Valitas Capital Partners

Valitas Insights: The High-Flying U.S. Middle Market…and its Impact on Canadian M&A

South of the border, middle market sentiment is bullish. Recently released Q1 2017 survey results reveal that U.S. middle market companies are outpacing their larger counterparts by a strong margin, with private equity (PE) owned companies leading the pack. And there is a notable level of optimism about the future.
U.S. middle market companies[1] generate 33% of U.S. private sector GDP, and as such, represent a significant economic force. From our perspective in Canada, this is a segment to watch for a couple of reasons:

i. There has been an increase in M&A as a driver of revenue growth, with the expectation that this will be sustained; and
ii. There is an expectation of increased revenues generated outside the U.S., with Canada identified as one of the top three contributing markets[2].

A thriving U.S. middle market with an appetite for growth through domestic and outbound M&A is likely to impact our own domestic deal activity, particularly when we layer on the discount attributed to Canadian company valuations relative to their U.S. counterparts.
So now that we've established our homegrown interest, here is what's happening south of the border…

The U.S. middle market kicked off the year with record high revenue and employment growth, driven in part by increased M&A. Trailing twelve-month revenue growth for middle market companies at the end of Q1 2017 was 9.2%, with employment growth of 7.5%. Revenue and employment growth at PE-owned firms was, respectively 14% and 11.8%[3]. Over the same period, revenue and employment growth for S&P 500 companies was 5.8% and a mere 1.6%.

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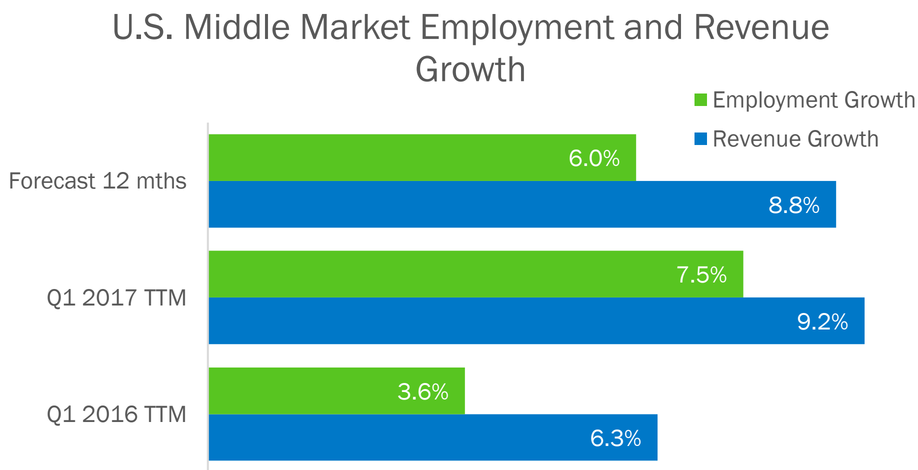
[1] As defined by the National Center for the Middle Market
[2] In a recent (post-election) Deloitte's survey of U.S. middle market companies, more than half of respondents reported this expectation.
[3] Read more about the value-creation principles employed by PE firms in our October 28, 2016 Valitas Insights Article.



Looking ahead, expectations are golden. There is a high degree of confidence in local, national, and global economies, and a forecast of 8.8% revenue growth and 6% employment growth. Growth drivers include innovation and new product development[4], and increased M&A. Of the companies surveyed, 39% expect to engage in M&A activity in the next twelve months, up from 24% for the previous 12-month period.

As we discussed last week, uncertain U.S. trade policy presents a challenge to our assessment of U.S. driven cross-border acquisitions. A significant concern is the potential increased cost of exporting to the U.S., a cost that could take shape through a border adjustment tax or tariff. In light of that, we want to pass along a couple of insights gleaned from a recent U.S. seminar: *Trump Policy on Trade – The First 100 Days and Beyond*[5]. With respect to NAFTA, it was noted that the draft of the US negotiating position recently circulated to US Congress suggests a more moderate approach, with, as expected, a key issue being rules of origin. Another highlight for us was that "President Trump's tax reform proposal does not currently endorse the Border Adjustment Tax proposed by House Republicans." While it will be some time before there is certainty on this particular issue, we are cautiously optimistic that Canada's inbound mid-market deal activity will benefit from the high-flying U.S. middle market.

[4] 42% of respondents expect to introduce a new product over the next 12 months
[5] Co-sponsored by the Massachusetts Export Center and law firm, Morgan Lewis.