2024 OUTLOOK

THE YEAR AHEAD

klarventures

ONE THING AFTER ANOTHER

A common fallacy in human thinking is to view the current moment as a turning point in history. In 2020, COVID-19 reminded the world that pandemics happen. In 2021 a single cargo ship blocked the Suez Canal and snarled supply chains across the world. In 2022, continental land war returned to Europe. As significant as each of these events felt in the moment (and were), humanity has a knack for adapting and moving forward.

The apparent heightened volatility of the past few years has made terms like “multipolarity” fashionable again and even spawned new ones like “polycrisis”. In fact, this is just what history is: “one thing after another”. While 2024 will bring plenty that nobody predicted, there will be many developments from 2023 the effects of which will carry over into 2024, such as the arrival of generative AI, potentially worsening geopolitical tensions and new developments in weight loss therapy that may meaningfully increase U.S. lifespans.

These macro trends can feel as if they’re beyond the grasp of lower middle market CEOs, but the CEO imperative remains constant: focus on what is within control, take timely action to prepare your business for unexpected events and adapt to rapidly evolving trends.

Our goal in this report is to demystify the macro trends we see as relevant to 2024 and to help CEOs think through how to prepare for success whatever 2024 may bring.

ABOUT KLAR VENTURES

Klar Ventures is an M&A advisory and value creation firm dedicated to assisting searcher CEOs and family-owned or founder-led companies. Leveraging extensive investment banking expertise with profound strategic insight and analytical capabilities, we aim for the optimal execution of capital raising, mergers, acquisitions, and exits. Our approach is tailored to each client's unique situation to help maximize value and drive seamless transactions.

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M&A ENVIRONMENT

2023 in review

M&A experienced another move lower in 2023, the continuation of a steady downward trend that has followed the 2021 post-COVID 19 dealmaking surge. Deal count and aggregate deal value in Q3 2023 were down 47 and 32 percent respectively from Q3 2021 (see Figure 1).

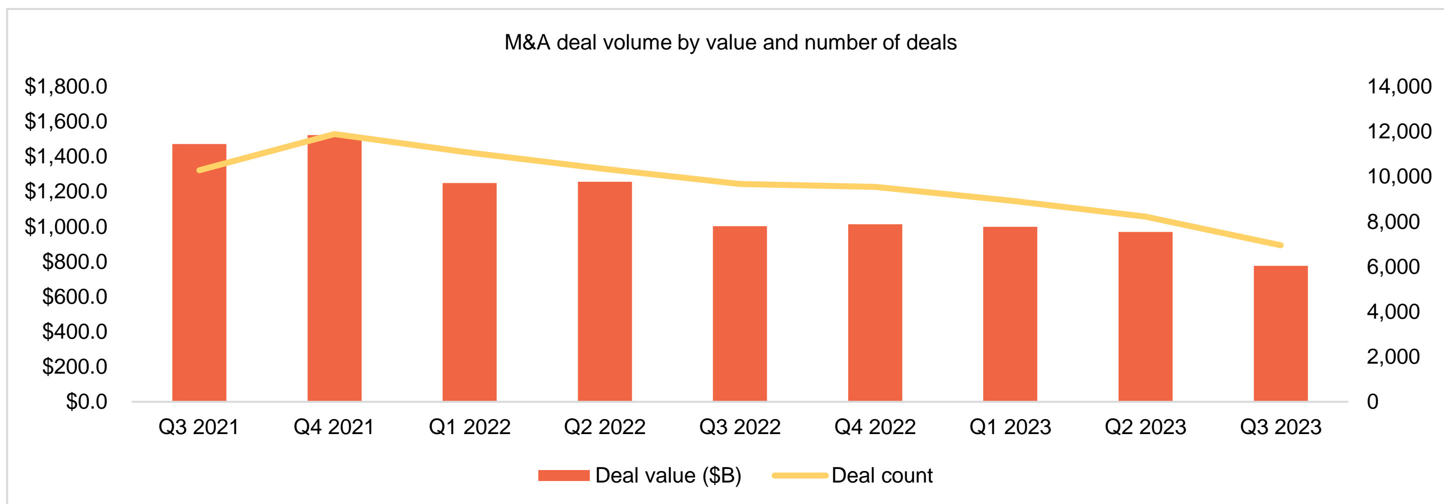

Figure 1
Source: Pitchbook Q3 2023 Global M&A Report

The decline in dealmaking has been driven largely by institutional M&A actors' (lenders and investors) broadly conservative response to a series of new risk factors in the M&A market. Importantly, institutional actors account for more and more of the overall M&A activity relative to non-institutions so their behavior has an increasingly strong influence on the overall state of the market. These institutions have significantly increased their underwriting standards to mitigate their exposure to potential capital loss. In conversations with Klar Ventures, they have expressed their reason for doing so is that they continue to perceive that the U.S. economy faces an elevated risk of entering a recession, notwithstanding increasingly rosy forecasts from some analysts.[1] This posture, which has resulted in deals taking longer to close and an increase in deals being abandoned following extended due diligence periods, has been exacerbated by equity investors' desire to avoid realizations of lower equity valuations by avoiding exits and instead driving extended value creation plans designed to drive investor return metrics over a longer than average period of time – "the median holding time of private equity assets from investment to exit grew to 6.3 years as of the end of Q3, marking the first time that the median holding period exceeded 6 years since 2014".[2]

[1] (Ranganathan & Dogra, 2023)
[2] (Clarke, Hinds, Choi, & Walters, 2023)

The complex geopolitical and macroeconomic backdrop has created a tale of two cities driven by the diverging agendas of strategic acquirors and financial acquirors. Despite this divergence, valuations on average have remained resilient at an average multiple of 10.0x EBITDA, well in line with historical metrics (see Figure 2). However, multiples paid by strategic acquirors (including those owned by private equity) have trended flat to lower since 2014 while private equity purchasers have paid significantly higher multiples over the same period in search of platforms into which capital can be deployed to acquire smaller add-ons at deeply discounted levels. This strategy reflects the more than $2.5T in dry powder accumulated by buyout groups.[3] The consolidation of fragmented industry niches has become one of the most frequently utilized strategies financial sponsors deploy to achieve limited partner return metrics. As such, they have remained willing to pay elevated multiples for attractive assets possessing reliable revenues and cash flows within industries positioned for further consolidation (see Figure 3).

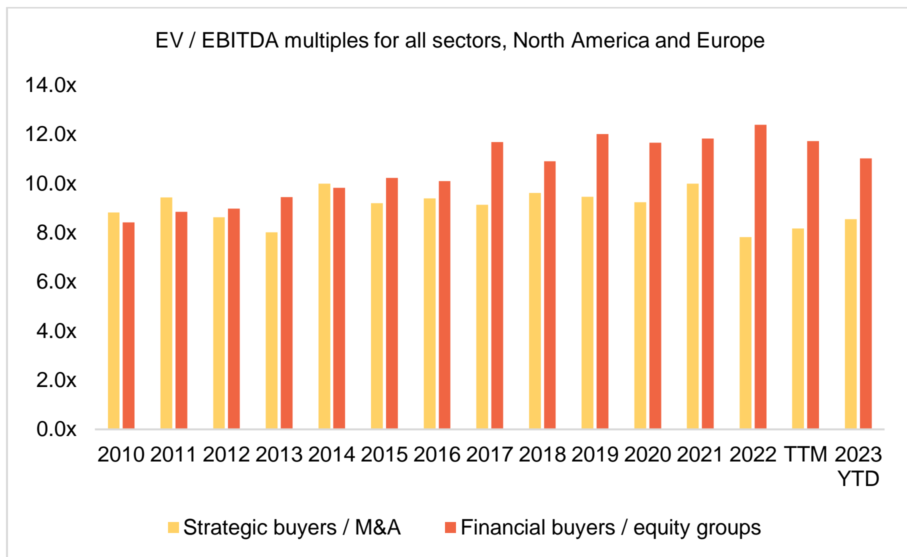

Figure 2
Source: Pitchbook Q3 2023 Global M&A Report

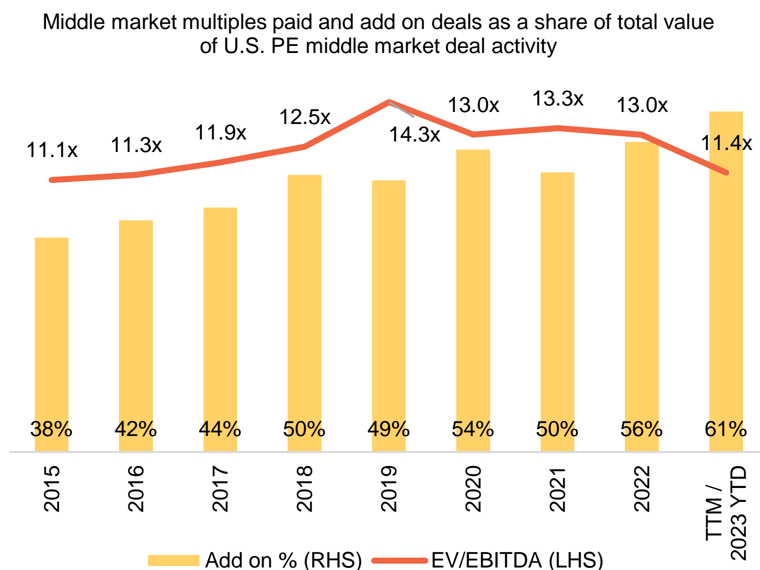

Figure 3
Source: Pitchbook Q3 2023 U.S. PE Middle Market Report

On the supply side, several factors have limited companies from deciding to pursue formal sale processes. First, sellers have been hesitant to sell performing assets given the scarcity of prime platforms leading private equity groups to explore novel approaches to realizing investment returns. For example, an increasing number of firms have utilized continuation funds whereby they sell the assets from one fund to another to extend their hold while also providing liquidity to their limited partners.[4] Other funds have pursued NAV or margin loans under which they pledge the shares of their assets as collateral to secure loans which can be used to make distributions to investors.[5] Private equity funds are often time-bound with general partners (GPs) obligated to deploy capital, generate returns and distribute proceeds over 10-14 year time horizons. Limited partners make capital commitments on such a basis. In the current environment, the limited partners that seek a return of capital are often the same limited partners that have made capital commitments to more recent fund vehicles. These limited partners need the return of capital from private

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[3] (Thomas & Sabater, 2023)
[4] (O'Dwyer, 2023)
[5] (Gara & Louch, 2023)

equity given their future capital commitments to private equity to avoid a mismatch in their overall capital allocation across their assets under management.

Second, many equity investors have been hesitant to undertake actions that might expose them to a potential downward repricing of assets amidst a widely held view that the Fed will begin lowering interest rates in 2024. These investors are opting to wait slightly longer to take assets to market in what will likely prove to be a more favorable environment for near term price maximization. As mentioned above, many of these portfolio companies are pursuing highly accretive consolidations, so their risk of waiting is low while the potential for gain is meaningful given the persistence of multiple spreads (see Figure 4). Furthermore, lingering COVID-19 aftereffects that may be depressing organic growth at the current time are more likely to revert to stable growth as more time passes beyond the 2020-2021 period during which supply chains experienced disruption.

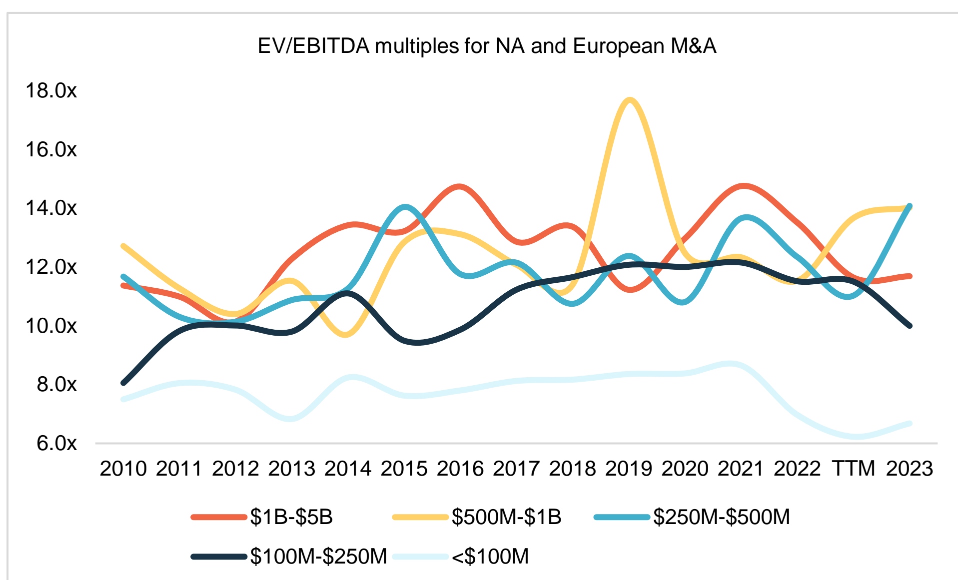

Figure 4
Source: Pitchbook Q3 2023 Global M&A Report

Looking ahead to 2024

We expect 2024 to be bifurcated between the period before the Fed begins reducing interest rates and the period after which rate reduction is underway. The need to deploy capital is not going away, but we anticipate that GPs will remain cautious as they and the broader economy wait for the Fed to shift policy given its previously well-advertised commitment to “higher for longer”.[6] Multiples in 2024 will remain strong unless we encounter a catalyst for a move lower, but still only for premium assets that provide buyout groups high confidence in their ability to hit their investment hurdle rates while withstanding a potential recession. Catalysts for reduced multiples could include the expansion of the Ukraine or Middle Eastern conflicts into broader wars or a retrenchment of inflation to higher levels.

Premium assets in this market are just like those in every other market, only more so. Certainty around future debt service capacity will be particularly important favoring business models with long-term customer contracts that drive recurring revenue. Or, similarly, business models with low churn such that their revenue may not be strictly recurring but can be classified as “re-occurring”. In addition to debt service certainty, higher capital costs will drive buyout groups to put even further emphasis on free cash flow.

We expect business services to remain attractive in this paradigm. Examples include facilities maintenance (interior and exterior), enterprise IT and specialty logistics. With high gross margins and high switching costs for customers, these industries enable financial buyers to minimize risk related to debt servicing.

[6] (Smith, 2023)

On the buyside, **for those entering the lower middle market particularly through search vehicles, sticking to your financial performance criteria will be more important than ever in 2024.** On the sellside, we encourage clients to dogmatically build companies possessing the critical platform characteristics that enable positive outcomes regardless of the deal environment. With such an approach, owners can be confident they will achieve a premium valuation in whatever the pricing environment and will have the flexibility to choose between an exit as well as continuing to drive attractive returns into the foreseeable future.

INFLATION

2023 in review

In 2023 the U.S. consumer finally obtained relief from runaway inflation, a consequence of massive fiscal stimulus and accumulated savings on the demand side, and commodity price volatility and obstructed supply chains on the supply side. Inflation peaked in June 2022 at 8.9% and had fallen to 3.1% by November 2023 (see Figure 5).

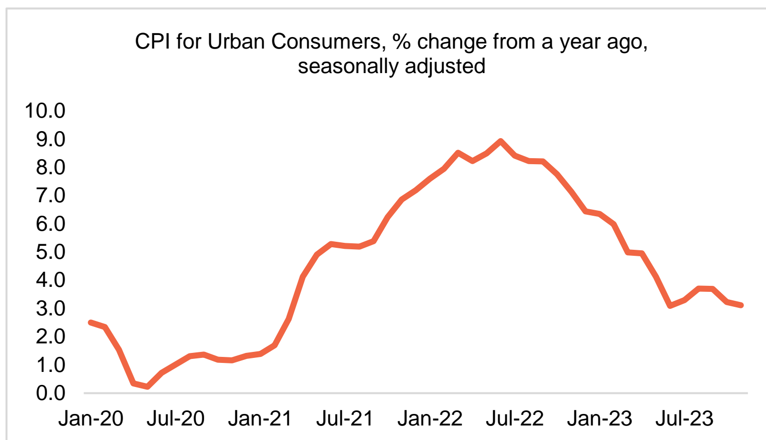

Figure 5
Source: Bureau of Labor Statistics

Between 2020 and 2021, the U.S. enacted six laws aimed at providing economic relief funds in response to the COVID-19 pandemic. Accounting for unspent funds, these bills injected $4.2 trillion into the economy.[7] Given that much of the economy was shut down during 2020 and 2021, this led to households accumulating unprecedented levels of savings (see Figure 6).

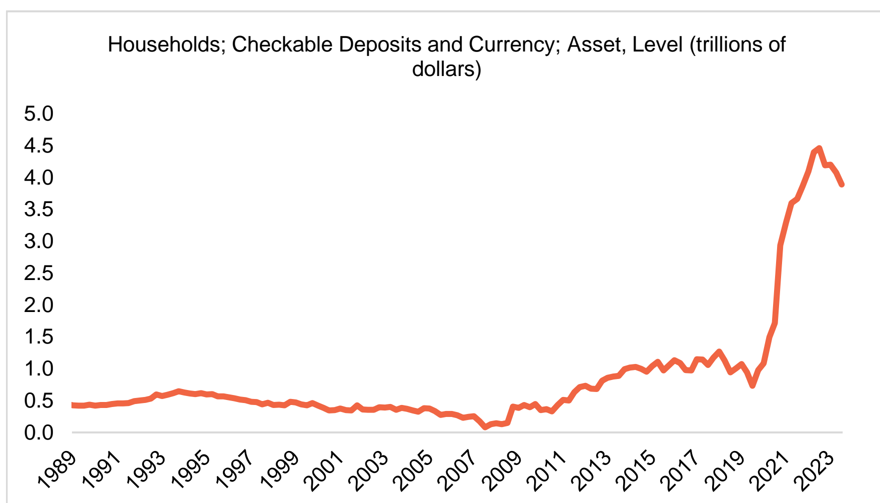

Figure 6
Source: Board of Governors of the Federal Reserve System

As vaccination rates rose over 2021 and the domestic economy fully reopened, households injected what they saw as surplus, COVID-related cash on their balance sheets into the economy which in turn drove demand-side inflation. By 2023, households had begun to exhaust those cash reserves which helped to slow inflation. Furthermore, the speed and severity of price increases had a self-correcting effect on consumer-driven inflation: consumers became more conscious of their purchasing habits in the face of higher prices and adjusted accordingly.[8]

In addition to a cooling of consumer spending as household balance sheets normalized, supply-side factors contributing to inflation also eased in 2023. COVID-19 initially caused a drop in commodity

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[7] (Government Accountability Office, 2023)
[8] (Horsley, 2023)

prices globally as demand collapsed. But as economies gradually reopened and demand came back, supply chains encountered numerous problems such as COVID-related staff shortages and increased burdens in terms of processing commodities to prevent the spread of the virus.

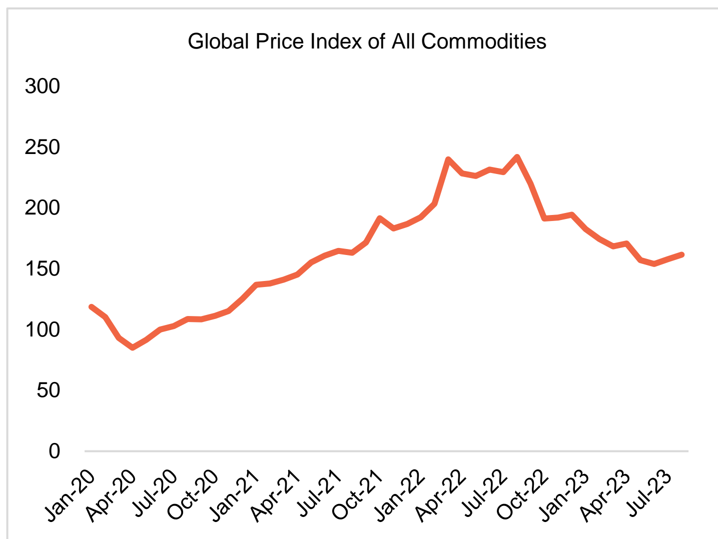

Figure 7
Source: International Monetary Fund

Russia's February 2022 invasion of Ukraine compounded these supply chain challenges as the U.S. and EU responded with harsh sanctions aimed at strangling the Russian war economy and creating domestic political pressure on President Vladimir Putin. However, over the second half of 2022 and the first half of 2023, supply chains normalized or solutions were found to alleviate price pressures while achieving policy aims (see Figure 7). In the case of oil, for example, U.S. production has increased significantly while a global price cap orchestrated by the U.S. and its allies has kept Russian oil on the market, but at below market prices (notwithstanding the fact that the price cap has not always been completely effective).[9]

Looking ahead to 2024

In June 2023, the U.S. Federal Reserve re-affirmed its commitment to a long run inflation target of two percent.[10] By November, inflation had fallen to 3.1% and analysts and the Fed itself were already turning their mind towards interest rate cuts.[11]

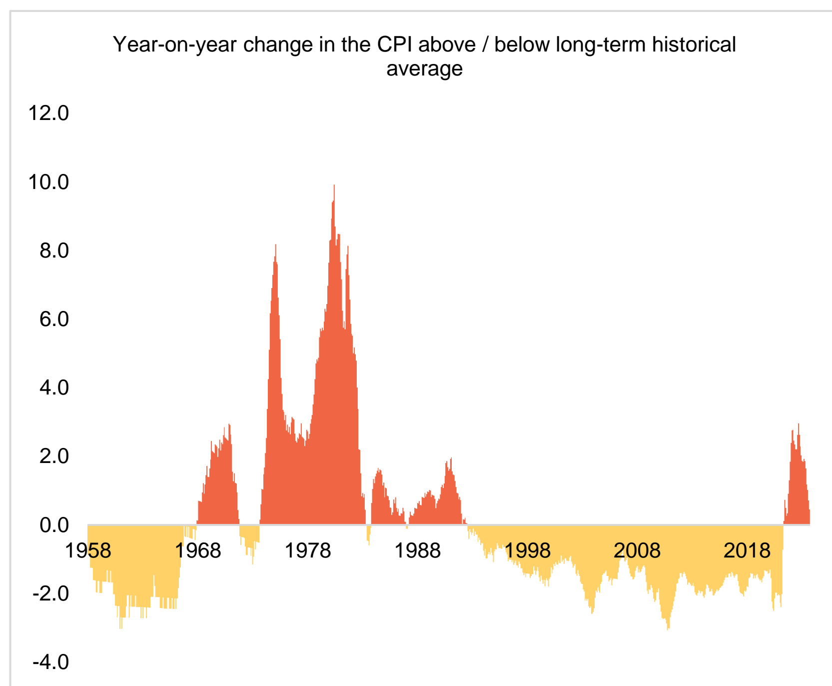

Figure 8
Source: Bureau of Labor Statistics

But the historical record indicates inflation can be stubborn. The long-term average year-on-year percent change in the CPI is 3.7%. Since 1958, the U.S. has experienced five periods with inflation greater than that long-term average. If we combine periods with less than 12 months between them, we end up with just three: December 1967 to November 1971, September 1973 to August 1992 and May 2021 to the present.

For the period starting in 1967, it took nearly four years to get inflation under control and underneath the long-term trend of 3.7%. But this relief would be short lived: the Yom Kippur War of 1973 and the associated Arab oil embargo would trigger a long-term

[9] (Cook & Wilson, 2023)
[10] (Board of Governors of the Federal Reserve System, 2023)
[11] (Bureau of Labor Statistics, 2023)

inflation cycle that would last just over 18 years (see Figure 8). **Inflation's persistence, historically demonstrated, should cause the Fed to default to a cautious stance even as it contemplates interest rate decreases.**

In addition to the inherent stubbornness of above-average inflation, we see two risks that could spur higher inflation in 2024. The first is further geopolitical instability that leads to a jump in commodity prices due to increased uncertainty of supply. We have already discussed the impact of Russia's invasion of Ukraine on several commodities. The October 7 terror attack by Palestinian militant group Hamas on Israel led to an immediate jump in the price of oil. While this price increase was not sustained, both situations highlight the continued vulnerability of supply chains to growing geopolitical instability which we address in greater detail in a subsequent section.

The second risk factor for higher inflation we observe is the persistent tightness of the labor market. Anecdotally, the number one obstacle to growth we hear from our clients is finding, training and retaining staff. The data confirms this sentiment. Total nonfarm job openings remain above pre-pandemic levels while the labor force participation rate remains below pre-pandemic levels, reflecting a smaller total workforce available for hire (see Figure 9).

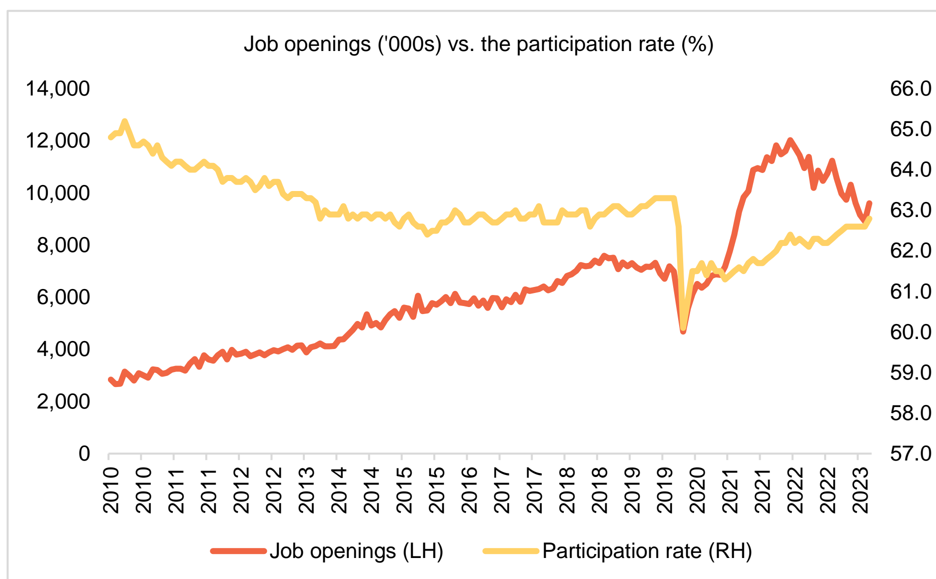

Figure 9
Source: Bureau of Labor Statistics

While conflict risk to commodities is difficult to mitigate for businesses in the lower middle market, the continued constraint in labor supply should motivate businesses to look for solutions. Automation and the use of AI is the most obvious potential lever: we believe that significant efficiencies remain in small to medium-size businesses from automation of administrative functions such as closing monthly financials and AR / AP processing. We encourage clients to invest in third-party support to implement automation where necessary. This one-time spend can be "added back" to EBITDA in a sale process and could even drive multiple expansion if the investment significantly improves the efficiency and accuracy of internal operations.

For CEOs operating seasonal businesses, or businesses that utilize temporary labor, we encourage you to investigate the H-2A Temporary Agricultural Workers program. The definitions applied to this program at times expand beyond strictly farm-related work making it a potential source of incremental labor in seasonal demand situations.

INTEREST RATES

2023 in review

Faced with both demand and supply factors driving inflation, the world's major central banks, led by the U.S. Federal Reserve, implemented a rapid tightening of global monetary policy throughout 2023. In the U.S., this move brought interest rates to their highest levels in more than a decade.

More surprising than the absolute level of interest rates achieved by the Fed was the speed of its interest rate increases. From January 2015 to July 2019 the Fed started raising interest rates to bring an end to the loose monetary policy used to counter the effects of the global financial crisis.[12] During that period the Federal Funds Effective rate rose 230 basis points over three and a half years. Contrast this with the period from January 2022 to July 2023 when the same rate rose 500 basis points in just 18 months: twice the absolute increase in less than half the time.

The most visible impact for the lower middle market from this sudden tightening of monetary policy was a commensurate increase in the cost of borrowing. The Bank Prime Loan Rate now sits at levels not seen in more than a decade, since before the global financial crisis (see Figure 10).[13]

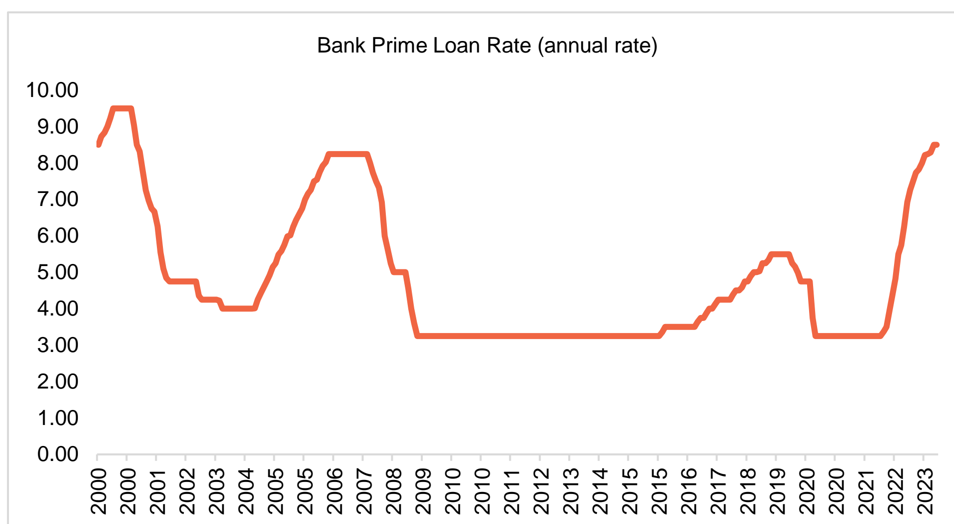

Figure 10
Source: Board of Governors of the Federal Reserve System

Higher interest rates mean increased risks for banks from a debt service standpoint, and small businesses have felt the resultant tightening in lending standards: nearly two thirds of businesses reported significant to moderate issues with collateral requirements while more than a quarter reported significant to moderate issues with the application, approval and closing processes for new debt issuances.[14] Surveys of lenders back up the perception among owners and operators of tightening credit requirements throughout 2023. By the second quarter of 2023, loan officers were reporting that banks were tightening credit standards for small firms at rates associated with the dotcom bubble, the global financial crisis and the immediate aftermath of the COVID-19 pandemic (see Figure 11).

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[12] From the Fed: "The federal funds rate is the interest rate at which depository institutions trade federal funds (balances held at Federal Reserve Banks) with each other overnight. When a depository institution has surplus balances in its reserve account, it lends to other banks in need of larger balances."

[13] From the Fed: "Rate posted by a majority of top 25 (by assets in domestic offices) insured U.S.-chartered commercial banks. Prime is one of several base rates used by banks to price short-term business loans."

[14] (National Federation of Independent Businesses, 2023)

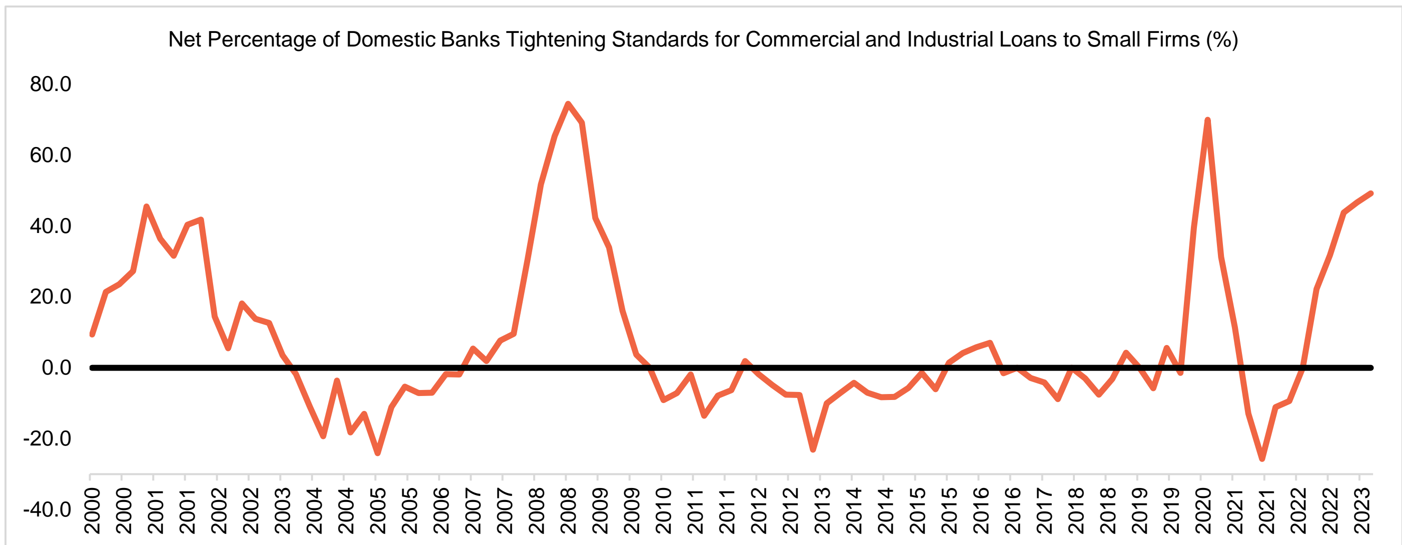

Figure 11
Source: Board of Governors of the Federal Reserve System; Senior Loan Officer Opinion Survey on Bank Lending Practices

Importantly, loan officers were right to apply stricter credit standards. Bankruptcy filings accelerated meaningfully in late 2022 and remain elevated in 2023 (see Figure 12).

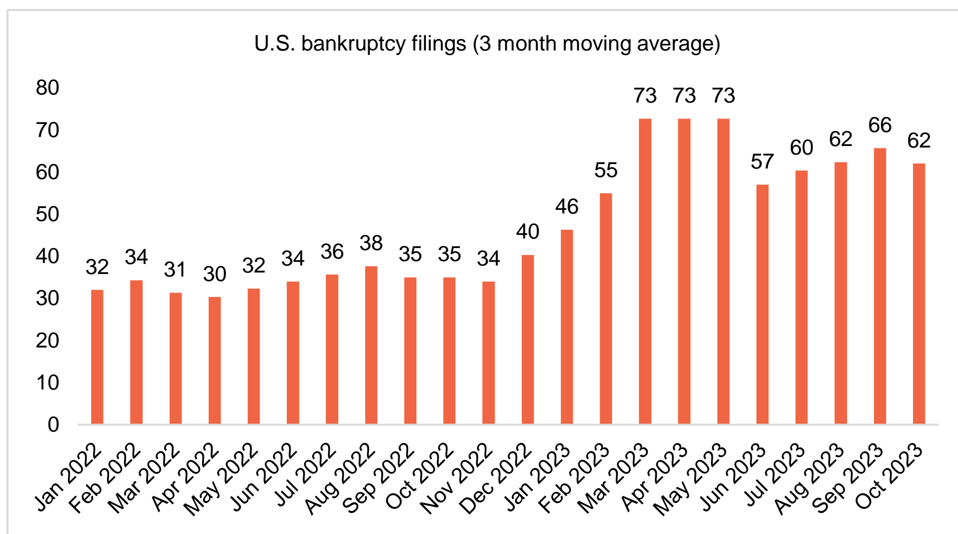

Figure 12
Source: S&P Capital IQ, Key Developments: Bankruptcy Filings

Beyond access to credit, the sudden increase in interest rates forced small businesses to confront the creditworthiness of their banks, most notably in the case of Silicon Valley Bank (SVB) which was shut down and taken over by the Federal Deposit Insurance Corporation (FDIC). The basic form of the problem in SVB's case was an asset/liability mismatch: SVB held large quantities of fixed rate Treasuries, the value of which fell as interest rates rose (because investors prefer newer, higher interest-paying Treasuries). This created a hole in SVB's balance sheet, making the bank appear insolvent and in turn triggering a run on the bank by its depositors, mostly Silicon Valley tech startups. On March 9, depositors withdrew $42 billion in a single day.[15] With the bank unable to meet its liabilities, it was taken over by the FDIC until it was sold to another regional bank, First Citizens.

Swift intervention by the Fed and the FDIC meant the crisis was largely contained: only four banks failed in 2023.[16] But the episode highlighted the potential fragility of financing and banking arrangements for small to medium-sized businesses in an interest rate environment unfamiliar to many.[17]

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[15] (Son, 2023)
[16] (FDIC, 2023)
[17] (Heeb, 2023)

Looking ahead to 2024

"Higher for longer". That was the position on interest rates adopted by the U.S. Federal Reserve, along with the European Central Bank and the Bank of England in September 2023.[18] By December, Fed Chairman Jerome Powell's rhetoric had softened, and the collective view of senior Fed officials based on the "dot plot" suggested as many as three rate cuts in 2024 (see Figure 13).[19]

Figure 13
Source: Board of Governors of the Federal Reserve System

The Fed's more optimistic tone was a surprise to some. As we discussed in our section on inflation, historical periods of above trend inflation have been difficult to tame in the United States. And with such a strong labor market, there is little pressure on the Fed to reduce rates. If anything, we see labor market tightness as a continuing risk to higher inflation.

Indeed, it is the consistent strength of the labor market that is driving us to encourage our clients to be cautious and not rely on rosy projections for interest rates in 2024. Instead, our recommendation is to focus on strategies that will accrete value regardless of the trajectory of interest rates.

In particular, we are encouraging clients to **"do the work" before assuming higher debt servicing costs will make inorganic growth unattractive.** Multiple spreads in the lower middle market remain wide enough that even with higher interest rates, attractive returns are still available for well-priced add-ons. Debt servicing is of course more challenging with higher interest rates, but it is important to dig deeply here and explore the numerous structures available to borrowers. Nonetheless, we see opportunities passed by based on faulty assumptions regarding credit availability.

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[18] (John, 2023)
[19] (Smith, 2023)

GEOPOLITICS

2023 in review

There were three major conflicts ongoing in 2023 with relevance to the U.S. economy. By far the most important was the ongoing rivalry with China in the Asia-Pacific region. With China now firmly recast as a national security threat to the United States, U.S. businesses spent much of their energy in 2023 confronting their exposure to China and the risk it poses to their business model. In many cases, this meant close examination of the supply chain and understanding what vulnerabilities exist both in terms of interruptions to supply but also from an intellectual property point of view.

For those firms dissatisfied with the level of China exposure in their supply chains, that meant some combination of “reshoring” (moving production closer to home) and “friend-shoring” (moving production to countries with friendlier relations with the U.S.). Bank of America noted that mentions of “reshoring” in S&P 500 earnings transcripts were up 128% in 1Q 2023 vs. a year prior, a signal of just how much focus companies are putting on this issue.[20]

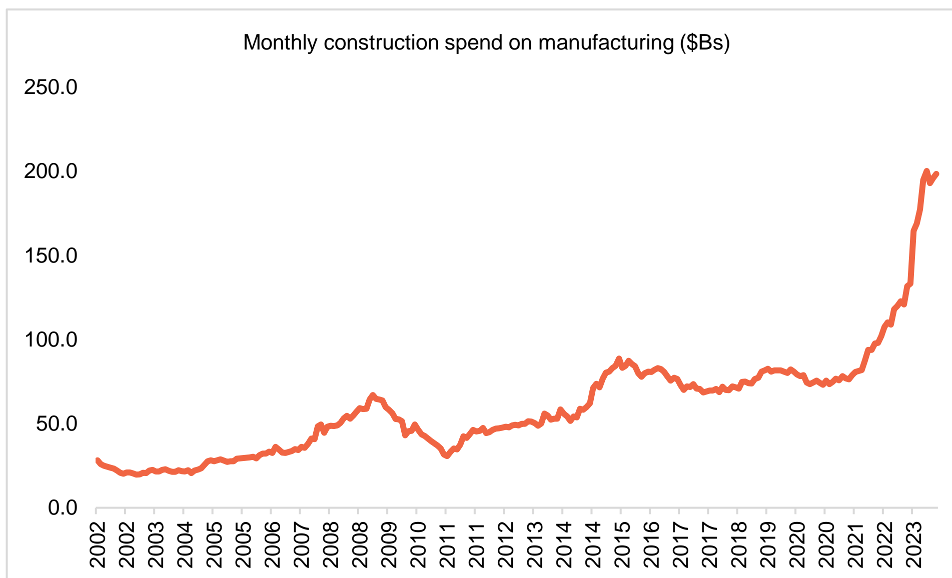

Figure 14
Source: U.S. Census Bureau

Federal policy acted as an accelerant for reshoring dynamics. One of the Biden Administration’s goals for the manufacturing incentives established by the CHIPS Act and the Inflation Reduction Act (IRA) in August 2022 was to reduce America’s reliance on Chinese manufacturing. These incentives showed real impact in 2023. Monthly spending on construction of manufacturing facilities is now more than twice as high as any other point in the last two decades (see Figure 14).

The second ongoing conflict with relevance to the U.S. economy was Russia’s invasion of Ukraine. During late 2022 and early 2023, the U.S. and its European allies supplied Ukraine with heavy equipment including tanks and infantry fighting vehicles to enable Ukraine to train and equip several heavy mechanized and motorized units. The U.S.’s hope was that these new units would enable Ukraine to pierce Russian lines and break into Russia’s rear areas, capturing large chunks of territory like the Kharkiv offensive in September 2022 when Ukraine recaptured nearly 800 square miles of territory.

Ultimately, this strategy proved overly optimistic due to the level of entrenchment of Russian forces and a slower than anticipated ability of fresh Ukrainian recruits to learn and deploy complex “combined arms maneuver” warfighting techniques. Russia’s defensive line consisted of multiple belts of anti-tank and anti-personnel mines; “dragon’s teeth”, concrete blocks designed to interrupt

[20] (Handley, 2023)

the movement of armored vehicles; anti-tank ditches; and trench fortifications up to three layers deep. The new units equipped with Western equipment proved unable to overcome Russian defenses and with minor exceptions, Russian lines in Ukraine looked much the same at the end of 2023 as they did at the start.

Consequently, as 2024 commences there remains no clear pathway to ending the conflict. Russia cannot negotiate with Ukraine because Russian President Vladimir Putin has expended too much domestic political capital on the war to suffer a negotiated peace. On the other side, Ukraine doesn't want to negotiate. Zelenskyy and the Ukrainian general staff remain hopeful that Ukraine can defeat Russia on the battlefield, or at least drastically improve Ukraine's negotiating position by capturing more territory in future offensives.

The third conflict with relevance to U.S. economic outcomes, was the resumption of open warfare between Israel and Palestinian militant groups. On October 7, members of Hamas, a Palestinian militant organization, launched a terror raid against Israeli towns and kibbutzim close to the Gaza Strip, which Hamas controls. The militants targeted civilians and killed more than 1,400 before being ejected by Israeli security forces.[21] In response, Israel immediately launched a campaign of airstrikes and artillery along with a ground invasion that had killed an estimated 20,000 Palestinians as of writing.[22]

Israel's military operations in Gaza prompted Houthi-controlled Yemen to begin attacking commercial shipping in the Red Sea as a show of solidarity with the Palestinian cause. The Houthis are an Iranian-aligned, Shia Islam-inspired political movement which toppled the prior Yemeni government in 2014. The Houthis' actions have forced significant volumes of shipping to divert from the Suez Canal route to rounding the African continent instead, a journey which is 10 days longer between the key European port of Rotterdam and the Asian port of Singapore. While a U.S.-led coalition is attempting to enable major shippers to resume using the Suez, the situation nevertheless highlights the potential for the conflict in the Middle East to create secondary effects on supply chains only just recovering from COVID-19.[23]

Looking ahead to 2024

We expect the reshoring dynamic to not just continue but intensify in 2024. China's leader, President Xi Jinping faces several intractable domestic problems including slowing economic growth, a heavily indebted property sector, and a rapidly aging population. In our view, the occurrence of a significant Chinese economic dislocation that spills over into the broader global economy is one of the most likely potential sources for an unanticipated rapid deterioration in the U.S. economy. Such a spillover might come in the form of financial contagion or military aggression, as one way for Xi to paper over these problems or at least distract the Chinese public from their impact will be to continue stoking Chinese nationalism. This inevitably means continued tension with the U.S. over Taiwan.

The confrontation over Taiwan is already serious. Chinese fighter jets and naval ships routinely harass American military planes and ships conducting "freedom of navigation" missions in and around Chinese waters.[24] President Xi heads into 2024 with every reason to ratchet up the tension. As mentioned, he faces serious difficulties on the domestic front and the U.S. now finds itself embroiled in not one but two proxy wars overseas. Xi must be tempted to push the U.S. even further to test its resolve to defend Taiwan in the event of military conflict.

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[21] (AbdulKarim, 2023)
[22] (AbdulKarim, 2023)
[23] (Roelf, 2023)
[24] (Oyen, 2023)

This will make the position of American firms in China less and less tenable. We see this as both a risk and an opportunity for our clients. From a risk standpoint, China is responsible for about 20 percent of global manufacturing output. **Therefore, we are encouraging our clients to develop a detailed understanding of their supply chain going beyond the first layer of vendors: firms need to understand who their suppliers' suppliers are and so on to assess the potential impact of disrupted trade between China and the U.S.** If there are critical components in the supply chain that are currently sole-sourced from China, that is a risk worth addressing.

Often, the solution will be to follow larger, publicly traded firms. In China's near periphery there are several countries actively positioning themselves as more reliable manufacturing partners thanks to their warmer relations with the U.S. Earlier in 2023, *The Economist* identified a bloc of nations it termed "Alt-Asia" that have the potential to replace China's manufacturing trade with the U.S.[25] We are encouraging our clients that source products or components from China today to begin familiarizing themselves with potential alternative sources in these countries.

With Russia's war in Ukraine approaching a stalemate, we do not anticipate further risk to commodity prices from that conflict. The conflict in the Middle East does, however, represent a risk to the price of oil. In echoes of the oil price shock of the Yom Kippur war, the World Bank has warned that prices could rise to $150 a barrel, from their current level of about $72, if the conflict persists. [26] The Bank points to the potential for Arab nations to cut output as a way of pressuring Israel via the U.S. should Israel's ground invasion of the Gaza Strip become unacceptable to their domestic constituencies. Another risk area is the potential involvement of Iran if it feels that its proxies in the region, especially Lebanon-based Hezbollah, are under threat.

Regarding opportunities, the reshoring trend has the potential to be a tailwind for some clients. Where the end customer involves the military or government agencies, end-to-end production in the U.S. or friendly states will become an even more valuable differentiator in 2024. For makers of low margin products where the cost of labor is a major consideration, Mexico is an increasingly attractive destination for manufacturing facilities.[27]

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[25] (The Economist, 2023)
[26] (Savage, 2023)
[27] (Salgado & Lopez, 2023)

ARTIFICIAL INTELLIGENCE

2023 in review

In 2023, the current practical application of artificial intelligence (AI) sprang into mainstream consciousness. The catalyst was the November 2022 launch of ChatGPT from OpenAI. Users quickly discovered they could ask the tool questions and receive relatively thoughtful, coherent answers. Questions soon evolved into requests for content generation or editing. And with the introduction of the GPT4 model, web-based plugins and API endpoints, businesses began integrating ChatGPT and other large language models (LLMs) directly into their business workflows. This rapid expansion of potential applications saw ChatGPT set a record as the fastest growing consumer application of all time.[28]

Large businesses moved quickly to cement relationships with the various providers of LLM capabilities, especially in professional services fields: McKinsey established a partnership with Cohere while BCG and Bain aligned themselves with OpenAI. Allen & Overy, the London-based law firm, quickly implemented an internal AI tool named HarveyAI. These and other deployments of AI did not lead to the mass layoffs many have feared as one of the side effects of increasingly sophisticated AI, at least not in 2023.

Instead, the impacts of generative AI came in unexpected places. One of the highest profile casualties of generative AI was the coding community Stack Overflow. For those unfamiliar with Stack Overflow, it has been a critical resource for developers for decades thanks to its vast repository of questions and answers regarding all manner of obstacles faced by software engineers. But with the arrival of LLMs and their ability to audit and write code, many developers began turning to ChatGPT instead of Stack Overflow for assistance with their code challenges. Figure 15 shows the share of searches on Stack Overflow related to Python, a popular programming language. The precipitous drop coinciding with the release of ChatGPT is hard to miss. It was hard to miss for Stack Overflow's bottom line too: the company layed off more than a quarter of its staff in October 2023.[29]

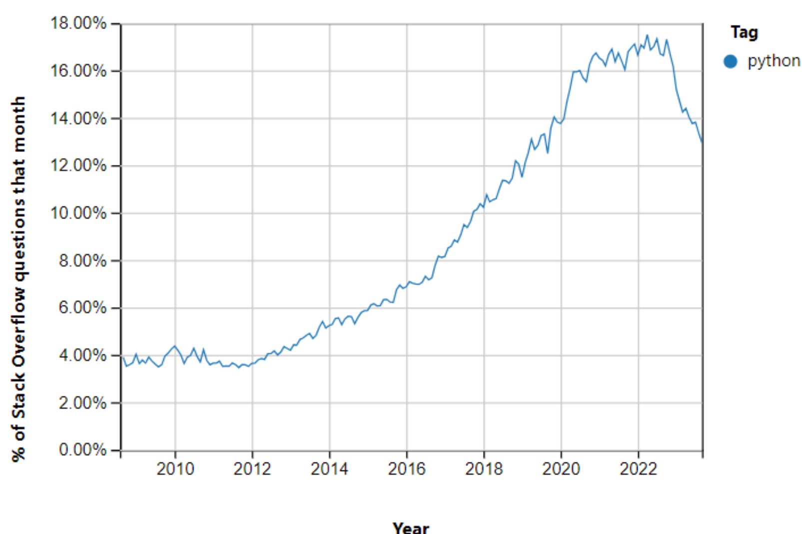

Figure 15
Source: Stack Overflow Trends

Another notable point of friction for generative AI was copyright enforcement. In late December 2023, the *New York Times* (NYT) filed a lawsuit against OpenAI citing copywright infringement violations. In the NYT's specific case, the paper alleged that OpenAI had improperly accessed and reproduced product reviews from the paper's *Wirecutter* section without proper attribution or providing a link to

[28] (Hu, 2023)
[29] (Mehta, 2023)

the source.[30] Given that the LLMs which underpin generative AI are based on massive datasets for which AI companies are generally not compensating the authors (inluding the *Times)*, the legal fight over AI appears to be just getting started.

But just as generative AI produced losers, so it inevitably produced winners. As of October 2023, Open AI, the owner of ChatGPT, was seeking a valuation of $86 billion.[31] Earlier in the year Anthropic, an Open AI competitor, raised additional equity capital at a valuation of $4.1 billion.[32] And their success has spawned an entire ecosystem of startups trying to wrap their technology with various tools to solve specific use cases such as Jasper.ai for writing brand content or Lasso for implementing robotic process automation.[33]

These huge valuations reflect anticipation that AI will create massive economic value. In 2024, that thesis will be put to the test as we have more opportunities to assess the potential for AI to integrate with the "real" economy.

Looking ahead to 2024

One of the lessons AI proponents learned from ChatGPT's launch was the importance of how the capabilities of AI are presented to users. The underlying model used by ChatGPT at the time of its launch in November 2022 was known as GPT3, the third generation of OpenAI's LLM. GPT3 first became available to the public in mid-2020.[34] But the interface, called the OpenAI Playground, presented GPT3 as a form of auto complete. Provide it with some starting text and Playground would complete the text for you in a form it thought most sensible.

Clearly, this orientation for interacting with the technology did not grab the attention of users. It was not until OpenAI presented GPT3 from a different point of view, with a question-and-answer orientation, that users "got it" and enthusiasm for generative AI took off.

In our view, this highlights the most significant obstacle to deployment of generative AI capabilities in small and medium-sized businesses: it is not immediately obvious to many of the operating personnel in companies of this size how generative AI applies to their work, or even what it is. And in many cases, they may be right to ignore the trend as largely irrelevant to their work. The problem with this attitude is that the impacts of generative AI and the use cases where it excels are unpredictable: nobody outside OpenAI could have predicted the impact of ChatGPT on Stack Overflow for example.

In small to medium sized businesses, we expect that CEOs or potentially Chiefs of Staff are going to need to lead the charge in terms of identifying the opportunities and risks related to AI. The below matrix (Figure 16) should serve as a useful starting point for internal discussions on where and how AI could be applicable. It shows the results of a McKinsey survey of large companies on where they have deployed AI in their businesses, and it is segmented by industry vertical.

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[30] (Grynbaum & Mac, 2023)
[31] (Hammond & Madhumita, 2023)
[32] (Wiggers, Anthropic raises $450M to build next-gen AI assistants, 2023)
[33] (Wiggers, These Y Combinator-backed startups are trying to build 'ChatGPT for X', 2023)
[34] (Vincent, 2020)

	HR	Mfg.	Sales and mktg.	Product development	Risk	Service ops.	Strategy	Supply chain
All Industries	11	8	5	10	19	19	21	9
Business, Legal, and Professional Services	11	10	9	8	16	20	19	12
Consumer Goods/Retail	14	4	3	4	15	31	29	11
Financial Services	1	8	7	31	17	24	23	2
Healthcare Systems/Pharma and Med. Products	15	7	2	4	22	12	8	8
High Tech/Telecom	6	6	4	7	38	21	25	8

Figure 16
Source: McKinsey 2022 AI Survey

It shows that service operations are an important focus area for the adoption of AI. This includes use cases such as chat bots to handle customer inquiries and AI "copilots" that can help customer service agents research issue resolution pathways. Strategy and Corporate Finance is another area seeing high rates of AI adoption. Here the benefits are primarily the efficiency of financial processes where AI can do things such as convert photographed receipts into structured data or assist with the classification of invoices to accelerate the monthly close process.

It is critical that CEOs of small to medium businesses adopt the mindset that AI can be for them too. ChatGPT demonstrated that with the right user interface, AI can be accessible to any business. For example, small businesses went from needing to pay several hundred dollars an hour for a good copywriter to being able to access one that could work on demand at any time for $20 a month. The ecosystem of AI-focused startups that we referred to earlier will make this even easier by creating the tooling necessary to serve niche use cases. If you run a small to medium sized business and you identify a potential AI opportunity, chances are there's a startup tackling your problem (or soon will be).

As it relates to assessing your company's AI disruption risk, we encourage clients to outline the requirements for success in their business at a deep and tactical level and then assess AI's ability to replicate such jobs or outcomes. For example, business services generally remain reliant on the physical delivery of a service whether it be maintenance, installation of equipment or some other outcome. AI does not have hands (yet), and so we anticipate businesses focused on delivery of physical services to remain resilient throughout 2024.

In a similar vein, business models where a degree of interpersonal empathy is required are unlikely to be significantly impacted by AI in 2024. For example, customer interactions for critical services such as healthcare and utilities are likely to remain human-oriented jobs in the near-term (although made more efficient through AI tooling).

In cases where AI disruption risk presents itself, rapidly embracing the use of AI within the enterprise is most likely to be the path to the development of newly sustainable competitive advantage in the new world order.

ENERGY TRANSITION

2023 in review

2023 was a year in which the energy transition raced ahead in some respects but encountered significant obstacles in others. In a prior section we referred to the Inflation Reduction Act (IRA) which was passed by the Biden Administration in 2022. In addition to extensive manufacturing incentives, the IRA was also the largest ever investment in renewable energy by the U.S. government, directing an estimated $369 billion towards the sector.[35] 2023 was the first full year of the incentives' impact and, clearly, it drove meaningful investment in clean energy technologies (see Figure 17).

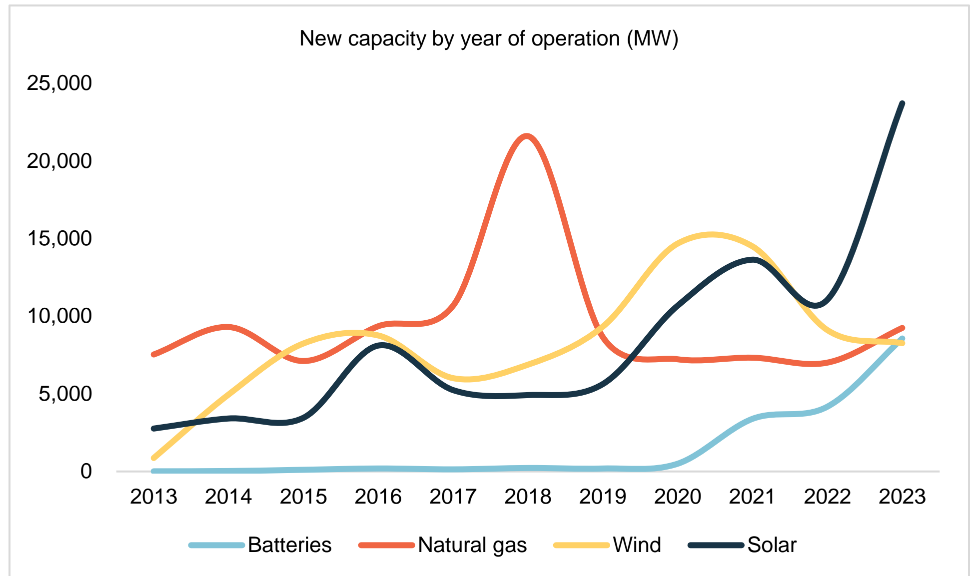

Figure 17
Source: U.S. Energy Information Administration

While the IRA directed significant capital towards clean energy sources, the volume of that capital simultaneously brought into focus obstacles the U.S. faces in adding large volumes of renewables to the grid. One is the intermittency challenge: sometimes the wind does not blow and the sun does not shine, but the U.S. consumer expects a reliable supply of electricity regardless. This mismatch between potential supply and demand at least partly explains the rapidly growing interest and investment in utility scale battery storage. It also explains the continued resilience of natural gas additions to the energy grid: much of the incremental generating capacity coming from natural gas represents "peaking" plants which provide dispatchable energy in times of high demand.[36]

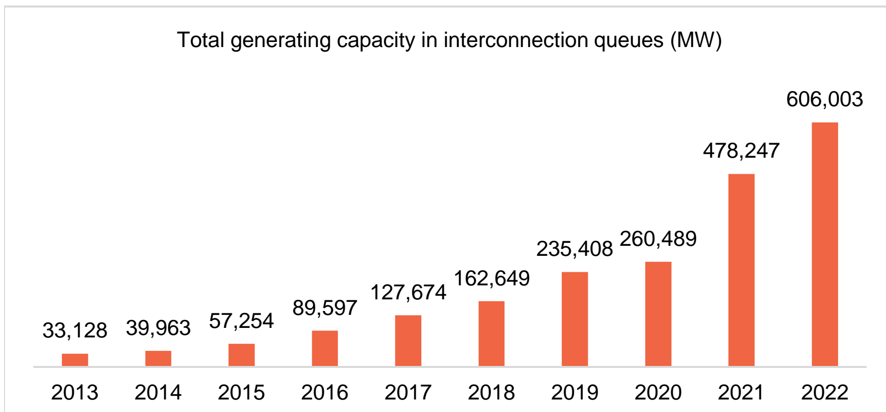

Figure 18
Source: U.S. Energy Information Administration
Note: Active capacity in queues exceeds installed capacity of US power plant fleet by ~1.6x

The growing interconnection queue is another obstacle that received greater attention in 2023. To connect to the electric grid, system operators require new projects to undergo a series of impact studies to determine what new equipment or upgrades may be required before the project can connect to the grid. Known as "interconnection queues", the total amount of generating capacity held up in

[35] (Levin & Ennis, 2022)
[36] (Mercado, 2023)

these queues has grown dramatically since 2013 (see Figure 18)[37]. A significant factor in the growth of queues is insufficient resourcing among system operating organizations. Staff are unable to keep up with the rapidly growing volume of requests and this adds delay and cost to renewable energy projects, undermining their economic viability.[38]

Finally, permitting reform moved further into the center of the national political stage given the obstacle it represents for both renewable and non-renewable energy projects alike. At issue is the complex permitting and regulatory regime that spans federal, state and local levels of government.[39] Navigating these requirements can add lengthy delays and additional costs to projects regardless of fuel source, which is why there is growing pressure on Congress from both renewable and non-renewable lobbyists to address the issue.[40]

Looking ahead to 2024

Based on planned additions to the U.S. electric grid over the next three years, photovoltaic solar is expected to represent most of the new generating capacity (see Figure 19). In isolation, the rapid growth of solar and to a lesser extent, wind and batteries, appear to presage a commensurate decline in the non-renewable energy sector. While that is likely true for coal-fired generation, we expect oil and gas to be resilient in 2024 and gas especially to continue thriving for the foreseeable future.

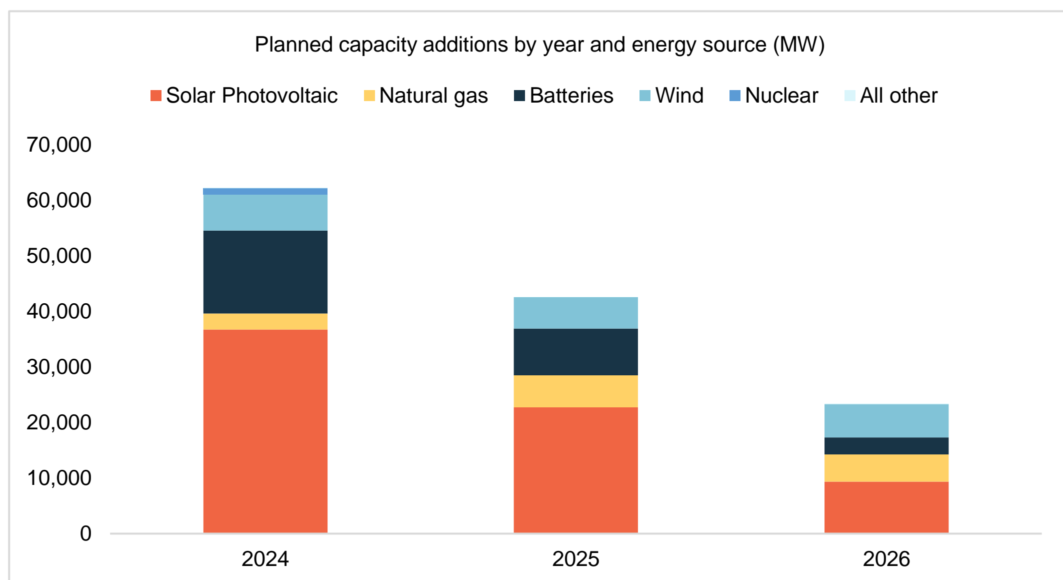

Figure 19
Source: U.S. Energy Information Administration

Gas retains the tailwind that we discussed earlier in terms of its suitability as a “dispatchable” energy source: it can be turned off and on depending on prevailing demand within the grid. Oil, we expect to continue having a crucial role both as the primary fuel source for the U.S. automobile fleet and as a feedstock into a wide range of products including plastics, fertilizers and home consumables (e.g., adhesives). All of these factors contribute to the Department of Energy’s forecast for increased fossil fuel consumption between 2022 and 2050 across a range of scenarios (see Figure 20).

[37] (Berkeley Lab, 2022); note that only approximately 20% of projects entering queues go on to be constructed
[38] (Collier, 2021)
[39] (Gribbin, 2021)
[40] (Eversole, 2023); (Solar Energy Industries Association, 2022)

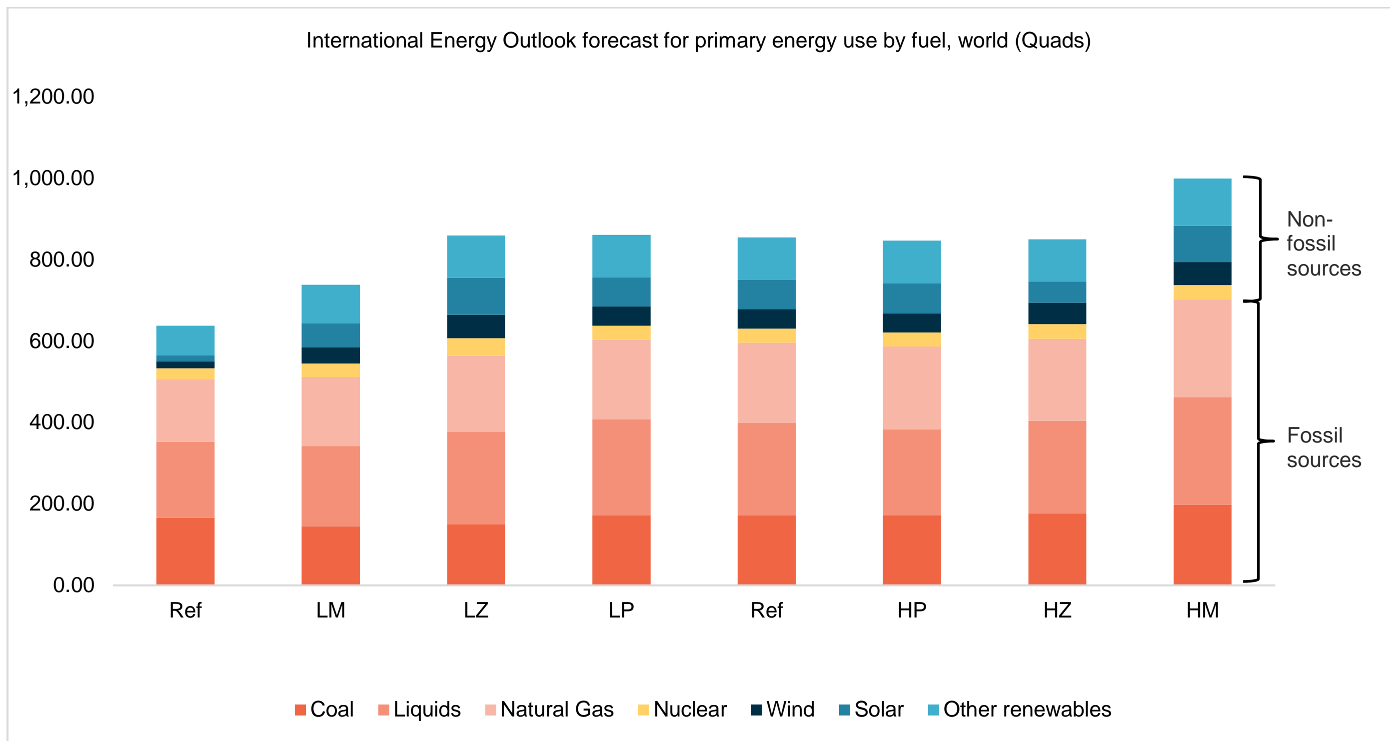

Figure 20
Source: Energy Information Administration, International Energy Outlook 2023
Notes: Ref=Reference; HM=High Economic Growth; LM=Low Economic Growth; HP=High Oil Price; LP=Low Oil Price; HZ=High Zero-Carbon Technology Cost; LZ=Low Zero-Carbon Technology Cost; a quad is a unit of energy equal to 10^{15} British Thermal Units

In terms of significant new developments, we are watching closely the potential for further improvement in the fortunes of hydrogen. The simplest and most abundant element in the universe, hydrogen can be extracted from larger molecules without a carbon footprint from a variety of sources including gas, coal and even water. It can then be used for a variety of purposes including grid-scale power generation, heating and as a fuel for personal vehicles. And, to some extent, it can take advantage of existing infrastructure: many existing natural gas pipelines can carry a 10-15% hydrogen mix.[41]

The Biden Administration has announced seven "hydrogen hubs" with a goal of producing three million tons of clean hydrogen by 2030. $7 billion in funding has been allocated to the hubs, which are located across the country, and it is hoped this investment will kickstart the evolution of a self-sustaining hydrogen industry. This is a major investment in hydrogen that has significant political backing behind it, making 2024 influential as an indicator of hydrogen's potential in future years.

With this backdrop, we are encouraging our business services and industrials clients to assess the growth opportunities in the renewables sector. Specifically, most if not all the "ecosystem" industries that have evolved to support non-renewables will be similarly required in renewables. Examples include scalable monitoring of infrastructure either from the air or using telematics, specialized facilities maintenance services, and safety and training services related to operation of renewable generation facilities. The rapid growth of renewables is a rare opportunity in a developed economy like the U.S. to capture a market leadership opportunity by being a first mover. Therefore, CEOs should be looking closely at what offerings their firm can bring to the industry.

In parallel, we are encouraging clients with exposure to the oil and gas sector to plan on the basis that it will remain resilient into the future. While expansion into renewables may be warranted, we do

[41] (Office of Fossil Energy, 2020)

not believe that implies an imminent need to pivot away from oil and gas. Instead, **we are recommending that CEOs become deeply familiar with planned expansions relevant to their business.** The U.S. Energy Information Administration makes detailed data on new energy infrastructure freely available which can be used to guide critical decision making such as hiring plans and capital expenditure.

U.S. ELECTIONS

2023 in review

The Republican party captured the lion's share of news media attention in 2023 due to its crowded primary field to determine the party nominee for the 2024 Presidential election and the factional contest in the House of Representatives.

Former President Donald Trump fired the starting gun on the 2024 Republican Primaries in November 2022 when he filed his statement of candidacy with the Federal Election Commission. In total, a further fourteen prospective candidates joined the race, but six have already withdrawn including, notably, former Vice President Mike Pence. The former President therefore heads into 2024 amongst a nominally crowded field with seven other challengers as of writing.

In reality, the former President is the runaway favorite in this field. He currently has a nearly 40 point lead against his closest challenger, former South Carolina Governor Nikki Haley.[42] Haley's ascent in the race has coincided with the effective collapse of support for Florida Governor Ron DeSantis whose support has steadily eroded over the course of 2023.[43] Only one other candidate has managed to poll better than 10 percent support, financier Vivek Ramaswamy, and his support has now pulled back to the point he is no longer planning further advertising spending, a sign he may soon drop out of the race.[44]

With other challengers fading away, the only meaningful threat to Trump's primary campaign as of writing were the various legal cases he faces in federal court and in the states of Georgia and New York. The trajectory of these cases is difficult to predict. Critical but unknown variables include the inclination of the Supreme Court to get involved in the two federal cases and the extent of cooperation provided to Georgia prosecutors by the former President's co-defendants in that case, arguably the most serious of the cases before the President.

The other source of significant media attention for the Republican Party in 2023 was the factional confrontation between the Freedom Caucus and more establishment members of the party in the House. Kevin McCarthy (R-CA) was elected Speaker of the new Congress in January after a record 15 ballots, and then McCarthy was ousted in favor of little-known Mike Johnson (R-LA) just over nine months later.[45] This intense factional disagreement within the party about the level of cooperation that should be extended to Democrats to keep the government open highlights the continuation of a political environment driven by extreme partisanship.

Just as the question of who to put forward to voters in the 2024 presidential election preoccupied Republican Party politics in 2023, so it preoccupied the Democratic Party too. Throughout 2023 uncertainty grew over incumbent President Joe Biden's age and its potential ramifications for his effectiveness as President. The President was 81 on the first day of 2024, older than any other president in history. And polling indicates that more than 70% of U.S. adults believe he is too old for a second term.[46]

[42] (270 To Win, 2023)
[43] (FiveThirtyEight, 2023)
[44] (Marquez & Tabet, 2023)
[45] (Kasperowicz, 2023)
[46] (Woodward & Swanson, 2023)

Biden has also faced deep criticism from the progressive wing of his party for his handling of the U.S. response to the war in Gaza. Biden's strategy of firmly embracing Israel's military response to Hamas, but pressuring the government of Israeli Prime Minister Benjamin Netanyahu behind closed doors was seen as totally inadequate by elements of the Democratic base. Consequently, many activist Democrats have vowed not to support Biden in 2024.[47]

But with no obvious successor to takeover from the President, that raises the specter of an open primary with its attendant risks for whichever candidate might eventually emerge. Thus, both Democrats and Republicans head into 2024 with the same party leader as four years prior.

Looking ahead to 2024

While polling averages currently favor former President Trump by 2 points, it is too far out from the first Tuesday in November to contemplate a meaningful prediction of the outcome.[48] In addition to the legal challenges facing former President Trump and potential health or age-related issues that might confront President Biden, developments in the economy will be hugely influential of the outcome. In polling of swing state voters, more than 83 percent identified the economy as "very important" for their voting decision.[49]

Given the uncertainty of these and other variables, our recommendation to clients is to assess the significance to their business of a Trump victory and a Biden victory. And, importantly, we do believe the candidates have material policy differences relevant to decision making. A Trump victory would likely curtail many of the subsidies and grants for renewable energy outlined in the Energy Transition section. While the cost of solar and wind are now low enough that, on average, they're competitive with non-renewables, there may be projects at the higher end of the cost curve that are not pursued due to a lack of government support.

This would likely be coupled with greater support for the non-renewable sector which would contribute to our expected resilience for oil and natural gas.

Immigration is another area where the two likely candidates differ. While net migration numbers between the Trump and Biden administrations are not comparable due to COVID 19, it is reasonable to assume that a second Trump administration would seek to curb inward migration, especially from across the southern border with Mexico. This would likely put further pressure on the already tight labor market, particularly for business service clients that make extensive use of unskilled migrant labor.

Finally, a Trump and a Biden administration would likely adopt very different approaches to international trade. In 2018, Trump leveled tariffs against China as part of a trade conflict and he may be inclined to do so again. Indeed, he may see China's weakened economic situation as a potential point of leverage to seek further concessions in the trade relationship between the two countries.[50] Even if such a tactic elicited benefits, it would not be without some short-term disruption – CEOs should be prepared.

Hopefully these examples highlight the approach we are taking to assessing the potential opportunities and risks at play in the 2024 presidential election. **CEOs should assess their exposure to government decision making and develop contingency plans accordingly.**

[47] (Iati & Itkowitz, 2023)
[48] (270 To Win, 2023)
[49] (Mejia, Haque, & Lu, 2023)
[50] (Yao, 2023)

GLP-1s

2023 in review

Generative AI was undoubtedly the breakthrough technological development of the first half of 2023, but GLP-1 agonists may have owned the second half of the year. Short for glucagon-like peptide 1, GLP-1 is a hormone with several crucial roles in the body including triggering insulin release and signaling how full a person feels after eating. GLP-1 agonists mimic the behavior of GLP-1 enabling significantly more effective treatment of, among other conditions, Type 2 diabetes and obesity.

Currently, the most well-known GLP-1 agonist on the market is semaglutide which is manufactured by Danish company Novo Nordisk and sold under the brand name Ozempic for diabetes and Wegovy for weight loss. In November, the U.S. Food and Drug Administration (FDA) also approved tirzepatide, under the brand name Mounjaro, from Eli Lilly for the purposes of weight loss as well (it already had approval as a Type 2 diabetes treatment).

Approximately 37 million Americans have diabetes and the CDC estimates that more than 130 million are obese (see Figure 21).[51] [52] Given the size of the market, the attendant costs associated with both conditions and the social stigma attached to obesity, GLP-1 sales surged in 2023. Total GLP-1 prescriptions reached 5 million by October 2023, up from about 2.5 million two years prior with Novo Nordisk holding about 50% of that share. In January 2023, Novo relaunched its Wegovy semaglutide injections aimed at weight loss and prescriptions surged from under 20,000 to nearly 100,000 in just ten months.[53] Indeed, the impact on Novo Nordisk's sales have been so dramatic, that the company's growth accounted for two thirds of the growth in the Danish economy in 2022.[54]

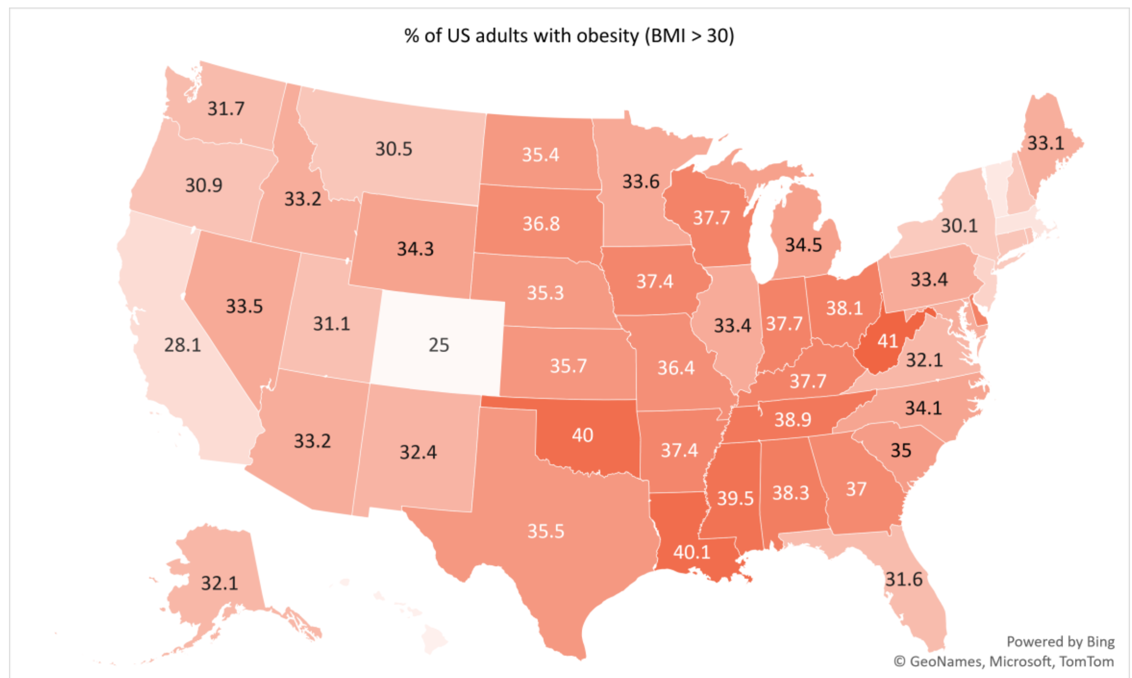

Figure 21
Source: Centers for Disease Control

Unsurprisingly, the dramatic success of GLP-1-based treatments has driven investor interest: Novo Nordisk and Eli Lilly's stock were up 83% and 52% in 2023.

[51] (Centers for Disease Control and Prevention, 2023)
[52] (Centers for Disease Control and Prevention, 2023)
[53] (Novo Nordisk, 2023)
[54] (Nelson, 2023)

Looking ahead to 2024

The connection between developments in big pharma and the lower middle market may not be immediately obvious but consider things from this perspective: what is the impact on your business if the surge in child and adult obesity in the U.S. does not just slow down, but reverses? Investors put this question, or some version of it, to public company CEOs in a wide range of industries in 2023.

The executives at food manufacturers Campbell's Soup and Conagra Brands were asked about the potential for GLP-1s to be a drag on sales due to lower consumer appetites.[55] A Jeffries analyst covering the airline industry estimated that United Airlines could save $80 million a year in fuel costs if average customer weight fell by 10 pounds as part of a broader Jeffries series covering the potential benefits of GLP-1s.[56] DaVita, the largest kidney care provider in the U.S., was forced to issue a press release addressing the rise of GLP-1s after the stock dropped 20 percent in a single day after clinical trials showed that Ozempic slowed progression of chronic kidney disease.[57]

These are just a small number of examples of the ways in which a clinically effective weight loss medication are forcing publicly traded companies to rethink aspects of their business models. And the extent and reach of these ramifications are only likely to extend in 2024 as Novo Nordisk and Eli Lilly ramp up production capacity to increase supply, and other competitors come into the market which will drive price competition to make the drug more affordable.

We do not believe the impacts of GLP-1s are just a public company concern. Obesity is such an embedded fact of economic life in the U.S. that meaningful reversal of its prevalence is likely to have widespread impacts, and we are pushing our clients to consider the risks and opportunities for their business. The clearest industry with potential GLP-1 headwinds is healthcare and pharmaceuticals. Any businesses with concentrated exposure to therapeutic areas that have Type 2 diabetes and / or obesity as primary risk factors should explore avenues for diversification. Similarly, given GLP-1s' capacity for impulse suppression, consumer-oriented businesses that rely on impulse purchasing for revenue should consider changes to their business model.

For the most part, however, we see GLP-1s as a tailwind for our clients. Obesity is a huge drain on the economy, costing more than $150 billion a year.[58] And much of that unlocked value can be captured by businesses in the lower middle market. For example, while GLP-1s are currently too expensive at present for most lower middle market firms to include in their pharmacy benefits plan, we suggest monitoring pricing with your pharmacy benefits manager. Eventually, a tipping point will arrive where the cost of GLP-1 coverage is outweighed by lower insurance premiums due to lower risk of conditions associated with obesity, and reduced risk of worker injury.

In addition to cost tailwinds, some of the value unlocked by GLP-1s will come from shifting consumer spending priorities. GLP-1s are most effective when paired with good diet and exercise, and we anticipate growing consumer demand for health foods and gym memberships. Consumer "experience" businesses are also set to benefit as consumers are more open to travel experiences that involve exercise such as walking tours.

[55] (Newman, 2023)
[56] (Schlangenstein, 2023)
[57] (DaVita, 2023)
[58] (Centers for Disease Control and Prevention, 2023)

There can be a temptation to overcorrect when assessing the potential impact of GLP-1s. Think about them long enough and soon almost any product can face either mortal threat or a generational opportunity. **CEOs need to put the hype aside, both to the downside and the upside, and think critically about their exposure to the conditions GLP-1 target and prepare their businesses accordingly.**

TAKEAWAYS FOR CEOS

The checklist

Below we summarize our recommendations for CEOs in the lower middle market to help them prepare their businesses for success in 2024 and beyond.

1. **M&A Strategy Adaptation**: Given the downward trend in M&A volume and to some extent valuation, CEOs should prioritize value creation initiatives that improve their company's revenue diversity and predictability. Additionally, CEOs should assess their acquisition strategies. This includes reconsidering the types of companies they target, the terms of deals, and their approach to due diligence.
2. **Dealmaking Posture**: Understand the changing landscape, including the prolonged holding periods and the conservative stance of institutional actors. CEOs should prepare for potentially longer due diligence and exclusivity periods while also being ready to demonstrate inorganic growth capabilities or other high-return-on-investment strategies warranting deployment of incremental investor dollars.
3. **Interest Rate Impact**: Prepare for a bifurcated year with changing interest rates. CEOs should closely monitor the Federal Reserve's policies and consider the impact on their debt servicing capabilities and investment plans. Prospective sellers may want to consider moving toward a "sale ready" stance to enable quickly approaching the market upon the Fed's decision to begin loosening with the goal of completing the sale prior to a potential resurgence of inflation.
4. **Geopolitical Tensions**: Develop strategies to mitigate risks associated with geopolitical tensions, particularly with China and the Middle East. This might include diversifying supply chains or considering reshoring or friend-shoring strategies.
5. **Labor Market Tightness**: Develop strategies to address labor market constraints. Consider investing in automation and AI to improve efficiency and explore programs like the H-2A for additional labor resources.
6. **AI Integration**: Embrace AI as a tool for efficiency and innovation. Identify areas where AI can automate routine tasks, enhance customer service, or drive strategic decisions. Stay informed about legal implications and ethical considerations.
7. **Supply Chain Resilience**: Deepen your understanding of supply chains, identifying critical components and potential vulnerabilities. Consider alternative suppliers and develop contingency plans.
8. **Navigating Inflation**: Monitor inflation trends and plan accordingly. This might include adjusting pricing strategies, cost management plans, and investment strategies to hedge against potential inflation spikes.
9. **Sector-Specific Strategies**: Depending on the industry, focus on sector-specific strategies. For businesses services, emphasize the reliability and efficiency of services offered. In manufacturing, consider the benefits of nearshoring and technology integration.
10. **Leadership in Innovation**: CEOs should lead the exploration of AI and other innovative technologies. Encourage a culture of continuous learning and adaptability within the organization.
11. **Stakeholder Communication**: Maintain transparent and frequent communication with stakeholders, including boards, investors, employees, and customers, to navigate the uncertainties of 2024 effectively.

12. **Regulatory Compliance and Risk Management**: Stay abreast of changing regulations, particularly in areas like AI and international trade. Enhance risk management strategies to cover a broader range of scenarios.

LOWER MIDDLE MARKET CEO SURVEY

Takeaways

In Q4 of 2023, Klar Ventures launched a survey to help lower middle market CEOs understand how their peers are thinking about 2024 from the perspective of M&A, business performance expectations, capital expenditures, and the labor market. While the full results are only available to survey participants, we are pleased to summarize some of the key findings here:

1. **M&A remains an opportunity:** On the M&A front, less than half of respondents had completed an acquisition in the past 12 months. This reinforces to us the opportunity that continues to exist in finding ways to provide low-cost deal support to searcher CEOs in particular: the multiple arbitrage available for deals in this layer of the market remain significant and based on our conversations with clients, senior management capacity remains one of the key obstacles to increasing M&A activity among search firms.
2. **Will higher sales hit the bottom line:** While most respondents expected to be able to grow revenue in 2024, CEOs were evenly split between those expecting to improve margins and those expecting margin compression. This reflects the complicated economic picture for owners and operators in 2024: fundamental economic indicators are strong, but this reflects an economy close to its capacity which creates cost pressures for businesses. Winners will be those with pricing power and / or an ability to identify and implement cost structure improvements.
3. **Optimism in hiring:** Hiring remains a persistent challenge for at least half of surveyed CEOs in the lower middle market. However, most respondents expected labor pressures to ease in 2024. In our view, this might be optimistic. As discussed earlier in this report, the labor market remains tight when looking at job openings compared to the participation rate. This is why we continue to encourage clients to consider solutions that enable them to if not fully automate roles, then to "bend the curve" in a way that allows revenue to grow with less than 1:1 growth in headcount.

For further information about the survey or if you have questions about how to complete it, please reach out to Nick Ward at nick@klarventures.com.

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