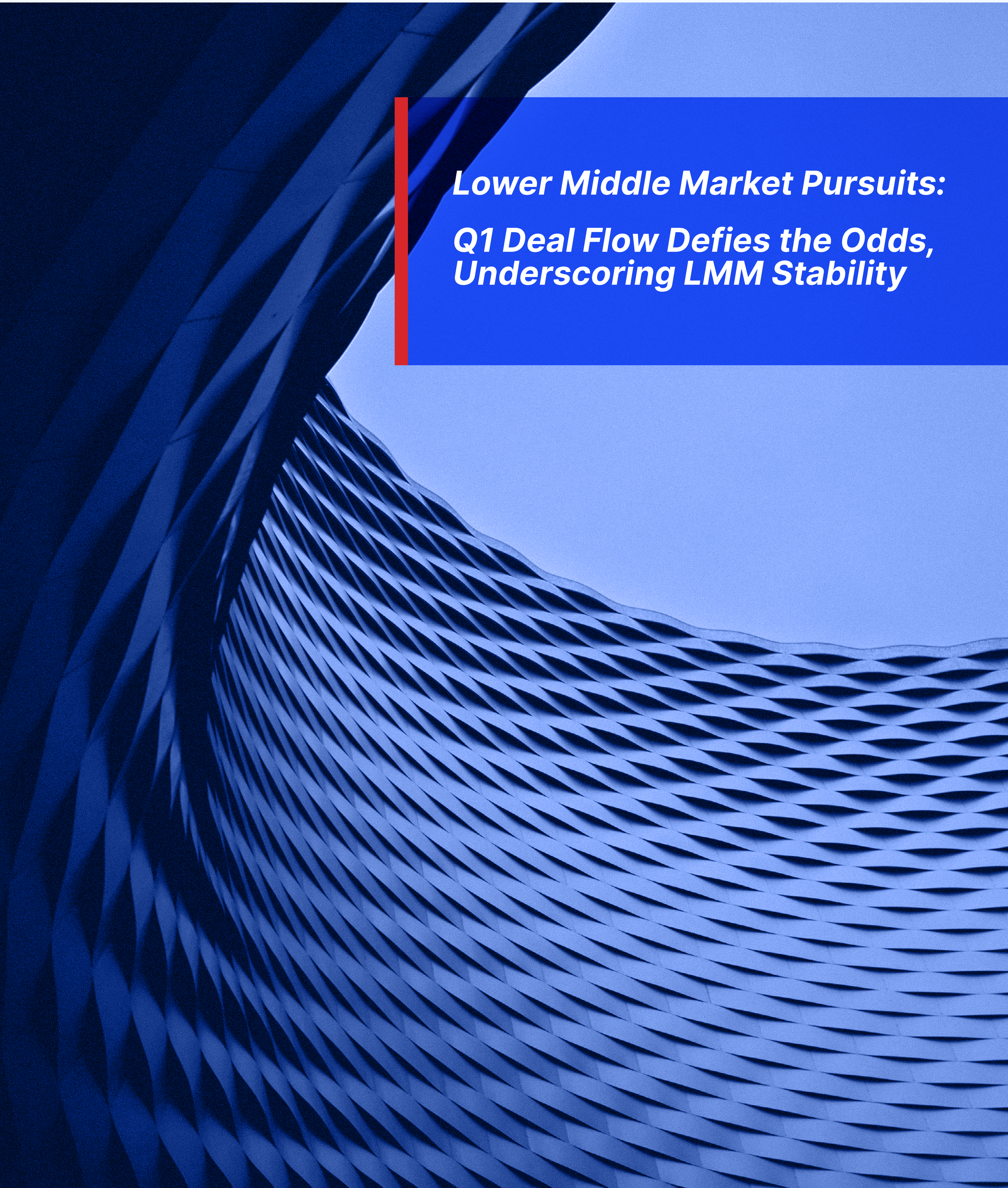
AXIAL

Spring, 2022



Lower Middle Market Pursuits:

Q1 Deal Flow Defies the Odds, Underscoring LMM Stability

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The Lower Middle Market's 'Axial Age'

The Encyclopedia Britannica defines the Axial Age as: "The period when, roughly at the same time – around most of the inhabited world – the great intellectual, philosophical, and religious systems that came to shape subsequent human society and culture emerged."

Connecting a major philosophical era to the lower middle market may sound aspirational, but we continue to see this vast (and much lower profile) segment of the deal landscape undergo an evolution. There has always been a population of enterprising business owners and founders who transacted in this M&A world. Over time, as more investors gravitated to this area, it's clear that the lower middle market is expansive enough to welcome a diverse range of investor types – from individuals embarking on a career change to the very largest asset managers in the world pursuing growth through programmatic acquisitions for their portfolio companies.

For instance, add-ons represent approximately 20% of the total value of PE deal volume over the past five years, but as much as 70% of the total PE-backed M&A activity. While it's hard to quantify, this suggests most platform deals are a precursor to future M&A activity, much of which occurs in the lower middle market.

The conventional wisdom has traditionally held that smaller companies are more subjected to economic turmoil than their large market peers. Indeed, smaller companies often lack the scale to access the public capital markets, raising the cost of capital for operators in these markets.

Ironically, as it relates specifically to deal flow and the availability of attractive assets, the lower middle market deal arena – thanks to its breadth and diversity across longstanding or emerging industry niches – has become one of the more stable areas of the market for both buyers and sellers. And certain dynamics now driving deal flow, be it succession planning or generational wealth transfers, are keeping M&A pipelines full.

As this report will show in the following pages, we saw evidence of this in Q1. This stability of activity and rising diversity of participants are likely to be defining elements of 21st century lower middle market.

There will be ups and downs, but as we continue to deepen our study of the lower middle market, there is demonstrable proof that it is a market segment that beats to its own drum. It does not see the manias of the public markets or reflect the same kind of excesses that can characterize dealmaking in the large market, but it also does not stall out or shut down during periods of turbulence.

Enjoy the report!

Lower Middle Market: M&A's Safe Haven in Q1

Last year, observers were anticipating a blockbuster quarter for deal making in Q1. Momentum from a record-breaking 2021 was expected to carry over into the new year, while sales backlogs anecdotally offered no occasion for misgivings. Then, in late January, talk of a potential pause began to emerge. The inflationary picture, as it worsened, roiled the public markets, while the war in Ukraine ushered in a new era of geopolitical uncertainty, exacerbating the supply chain crisis in the process. As it turned out, deal flow remained remarkably steady, portraying a relative calm that contradicts the volatility evident almost everywhere else. At least this was the case in the lower middle market.

To put it into context, LMM deal flow in Q1 jumped by 10% from the fourth quarter, as new sale processes on the Axial platform nearly matched the high-water mark set in the first quarter of last year. Buy-side activity also surged, growing by nearly three quarters (72%) sequentially versus Q4 and by a third (33%), year over year.

The pace of activity should stand out on its own. However, contrasted against global M&A – which slumped by nearly a quarter (or 23%), year over year, according to Refinitiv – the lower middle market distinguished itself as a model of consistency.

There are some caveats. The global M&A figures, for instance, only track closed deals. Axial's Pursuits Reports, alternatively, measure new auction processes initiated by sellers in the lower middle market, as well as new buy-side mandates launched by prospective acquirers. So, while the volume of closed deals may provide a definitive look at the recent past, the activity on the Axial platform offers a glimpse into the future, capturing the intent of both buyers and sellers. In a sense too, pursuits data offers a more accurate measure of actual activity as it occurs throughout the deal funnel rather than a static view at the very bottom.

The prevailing takeaway, though, is that while deals may be moving more slowly down the funnel, dealmakers are no less engaged even as the economic and geopolitical threats grow.

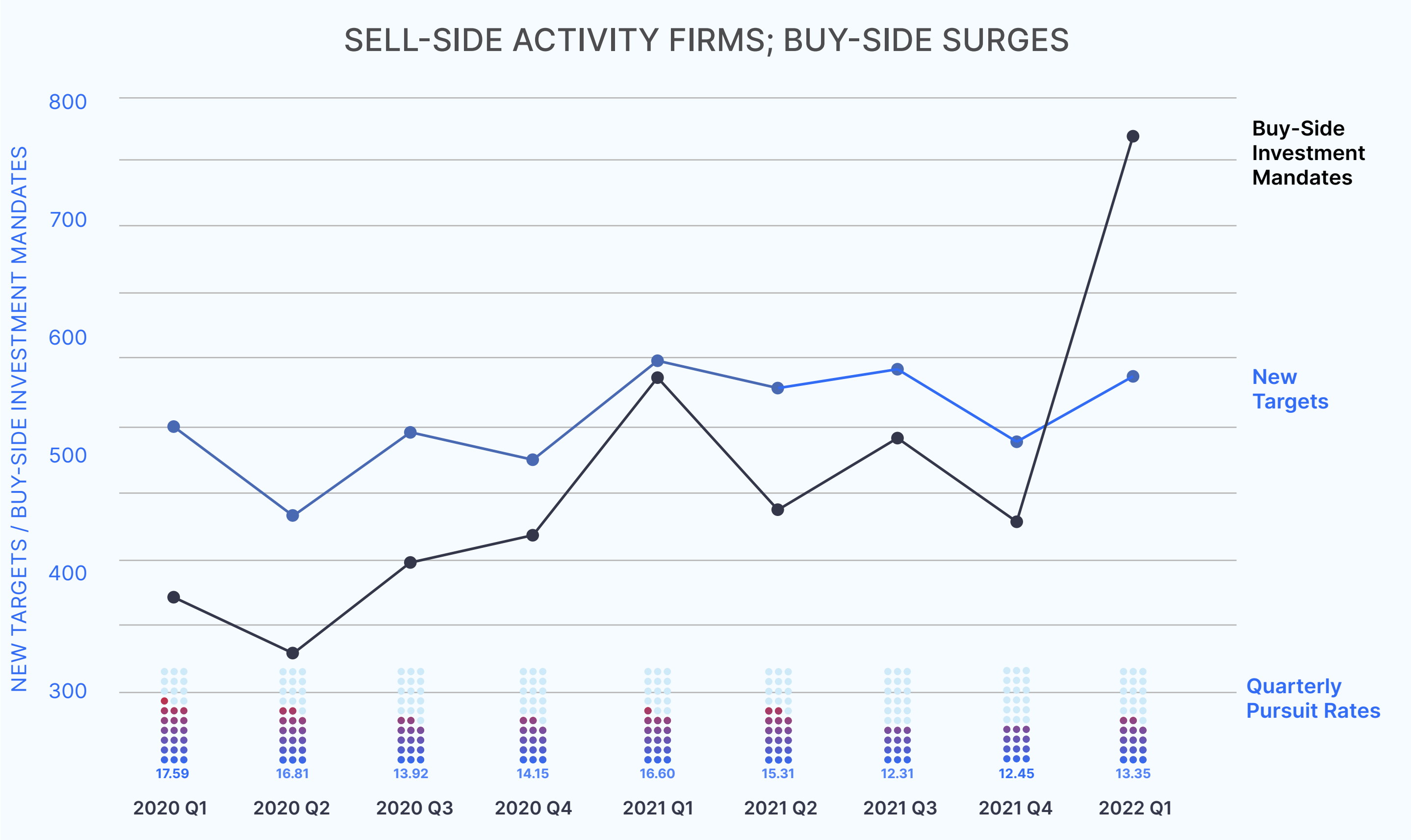
WHAT YOU'LL FIND INSIDE:

SURVEY OF ONE

Kevin Short
Managing Partner and CEO
Clayton Capital Partners

I believe we are seeing more sell-side candidates, in part, due to the supply chain pressures facing business owners. In addition, founders and investors remain motivated to sell prior to any prospective changes to the tax code and capital gains rates going up.

Beyond those two drivers, sellers are selling for the same age-old reasons that have traditionally driven sell-side activity in the lower middle market – health, burnout, succession planning, etcetera.



Rebound Sets Tone for 2022

Seasonality, to a certain degree, always affects the cadence of deal flow. And Q1, historically, represents the "pace-setting" quarter that establishes the tone for the rest of the year. Should history serve as a guide, the new sale processes at the top of the funnel through the end of March do indeed bode well for the market in 2022.

The Q1 activity reflects the ongoing stabilization of the deal market after a series of fits and starts over the previous two years. On average, new targets in Q1 might have been slightly smaller than most previous quarters over the past two years, with average revenues of $19.3 million. However, the quality of deal flow was also elevated, with an average Ebitda margin that stood at 16.68%.

This doesn't exactly match the flight to quality that was so pronounced in 2020, when average revenues and margins exceeded $25 million and 17%, respectively. But compared to last year, the average profit margin is comfortably above 2021 levels (14.89%), while the median revenue of new targets came in below the average last year ($21 million), signaling perhaps that smaller sellers may feel somewhat insulated from the geopolitical disruptions.

On the buy-side, the burst of new mandates very likely speaks to the knock-on effect of a record year for PE in 2021, as sponsors turn their attention to value-creation efforts. Add-ons, in that regard, offer a compelling way for investors to "average down" entry multiples, while fueling top-line expansion to complement organic growth even if certain industry tailwinds begin to dissipate. (Anecdotally, though, many business owners would note backlogs are as strong as ever).

Even as buyers are in abundance, it's not with the same sense of reckless abandon that might characterize an overheated market. In fact, the average pursuit rate in the first quarter – documenting buyer interest as new assets are introduced onto the platform and prospective acquirers solicit more information – didn't quite recover to reach early 2021 levels. However, the average at 13.4% did improve on the second half of last year.

Quality, Size Fuel Q1 Pursuit Rates

Informally, pursuit rates above 15% tend to signal elevated interest among buyers, while pursuit rates below this threshold trail the longer-term average for assets marketed over the Axial platform. The pursuit rate for any individual target could theoretically reach as high as 100% assuming every potential acquirer who came across the company solicited additional information or initiated more formal discussions with the sellers. This helps explain how certain pockets of activity can disproportionately drive pursuit rates higher or lower.

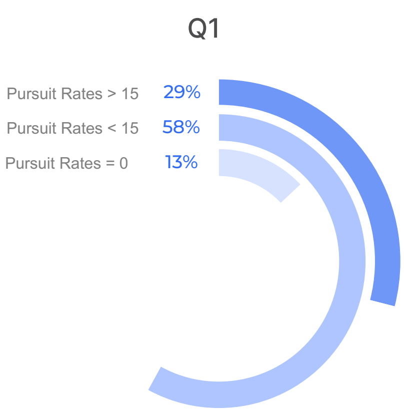
One of the shifts evident in Q1 was a slightly higher proportion of new targets with pursuit rates exceeding the 15% index (29%), and far fewer companies for sale showing pursuit rates of zero. In Q4 of last year, as the quality of assets waned, approximately 20% of available targets generated no interest from buyers, who themselves were likely racing to complete deals already in their pipelines. In Q1, the proportion of assets with pursuit rates of zero shrank to barely one out of every ten new targets (or 13%), which is more in line with the historic average.

Similar to previous quarters, higher pursuit rates generally correlated with larger companies. Notably, though, interest in assets with revenues between $10 million and $25 million saw slightly more demand than assets with revenues ranging from $25 million to $50 million. The same correlations were evident as profit levels increased. The exception, however, was unprofitable companies, whose pursuit rate of 17.41% nearly matched companies with profits between $2.5 million and $5 million. Not surprisingly, all but two of the unprofitable targets with pursuit rates in excess of 15% were technology or SaaS companies, a handful of which boasted pursuit rates topping 50%, helping to prop up the entire cohort. Still, companies with profits between $5 million $10 million proved to be the most intriguing to buyers in Q1, boasting a collective pursuit rate of 20.1%.

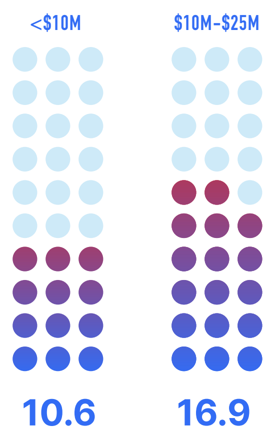
The gravitation to larger assets may have also contributed to the wider gap evident in the pursuit rates for companies marketed by investment banks and those sold by M&A advisors. Deals from former attracted pursuit rates of nearly 17%, whereas M&A Advisor-led targets slumped to 11.4% (versus pursuit rates of 13% last year). Combined, investment banks and M&A advisors accounted for 91% of new targets in Q1, which is consistent with the proportion of dealflow stemming from these sources last year.

PURSUIT RATE DISPERSION

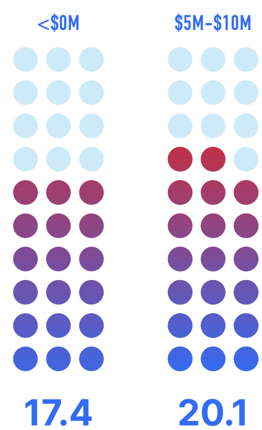
% of Targets Attracting Pursuit Rates Above and Below the Index



PURSUIT RATES BY REVENUES



PURSUIT RATES BY EARNINGS



SELL-SIDE STANDOUTS AND SLUMPERS*

Sectors Showing the Biggest Increases Sequentially in Q1 (vs. Q4, 2021)	Sectors Showing the Biggest Increases (or Smallest Decreases) Year over Year in Q1 (vs. Q1, 2021)	Sectors Showing the Biggest Declines Sequentially in Q1 (vs. Q4, 2021)
Industrials: 54.3%	Industrials: 22.1%	Healthcare: -29.9%
Energy & Renewables: 22.2%	Business Services: 13%	Transportation: -22.5%
Technology: 22.1%	Consumer Goods: -2.8%	Consumer Goods: -6.8%

*Minimum of at least 10 new targets each quarter

Usual Suspects Spur Sell-Side

Last year, in certain sectors, the pace and volume of deal flow represented a tale of two halves. New sale processes from the technology and industrials sectors, in particular, surged in the first half of the year, but then slumped in the second half. In fact, these were the only two sectors to show a decline in the last six months of the year. In the first quarter of 2022, the number of technology and industrial targets rebounded, and were among the top three showing the most sequential growth in new targets versus Q4. Proportionally, these sectors also accounted for more new deal flow than any other industry, comprising half of all new targets in Q1.

> The industrial and technology sectors comprised approximately half of all new targets in Q1.

It is worth noting, however, tech deal flow is still off of last year's initial torrid pace, and trailed by a significant margin, 23%, year over year. But then again, so were most other sectors. Of those with at least 10 new sale processes this quarter, only the industrials and business services sectors registered an increase over 2021's first quarter. This, of course, reflects the build up and release of deal flow last year, long delayed by the onset of the pandemic, which created tough comparisons in most other areas in Q1.

What's more notable are the sequential declines registered in some of Q4's "hot" sectors. Healthcare deal flow was down by nearly 30% over the first three months of the year, while new sales processes for transportation assets were down by approximately 23%. Even consumer goods, which accounted for 12% of all sell-side activity, saw new sale processes decline by approximately 7%. Each of these sectors were in the top three in terms of dealflow growth in the second half of last year, but also suffered year-over-year declines as well.

Pursuit Rates: Buyers Back on the Offensive

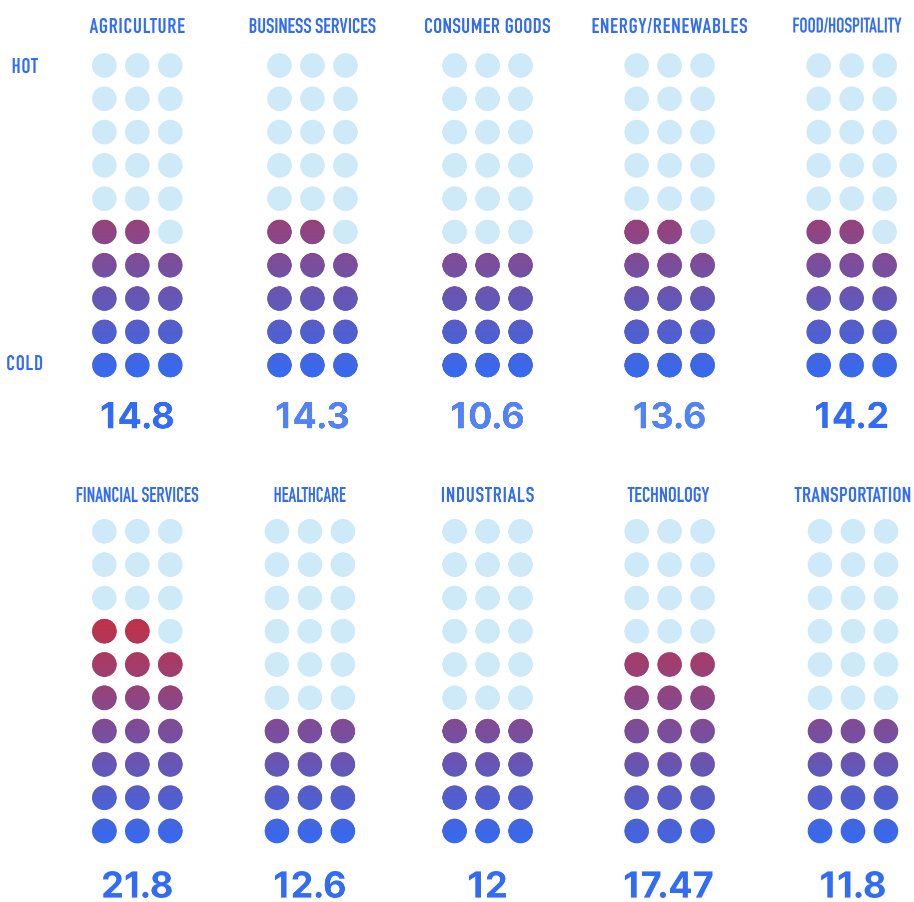
In previous reports, it's been noted how higher levels of deal volume on the sell-side can have a corrosive effect on pursuit rate. Prospective buyers afforded more choice become more discriminating and naturally gravitate to the assets with the most attractive fundamentals. This is also one of the compelling draws of the lower middle market – the inefficiencies and value afforded through the availability of choice. That being said, it can mask the extent to which buyers are pursuing deals in certain sectors.

For instance, the trailing 12-month pursuit rate in the industrials sector slumped to 12% in Q1, overshadowing the fact the sector accounted for nearly a third (32%) of all targets across all sectors with pursuit rates above 15% in Q1. The healthcare sector, similarly, witnessed considerable enthusiasm from buyers in certain pockets, as over 30% of new targets generated pursuit rates above 15%. Yet the average was still weighed down on a TTM basis, given the higher dispersion between in-demand assets and those receiving less attention.

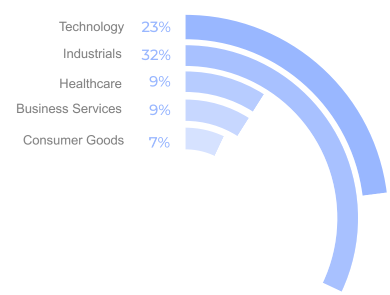
Assets that might normally fall under other, less-glamorous sectors are today being marketed as SaaS disruptors.

The exception was the technology sector, where the growth in new targets is meeting a surge in demand that fuels pursuit rates. Another factor, as digital transformation works its way through the broader economy, is that assets that would normally fall under other, less-glamorous sectors are today being marketed as SaaS disruptors (think edtech, healthtech, martech, etc.) This can have the effect of inflating the technology pursuit rate at the expense of other areas.

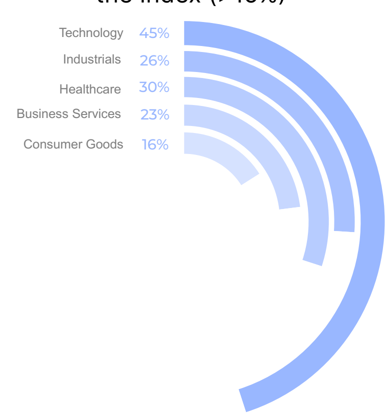
PURSUIT RATE BY SECTOR (TTM)



Sectors Accounting for Largest Percentage of Assets w/ Pursuit Rates Above the Index (> 15%)



Percentage of Assets within Each Sector with Pursuit Rates Above the Index (>15%)

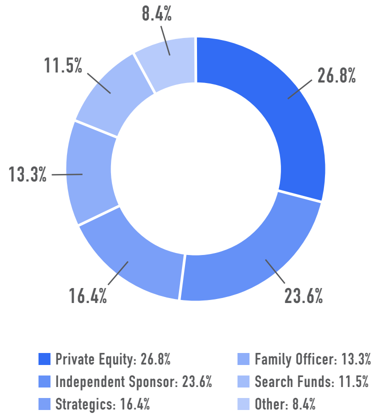


Private Markets Catalyze the Buy-Side

While the sell-side activity bucked broader M&A trends, showing steady growth even as closed-deal volume pulled back worldwide, the bigger surprise was the extent to which buy-side activity exploded in the first quarter. Beyond underscoring a sense of insulation among domestic operators in the lower middle market – particularly as global geopolitical threats escalate – other factors are surely at work.

Seasonality, for instance, can explain the exaggerated delta between the growth of new mandates sequentially (72% versus Q4). The growth over the corresponding period last year (33% versus Q1, 2021) reflects another catalyst that can be found in the breakdown of the buy-side participants.

THE BUY-SIDE PLAYERS
(% OF NEW MANDATES Q1)



PE Assumes Lead on LMM Buy Side

Private equity buyers now represent the largest category of acquirers on the buy-side. Last year, for instance, financial sponsors accounted for approximately 19% of all buy-side mandates; in Q1, the percentage jumped to 26.8%. This can be directly attributed to the growth of the private markets. Similarly, independent sponsors have increased their presence on the buy-side as well, and represented nearly a quarter (24%) of those initiating new mandates in Q1. While independent sponsors may lean less on add-on activity than their "funded" peers, they're just as motivated to find attractive dealflow and put capital to work on behalf of their backers.

Strategic acquirers, comprised of both holding companies and corporations, also maintained a steady presence on the buy-side representing 16% of new mandates, while initiatives stemming from family offices represented 13% of the overall pie.

The buy-side interest largely corresponds with sell-side activity. The industrials, consumer goods and business services sectors attracted the most mandates, while business services, transportation and consumer goods saw the most growth, year over year. However, technology was a distant fourth in terms of total new buy-side initiatives, representing just 10% of the total activity. The sector also saw less growth (13%) than most other industries year over year. One possible explanation could be that buyers, to drill into a specified investment thesis, will tailor their sourcing efforts to an end market, whereas sellers, aiming to maximize multiples, position targets as software or tech companies first to realize premiums not available in other segments.

BUY-SIDE STANDOUTS

Sectors Showing the Biggest Increases Year over Year in Q1 (vs. Q1, 2021)

FASTEST GROWERS

Business Services: 70%

Transportation: 35%

Consumer Goods: 33%

BUYER DRILL DOWN

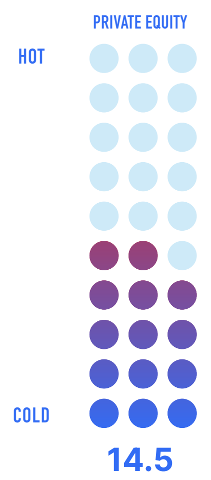
Private Equity's (Latest) Moment

The growth of private equity over the past 20 years has been remarkable. Jamie Dimon, in JPMorgan's latest annual report, highlighted that the number of PE-backed companies in the U.S. today – at over 10,000 – more than doubles the number of listed companies. After a year like 2021, in which sponsors set new highs for both fundraising and deal volume, it shouldn't be a surprise PE now represents a powerful catalyst fueling lower middle market activity even in the face of economic and geopolitical headwinds.

So what does the data tell us about the behaviors of PE investors? For one, they're very picky, in fact the most discriminating of any category. Buy-side pursuit rates, for instance, are calculated by the number of times prospective acquirers solicit more information about a deal, divided by the number of opportunities available to them. At 14.5%, PE firms logged the lowest pursuit rates of any acquirer type last year. (Strategics, by comparison, registered an average pursuit rate of 22.5%, the highest among acquirers).

That being said, sponsors are more likely to close a deal than most other categories. Of all the closed deals on the Axial platform last year, 22% were completed by PE firms. And deals in PE beget add-on activity (which tends to gravitate to the LMM arena) and, ultimately, exits. This creates a virtuous cycle that should keep the lower middle market machine churning for the foreseeable future.

2021 PURSUIT RATE



SURVEY OF ONE

Michael Goletz,
Director,
Lawrence, Evans & Co., LLC

Q. Before we get into the buy-side activity being fueled by private equity, what are some of the reasons for optimism as sponsors look to pick up where they left off in 2022? Based on the data, for instance, it seems like sell-side activity at the top and middle of the funnel is unfazed by the evolving macro-economic picture.

So what's driving deal flow for investors amid the changing conditions?

A. *A lot has been written around the "Great Resignation" and there is potential that a similar phenomenon is occurring with the new sell-side engagements. Business owners are grappling with similar emotions of prioritizing what they want from life. The last two years have challenged us all to realize what is truly important.*

These additional sellers may be interested in the next phase or challenge with their life. Case in point, during a recent pitch, the owner expressed the interest to sell one successful company, which required little of his day-to-day input, to focus more attention on a smaller business in his portfolio, but one that is well positioned for growth and success.

Q. It probably doesn't hurt that buyers have also been unfazed by the economic uncertainty, and private equity in particular seems to provide a stabilizing force. What's motivating PE investors to remain so active in your opinion?

A. *Increased buy-side volume is driven by two factors: First, the buy-and-build playbook being executed by many sponsor-owned platforms, and, second, historically high multiples are forcing groups to find off-market deals for better value.*

The buy-and-build strategy has been executed across many fragmented industries – HVAC, dental, and landscaping representing three examples. It is not rocket science, but it can yield outsized returns.

Responses have been edited for clarity and brevity.

SELLER DRILL DOWN

Investment Banks Ride the Tech Wave

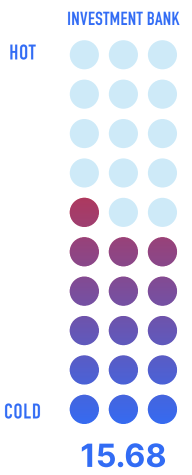
The presence of PE has helped to institutionalize the lower middle market. On the other side of the same coin, M&A advisors and investment banks have been essential in preparing business owners for the scrutiny and pace that comes with a sale today.

Investment banks, in particular, have maintained a steadfast presence and in any given year will represent anywhere from a quarter to nearly a third of all sell-side activity. What stands out among the deals marketed by investment banks is that no other source produces the volume of deal flow, while also maintaining pursuit rates consistently and comfortably above the 15% index.

In fact, in 2020 and 2021, deals marketed by investment banks generated pursuit rates of 16.8% and 15.5% respectively. In Q1, which saw somewhat depressed pursuit rates across the board, targets from investment banking sources stood out with a TTM average of 15.68%.

Other sellers, naturally, are wondering what it's in the "ibanking water" that translates into so much buyer interest? Looking at the first quarter data, a few different variables may be at play. Size, to be expected, seems to favor investment banking sources, as the average revenue and EBITDA of available targets stood at approximately $25 million and $3.8 million, respectively in Q1. Perhaps a bigger factor relates back to what they're selling, as technology targets accounted for 19% of all new processes from investment banks, versus 13% for the rest of the field. In the lower middle market, for many of the most successful investment banks, sellers can often be as discriminating as buyers in choosing who to work with on prospective deals.

TTM PURSUIT RATE



SURVEY OF ONE

Matthew Searles,
Managing Partner,
Merritt Healthcare Advisors

Q. In the lower middle market, investment banking and M&A advisory deal flow has held steady despite some economic and geopolitical threats that have started to surface. Why is that?

One would assume that sellers might start to get cold feet given the worsening inflation picture, unresolved supply chain issues, or even the war in Ukraine. So what's instilling confidence from your perspective?

A. *While some indicators show possible economic headwinds are on the way, the actual impact thus far on the cost of capital and consolidation interests in M&A is still minimal.*

This could change if the economy enters into a true recessionary period due to a cyclical economic downturn.

Q. So what should observers be looking at in terms of the most pronounced threats that could potentially begin to affect deal flow?

A. *Keep an eye on continued inflationary pressure, impacts of fed tightening and general growth indicators. Each of these factors could conspire to impact M&A in the near term; at this point in the first quarter, they just have not had an impact yet.*

Q. On the buy-side, meanwhile, we've never seen more new mandates initiated in one quarter on the Axial platform. From your perspective as an investment banker, what does this reflect? Could it potentially be more proactive origination efforts anticipating that sellers could pull back? Does it reflect the record-breaking PE activity last year, driving subsequent add-on activity? Or could it be something else?

A. *Again, this may be more a matter that the economic changes we have seen evolve in the last six to 12 months have not had an impact on the key factors that can impact M&A activity. To support this point, capital is available and growth through acquisition and consolidation is still an attractive pathway to value creation.*

Responses have been edited for clarity and brevity.

INDUSTRY DRILL DOWN

Ground Zero for Digital Transformation

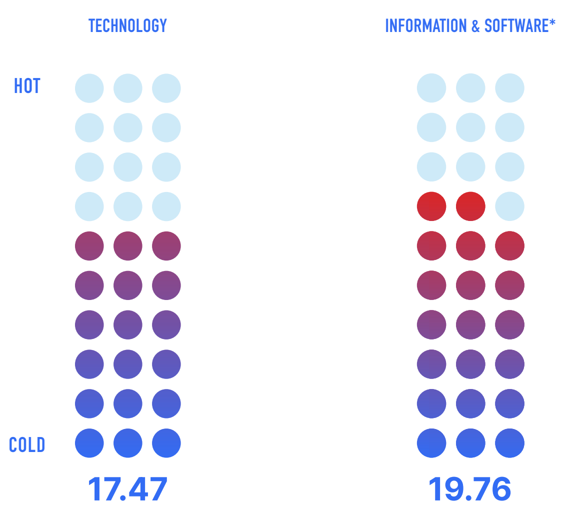
Previous Pursuit Reports have touched on the strength of the technology ecosystem that flourishes in the lower middle market, even if it's overshadowed by the unicorns and celebrity startups in Silicon Valley, New York or Boston. What's harder to quantify is the extent to which technology is indeed "stealing" deal flow from other areas, just to reiterate an earlier point.

For instance, out of the top 15 companies based on pursuit rates in the tech sector, three could just as easily qualify as education deals, three as healthtech, and the balance as either marketing and professional services, regtech and even real estate tech-enabled companies. Contrast these characterizations with transaction profiles on the buy-side, where investors categorized mandates seeking education technology under "education" or "healthcare technology" companies as healthcare services.

Whether it's semantics or gamesmanship or a little bit of both, the fact is technology assets and software is everywhere and in demand. Moreover, the growth in Q1 and the acute buyer interest in these assets based on the pursuit rates underscores the resiliency of the sector. Subscription-oriented business models and recurring revenues instill further confidence, while the pandemic confirmed that business leaders will prioritize technology spending.

However these deals are being categorized, the growth signals that the lower middle market represents ground zero for digital transformation in every sector.

TTM PURSUIT RATES



Subsector across all industries

SURVEY OF ONE

Aaron Solganick,
Chief Executive Officer
Solganick & Co.

Q. Have we reached the point Marc Andreessen referred to 10 years ago when he claimed that software is eating the world and every company is effectively a tech company?

A. *I think that's becoming true. Most companies today need to have some sort of tech enablement as part of their value proposition or leverage software in some capacity or function. If you're not using software, data and analytics in some fashion, there's a good chance you're going to be left in the dust.*

From our perspective, the clients we're looking to work with have built proprietary software or have a unique or proprietary offering to attract the premiums most associate with the sector. Even as a banker, we're picky in choosing which companies we're going to work with and have minimum financial requirements before we take on a new client.

Q. Given the breadth of digital transformation, what are the most attractive niches today?

A. *We see a lot of activity revolve around four core areas. Healthcare IT is extremely active. There's a lot of attention around taking costs out of the system and that's driving growth in segments such as healthcare software and managed service providers (MSPs). We completed six deals in that area alone last year. Data and analytics is another hot area, particularly as AI technology relies on data. More recently, the edtech space has seen an acceleration of investment activity and consolidation fuel valuations. There's a large amount of interest in solutions providers that help companies manage or automate their supply chains.*

Q. The pandemic helped tech prove out its safe haven bona fides, but how are buyers and sellers approaching the new threats?

A. *Interest rates are still low, historically. That being said, sellers are aware of the threat, and that may be motivating some to get out into the market sooner rather than later. Among buyers, they're very focused on ARR growth or, in IT services, gross profit margins. But valuations for private companies remain high, which reflects their confidence.*

Responses have been edited for clarity and brevity.

Availability of Choice Characterizes LMM

Lower middle market participants are attuned to the outside threats influencing closed-deal activity in the larger market. There just happen to be more reasons for optimism. For instance, the constituents in this segment continue to enjoy strong business growth and healthy backlogs. Meanwhile, private debt providers are helping the market maintain liquidity and arming businesses to invest in growth. And while acquirers anecdotally remain as discerning as they've ever been, they're also prepared to bid aggressively for great companies. Again, this is one of the featured attributes of the lower middle market, choice.

No one knows what the balance of the year will bring. But the lower middle market activity in the first quarter should signal to the rest of M&A universe that this segment can no longer be overlooked. It's where the Fourth Industrial revolution is currently re-imagining the manufacturing and industrials sector; it's where digital transformation trends may be most acute; and it's fast becoming a favorite destination for acquirers seeking the rare combination of both value and growth.

The bad news is that the lower middle market may no longer be the best kept secret in M&A. The good news, though, is that there is no shortage of deals to go around. This should bode well for the balance of 2022.

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