

Opportunities, Challenges and Strategies for Lower Middle Market M&A Deals in 2024



By: Ben Hangge at Highland Bank

It's that time of year again when analysts try to predict what's to come for lower middle market M&A deals in the coming year. In this case, deals that are \$3 million and

under in EBITDA fall into this scope. While the adage—the only certainty is uncertainty—may apply to some extent, we can look to the current headwinds and tailwinds at the end of this year to provide an outlook on what to expect in 2024.

Here are a few opportunities, challenges and strategies to help navigate the lower middle market M&A landscape for buyers and sellers alike.

Opportunities

Supply is Expected to be Healthy

There are still many family and individually owned businesses with owners at retirement age, which should keep supply healthy in 2024. Given geopolitical uncertainty, mixed economic results, looming tax sunsets, and a presidential election, 2024 could be the nudge some business owners need to sell—providing more supply for buyers.

Ample Dry Powder Available

Private equity firms, independent sponsors, search funds and strategic buyers are hungry to make acquisitions—and they have capital to be deployed. After a slow start in 2023, private equity fundraising ticked up in Q3 of 2023. According to S&P Global, private equity dry powder swelled to a record high of \$2.49 trillion in 2023, which is up 11% compared with year end 2022. This is expected to result in healthy demand for sellers.

Value Creation Opportunities for Buyers

Buyers are looking to create value for their portfolios and acquiring lower middle market businesses is still very attractive. Typically, they

can acquire lower middle market businesses at lower EBITDA multiples and still have growth opportunities such as expanding sales/marketing, professionalizing the business, and adding complementary business lines.

Challenges

Valuation Uncertainty for Sellers

Valuations have stayed elevated for the past several years, but with interest rates increasing significantly, this has created some uncertainty. EBITDA multiples could trend down slightly if interest rates remain high. Or if prices remain elevated, structures might change with additional equity requirements, more seller financing, or earnouts.

Tax Law Uncertainty for Sellers—Presidential Election Year

Election years typically drive sellers to the M&A market due to tax law uncertainty. In addition, the sunset of the Tax Cuts and Jobs Act (TCJA) at the end of 2025 could lead to material tax law changes before the sunset occurs, which could drive M&A activity in 2024.

Ongoing Talent Shortage

Talent shortages are widespread in most industries, but manufacturing is especially hit hard as baby boomers retire and fewer workers are entering the space. As M&A transactions occur, buyers and sellers need to have talent retention and attraction strategies in place, such as fostering a positive culture, competitive compensation, strong benefit plans, bonus potential, and career advancement opportunities.

Strategies for 2024

Expect a Longer Process

Over the past year, there has been an increased focus on due diligence and financial trends over a longer period as economic reports have been mixed—which has led to a longer sale process in general. Sellers should expect a longer process and more in-depth due diligence such as cybersecurity assessments and quality of earnings reports.

Successful Diligence Process

In order to accelerate the process, sellers should consider completing proactive sell side diligence such as cybersecurity assessments and quality

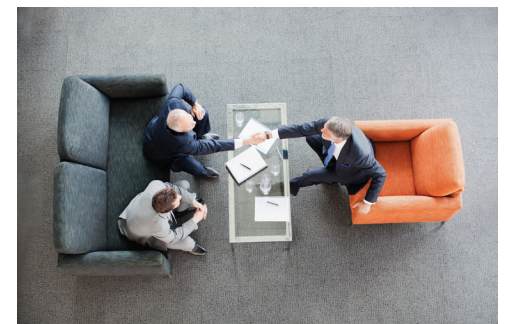
of earnings reports to identify and address any issues before the buyer does. Both buyers and sellers should proactively assemble a deal team with substantial M&A experience to ensure a smooth process.

Pursue Patience, Flexibility and Partnership

Both sides should keep flexibility in mind so the ultimate goal of a successful transaction is achieved. While it's still a good time for continued M&A activity, it might take more flexibility and creativity than prior years when it comes to seller financing, purchase agreement language, and earnouts. Individual buyers who need access to equity may need to leverage a ROBS 401(k) rollover or other creative avenues. Rely on a solid community banking partner with expertise in lower middle market M&As for guidance through all the knowns and unknowns in the coming year.

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Hangge is a senior commercial banker at Highland Bank who primarily serves lower middle-market commercial and industrial clients. With nearly 20 years of experience, he offers a broad range of expertise in all types of commercial banking. Throughout his career, Hangge has provided well over \$225 million in new financing for his clients. He holds a bachelor's degree in economics, finance and marketing from Bethel University, St. Paul, Minnesota.



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