CAPITAL ADVISORY

VALUATIONS & OPINIONS

Forecasting Success: Mid-market European M&A Set for Active 2024

2023 was a slower year for mergers and acquisitions (M&A), but the private mid-market fared better than the large-cap arena. Globally, the elements are in place for 2024 to be a year of M&A recovery, with deal flow expected to buoy in the second half. This article outlines the fundamentals of the European mid-market's strength, catalysts for an uptick in deal flow in 2024 and key issues dealmakers will be watching closely that could put a brake on activity.

A tough 2023, but better than the large-cap market

2023 saw a decreased level of dealmaking. High costs of energy, interest rates and soaring inflation reduced the availability of debt, forced up company costs and fostered a valuation mismatch between potential buyers and sellers. But transactions continued to get done for the small number of high-quality mid-market assets put up for sale. Lincoln International's analysis of its private equity (PE)-backed mid-market deals in Europe showed that, in many cases, assets were sold with robust multiples. At 13.2x, the fourth quarter showcased the most positive median EV / LTM EBITDA transaction multiples of the year, well above the two-year rate (12.7x), with healthcare performing the most positively. While sponsor-backed firms' post-COVID-19 revenue growth continued to decline in the deals Lincoln analyzed, margin compression reduced because of ongoing EBITDA growth.

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On the private credit side, distress levels in 2023 were modest within the mid-market companies Lincoln valued in Europe (and the U.S.), with just 2% of businesses falling into that category, based on fair values. The proportion of companies defaulting on covenants continued to decline throughout the year, to 3.4% in the fourth quarter, way below the 9.4% peak during the pandemic. Throughout 2023, lenders worked closely with borrowers to help them manage their positions. Unsurprisingly, the consumer and retail sectors faced the greatest proportion of defaults (8.9% of companies), more than double those of the same quarter last year.

Deal-drivers for 2024

With inflation reduced from its recent highs, a significantly decreased cost of energy (natural gas in particular) and the expectation that interest rates have peaked and could start falling from around the middle of the year, the macroeconomic picture in Europe is much more stable than it has been for months.

Debt financing is becoming increasingly available from banks, including through their direct lending divisions as well as syndicated loans, and debt funds, typically now providing more creative deal structures to get transactions done, often including payment-in-kind (PIK) and unitranche options.

There is a huge volume of dry power waiting to be deployed, around $2.59 trillion in PE and $400 billion in direct lending, and corporates are in a strong position to ramp up their acquisition strategies as they typically carry less leverage than PE-backed companies.

On the sell side, whereas in 2023 many financial sponsors held onto portfolio assets rather than bring them to market, the more stable economic environment, and the increasing availability of debt for buyers will encourage owners to seek an exit. There is also the pressure on PE firms to generate liquidity for their investors by selling portfolio companies before the cycle of generating new funds can begin as well as through mechanisms such as continuation vehicles and dividend recaps. A further catalyst to dealmaking is likely to come from the many private company owners, perhaps at the later stage of their careers. Having survived two crises in quick succession, they rationally want to diversify their wealth by bringing their business or at least part of it to market.

As ever, deal dynamics will vary by sector and asset type, but in many cases, financial sponsors and vendors will have to accept the higher interest rate paradigm of considerably lower valuations. Given the confluence of deal drivers, the valuation mismatch of the last 18 months keeping assets off the market will become a factor of the past.

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Lincoln has a strong backlog of M&A deals, and we are seeing a significant increase in new pitch requests. We anticipate that many of these deals will come to market towards the end of Q2 and into Q3. The technology, media and telecom industry has been the hardest-hit M&A sector since the pandemic, and we expect it to experience a rapid recovery. Energy transition, artificial intelligence (AI) and environmental, social and governance (ESG) assets are in strong demand, and we will continue to see transactions based on diversifying from dependence on China as a manufacturing base. We anticipate a step-up in take privates, corporate carve-outs—some following shareholder activism—distressed sales and takeovers by public companies riding elevated stock market valuations.

Bumps in the road?

While the 2024 outlook is positive, the global geopolitical outlook remains highly uncertain, and the playout of events could hamper M&A recovery. Top concerns include an escalation of unrest in Gaza into a wider regional conflict, further drawing in the U.S. and Europe and lengthening supply chains as more volume is forced around South Africa instead of through the Suez Canal, as well as the ongoing tension between the U.S. and China, including about Taiwan.

Dealmakers will also closely monitor the outcome of the U.S. election, with likely greater protectionism if Trump returns to the presidency as it may put a brake on some transactional areas. However, when Trump was President, his protectionist approach and tax subsidies for European investment drove companies to seek acquisitions of U.S. companies rather than relying on exports to the country. The UK election is likely to be another critical moment for M&A as the UK Labour Party, which is expected to come to power, has plans to significantly increase the taxation rate of carried interest on PE deals. But regardless of any geopolitical outcome, the U.S. will remain by far the most important target and buyer nation for European companies due to its market value.

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