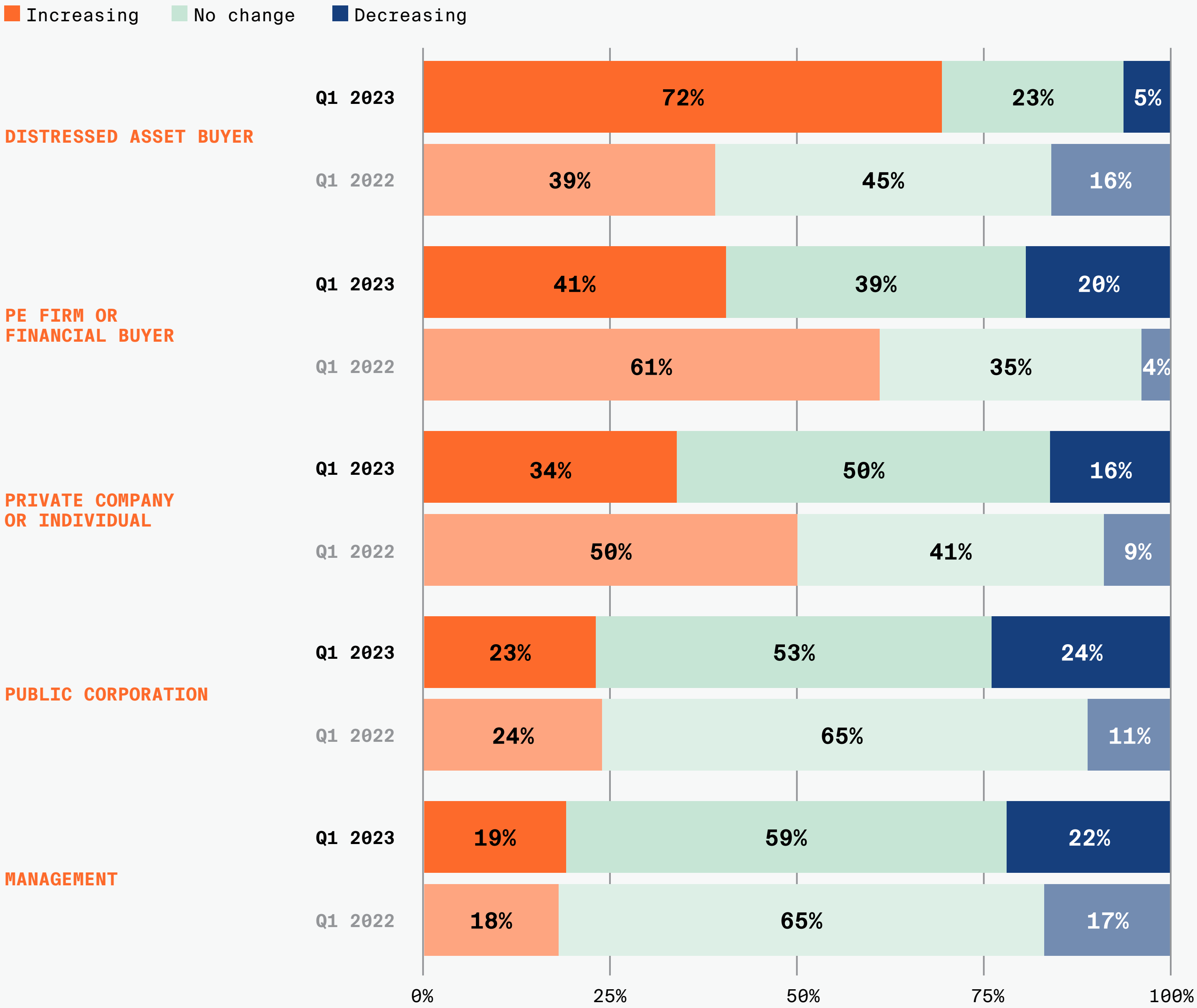
Buyers and Sellers

Distressed asset buyers are gearing up for activity. Seven of ten advisors expect that distressed asset buyers will be increasingly active in 2023. A year ago, only 39% saw distressed asset buyers increasing.

Meanwhile, the expansion of private equity firms and other financial buyers may be decelerating. In the recent survey, 41% said financial buyers would be increasingly active, while 39% said they would stay the same. A year ago, 61% of advisors predicted that financial buyers would be in a larger share of their deals.

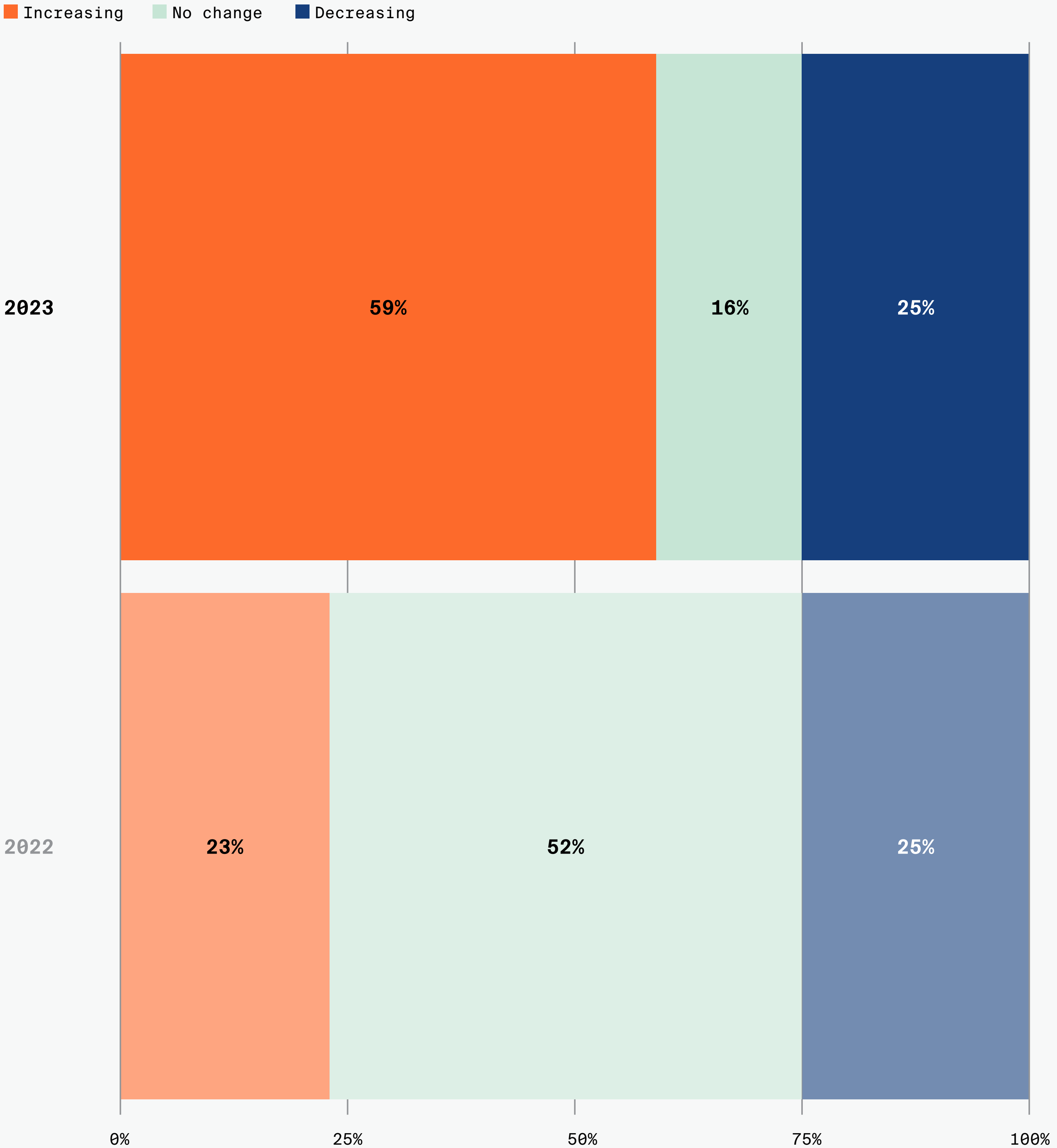
As for sellers, three out of five advisors said they expect to see more companies putting themselves on the block in 2023 than they did in 2022. That's a reversal from a year ago, when less than a quarter of advisors predicted the number of sellers would rise.

Among the deals your firm handles, do you expect the following types of buyers to increase, stay the same, or decrease this year?



Buyers and Sellers *CONTINUED*

How do you expect to see the number of active sellers on the market change this year compared to last year?



Success Rate

It got harder to close deals in 2022. All year, advisors have been telling us negotiations have been dragging on amid the economic and political uncertainty.

In the most recent survey, a plurality of advisors (39%) said in 2022 they had a below-average success rate—the portion of the deals they started working on that eventually closed. Only 23% said their success rate last year was above average.

That's a reverse from 2021. Last year, more advisors said their success rate was above average (36%) than below average (27%).

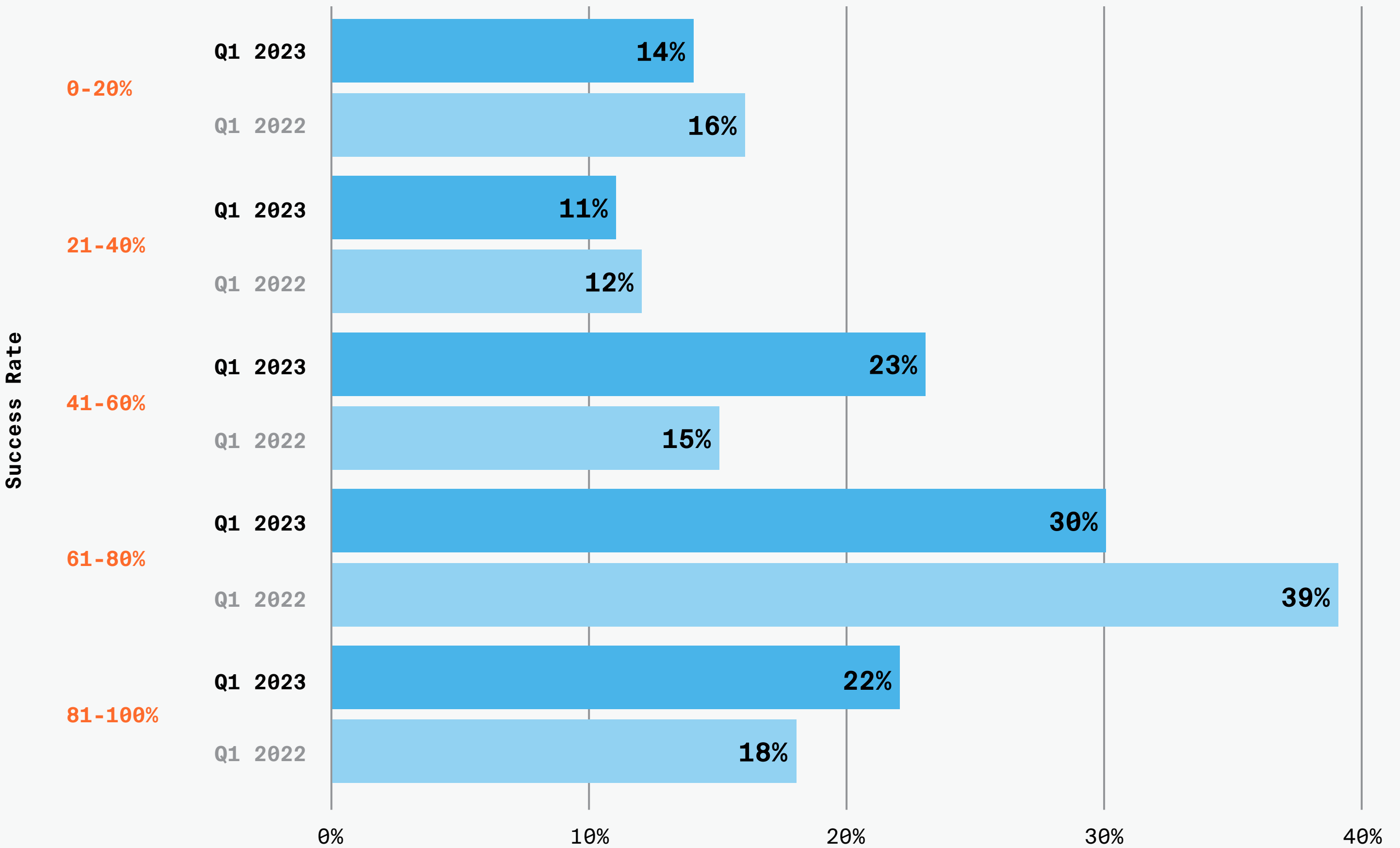
Interestingly, when we asked advisors to estimate their success rate for 2022, the average response was 63%. That's actually a slight increase from the average response a year ago (61%).

Looking forward, 58% of the advisors expect to close a greater share of their deals in 2023, compared to only 17% who expect to close fewer.

The key to closing more deals, the advisors told us, is by building a trusted relationship with the parties. With a mix of empathy and experience, an advisor can help buyers and sellers become comfortable with the terms of a deal.

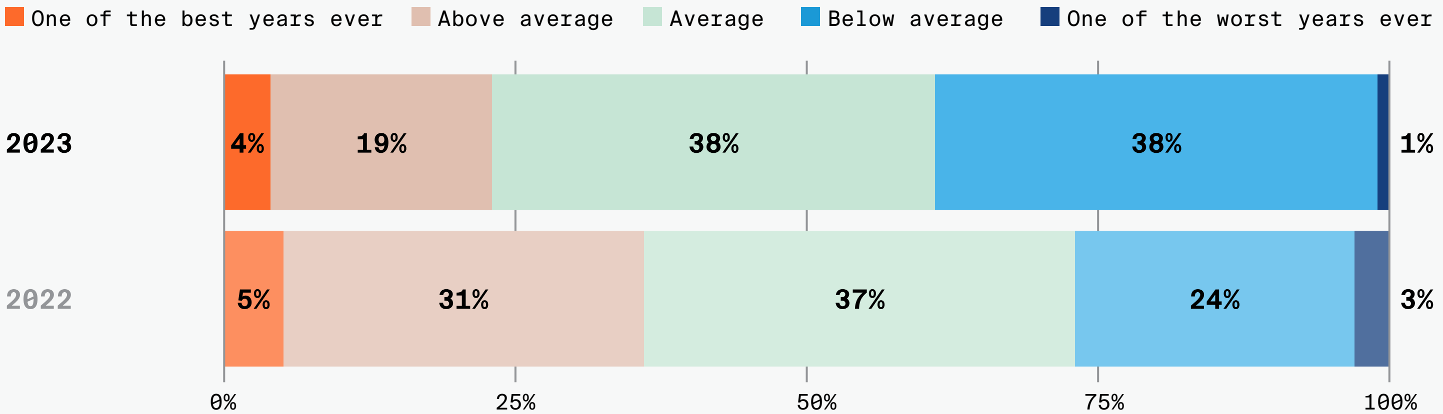
"Success comes from treating people like precious gifts, for without them, we would have no business," said one investor in New Zealand.

As a percentage, what do you estimate your firm's success rate (deals started vs completed) was last year?

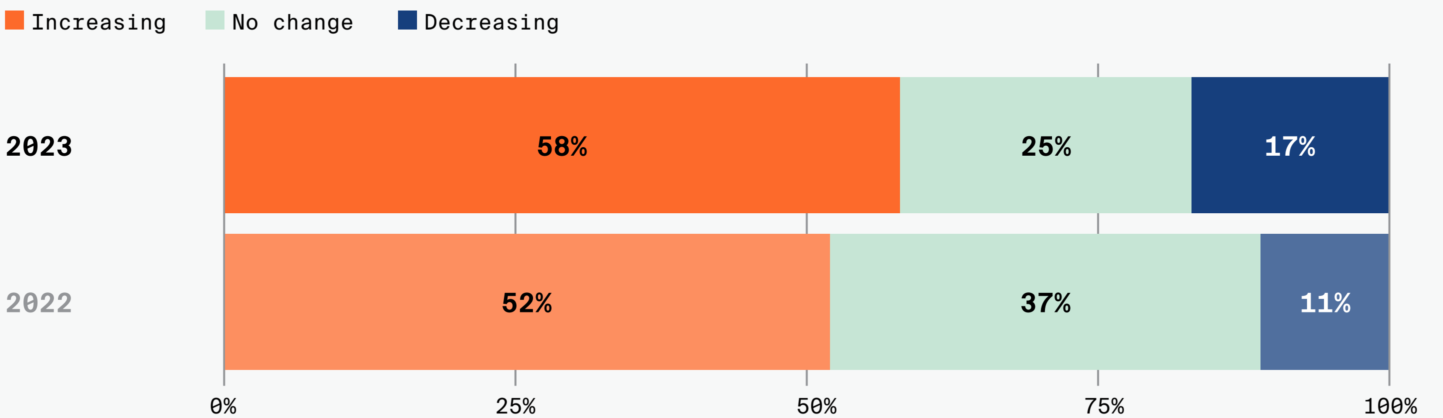


Success Rate *CONTINUED*

How does your estimated success rate for last year compare to a typical year?



How do you expect your firm's success rate this year to compare to last year's rate?



Observations

What factors are most influencing your success rate now?

Buyers' selectivity and their access to debt capital.
—Investment Banker/M&A Advisor, United States

Being more critical of the sectors and companies we decide to try and sell.
—Colin Marson, Business Broker, United Kingdom

Meeting seller price expectations, where sellers view their own valuation higher than the market sees it.
—Investment Banker/M&A Advisor, United States

Making a great effort to get deal issues resolved early in the process (by the letter of intent stage).
—Arthur Nathan, Lawyer, United States

The threat or opportunities presented by tough economic times and the absence of governmental support. ***—Kevin Astle, Investment Banker/ M&A Advisor, Canada***

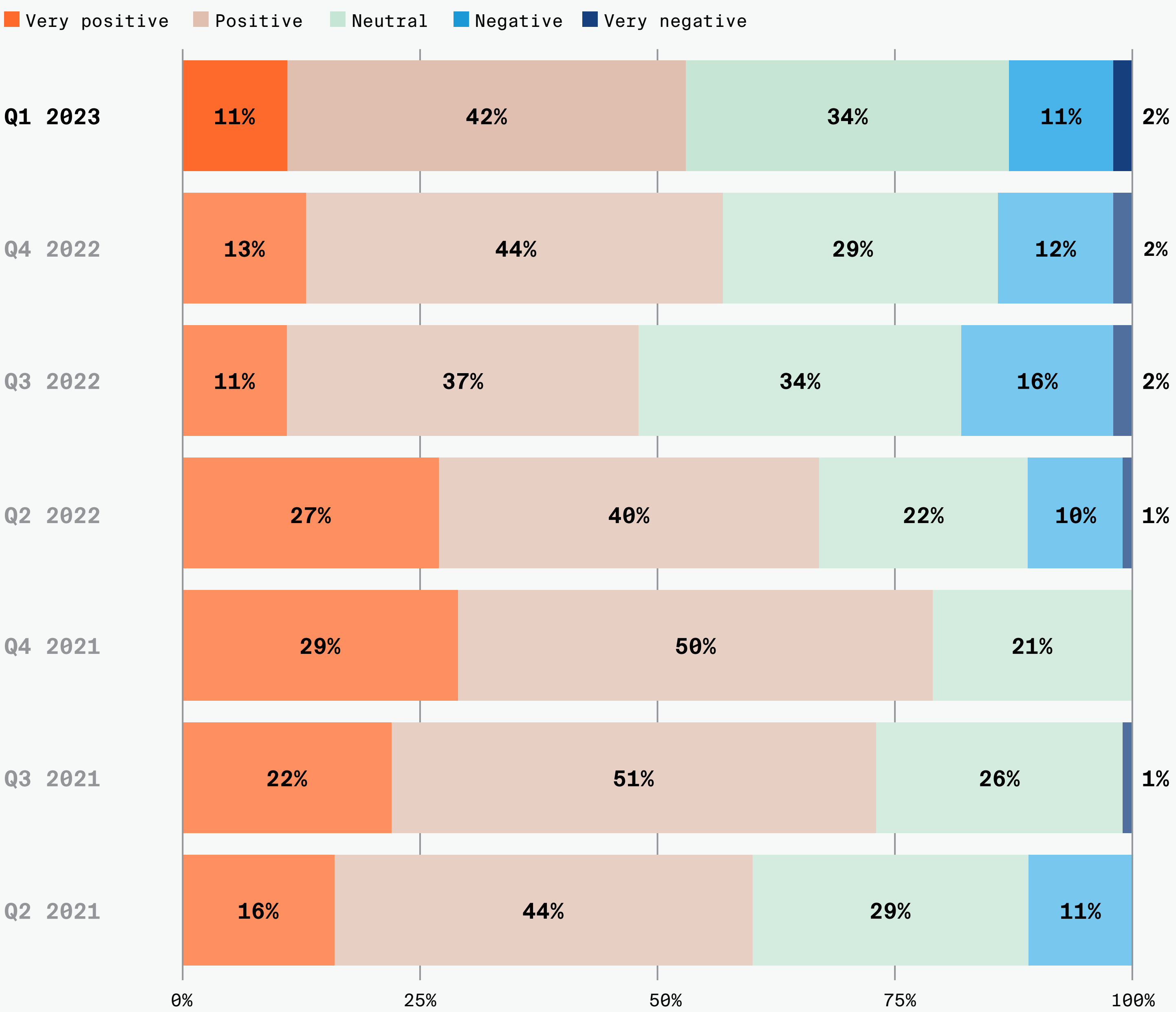
Overall Mood

The middle market merger advisors are feeling upbeat heading into 2023, if not quite as giddy as they were 18 months ago.

Since 2021, we've ended our quarterly survey asking, "As a whole, how are you feeling about the M&A market over the next three months?" In January 2023, just over half of the advisors (53%) said they had positive feelings, and only 13% expressed negative feelings.

Those responses are roughly the same as they were in September 2022, when optimism rebounded from a slight dip after war broke out in Europe. The peak of positive feelings was in September 2021, when 79% of advisors were upbeat about the M&A market.

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



Overall Mood *CONTINUED*

To be sure, there are some that see bad omens for 2023.

“Fewer business owners are willing to engage for a sale at this time due to recession fears, rising interest rates, supply chain shocks, and volatile business performance,” said Greg Carpenter, Managing Partner at M&A Business Advisors in San Jose.

But more argue that the market has already adjusted to these stresses.

“We are very optimistic about deal activity in 2023,” said Jim Friesen, founder of Portage M&A Advisory in Grimsby, Ontario. “First, sell-side activity was up significantly in Q4 2022, and it is apparent that there is a large cohort of business owners who are looking to transition into retirement. Second, lenders have already adjusted to the impact that increased interest rates have on deals (for example, increasing the number of years to repay a loan) in order to capture more business.”

Observations

Deal flow for companies with enterprise value between the $50 million and $150 million space will remain even or increase against last year. Ebitda multiples may fall as the cost of financing increases for buyers. Quality businesses will still experience demand. ***—Mark Carmichael, Investment Banker/ M&A Advisor, Canada***

I think M&A volume is cresting and will start to slow down by the second half of 2023. ***—Graham Morrison, Investment Banker/M&A Advisor, United States***

Private equity still has a lot of money to put to work and quality deals will continue to get completed. Valuations will likely drop to compensate for higher leverage costs. ***—Michael Schuster, Investment Banker/ M&A Advisor, United States***

The market still needs more time for all the economic and valuation news to work through pricing. ***—Business Development Executive, United States,***

Until the end of the war, the market will be full of companies that would like to sell themself, and there will be a shortage of potential buyers. ***—Jaroslaw Polanski, Business Broker, Poland***

Conclusions

Advisors in the middle-market sometimes seem like they are in a different universe than their cousins who do larger deals. Morgan Stanley and Goldman Sachs each just reported that M&A revenue was down nearly 50% in 2022. Our respondents endured a few slow months and are back at business and prepared to grow.

Some of this difference can be explained, as we've noted, by the generational shift in entrepreneurs and the growth of private equity. There's another factor that comes through in these surveys: The determination of the advisors themselves. Most of them, like most of their clients, have built up their own businesses. They are personally and financially invested in the success of their firms.

When we ask about the factors that drive deal volume, many advisors don't talk about macroeconomic forces or the shifting moods of buyers and sellers. They focus on their own actions: marketing their services, building their referral networks, developing industry expertise, and, most of all, delivering exceptional service to their clients.

In that universe, advisors can thrive no matter what happens on Wall Street.

Stay up to date on deal flow with our upcoming quarterly bulletins and *subscribe here*.

Appendix: Respondent Demographics

Which of the following best describes your current occupation?

61%	Investment Banker/M&A Advisor
11%	Business Broker
8%	Executive
7%	Lawyer
6%	Corporate/Business Development
4%	Other
3%	Investor (Fund Manager, Family Office, etc.)

Which of the following best describes your job title?

56%	Head of Firm (CEO, Managing Partner)
20%	Executive (Managing Director, Vice President, Partner)
13%	Senior Executive (Senior Managing Director, Senior Vice President)
9%	C-Suite (CFO, President, CXO)
1%	Other
1%	Staff (Associate, Analyst)

Do you specialize in any of the following industries?

47%	Generalist
34%	Technology, Media, and Telecommunications
31%	Manufacturing, Construction and Transportation
27%	Business Services
23%	Healthcare
13%	Financial Services
12%	Real Estate
11%	Oil & Gas and Mining
10%	Other
7%	Consumer and Retail
6%	Renewable Energy

Appendix: Respondent Demographics *CONTINUED*

Which of the following best describes your current occupation?

40%	5 or fewer
36%	6-20
11%	21-50
3%	51-100
7%	101-500
3%	501+

What is the size of deals that your firm is typically involved in?

39%	$0-5 million
57%	$6-10 million
68%	$11-25 million
54%	$26-50 million
32%	$51-100 million
19%	$101-200 million
10%	$201-500 million
0%	$501+ million

What country do you primarily work in?

61%	North America
27%	Europe
6%	South America
6%	Asia-Pacific

Are your clients:

18%	More on buy-side
60%	More on sell-side
23%	Roughly equally on buy- and sell-side

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

42%	5 or fewer
25%	6-10
16%	11-15
18%	16 or more

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