CIBC

CIBC CAPITAL MARKETS

US MIDDLE MARKET MONITOR

M&A and financing update
1st Quarter 2023

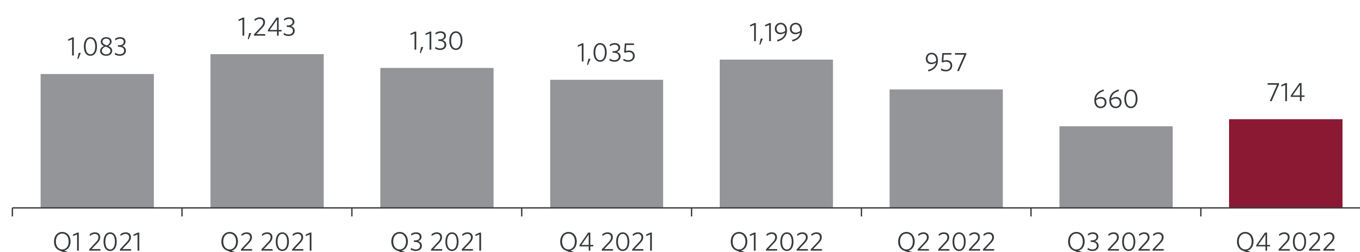
2022—Year in review

After the COVID investing boom of 2021, deal volume in 2022 returned to a more normal investment pace.

Transaction volumes

M&A activity slowed throughout 2022 due to growing macroeconomic uncertainty, rising inflation, increased borrowing costs, and a retrenching in the bank syndicated LBO market. According to Robert W. Baird & Co., the number of middle market (under $500 million of enterprise value) transactions in Q4 was 24% below the average quarterly volume for the first three quarters of 2022.

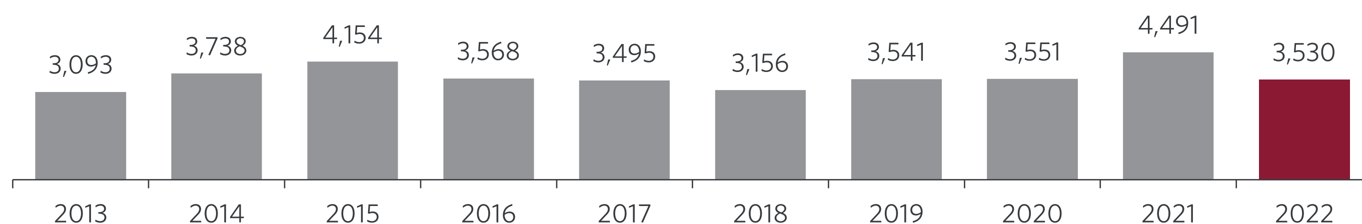
Quarterly number of US M&A transactions under $500mm



Source: Robert W. Baird & Co.

Although early in the year the middle market proved more resilient than billion dollar-plus transactions, the headwinds began to have a material effect on M&A activity across all size categories in late Q3 2022. Total middle market deal volume for the year was down 21% compared to a record year in 2021, but up 2% compared to the average transaction volume from 2017 to 2020. It is important to remember that 2021 was a record year because many deals that would have otherwise closed in 2020 were delayed by COVID shutdowns.

Annual number of US M&A transactions under $500mm



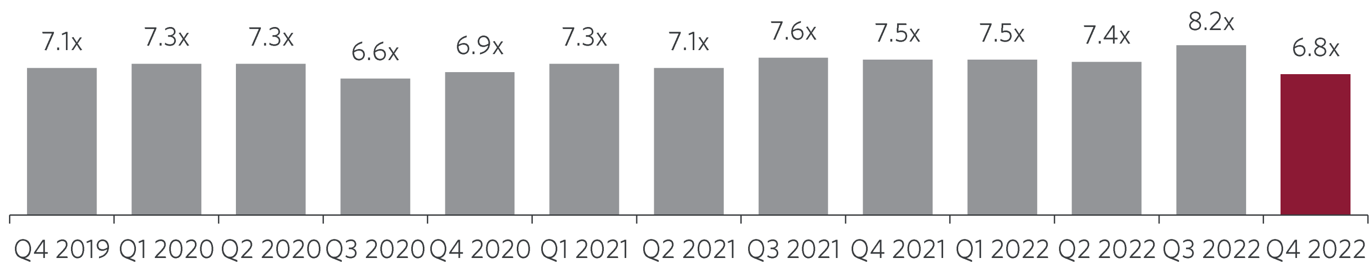
Source: Robert W. Baird & Co.

Add-ons as a share of total transactions increased to 78% as lenders were more receptive to supporting existing borrowers in a tightening credit market during the first 10 months of 2022 versus supporting new borrowers in a LBO. However, the level of support that lenders provided to highly-levered portfolio companies changed during Q4 2022. In Q4, highly leveraged platforms that required an amendment to a revolver and/or an acquisition term loan to complete an add-on with 100% debt financing experienced a reset in risk appetites from their debt financing sources. During Q4 2022, lenders repriced facilities, reduced hold sizes to limit their risk, and increased fees to recapture lost spread during the rapid increase in interest rates. Many private equity-backed portfolio companies were caught off guard by the risk over relationship approach that their long-time lenders took on small revolver amendment requests and total facility size increases that remained within existing covenants to fund add-ons. These lending challenges either led to a deal getting pulled, re-traded based on the new economics, or delayed to accommodate the unexpected financing process needed to fund the add-on. As we look to 2023, we anticipate that add-ons will still account for over 75% of the completed transaction volume. However, we would not be surprised to see a shift in the buyer profile from a highly-leveraged private equity backed portfolio company to a well-financed strategic buyer or private equity-backed portfolio company with sufficient debt availability within their existing debt facility to support the transaction.

Valuation

In Q4 2022, average EBITDA valuation multiples for small to medium-sized (under $250 million of enterprise value) private equity-backed leveraged buyouts ("LBO's") declined to 6.8x EBITDA from their peak of 8.2x EBITDA in Q3 2022, according to GF Data®. The decline in valuation multiples was attributed to ongoing macroeconomic conditions including inflation, recession concerns, and the pullback in the debt markets during Q4 2022. Additionally, some lower-quality assets traded at reduced multiples, offsetting valuation multiple increases for business models that proved to be recession and pandemic resistant which had positively impacted valuation multiples throughout 2022. CIBC has observed a decline in valuation multiples in certain sectors experiencing a "COVID bump" that now appears unsustainable. The markets that have segments experiencing multiple compression include consumer, software & technology, housing and building products, and food & beverage. The receptivity of buyers and lenders in these markets has been negatively influenced by factors such as public market sentiment, inflation, and supply chain disruptions. Currently, market segments that are experiencing multiple expansion include specialty contract manufacturing, specialty distribution, and facility services. CIBC has witnessed continued strength and sometimes multiple expansion in these high performing sectors because of the following factors: recurring revenue, supportable 2023 forecasts, proven financial resilience during and after the pandemic, and sustainable growth and margin expansion tied to the fundamental shift in the global supply chain to local production and consumption.

Average quarterly EBITDA multiples for $10mm - $250mm of enterprise value LBOs

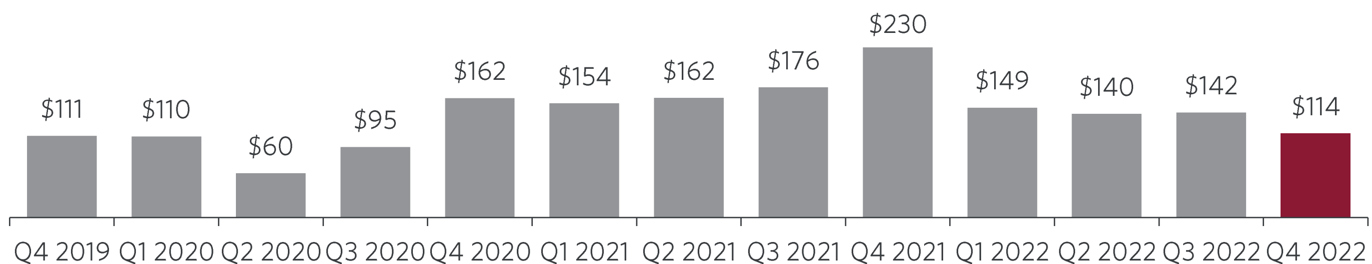


Source: GF Data®

According to Pitchbook, total quarterly deal value for LBOs in the US declined 20% from Q3 to Q4 2022. The significantly larger decline in value as compared to volume implies that larger deals were more affected by the pullback in the lending market and recession fears than smaller deals. According to Robert W. Baird & Co., larger transactions (between $500 million to $1 billion) declined by 26% from Q3 to Q4 2022 due to a combination of higher debt pricing, lack of available leverage, and a slowdown in software & technology deals tied to staffing cutbacks at technology and e-commerce market leaders.

Quarterly US PE deal value for LBOs under $500mm

$'s in billions



Source: Pitchbook

Despite a pullback in valuation multiples, high-quality companies continued to comprise the majority of reported LBOs. Defined by GF Data® as having stable, recurring revenue, strong management teams, and recession-resistant business models, companies with these above average financial characteristics constituted 68% of transactions for 2022, up from 64% in 2021 and well above pre-COVID levels. Although the premium paid for high-quality companies declined by 8% from a year ago, the "quality premium" remained elevated in 2022.

Buyout quality premium

Transaction Size	2003 – 2017	2018	2019	2020	2021	2022
Above Average Financials	6.6x	7.8x	7.6x	7.7x	8.1x	7.9x
Other Buyouts	6.1x	6.4x	6.2x	6.1x	6.1x	6.3x
Premium / (Discount)	8%	23%	21%	26%	32%	24%
Incidence	56%	58%	51%	54%	64%	68%

Source: GF Data®

Debt

During 2022, the Federal Reserve initiated the fastest credit tightening cycle in over 40 years, increasing the Federal Funds Rate from 0.08% in January 2022 to 4.10% by year end. As a result, the typical all-in cost of debt for PE-backed portfolio companies increased from a range of 6% - 9% in Q1 2022 to a range of 11% - 13% by Q4 2022. Lending standards have also tightened, with a focus on historical cycle performance, interest coverage, and fixed charge coverage ratios, typically resulting in a 0.5x to 1.0x decline in available leverage.

Year-over-year debt/EBITDA multiple comparison

Period	Debt	< 5M EBITDA	> $10M EBITDA	> $20M EBITDA
February 2022	Senior	1.75x – 2.75x	2.75x – 3.5x	3.5x – 5.5x
February 2022	Subordinated	1.25x – 1.75x	1.25x – 2.0x	1.5x – 1.5x
February 2022	**Total**	**3.0x – 4.5x**	**4.0x – 5.5x**	**5.0x – 7.0x**
February 2023	Senior	1.5x – 2.5x	2.5x – 3.0x	3.0x – 4.0x
February 2023	Subordinated	1.5x – 1.5x	1.0x – 2.0x	1.0x – 1.5x
February 2023	**Total**	**3.0x – 4.0x**	**3.5x – 5.0x**	**4.0x – 5.5x**
	Total YoY Difference	(0.0x – 0.5x)	(0.5x – 0.5x)	(1.0x – 1.5x)

Source: SPP Capital Partners

Year-over-year debt pricing comparison

Period	Debt	< 5M EBITDA	> $10M EBITDA	> $20M EBITDA
February 2022	Senior	2.3% - 4.1%	5.1% - 7.6%	4.6% - 6.1%
February 2022	Subordinated	11.0% - 14.0%	9.5% - 12.0%	9.0% - 11.0%
February 2022	**Total***	**5.9% - 7.9%**	**6.5% - 9.2%**	**5.9% - 7.1%**
February 2023	Senior	8.3% - 9.6%	11.1% - 12.6%	10.6% - 12.1%
February 2023	Subordinated	13.0% - 15.0%	12.0% - 14.0%	11.0% - 13.0%
February 2023	**Total***	**10.7% - 11.6%**	**11.3% - 13.1%**	**10.7% - 12.3%**
	Total YoY Difference	+ 3.7% - 4.7%	+ 3.9% - 4.9%	+ 4.8% - 5.2%

Source: SPP Capital Partners

* Weighted average pricing based on debt/EBITDA multiples from "Year-over-year EBTIDA multiple comparison" chart.

CIBC has observed in its Q4 2022 and early 2023 transactions that the cost and availability of debt is having an impact on valuation and/or post-LOI timing to close. To show the impact that debt markets are having on LBOs and add-on activity, we developed this hypothetical example for an "A" industrial asset with $10 million of EBITDA forecasted to grow to $15 million of EBITDA organically over the next five years:

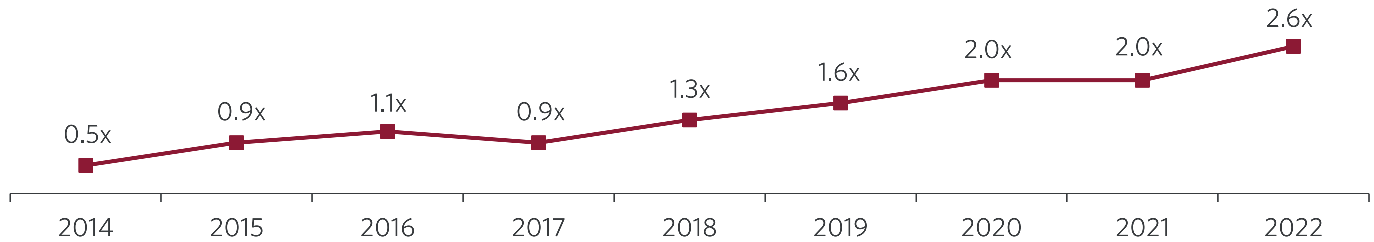
- In 2022, the debt markets would have supported this LBO with 4.0x total debt, priced at a 7.5% blended interest rate. To achieve a 20%+ IRR over a five year hold period, a PE buyer could have paid 9.0x, or $90 million.

- In 2023, the debt markets are supporting this LBO with 3.25x total debt, priced at a 11-12% blended rate. To achieve a 20%+ IRR over a five-year hold period, a PE buyer would only be able pay 7.8x, or $78 million, which is 13% less than it could have paid for the same asset last year.

As a result of the conservative approach that lenders are taking in the current environment, smaller transactions are closing with larger equity checks. According to Refinitiv, the average middle market equity commitment reached 60.5% in Q4 2022. This is the second time in the last five years that equity commitments to deals has exceeded 60%—the last occurrence was at the onset of COVID in early 2020. According to GF Data®, an average equity share above 55% has typically signaled downward pressure on valuations. Increased equity checks have also come in the form of seller notes and earnouts, which CIBC has seen increasingly in the consumer market and segments of the industrial market, as buyers and sellers have sought creative ways to complete deals. In addition, transactions have increasingly relied on subordinated debt to supplement a pullback in senior lending. Subordinated debt made up 11.5% of the average capital structure for platform investments in 2022, up from 10.3% in 2021, which is not surprising based on the fact that average senior debt interest rates and subordinated debt interest rates are similar. Meanwhile, senior debt decreased from 35.3% in 2021 to 32.5% in 2022, the lowest level in the last five years.

A bright spot in Q4 2022 was the private credit market's continued support of the LBO market, while the syndicated bank market was essentially closed. For LBOs, the private credit and direct lending market can offer increased efficiency and more borrower-favorable terms, relative to the syndicated bank market, on availability, covenants, repayment terms, deal structure, and speed to diligence and document. These efficiencies have driven private equity sponsors to direct lenders, who are expected to remain competitive against the syndicated bank market as interest rates continue to rise and credit continues to tighten in 2023.

Number of direct lending LBOs funded for each syndicated bank LBO funded

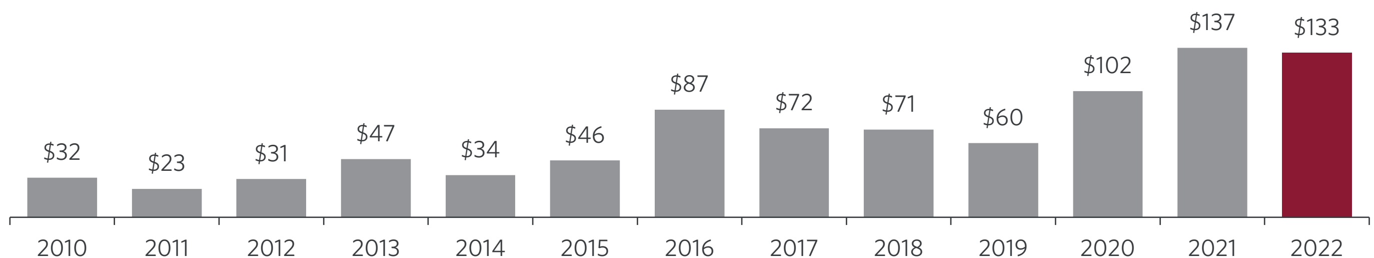


Source: Refinitiv

Private credit funds raised near-record amounts of capital in 2022. The rise in rates and credit spreads, which are also increasing returns to limited partners in these funds, are driving an increased allocation of alternative investment dollars to private credit by pension funds, foundations and endowments. In 2021, private credit funds raised a record $137 billion, followed closely by another $133 billion in 2022 to capitalize on the fact that direct lenders are closing 2 to 2.5 LBOs for every LBO funded by a syndicated bank group. Given the substantial amount of new capital, there should be sufficient available leverage to support dealmaking in 2023 despite the rising interest rate environment.

US private credit fundraising

$'s in billions

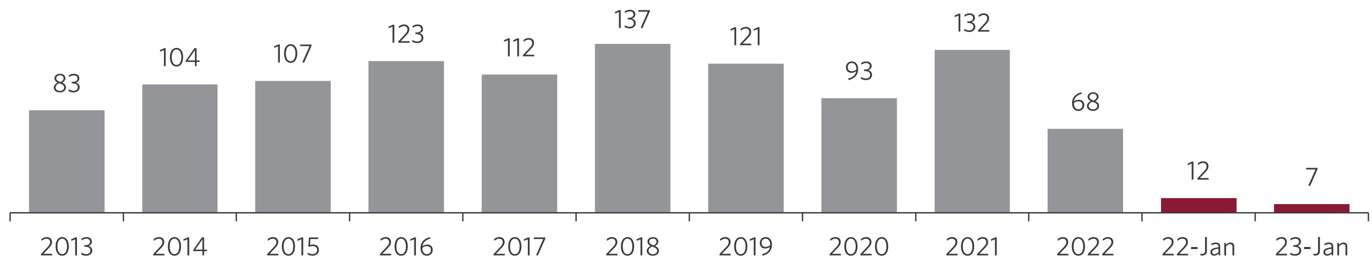


Source: Preqin

Sector Focus—Consumer

The consumer sector experienced a higher decline in deal volume compared to historical averages in 2022 due to the threat of a recession in 2023, excess inventories at retailers, and sinking consumer confidence tied to inflation outpacing wage growth. The consumer market continues to face supply chain issues, commodity input pricing volatility, and uncertainty related to the sustainability of strong profits achieved in 2020 and 2021. According to Robert W. Baird & Co., transaction volume in the consumer market decreased 48% in 2022 compared to 2021, which was more than double the 21% decline in deal volume that the overall M&A market experienced in 2022. In addition, a larger percentage of deals completed in 2022 related to non-core divestitures of divisions and product lines within larger consumer conglomerates. The weakness in 2022 has continued into 2023 with transaction volume in January down 42% compared to January 2022. Lower transaction volume is expected to continue in Q2 2023, but is expected improve during the second half of the year.

US M&A consumer transactions



Source: Robert W. Baird & Co. (disclosed deals under $1 billion)

In 2022, we said goodbye to many COVID-era measures, including mask requirements, vaccine passports, and most employees returned to the office, albeit on a hybrid schedule, but the consumer market walked directly into a new headwind—Inflation. Consumer product companies that posted strong profits during COVID began to experience year-over-year declines in profitability because they could not raise prices sufficiently to cover rising input prices. Rapidly rising input costs resulted in year-over-year declines in profits, especially for consumer durables and commodity segments of food and beverage. As expected, financial performance concerns resulted in a decline in transaction volume in 2022. However, not every consumer sector felt the sting of inflation and the threat of a recession in 2022. In 2023, we expect the market will experience increased demand for companies in health & wellness and consumer services as consumers look to spend money on self-care, both mental and physical, and enjoy experiences like entertainment and vacations to make up for lost time during the pandemic.

At the end of 2022, consumer spending remained strong (much to the dismay of the Fed) despite multiple signs of a pending recession in 2023. As we move forward in 2023, consumer spending is shifting from goods to services and consumers are experiencing the impact of inflation by shifting their spending trends to lower priced alternatives or delaying purchases on higher priced consumer durables. Despite the challenges and uncertainties facing the consumer sector, employment is high, spending is strong, and the consumer remains more resilient than expected…at least for now. Buyers and lenders, however, remain cautious based on the broader uncertainty related to the economy and the decline in profits many consumer businesses experienced in 2022. The uncertainty around financial performance is the most significant, so deal volume is expected to lag historical averages for the balance of 2023 in the consumer market.

In 2023, there are still opportunities for sellers of high-performing consumer companies to achieve successful outcomes if their business has shown resilience and sustainable profits. As always, the challenge for the M&A market is to find a way for sellers and buyers to agree on the future and simultaneously achieve their objectives. Those that choose to go to market in 2023 will face less competition from other sale processes and can achieve reasonable valuations despite potentially less supportive credit markets.

Firm overview

US Middle Market Investment Banking is a nationally recognized boutique investment banking firm with a global reach. We advise private equity funds, entrepreneurs, and small publicly traded companies on mergers and acquisitions, private debt and equity financings and recapitalizations and other transactions.

Our talented team has completed hundreds of middle market transactions delivering more than $8 billion in value. With an average of more than 20 years of deal experience, our skilled senior investment bankers bring knowledge, integrity and relentless determination to deliver great outcomes for our clients.

CIBC is a 150 year-old financial institution that provides US clients with tailored commercial banking, wealth management, personal and small business financial solutions, as well as cross-border banking services to clients with North American operations.

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Contacts

Mike Boyd
Managing Director and Head,
Global Mergers & Acquistions
416 594-7554
mike.boyd@cibc.com

Ronald Miller
Managing Director and Head,
CIBC US Middle Market Investment Banking
414 291-4528
ronald.miller@cibc.com

Patrick Bremmer
Managing Director
414 291-4548
patrick.bremmer@cibc.com

Ryan Chimenti
Managing Director
414 291-4531
ryan.chimenti@cibc.com

Gregory Gorlinski
Managing Director
414 291-4559
gregory.gorlinski@cibc.com

Ryan Olsta
Managing Director
414 291-4555
ryan.olsta@cibc.com

John Peterson
Managing Director
414 291-4551
john.peterson@cibc.com

Eric Reuther
Managing Director
312 564-2786
eric.reuther@cibc.com

Christopher Larsen
Executive Director
414 291-4547
christopher.larsen@cibc.com

James Olson
Executive Director
414 291-4552
james.olson@cibc.com

Patrick Ringsred
Executive Director
414 291-4553
patrick.ringsred@cibc.com

Alexander Eskra
Director
414 291-4533
alexander.eskra@cibc.com

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