PBMares Capital Markets

KEY TAKEAWAYS | THIRD QUARTER 2023

VITAL SIGNS

The State of the Markets

ECONOMY

Consumer sentiment is still high. Although consumer sentiment has been retreating from the two-year high of 71.6 in July, it remains higher than the level achieved at the end of 2Q23. Despite their continued optimism, consumers are apprehensive of the economy's future course due to several unknowns, including labor issues and the possibility of a federal government shutdown.

Inflation remains higher than expected. The US inflation rate remained steady at 3.7% in September 2023, defying market expectations of a slight decrease to 3.6%. Meanwhile, the core CPI, which excludes volatile food and energy prices, slowed to 4.1%, marking its lowest reading since September 2021. While the economy remains strong, consumer spending is slowing, which raises hopes that the Fed will not raise interest rates in November.

The unemployment rate held steady in September at 3.8%. Although the unemployment rate increased marginally from 2Q23 due to an increase in the number of people looking to enter the workforce, employers added jobs during 3Q23 in nearly every industry. The strong job growth is welcome news for those looking for work, but it could make the Fed's efforts to control inflation harder. The main concern with a hot labor market is that it could put upward pressure on wages and cause further inflation.

Indicator	Latest Available Data (eop)	Change: Average Last 5 Years	YoY	YTD	QoQ
Consumer Sentiment	68.1 Sep	↘	↑	↑	↗
Inflation (CPI)	3.7% Sep	↑	↗	↑	↗
Unemployment	3.8% Sep	→	↗	↗	↗

CAPITAL MARKETS

Investor uncertainty persists in the stock market. The S&P 500 index lost 3.6% in the third quarter as investors continued to adapt to the Federal Reserve's interest rate policy. In fact, equity investors are starting to realize that interest rates will stay "higher for longer" because inflation has not yet been adequately suppressed, and this creates an incentive for investors to look for other investment alternatives to stocks.

The 10-year Treasury reached record territory. The yield on the 10-year Treasury Bond, a key measure of the interest cost for future government borrowing, rose to 4.6%—its highest level in 16 years. Such an increase is being driven by a surge in job openings, thus raising the expectation that interest rates will remain "higher for longer." In turn, this will probably have an impact on the government's ability to take on additional Venture Capital debt. For context, the yield on the 10-year Treasury was 0.8% only three years ago.

The VC ecosystem is struggling to adapt. In Q3, VC activity, including investments, exits, and fundraising, was below the historic heights of 2021 and early 2022. The response from investors in the current limited capital environment has been to focus on strengthening their existing portfolio companies and making high-confidence investments. Likewise, startups are concentrating on cutting costs and pursuing revenue generation opportunities to extend their runways.

S&P 500	4,409 Sep	→	↗	↗	→
10-yr. T-Bond Rates	4.3% Sep	→	↗	↗	↗
VC - Investments ($bn)	40.2 3Q23	→	↘	↘	↘
VC - Exits ($bn)	39.5 3Q23	↗	↑	↑	↑
VC - Fundraising ($bn)	9.4 3Q23	→	↓	↘	↘

M&A ACTIVITY

U.S. M&A activity down 14% in 3Q23. Deal activity during the third quarter declined 14% from the previous quarter and 12% from a year ago. The decline is even more pronounced in the middle market, where deal activity dropped by about 50%. Geopolitical instability and a high interest rate environment are fueling uncertainty. As a result, buyers are being highly selective, and transactions are taking longer to close.

M&A multiples rebounded in 3Q23. Despite a drop in M&A activity, EBITDA multiples in the middle market increased from the low achieved last quarter to close the third quarter at 7.5x. The increase in pricing multiples reflects deal makers' pursuit of larger acquisitions amid uncertainties involving transactions in smaller companies.

U.S. M&A ($bn)	112.4 Sep	→	↘	→	→
M&A EBITDA Multiples	7.5x 3Q23	→	↘	→	↑

Enrique C. Brito, CFA, CVA, CM&AA
Managing Director of Transaction Advisory Services
804.977.5051 | ecbrito@pbmares.com