2024 Wrap-Up | ***2025 Look Ahead***

M&A *Market Update*

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Deals Closed (#): 2,190 (QoQ ↓ 3%) Deals Closed Value: $185.8B (QoQ ↓ 28%) PE Fundraising: $48.3B (TTM ↓ 23%)

M&A MARKET PERSPECTIVE

Breaking the Stalemate: What's Next for Private Equity?

In many ways, 2024 has left us in a stronger position than where we started. Deal activity is picking up, exits are on the rise, and there's a growing sense that we're gearing up for a big M&A resurgence. The middle-market M&A scene seems ready for a comeback in 2025, with optimism spreading across the industry after a tough few years.

Economic signals are pointing to better days for dealmaking, with inflation easing, interest rates dipping, and investors feeling more confident in the wake of the U.S. election. But even with these positive signs, private equity is at a pivotal moment. The recent slowdown in exits is raising some real questions about whether current valuations can hold and how the broader market might balance out.

As we wrap up 2024 and set our sights on 2025, we're taking a closer look at some of the key factors shaping private equity in the current environment —the driving force behind middle-market M&A activity.

The exit puzzle and its impact on fundraising slowdowns: Fundraising is expected to be tougher in 2025, even though the overall M&A outlook is optimistic. The time it takes to close a private equity (PE) fund has stretched from 13.8 months in 2023 to 16.2 months now—the longest since 2010. This extended timeline means fewer funds are closing, and as a result, less capital is being raised. One of the clearest signs of this slowdown is the drop in dry powder. By the end of 2024, dry powder accounted for just 28% of assets under management (AUM)—its lowest level on record, and well below the 10-year average of 36%.

The lack of exits in recent years has some questioning whether the PE model can withstand and evolve to fit the changing market environment. For instance, U.S. pension funds, traditionally major backers of PE, are saying they simply don't have liquidity to invest. Their reasoning? "You haven't had exits in years, and we're running dry."

While PE firms continue to mark up the values of their portfolio companies, these valuations remain largely hypothetical without actual exits. Some of these assets might indeed be worth their stated values, but others could be overly optimistic, creating a sense of "make-believe." And here's the catch: even if exit activity picks up, it might not be enough to give fundraising the jolt it needs—especially if those lofty valuations don't hold up when it's time to sell.

Standing out in a crowded market: In today's tougher and more competitive fundraising environment, PE firms need to find ways to stand out and capture investor attention. When exits stalled and borrowing costs climbed, many firms turned to roll-up strategies—pursuing smaller, manageable acquisitions to create value through aggregation. But this playbook has become commonplace, with little innovation.

To really differentiate themselves, PE firms must shift their focus to creating sustainable value within their portfolio companies. This means going beyond the basics and implementing transformative, value-enhancing initiatives. Automation and cutting-edge strategies are essential parts of this equation. This will be key for fund managers to build trust with investors, stand out as leaders in a crowded market, and gain a competitive edge when it comes to future fundraising.

A phenomenon reshaping the investment landscape: The convergence of public and private markets is a trend that gained significant momentum in 2024 but has been evolving for decades. Historically, private markets offered significant valuation discounts due to liquidity constraints and information asymmetry. However, increased transparency, better access to private company data, and competition for deals have compressed valuation gaps. Periods of low-interest rates and abundant capital have driven public and private investors to compete for similar assets, often targeting overlapping sectors and industries. Private equity-backed companies are increasingly remaining private for longer (evident by the current private-to-public company ratio around 2.5:1 compared to 1:5 in 2005) but maintaining high levels of institutional visibility, narrowing the gap in market accessibility.

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M&A MARKET PERSPECTIVE

Breaking the Stalemate: What's Next for Private Equity?

(continued)

The rise of secondary markets for private equity assets has also improved liquidity, making private equity investments more accessible and reducing one of their key differentiators from public markets. Publicly traded private equity firms (e.g., Blackstone, KKR, etc.) and their strategies have further blurred the lines between the two markets. These firms often manage public funds while executing private-equity-style deals. While public and private equity markets still differ in terms of liquidity, governance, and investment horizons, the increasing overlap in strategies, participants, and valuation frameworks has reduced the historical distinctions between them.

Even with the shifting landscape, big questions linger: Will today's high portfolio valuations stand up when it's time for exits, or will valuation gaps make a comeback? And how will the reopening of public markets and lending options shape where investors choose to put their money?

The Bottom Line

It all comes down to one core issue: the lack of favorable selling conditions. In recent years, markets haven't supported the kind of multiples PE firms are aiming for. As a result, many firms have chosen to hold onto their investments, hoping for better market conditions that could lead to stronger valuations down the road.

But without a change in strategy or a notable uptick in exit activity, there's a risk of losing the confidence of key stakeholders. For now, the market is optimistic but remains in limbo—waiting for the moment when balance and momentum can finally return.

References:
Pitchbook
Financial Times: Investors offloaded record volume of private equity stakes in 2024

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DEAL METRIC UPDATE
Q4 2024 By the Numbers

The Brightline of Q4 Results: Deals are Up

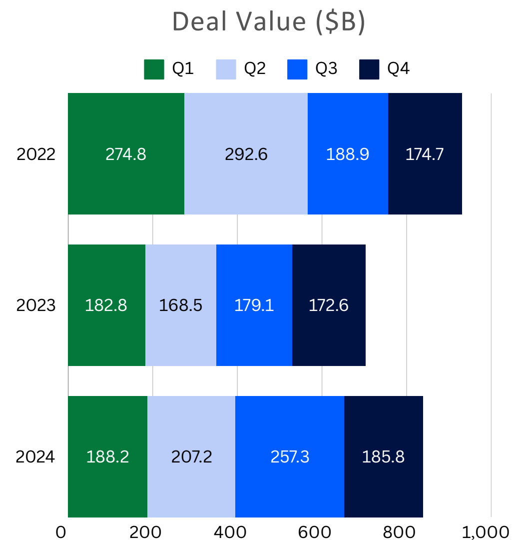
Q4 2024 rounded out Private Equity's recovery year. While quarterly deal value and count came in 28% and 3% less than Q3 2024, respectively, YoY results are strong – deal value improved by over 19% against 2023; and deal count, the more meaningful metric, ended almost 13% higher than the prior year. In hindsight, the market found the bottom in 2023 and spent 2024 in a cautiously optimistic upward climb. While not one factor alone boosted activity, the decline in interest rates, a stronger lending market, and tighter credit spreads all contributed to improved investor confidence and increased market activity.

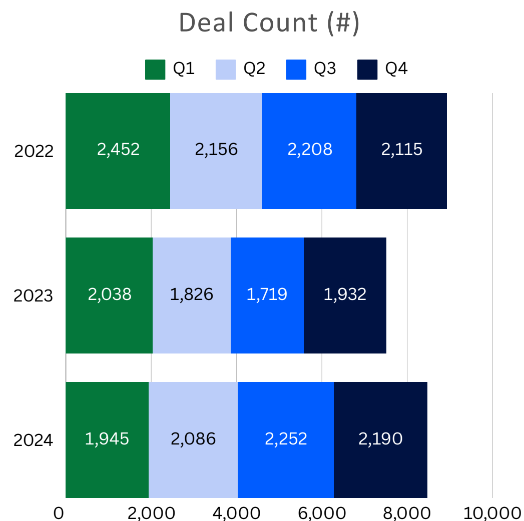
Similar to previous quarters, continued access to credit through banks and private lenders has created more opportunity for PE fund managers. The syndicated leveraged buyout (LBO) market ended 2024 with double the volume of 2023. These results are still 40% below pre-2021 levels. But in an environment with emerging alternative credit options, perhaps more current results will represent the new market norm.

The Broadly Syndicated Loan market finished 2024 at an all-time high, surpassing the previous record set in 2013. Loan types maintained the split seen in previous quarters, with activity favoring refinancing two-to-one over new issue debt – an expected outcome given the current leverage models of portfolio companies.

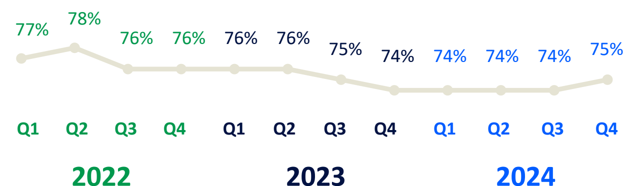
Add-ons as a percent of overall deal activity declined 1% compared to 2023. Improved market sentiment will continue to bolster the attractiveness of other, larger deal types (more traditional "platforms" in terms of size and scale) and as a result add-ons relative to the whole are expected to decline to historical levels, sub 70% prior to 2020.

Quarterly PE Deal Activity





Quarterly PE Add-On Activity (% of Deal Count)



Source: PitchBook Data, Inc. US PE Breakdown

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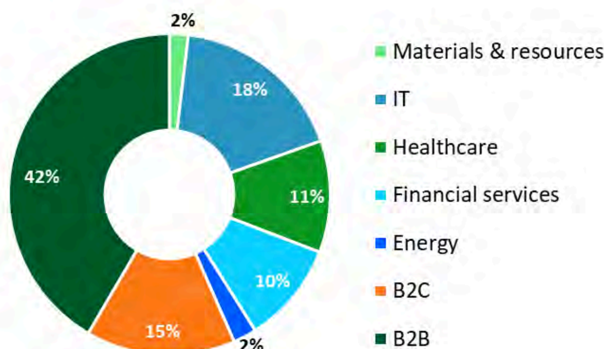
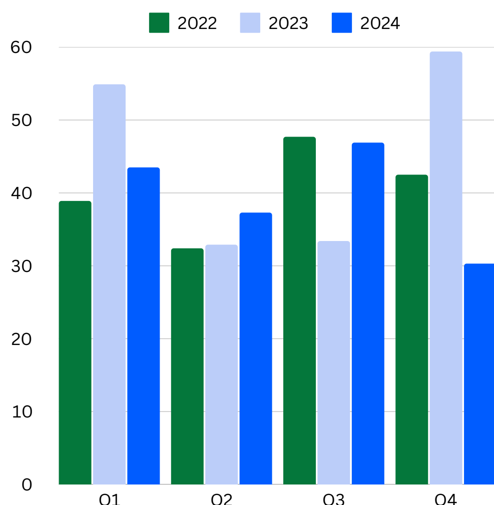
DEAL METRIC UPDATE
Q4 2024 By the Numbers

Quarterly Deal Activity Breakdown

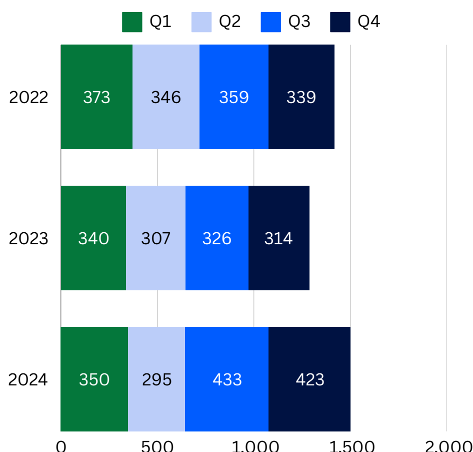
PE Deals by Sector (#)



Quarterly PE Middle Market Fundraising ($B)



Quarterly PE Exit Activity (Deal Count)



Source: PitchBook Data, Inc. US PE Breakdown

Exits Logjam Cracks under High Value Deals

2024 exit metrics were enough to bring some surface-level excitement to the market - exits finish 2024 up YoY, with a 49% increase in exit value and a 17% increase in deal count. However, larger deals with corporate and public buyers buoyed those results, and the outsized growth in exit value over deal count highlights that selling is still comprised of the highest quality assets, and still leaving behind the matured, but underperforming ones.

With the overall market sentiment improving and exit activity on the rise, it's easy to overlook some significant factors still at play. According to Pitchbook, US PE inventory has expanded by nearly 3,000 companies over the last six years, reaching a total of almost 12,000. 2024 in and of itself ended the year with an exit/investment ratio of 0.36x, a record low. This imbalance left us with a $321 billion net gap between exits and acquisitions at year end. At the current exit rate, it would take approximately eight years to divest of the inventory build-up. Two quarters does not a trend make, and only continued momentum, and growth in exit avenues will fully correct course.

Fundraising Drops Amid Locked-Up Capital

Both, overall US and middle-market fundraising finished 2024 with a flop. Middle-market fundraising saw its weakest quarter in three years, with Q4 2024 finishing 49% under Q4 2023, and 2024 ending 12% under 2023 results. The decline has been expected as fundraising is a lag indicator. With the lockup of capital in investments and record low distributions, investors do not have the capital to recycle back into the market. Even as exits build momentum and distributions to paid-in capital (DPI) improve, we expect middle-market fundraising's overall share to decline.

STATE OF THE ECONOMY
The Good and The Bad of the Upward Trends

Because the economy consists of and is operated by humans, sentiment is an important driver of growth. Since the November 2024 election, the mood of the financial markets and the economic environment has soared to new heights. However, such euphoria ultimately needs to be supported by fundamental realities in the form of improved borrowing conditions, increased M&A activity, a thawing housing market, and a robust venture environment. With the inauguration of Donald Trump on January 20, 2025, the countdown has begun.

- **A new power dynamic**: Since Donald Trump's Presidential win in early November and the subsequent Red Wave in Washington, the market sentiment has shifted decidedly toward unmitigated optimism. There are hopes for deregulation and the extension of the 2017 tax cuts, and a general business-friendly environment. However, details remain elusive. The uncertainty surrounding tariffs and a razor-thin Republican majority in Congress may impact the current sentiment.

- **Inflation and Fed policy**: Inflation has reemerged as a concern, especially as many economists worry that tariff policies may apply upward pressure on prices. Renewed attention on inflation means potentially higher interest rate policy from the Federal Reserve. During their December 2024 meeting, the Fed revised their 2025 policy outlook from four cuts of 25-bps each to only two cuts. This change of posture represents a Fed that is still wary of price stability and is willing to keep rates higher for longer, which will impact everything from consumer lending, residential and commercial real estate, and valuation, to M&A activity.

- **Priced for perfection?** As of January 17, 2025, the forward 12-month price-to-earnings ratio for the S&P 500 Index is 21.6x, a high multiple from a historical perspective and above the 10-year average of 18.2x.[1] As markets tend to revert toward the median over time, the high valuation profile of the benchmark index is a source of anxiety for investors. However, the market is buoyed by optimism around the new administration and its business-friendly stance. As details of the new economic policies and executive orders emerge, the blanket enthusiasm may correct itself in the form of a public markets price adjustment.

- **Credit markets**: Even with the Fed's more hawkish outlook on rates, the investment grade and high yield new issuance markets have been strong to start the year. As long as the public equity market sentiment remains positive, the credit markets are expected to perform well since they sit higher up on the capital stack. However, as the option-adjusted spreads get tighter, the risk / reward aspect of credit investing becomes less attractive. If we get a correction in the public equity space, we may see spreads widening, and investors may find a window of opportunity for better returns.

Investors in the public markets are starting 2025 with robust optimism about the coming year. But there are reasons to be cautious, especially in light of the new administration's yet unknown economic and geopolitical positions. The first one hundred days of the Trump administration will be important to watch for details that will define the White House's policies. In addition, the topics of inflation and interest rates are still an important determinant of financial market activity, and the future trajectory of rates remains to be seen. Under these conditions, a dose of skepticism may be prudent as realities of fundamentals adjust the lofty expectations of the year ahead.

[1] FactSet Earnings Insight, 1/17/2025

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WHAT'S TRENDING

Anticipating Tax Policy Shifts in 2025: M&A Implications

Tax reform is expected to take center stage in 2025, particularly with the scheduled expiration of significant provisions from the Tax Cuts and Jobs Act (TCJA). The stakes are high for mergers and acquisitions, where tax policy directly influences deal structures, valuations and long-term strategy. However, misalignments on approach within the Republican party could slow progress.

Lawmakers are split on how to approach tax reform — some are calling for swift action to extend TCJA provisions and introduce new incentives to boost economic growth, while others want to tie tax reform to broader policy negotiations. At the same time, all are weighing tax cuts against the deficit, underscoring the difficulty of moving legislation forward, even with Republican control of both chambers.

Key Legislation to Monitor for M&A

- **Tax Rates**: The possible expiration of TCJA provisions on the Qualified Business Income deduction could increase tax burdens on pass-through entities. Conversely, corporate tax rates have been mentioned as a potential area to raise revenue in upcoming legislation. Tax rates for flow-through entities and corporations are both up for a potential significant change.

- **Bonus Depreciation**: With the phasedown of 100% bonus depreciation already underway, its future remains uncertain. The availability of accelerated depreciation can be a critical factor in capital-intensive transactions as Buyers may not be able to rely on the immediate expensing impact when buying equipment or other bonus eligible property.

- **Interest Deductibility**: The current limitations under Section 163(j) may be further restricted or revised, impacting leveraged buyouts and transactions relying on debt financing. The result could be cash expense for interest without a related tax deduction.

- **State Tax Cap**: Asset deals have become more attractive to sellers by utilizing Pass-Through Entity Tax elections where available in an asset sale. This has been a win-win as both Buyers and Sellers obtain tax advantages from an asset deal. However, changes to the state tax deduction limitation could change preferred structure of Sellers and create resulting friction between the parties.

Recommendations for Investors

- **Plan for current laws but remain agile**: Given the uncertainty, it's advisable to structure deals based on existing laws while building flexibility in agreements.

- **Scenario planning**: Work with advisors to develop models that account for various legislative outcomes. This will help identify risks and opportunities, ensuring decisions are well-informed.

- **Monitor legislative developments**: Stay up-to-date on discussions in Congress and committees. The outcome of these negotiations will significantly shape the business tax landscape.

Tax policy is poised to be a defining theme in 2025, and investors and fund managers must be prepared for a range of possibilities. By planning for current laws and staying alert to possible changes, businesses can confidently navigate this uncertainty. Quick adaptation to new legislation will be key to seizing opportunities and managing risks.

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