Economic headwinds cause M&A to take different shape in lower middle market – Conference Coverage

- Number of bidders participating in sale processes down significantly
- Dislocation between private, public valuations changes playing field

More discriminating buyers are making it difficult to sell private companies in the lower middle market, dealmakers said at B Riley’s 22nd Annual Institutional Investor Conference last week in Los Angeles.

Bidders are reassessing potential targets that saw revenues spike during the Covid-19 pandemic, and closely scrutinizing fundamentals to determine whether businesses have staying power, they said.

Buyers are having a challenging time too, according to these dealmakers, as the value destruction occurring in the public stock markets has not yet taken hold in the private lower middle market.

“It really has been shocking to us how prices continue to climb,” said Gus Spanos, co-founder and managing partner of Walnut Creek, California-based SBJ Capital. “It’s a tough market to find value.”

In the last year, SBJ Capital issued fewer indications of interest than usual, he noted. Asset prices may come down in the second half of the year, but SBJ Capital is not building that into its models, he said.

The firm, which specializes in consumer, business services and healthcare services, has had to pay more in recent times than it normally would to successfully complete acquisitions, according to Spanos.

To avoid bidding wars, Robert Castillo, founding director at Invision Capital, said his Chicago-based private equity firm prefers to scout for low volatility businesses outside of auction processes.

Fueled by cheap financing and soaring stock markets, global M&A volumes breached USD 5tn for the first time in 2021, according to Dealogic. But runaway inflation, the specter of a recession, and Russia’s invasion of Ukraine have caused global M&A to drop 29% in the first quarter of 2022 compared to 4Q21.

In North America, which accounts for just over half of the world’s deal value, M&A transactions slipped 10% in 1Q22 compared to 4Q21 and they fell 30% compared to 1Q21, Dealogic’s data shows.
With large pools of buyside capital still on the sidelines, this quarter could see M&A activity increase relative to 1Q, Spanos said. Many business owners are aging and ready to retire, added Castillo. "We are also seeing Covid fatigue. They're saying: 'I'm done. I don't want to do this anymore. Sell my business."

But the number of bidders showing up to sale processes is down significantly, the dealmakers said.

“It's a different market,” said Nishen Radia, founding partner of FocalPoint Securities, a middle market investment bank in Los Angeles that B Riley Financial [NASDAQ:RILY] bought for USD 175m in January.

Macroeconomic headwinds and volatility in the public markets are causing bidders to be more judicious in how much leverage they use and more prudent with the capital they risk, Radia said. Buyers are also inserting more downside protections in deal structures and seeking minority-stake investments, he said.

There has been a “flight to quality” with bidders targeting recurring services businesses that are non-discretionary like heating, ventilation, and air conditioning (HVAC) repair, according to Radia.

“It sounds dull, there's no sex appeal,” but HVAC companies are trading at 13x or 14x EBITDA, he said.

The dislocation between private and public valuations could soon change the competitive landscape, he added. A strategic buyer that has seen its valuation shredded in the public markets may be less willing to pursue acquisitions, which, Radia said, could be an advantage for private equity firms looking for targets.

Additionally, value destruction in the public markets should lead to more buyout opportunities, Radia said, pointing to Elon Musk’s USD 44bn controversial offer to buy Twitter [NYSE:TWTR]. “We'll see more take-privates this year,” he said. “They won't all be led by Elon Musk, but we'll see quite a few.”

by Troy Hooper in Los Angeles