AXIAL

The Lower Middle Market Add-On Report

Axial's inaugural study of add-on activity quantifies the growing role of private capital in the lower middle market and offers a forecast for future deal flow based on the sentiment of active buyers intent on building out their portfolio companies.

Add-Ons Buttress Lower Middle Market M&A

In its 2022 Global Private Equity Report, Bain & Co. called attention to financial sponsors' newfound strength to compete against and outbid strategic acquirers. The record levels of dry powder, obviously, position financial sponsors to pay up for assets they really want. The consultant, however, pointed to the growing propensity of add-on acquisitions – which it estimated accounts for approximately one fifth of the total PE deal volume over the past five years. In effect, add-ons have helped transform GPs into strategic buyers able to factor in anticipated synergies and accelerated growth at the very onset of a potential platform investment.

To be sure, buy-and-build strategies or rollups in private equity are hardly new. But anecdotally, the proportion of deal flow stemming from consolidation activity among PE-backed portfolio companies has grown considerably over the past ten years. Higher asset valuations, for one, have forced many private equity investors to embrace growth strategies versus purely value-oriented investments. Add-on acquisitions have thus become an invaluable tool to help GPs quickly drive top-line growth. Add-ons can also support multiple expansion as portfolio companies gain scale, while lowering investors' all-in "entry" multiples through smaller tuck-ins or bolt-ons transacted at lower valuations.

The lower middle market naturally has become a beneficiary as sponsors of all sizes turn to this fertile pool of assets to source their tuck-in and bolt-on activity. Market participants well know that add-on activity represents a large proportion of deal flow. Exactly "how large," however, has never been quite clear. It's hard enough to track closed deal activity in a market that generally operates under the radar, but to discern with precision which "strategic" buyers are backed by investment groups and which are independent is a tall order for anyone unfamiliar with the nuances of the lower middle market. To help contextualize the extent to which add-on activity is fueling LMM deal flow, Axial went to the source through a survey of buy- and sell-side deal professionals, who not only helped to dimensionalize the role of add-on activity in the market, but also offered thoughts and forecasts around how economic shifts and the potential for future rate hikes might influence this activity in the years ahead. Future reports, meanwhile, will continue to track sentiment but also provide a longitudinal reading that documents how sentiment changes from year to year.

The good news for sellers is that almost universally, out of 150 deal professionals surveyed, most anticipate appetites for add-ons will either continue to grow or at least remain consistent with current levels. This helps to confirm a hypothesis that add-on activity can provide something of a stabilizing force to the LMM. But there is more to the story as the survey revealed.

WHAT YOU'LL FIND INSIDE:

Defying Expectations: Add-ons Fuel LMM Activity

The survey, which was conducted in April, captured feedback from a range of buy-side perspectives, including private equity investors, independent sponsors, family offices and even strategic buyers – both PE-backed enterprises and founder-led companies. The survey also solicited the sell-side perspectives of investment bankers and advisors, which accounted for roughly half (52%) of the 150 respondents.

Among the buy-side investors, private equity GPs represented 56% of those surveyed, while independent sponsors accounted for 29% and family office representatives comprised the balance. The diversity across the survey should not be unexpected given the range of buyers who traffick in the lower middle market. It was even challenging to pinpoint a “typical” transaction size, as there were roughly as many participants who pursue deals under $10 million in size as those targeting transactions valued between $50 million and $100 million. If there was a common thread it was the level of activity fueled in large part by add-ons, as the average number of completed deals across all financial buyers surveyed stood at 3.1 last year. And more than a third (or 35%) claimed that add-on transactions represented at least half of their new deal activity and in many cases as much as 75% to 100% of their 2021 completed deals.

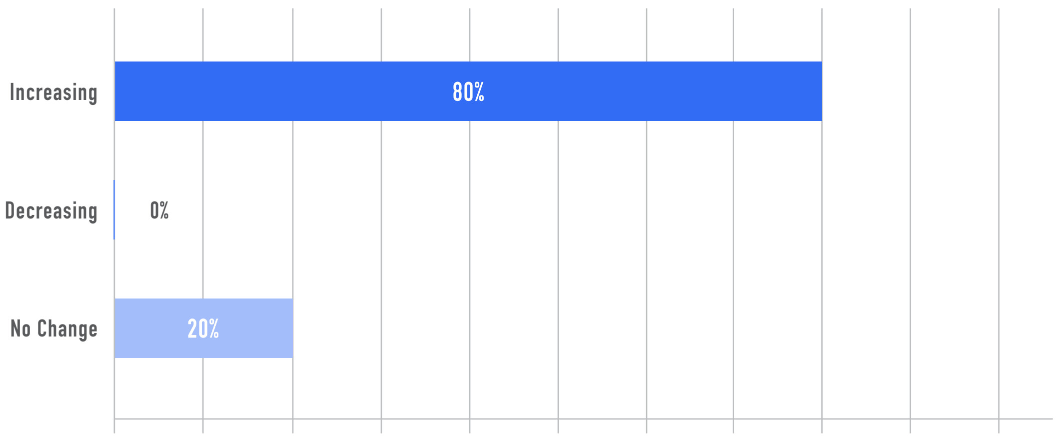
The responses help to confirm what most participants in the lower market already assumed, which is that the accelerating pursuit of add-ons among financial buyers have indeed been fueling buy-side activity in the lower middle market. This was evident, for instance, in Axial’s most recent *Pursuits Report*, documenting a roughly 33% surge in new mandates on the buy-side in Q1, as sell-side activity, or the number of new sale processes initiated on the Axial platform, nearly matched the historic pace set in the first quarter of the 2021. The data stood in stark contrast to the global M&A market, which saw completed deal volume slump by 23%, year over year, according to Refinitiv.

While buy-and-build strategies are helping the lower middle market defy expectations, among the financial buyers surveyed respondents overwhelmingly expect to see the pace of add-ons grow from here. Eighty percent indicated that the appetite for add-ons among their portfolio companies is expected to increase, while roughly 20% cite no change in strategy (in many cases because add-ons were already core to their investment thesis). Exactly zero respondents among the financial buyers, though, anticipate the appetite for add-ons will decrease.

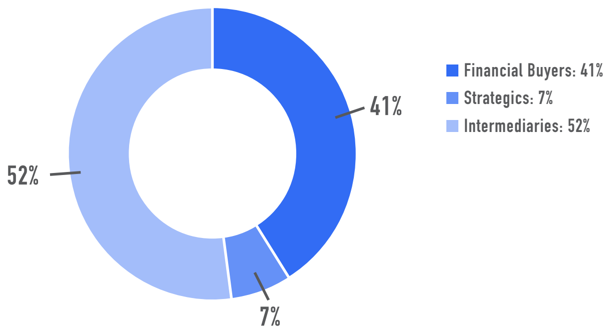
SURVEY OF ONE

“It varies by portfolio company but in some cases, organic growth is proving more and more challenging to achieve under the current market conditions.”

HOW WOULD YOU CHARACTERIZE THE APPETITE FOR ADD-ONS ACROSS YOUR PORTFOLIO COMPANIES?

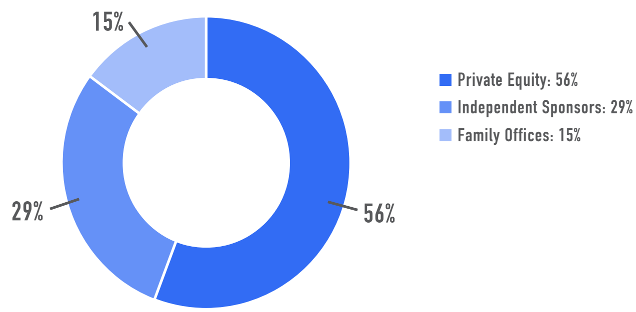


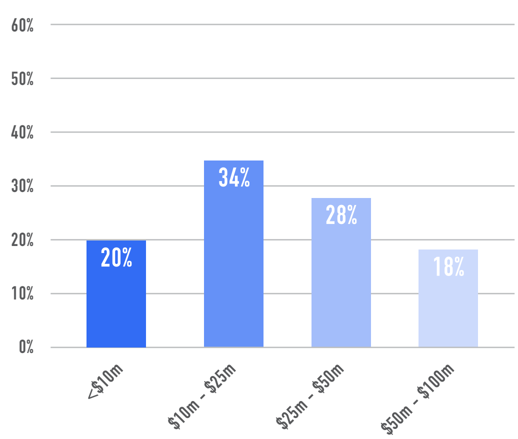
Survey Composition



SURVEY RESPONDENTS

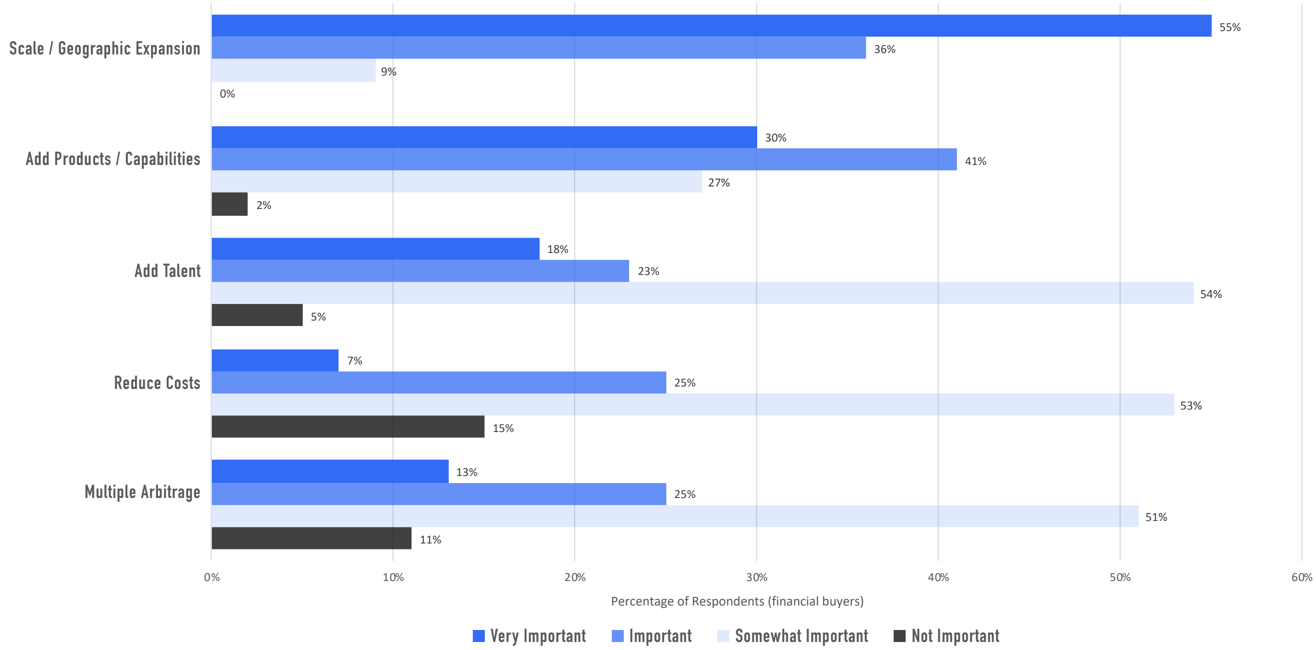
FINANCIAL BUYER RESPONDENTS





TYPICAL PLATFORM DEAL SIZE

ADD-ON OBJECTIVES: WHAT MATTERS/WHAT DOESN'T



Deconstructing the Buy-and-Build Playbook

There has been no shortage of literature exploring private equity's buy-and-build strategies. One recent study, out of the Erasmus Research Institute in the Netherlands[1], for instance, concluded that investors generated a "significantly higher return on sales" compared to value-creation strategies centered solely on organic growth. The research also underscored financial buyers are indeed effective in their efforts to realize operating synergies in an "economically meaningful" way. Meanwhile, a separate study[2] confirmed that sponsors are indeed factoring anticipated synergies and "inorganic" growth into their valuation calculus at the very onset of their investments, which fuels premiums when they identify a scalable platform. This can create a self-fulfilling prophecy as it relates to future add-on deal flow.

Axial's survey supports many of these findings. And against an economic backdrop in which organic growth is only becoming more challenging to effect, financial sponsors can be expected to lean even more heavily on add-ons to fuel value creation efforts. However, there were some surprises that emerged that hint at what buyers will be prioritizing in their hunt for deals.

For instance, among the financial buyers surveyed, every respondent cited adding customers or geographic expansion as being at least slightly important to their objective in pursuing add-ons. But more than nine out of every 10 (91%) characterized these objectives as being either very important or important to their strategy. Likewise, more than seven out of 10 also cited adding new capabilities or products as either being very important or important. However, fewer than a third (32%) noted that cost reductions were important to their strategy.

This suggests buyers are prioritizing revenue synergies above cost synergies to achieve their financial goals. In fact, 15% noted that cost reductions weren't a factor at all in their deal analysis. Moreover, using add-ons to acquire talent or as a financial engineering tool to effect multiple arbitrage seemed to be secondary considerations based on the responses.

SURVEY OF ONE

"Add-ons provide an opportunity to drive operating scale and monetize best practices."

1 "Can Private Equity Funds Act as Strategic Buyers? Evidence from Buy-and-Build Strategies;" Dyaran S. Bansraj, Han T.J. Smit, Vadym Volosovych, July 7, 2020

2 "Do Private Equity Firms Pay for Synergies?"; Benjamin Hammer, Nils Janssen, Denis Schweizer, and Bernhard Schwetzler; January 29, 2021

Navigating the Add-on Challenges

On paper, the case for add-ons is pretty cut and dried. In reality, buy-and-build strategies can be quite challenging to get right, especially as the shifting economic backdrop creates something of a moving target to assess and execute M&A. When asked what stands in the way among the buy-side investors pursuing add-ons, the biggest challenge cited was the availability of attractive targets. Nearly half (or 48%) believe this represents the biggest hurdle. Meanwhile, the frenzied competition for available assets – or at least the best assets marked by stable cash flows and healthy balance sheets – was the second-most cited challenge, identified by 28% of financial buyer respondents.

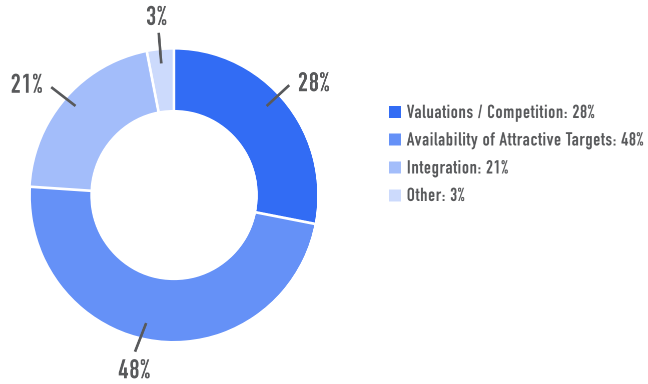
The conventional wisdom might assume that value becomes more readily available amid economic uncertainty. That hasn't always been the case, however, as less-than-pristine assets will often move to the sidelines, while the very best companies get bid up amid buyers' flight to quality. During uncertain periods, both challenges – a lack of attractive targets and competition – can conspire to keep valuations elevated even as visibility into the future recedes. PE sponsors, following a record year in fundraising and armed with considerable dry powder, could amplify this competitive dynamic.

Surprisingly, the integration challenge was only cited by approximately one fifth of respondents (21%). This would seem to debunk the platitude that between 70% and 90% of all mergers fail and that the breakdowns stem from lapses in post-merger integration planning and execution. It also could speak to the fact that those pursuing add-ons are serial acquirers and thus have developed playbooks to sharpen integration processes and have familiarized themselves with any prospective pitfalls and where they may lie.

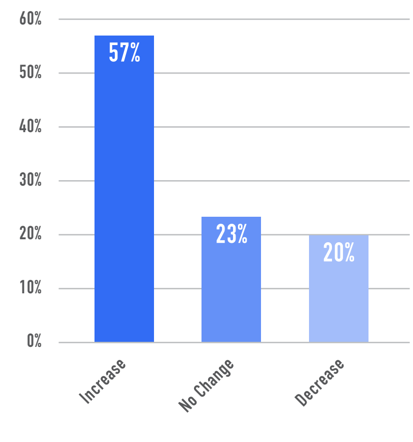
To go back to the valuation question, though, no consensus seemed to form in terms of where asset prices may be headed. Thirty percent predicted valuations would increase this year and next and the same number of respondents expected valuations to show no change. But 40% are anticipating asset prices will decrease in the years ahead.

That being said, 80% anticipate deal volume in the lower middle market will either level off at its current record pace (23%) or continue to increase (57%), while just 20% see deal flow moderating in the years ahead. This is consistent with the overwhelming proportion of financial buyers who, themselves, expect to accelerate add-on activity in the future.

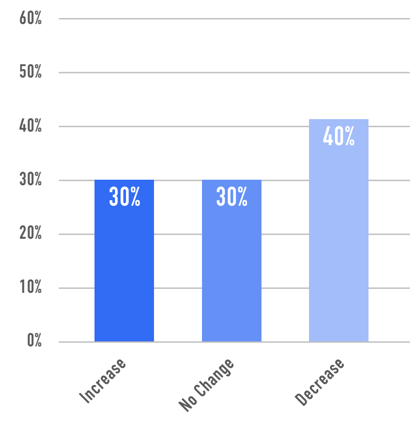
WHAT IS THE BIGGEST CHALLENGE IN EXECUTING ADD-ON STRATEGIES?

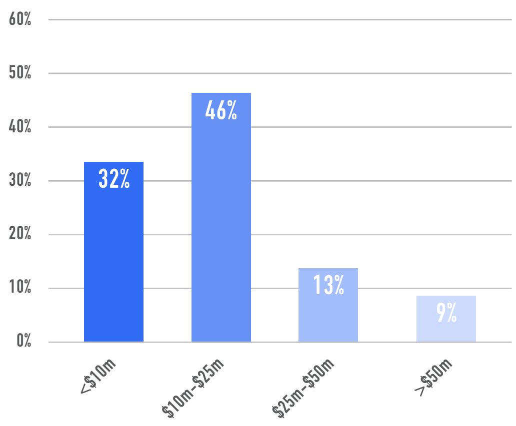


MOST LIKELY CHANGE IN DEAL VOLUME (NEXT TWO YEARS):



MOST LIKELY CHANGE IN VALUATIONS (NEXT TWO YEARS):





INVESTMENT BANKS / ADVISORS:
TYPICAL REVENUE RANGE OF CLIENTS

Strategics, Sell-Side Observations

While the financial buyers surveyed obviously have an unobstructed view into potential add-on activity in the months and years ahead, the responses from the strategic buyers, investment bankers and advisors reinforced the sentiment that add-ons should provide an undercurrent of activity. In fact, while only a handful of executives from PE-backed portfolio companies participated in the survey, those that did have averaged more than three deals per year over the past two years. The executives at founder-owned companies, in contrast, documented that on average companies without PE backing secured fewer than one deal on average over the same time period. The entire cohort of strategic buyers only represented 11 of the 150 responses, but across the board, the executives surveyed expect deal volume to either increase or remain the same and were split over the direction of valuations the next two years.

On the sell-side, respondents from investment banks and M&A advisory firms are just as bullish. Most sell-side respondents, for instance, said that the propensity of add-ons in their respective markets do indeed influence valuations. However, there was a divide over the extent to which add-on activity is driving asset prices higher. Thirty seven percent of respondents characterized add ons as being a significant force, versus 45% who see these deals as just a minor force. (The balance said they either weren't sure or didn't think add-ons had a material impact on purchase prices.)

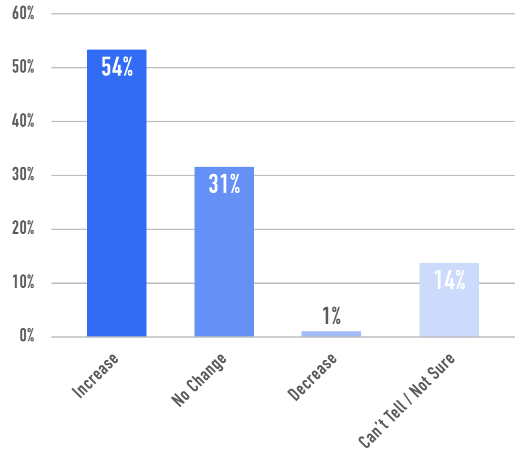
The split, though, makes sense given the composition of prospective acquirers that advisors and bankers are targeting. Over a third (35%) said that PE-backed portfolio companies pursuing add-ons made up at least half of the acquirers who bought client companies last year. Among this cohort, it's worth noting that these bankers and advisors completed more deals on average over the past year, 7.6, than all other sell-side respondents, who averaged 5.6 deals over the same time period. Apparently it pays to understand add-on appetites.

Across sell-side respondents, only a small fraction (4%) saw add-on activity decrease over the past year, while 69% reported an increase in add-ons. Looking ahead, assuming further market turbulence is in the offing, over half of sell-side respondents (51%) believe add-ons will outperform the broader M&A market, while 37% believe add-on activity would mirror the rest of the market. This speaks to the stability impart to deal flow.

SURVEY OF ONE

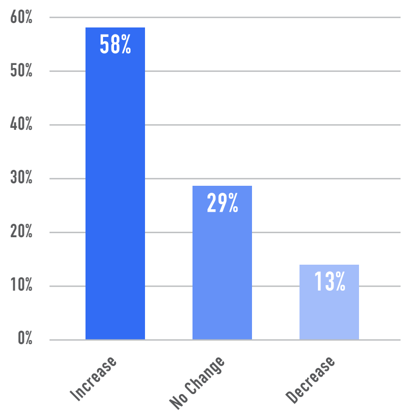
"Our markets are still highly fragmented, particularly in the lower middle market segment, so we anticipate there will be increased PE platform activity. At the same time, valuations are challenged given broader macro conditions and run-up in the last two years."

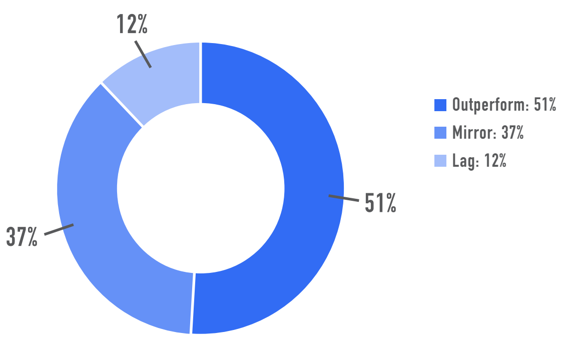
Advisor Forecast



INVESTMENT BANKS/ADVISORS:
ADD-ON ACTIVITY OVER THE PAST YEAR

INVESTMENT BANKS / ADVISORS:
EXPECTATIONS FOR TOTAL DEAL VOLUME





IN THE EVENT OF ONGOING TURBULENCE,
ADD-ONS WILL ____ THE BROADER MARKET?

Exit Interviews

Given what's happening in public equities and even other emerging asset categories (such as cryptocurrency), the optimism among lower middle market deal professionals may sound almost Pollyanna in comparison. In April, alone, the month during which the survey was released, the NASDAQ lost more than 13%, while the S&P 500 slumped by nearly 9%. As of mid-May, neither index had showed any signs of a rebound. Yet, as the deal activity in Q1 helped to demonstrate, the lower middle market is somewhat insulated to a certain degree from broader economic and market disruptions.

Based on the open-ended survey responses, neither sellers nor buyers are overlooking the new variables that promise to shape deal activity at least in the near term. It's just that many respondents also view the challenges facing the broader market as an opportunity that enterprising investors are positioned to help solve.

For instance, on the sell-side, one investment banking respondent noted that rising rates would likely motivate owners of closely held businesses to remain on the sidelines. But the same observer cited that the supply chain crisis — currently driving domestic onshoring activity among manufacturers — represents one of the most appealing opportunities for deal makers to address through M&A.

On the buy-side, not everyone is necessarily grieving a renewed sense of caution. According to one respondent, "A small recession will shake up some of the high-risk behavior we've seen from other sponsors and ultimately benefit more disciplined groups not willing to overlook key diligence risks."

At the same time, there's an overriding sense that the pressures facing public markets are motivating founders and independent business owners to seek alternatives. Some mentioned the ongoing retirement trends of the baby boomer generation, while others mentioned fatigue from the last few years as helping to underpin deal volume in the lower middle market (Covid, supply chain disruptions, digital transformation, balance sheet challenges, etcetera). It's also no secret that buyers in this corner of the M&A market are less dependent on debt and the capital markets to fund their deals.

Add-ons, in many ways, represent an ideal vehicle for financial buyers to grow their platforms, while adding economies of scale that can position the combined business to take on external challenges that may await. Make no mistake, there will be ups and downs across the M&A market. And the lower middle market, while insulated, certainly isn't immune to the economic factors pressuring other segments of the deal landscape. At the same time, as it relates to fueling the lower middle market activity, add-ons can be expected to help drive buy-side interest. And as one PE respondent noted, there can be a virtuous cycle that begins to form as investors pursue buy-and-build strategies. "As we acquire more companies," the respondent observed, "there is increased opportunity for add-on economics to work."

For that reason, buyers should remain motivated, which will give sellers confidence there's a market for their assets. And this could help create its own virtuous cycle that helps to underpin LMM activity even in an uncertain environment.

Founded in 2009, Axial is the largest online transaction platform empowering lower middle market deal makers. Axial's proprietary matching technology enables advisors & business owners to confidentially connect with relevant buyers & investors. To keep up with rankings, industry developments, original stories and more, sign up for Middle Market Review, here.

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