

# Foreign Direct Investment May Be the Final Tipping Point to M&A Exit for Private Companies in 2017

*Don Bravaldo, CPA*

After 18 years of deal making and two business cycles working for lower middle market privately held businesses in the field of mergers and acquisitions (M&A), you would think that nothing should surprise me when it comes to owner/founders and their plans for succession and exit from their businesses. But with record-high valuations last year and an abundance of cheap capital, I was not expecting to see the number of a transactions drastically decrease in North America (down 23 percent). If the “seller’s market” in 2016 wasn’t enough to get retirement-minded boomers and other business owners into the market, what will it take? 2017 may have the answers.

With the distracting election cycle behind us, there is less uncertainty, which causes concerns and hesitation for buyers and sellers alike. In addition, it’s likely that we will see less regulatory scrutiny and looser lending controls under the new administration. But the biggest game changer for the lower middle market in 2017 could be foreign direct investment (FDI) in the U.S. through M&A, as the Chinese and other foreign investors look to satisfy their ever-growing appetite for growth. We saw a number of indicators in 2016:

- The U.S. continues to be the most attractive country for Foreign Direct Investment (FDI) as a record \$396B was invested in the U.S. by foreign investors in 2016, an increase of 12 percent year over year. More than 50 percent of U.S. inbound FDI in 2016 was invested in the manufacturing sector. Global business executives

are more optimistic about the economic outlook for the U.S. than for any other country. Furthermore, foreign investors are attracted to the large U.S. market, world-class research universities, and solid infrastructure.


- In the Southeast, our firm has seen a strong inflow of investment from Germany as a new wave of German Mittelstand (middle market) companies prefer to pursue M&A to gain entrance to our higher growth market rather than “Green Fielding” new expansion opportunities.
- Chinese outbound M&A doubled in 2016 to \$220B, representing approximately four times the average annual M&A value from 2007 through 2014. Outbound M&A from China exploded in 2016 due to the desire by Chinese companies to enhance technological capabilities and industrial know-how, and to fuel consumption by the rising Chinese middle class.

Why might FDI be a catalyst for lower middle market owners to consider an M&A exit from their businesses? The simple answer is a premium valuation. A foreign buyer is more likely to pay a strategic premium for the right U.S. company that offers a strategic entrance point into U.S. markets, customers and know-how.

While M&A may offer an attractive option in 2017, there are many different factors that a business owner should consider other than just maximizing valuation. Many

private owners will prefer to pass their businesses on to the next generation of family in a family run business. Others may wish to reward their management teams and employees who helped them build the business. In these cases, with financing so readily available at attractive rates, exploring intergenerational transfers, management buyouts and employee owned stock programs (ESOP's) combined with conservative leverage are also readily available exit options at this point in the economic cycle.

It remains to be seen how this year will unfold in our industry. I am encouraged that our pipeline has started

to trend up for initial conversations on succession and exit planning with private owners as well as the addition of several new, sell side mandates during the first quarter of 2017. Our buy side practice has never been busier and is being led by foreign buyers' clients that have selected our firm for searches and M&A advisory work. There has never been a better time in the last nine years to consider succession and exit options from a privately-held business. It is my hope that in 2017, business owners will conduct strategic planning for their businesses and utilize the later stages of this M&A cycle to maximize value for the businesses they have worked so hard to build. 

## 2016 M&A MARKET HIGHLIGHTS

### Transaction Deal Flow & Dollar Value

- Global M&A deal value decreased 18 percent to \$3.8T in 2016, but the M&A market remains robust, and high M&A activity should continue through 2017.
- M&A market continues to be characterized by mega deals and more than 80 percent of M&A deal value in North America and Europe was derived from deals with enterprise values greater than \$1B.
- Global M&A deal volume has been dominated by strategic buyers for the last several years. Since 2014, strategic buyers have annually closed more than 14 times the number of global M&A deals for each closed private equity acquisition. Strategic buyers are also willing to pay more, and since 2012, strategic buyers have paid between 0.5x and 1.5x higher EBITDA (Earnings before interest, taxes, depreciation and amortization) multiples compared to private equity. We expect these trends to continue in 2017.
- Foreign investors have been highly active in the U.S. market, accounting for \$507B in transactions, or nearly 30 percent of 2016 total U.S. transaction value.

### Middle Market M&A

- Competition, cheap debt, and lack of quality companies have led to record M&A valuations, and buyers in the lower middle market continue to pay a quality premium for more attractive targets.
- Private equity deal volume for M&A transactions with enterprise values between \$10M and \$250M has been range bound over the last five years. Valuation EBITDA multiples, however, have consistently increased during the same time frame, and may have peaked at 6.9X in 2016.
- Financial sponsors continue to have difficult time competing with strategic buyers possessing cash-heavy balance sheets and high stock prices.
- Searches for add-ons by private equity contributed to 20 percent increase in lower middle market M&A

**Don Bravaldo, CPA** is the founder of Bravaldo Capital Advisors, a full-service investment banking to middle market clients. Throughout his career, Don has conducted and administered all phases of the merger and acquisition process.