Considerations for a Successful Private Equity Exit

After a period of slower deal activity, middle market mergers and acquisitions (M&A) are showing signs of resurgence, with data from **PitchBook's Q2 US PE Middle Market Report** indicating a 12% increase in the first half of 2024 compared to the same period in 2023.

This momentum is likely to continue — following a change in administration after the U.S. presidential election and the Federal Reserve's November decision to lower the **benchmark federal funds** rate another quarter point to a range of 4.50 – 4.75%.

Lower interest rates are already impacting the broader market. In its **Q3 US PE Breakdown**, which covers all US PE deal activity, PitchBook reported its highest level of estimated exits (394) since Q1 2022. The Russell 2000 Index — often viewed as a bellwether for private company valuations — **rose 1.8%** immediately following the rate cut and is up nearly 9% year-to-date.

These tailwinds should ripple into the portfolio companies of private equity (PE) firms, as these funds look to increase exit activity, which has remained flat year-over-year.

Middle Market Dealmaking: What We're Seeing

Although deal activity is expected to increase, PE exits in the middle-market have stabilized as noted below but not meaningfully improved.

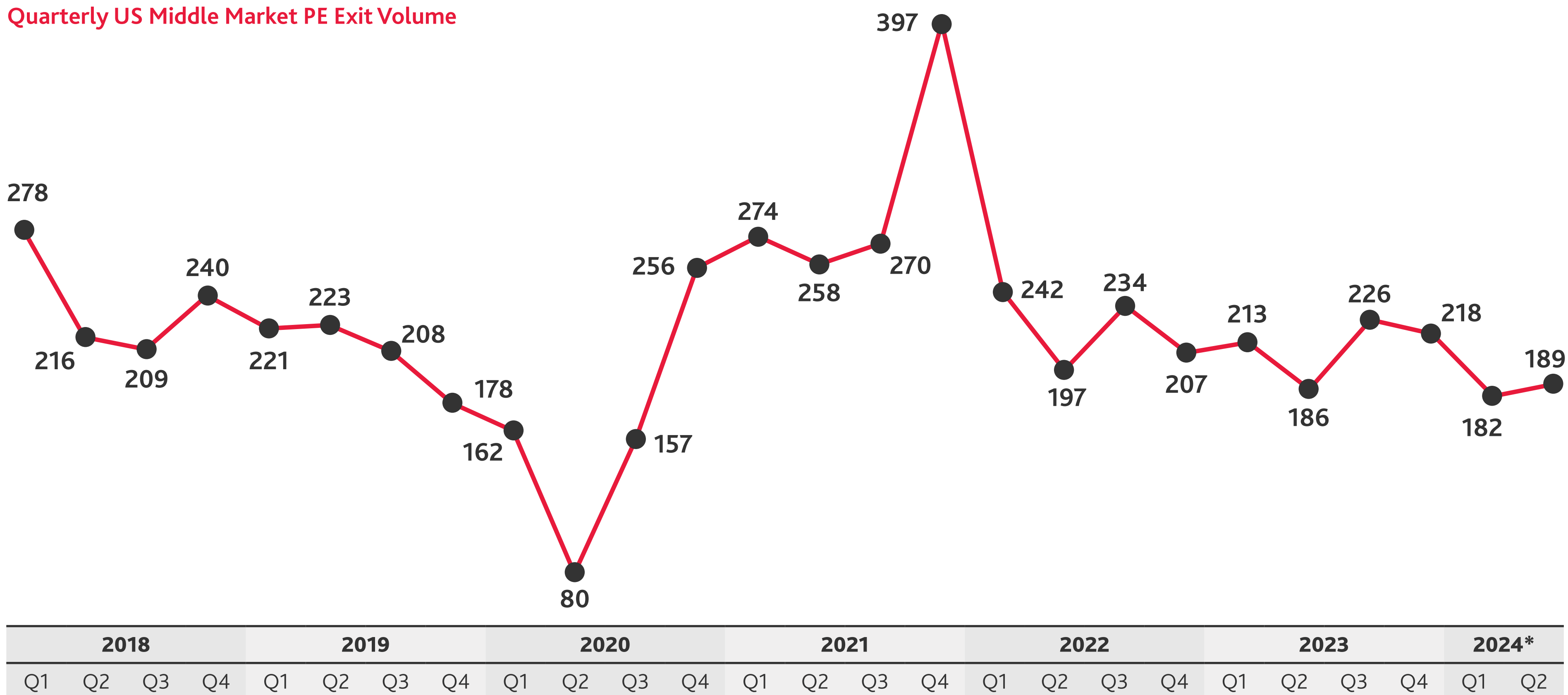

Figure 1: [PitchBook Q2 US PE Middle Market Report]

*As of 6/30/24

EXIT BACKLOG SHOULD INSPIRE MORE M&A

Due to the exit backlog, many PE funds are facing increasing pressure to sell portfolio companies (portcos) after historically long holding periods. U.S. general partners (GPs) have been waiting for more favorable exit market conditions, extending the median holding period for middle-market PE investments to a record 6.4 years in 2023, according to PitchBook.

Given the recent increase in the Russell 2000 Index noted previously, as well as the rise in middle-market deal multiples, which have recovered to 12.9x EV/EBITDA from a bottom of 11.0x in 2023, we believe the exit market conditions have become more favorable. Anecdotally, we've seen earnings of private companies steadily improve which should also help bolster their valuations.

These two factors should set the stage for renewed deal activity. We expect that a rebound in exits will power PE M&A activity in the middle market, as more funds kick off sales processes for the portcos they have been holding onto for an extended period of time.

Learn more about BDO's approach to M&A and Transaction Advisory Services ▶

STRATEGICS PLAY IMPORTANT ROLE IN MIDDLE MARKET EXIT ACTIVITY

As they kick off their expected sales processes, PE funds operating in the middle market are likely to look at other sponsors and strategic buyers.

Since Q1 2023, sponsor-to-sponsor exits have consistently outpaced exits to corporate strategics, making up over **55% of exit activity** in Q1 and Q2 of 2024, excluding public listings according to PitchBook.

But strategic buyers remain highly competitive in the middle market. In fact, 69% of fund managers and operating partners in ***BDO's 2024 Private Equity Survey*** reported strategic investors as their top competition for deals, indicating that strategics are still highly engaged and poised to capitalize on opportunities. Moreover, 57% of respondents said they will pursue a sale to a strategic for their exits compared with 37% who cited a sale to a financial sponsor.

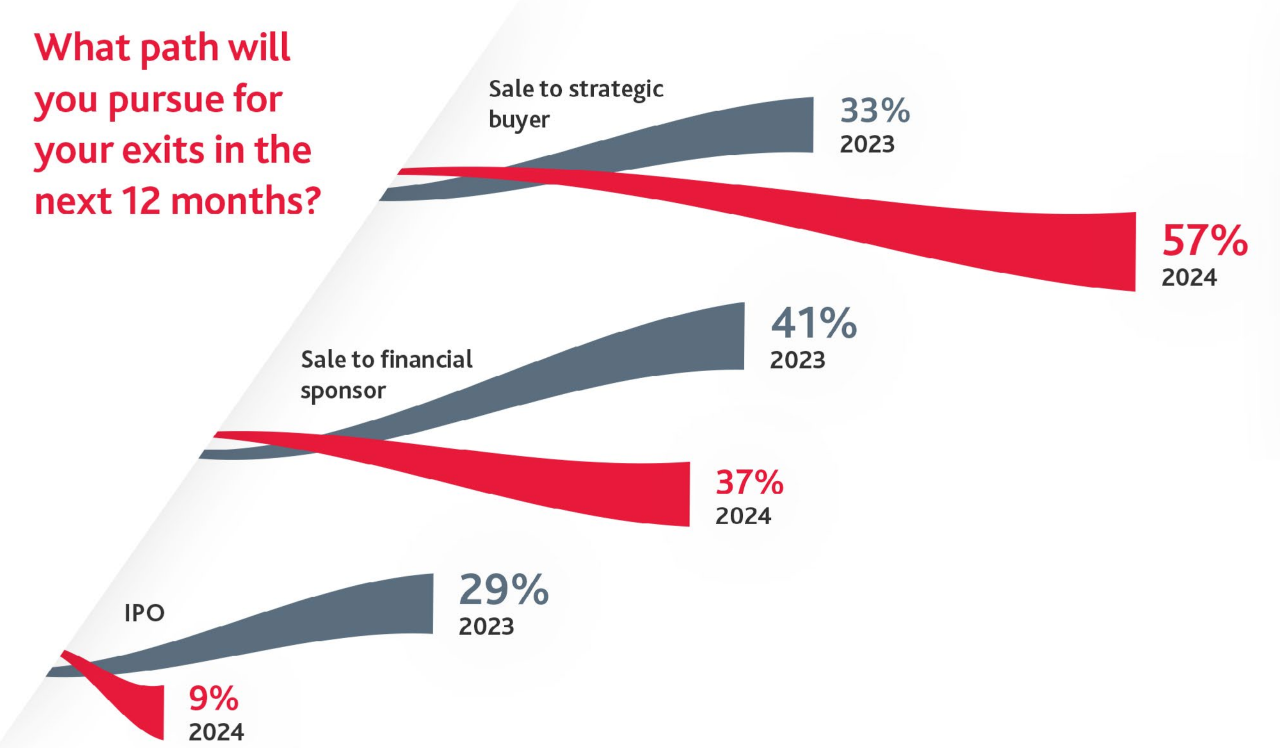

Figure 2: BDO's *2024 Private Equity Survey*

Driven by the substantial dry powder accumulated over recent years ($499.4 billion for US middle market funds according to the **American Investment Council and PitchBook** PE firms are moving more quickly on deals—which is something we're already seeing play out among our current client base.

Sell-Side Due Diligence: How to Prepare for An Exit

Poor strategic planning, non-disclosure of material changes or events, inconsistent internal controls, and cultural disparities between the buyer and the target — can all derail M&A transactions. With sell-side due diligence, PE firms can address these issues before the sale process begins. While deals can fall apart due to factors outside of the sellers' control (e.g., political changes or economic turbulence), PE firms should prepare their portfolio companies for exit by managing what they can control with a sell-side due diligence process.

Sell-side due diligence helps GPs maximize the value of portfolio companies and minimize transaction risk during the deal evaluation, negotiation, and closing processes.

When executed effectively, sell-side due diligence offers three key benefits for sellers:

1 Maintain Control

By identifying potential issues early in the transaction, sellers can take the necessary time to resolve these issues before commencing a sell-side process.

2 Streamline the Process

Sell-side due diligence reduces the need for extensive—and often repetitive—interactions between management, potential buyers, and their advisors, while also accelerating the winning buyer's own due diligence process, as they can leverage the seller's findings.

3 Enhance Value

By organizing and optimizing information ahead of the transaction, sellers can facilitate negotiations for the highest possible price, positioning the portco favorably in the eyes of potential buyers.

BDO's Take: How We Think about Sell-Side Due Diligence

Our core sell-side due diligence offering achieves two primary objectives:

- Identifying and capitalizing on opportunities
- Identifying and mitigating transaction risks

We apply this approach uniformly across the seller's financial and tax positions in relation to a potential transaction.

1. Quality of Earnings

Quality of earnings analysis is essential for understanding the sustainability and reliability of a portco's earnings.

- **Identify and Capitalize on Opportunities:** Analyze operating trends by business unit, product line, and customer, and bridge these results to projections. Our analysis can often identify one-time costs or possible pro forma adjustments that can increase the seller's adjusted EBITDA.
- **Identify and Mitigate Transaction Risks:** Assess the quality of earnings and identify any revenue recognition issues, cost capitalization concerns, non-recurring charges or credits, and changes in estimates or reserves that may impact the quality of reported earnings and cash flows. Evaluate all proposed earnings before interest, tax, depreciation, and amortization (EBITDA) adjustments and supporting analysis.

2. Tax Due Diligence

Establish the portco's **tax position** and address compliance with various tax obligations.

- **Identify and Capitalize on Opportunities:** Determine the appropriate transaction structure for the seller and assess its impact on potential buyers.
- **Identify and Mitigate Transaction Risks:** Identify tax-related risks, including federal, state, and sales tax obligations. Quantify and address potential tax exposures to avoid future liabilities.

3. Balance Sheet Due Diligence

Evaluate the financial health of the portco to identify opportunities and risks that may affect the transaction.

- **Identify and Capitalize on Opportunities:** Evaluate monthly working capital trends, focusing on balances and turnover statistics directly attributable to operations. Identify the most favorable working capital target possible for the seller.
- **Identify and Mitigate Transaction Risks:** Analyze the quality of assets, the completeness of liabilities, debt-like items, and any contingent obligations. Review capital expenditure requirements and assess the sufficiency of the assets to deliver projected results.

Additional Due Diligence

Larger deals may require additional due diligence to cover more complex transactions. In these cases, sellers may explore:

- Workforce Due Diligence
- Commercial Due Diligence
- Operational Due Diligence
- Cyber/IT Due Diligence
- Investigative Due Diligence
- Insurance & Risk Due Diligence
- ESG Due Diligence

BDO can help you throughout the M&A process — supporting sell-side due diligence to help reduce the burden on in-house teams and allow you to **invest with confidence**.

Contact us to learn more.