Q1 2020 EDITION

Pursant
INSPIRED PURSUIT

DEAL insider

M&A and Strategic Transaction Insights

THE INVESTMENT BANK THAT ALSO BUILDS THE VALUE OF YOUR BUSINESS

Q1 2020 Highlights:

- M&A activity down nearly 50% from 2019
- Most deals in-play paused or restructured
- Deals that closed in Jan. and Feb. showed continued multiple strength

Pursant's Thoughts on the Near Future

- We are shifting from a prolonged Seller's market to a more Neutral or Buyer favorable market
- Fatigued business owners becoming motivated Sellers
- M&A volume is expected to return in late Q3/early Q4
- Borrowing costs for deals will remain low, but we will see more conservative M&A borrowing behaviors

Q1 2020 – How Quickly Things Change in a Few Weeks

Pursant traditionally starts finalizing its view of the previous quarter's deal environment thirty days after a quarter ends, after the dust has settled, when there is more clarity of data and greater visibility into what is to come. But as we sat down to report on Q1 2020, the dust had not settled; to the contrary, the second half of the quarter became a dust storm of uncertainty, with zero visibility into the state, direction or pace of deals.

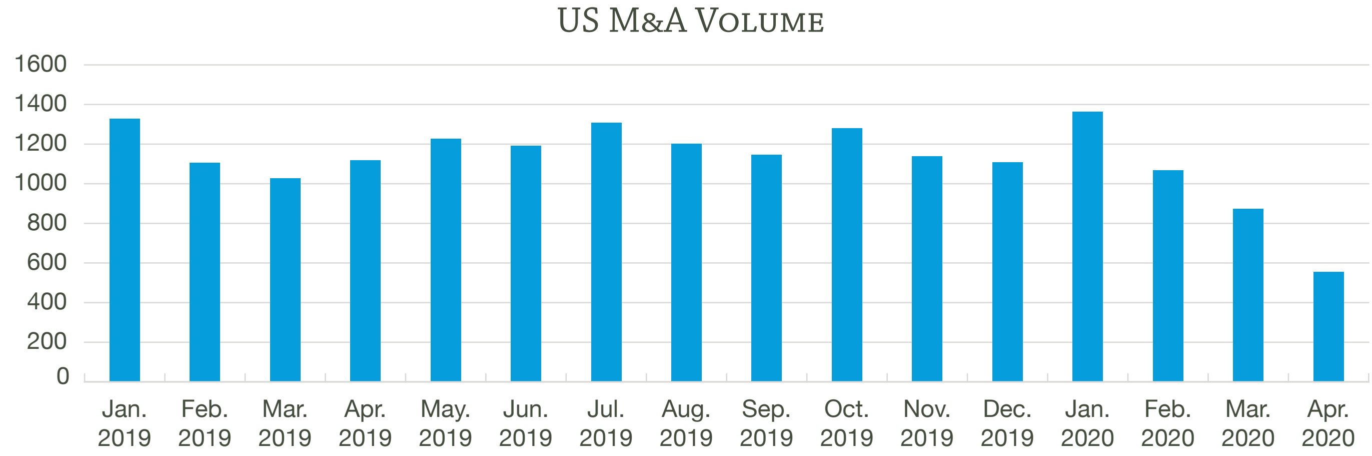
We have spent April and May processing the impacts of the health crisis on M&A and the recession to follow, being a sponge absorbing insights from our network, navigating the twists and turns of the deals our firm had in-play pre-COVID-19 and fielding questions from those that look to us for guidance. The conclusion is that while there are normally winners when the market turns, there were very few winners resulting from this crisis. However, as we now move to the back side of the pandemic, we see that the chess board has been reset with parties that either stand to gain from the new market, lose or neither.

As we can see in Chart 1, Q1 began with volume expected to be on par with healthy Q1s of the recent past, but then came a precipitous drop mid-quarter, ending down nearly 50% from previous quarters, according to Pitchbook & Factset. Valuations came into question, making it nearly impossible for Buyers and Sellers to agree on terms. But this remained intact: the motivation to get deals done somehow and at some point in time.

(Continued...)

The Pursant Deal Insider is a quarterly publication offering analysis of the marketplace and climate for middle market mergers, acquisitions and strategic transactions. Our emphasis is on transactions with a total enterprise value of less than $250M. Our goal is to arm business owners and other parties with insight to help prepare for such transactions in order to optimize transaction outcomes.

Chart #1



Source: Factset®

The last 30 days of Q1, which were very different than the first 60 days, can be better understood by looking at deals by Stage, Sector, Size and Buyer Type.

Deal Impact By Stage – Transactions in the initial stages of marketing and those about to be launched were paused due to Buyers and Sellers having limited physical, intellectual and emotional bandwidth to navigate a strategic transaction. Even companies that stood to gain from the crisis were consumed with too many new twists, turns and unknowns to stay the course on a complex, time consuming M&A event.

Transactions in progress and either near LOI stage or under LOI were often proceeding, albeit at a slower and more cautious pace. Exceptions include deals in which the underlying business and/or industry was negatively impacted by the crisis in the mid to long term; such deals were halted or at the very least had more structure such as contingent payment introduced and more robust material adverse change (MAC) language inserted into definitive agreements.

Those contemplating a sale transaction in businesses not negatively impacted by or potentially benefiting from the crisis were taking advantage of temporary professional services bandwidth to help prepare for a transaction process. Those with companies unfortunately hurt by the crisis and recession to follow may have missed their optimal exit window—one which is not likely to open again for many years, as we have now entered a more Neutral to Buyer-favorable period in the business transfer cycle.

Deal Impact By Sector – In the mid-to long term, sectors fall into one of three categories as a result of the crisis.

- Businesses in sectors negatively impacted by travel and other group gathering restrictions—for example, event companies, dine-in restaurants, hotels, movie theaters—were absent from the deal world unless a distressed acquisition. These sectors are not likely to recover to pre-crisis valuation levels for years.
- Businesses thriving during and after this period, such as those that provide work-at-home technology and products, telecom, sanitation services, gaming, at-home and streaming entertainment services, some food products and services and e-commerce were in the spotlight of acquisition interest. These safe haven businesses likely will trade at pre-crisis levels or better when M&A comes back online.
- Businesses that do not fall into either of the above categories and were simply "down" for the period are likely to see the negative impact adjusted out of the proforma earnings formula, assuming the business returns to pre-crisis levels. These businesses will likely trade at pre-crisis or softened valuations when normal M&A activity resumes.

Deal Impact By Transaction Size – Putting the health of a business and its underlying sector aside, larger transactions dependent on Buyers securing senior and mezzanine (junior) debt to fund them saw slowed or halted activity as the credit markets locked their doors. Lenders were preoccupied with assessing the impact on current loans, processing PPP loans and overall uncertainty about the future.

A lot of leverage had already built up in the financial system since the country's eleven-year economic expansion. This means that any Buyer with less than stellar credit struggled to get new loans and even saw existing credit lines cut.

Smaller transactions (less than $100M in value) where there is less leverage involved were less impacted than larger transactions where a greater degree of leverage generally came into play. Over the month of May, credit markets have gradually started to move again and the expectation is that M&A capital will be available very soon.

Deal Impact By Buyer Type – Fully funded Private Equity (PE) Buyers were still looking to make acquisitions, as it is central to their business models; however, their ability to deploy large amounts of leverage in transactions was and will be compromised going forward. The good news is that US non-bank lenders will still be looking to lend to investors doing deals with North American businesses.

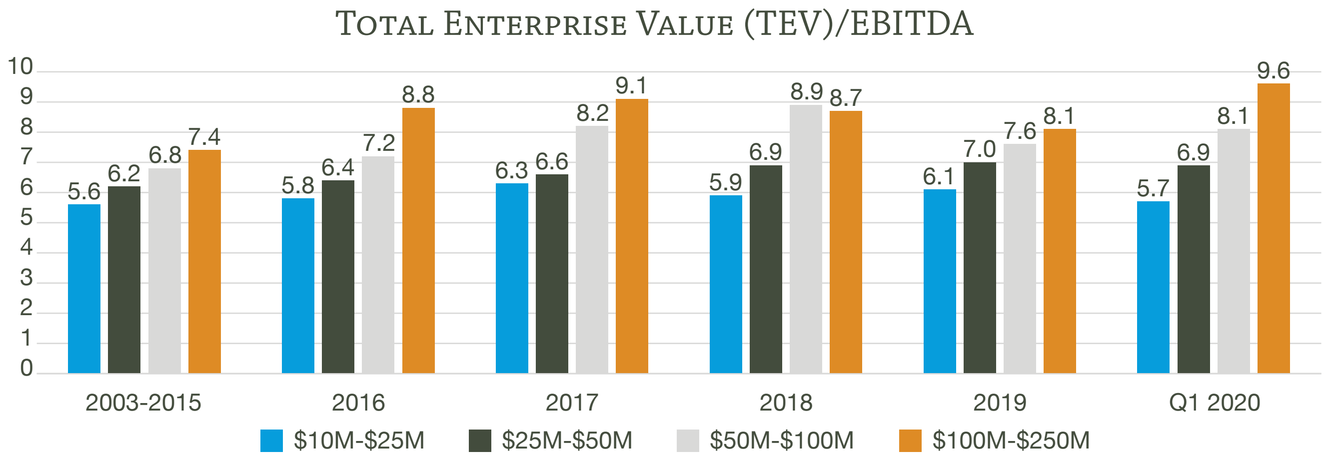
Corporations that had cash on their balance sheets paused deal activity, preserving their cash due to the uncertain future. However, many of these parties have already started to re-fire the acquisition engine as we exit the pandemic, looking forward to the increased deal flow that will certainly result from the emergence of more fatigued business owner Sellers.

In short, the quarter felt like a roller-coaster ride in the dark: with no idea of when the next loop will happen and when the ride will end, all one could do is hold the harness and hope the ride would end soon. The dealmaking community has started to see the light at the end of the tunnel, and expectations are that the second half of Q3 of this year should show a return to some version of M&A normalcy.

Q1 Valuation Multiples - The first quarter of 2020 was active, with two-plus months of "normal activity" prior to the onset of the coronavirus. Chart 2 thus provides a last view of the improbably long-lived Sellers' market that encompassed nearly all of the last decade. The environment in which this data is being read is quite different than the one in which the transactions were completed.

For the lower middle market deals that were completed in Q1, valuations reflected a continuation of the conditions that had prevailed since 2017. Average valuations for deals under $250M across the 3+ years were in the 7.1-7.4x range. Size remained a significant pricing factor in the lower middle market. Average multiples expanded in fairly lockstep fashion, from 5.7x in the $10-25 million TEV range to 9.6x at $100-250 million.

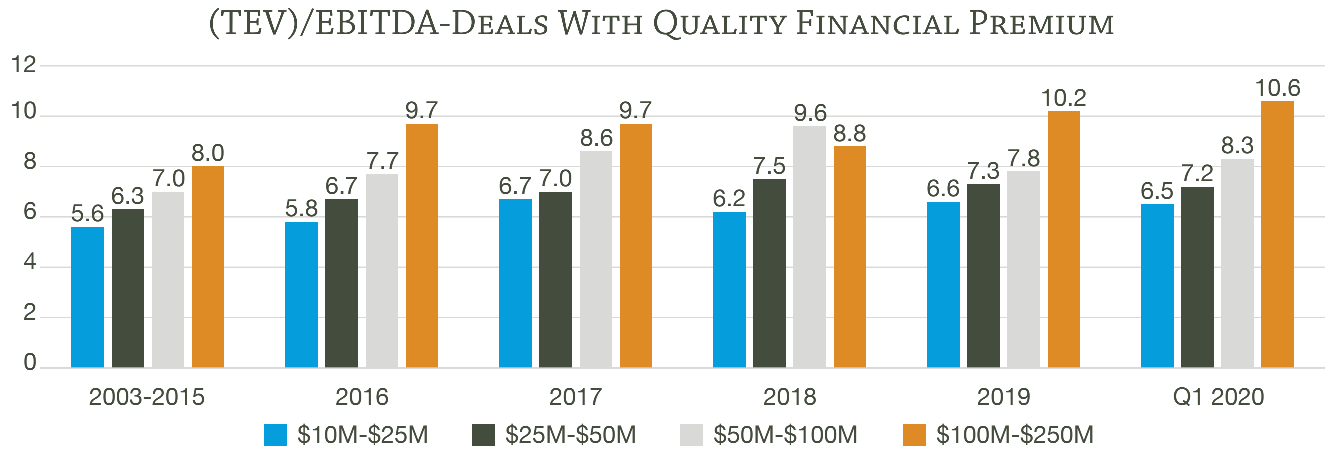
Chart #2



Source: GF Data®

The Quality Financial Premium – Larger businesses of quality continued to be rewarded for their size and favorable financial profiles. As shown in Chart 3, selling businesses in each size tier received premiums for above-average financial characteristics. A financial premium is paid for businesses with trailing twelve-month (TTM) EBITDA margins and revenue growth rates both above 10 percent, or one above 12 percent and the other at least 8 percent. Outliers on the high side are excluded from this calculation. The data shows that if there are two virtually identical companies, on average, the company with more impressive revenue and margin growth rates will command nearly a full one multiple (1x) premium.

Chart #3



Source: GF Data®

EBITDA Defined *– For most middle-market businesses, valuation is typically expressed in the form of a multiple of EBITDA (earnings before interest, taxes, depreciation and amortization)—a measurement of a company's ability to generate cash flow. EBITDA figures also serve as a barometer of the company's health and performance. Multiples of EBITDA vary greatly depending on a company's risk profile, the markets in which it operates and the likelihood of continued returns.*

The US Macroeconomic Picture for Q1 2019 and its Impact on M&A

GDP – The US economy shrank by an annualized 5 percent in the first quarter of 2020, ending the longest period of expansion in the country's history. It is the biggest drop in GDP since the last quarter of 2008 as the COVID-19 pandemic forced a number of states to impose lockdown measures in mid-March, throwing millions of people out of work. We see here the relationship between a healthy economy and dealmaking. When the economy's trajectory turns, dealmaking will follow.

Inflation – The US annual inflation rate finished Q1 down 1.5 percent. It is the lowest inflation rate since February of 2019, mainly due to a 10.2% drop in gasoline costs and a 1.6% drop in apparel prices. Food inflation edged up. Decreases in airline fares, lodging and apparel also contributed to the decline. We watch this key indicator, as it influences Fed behavior and the Fed's management of interest rates, which effect M&A.

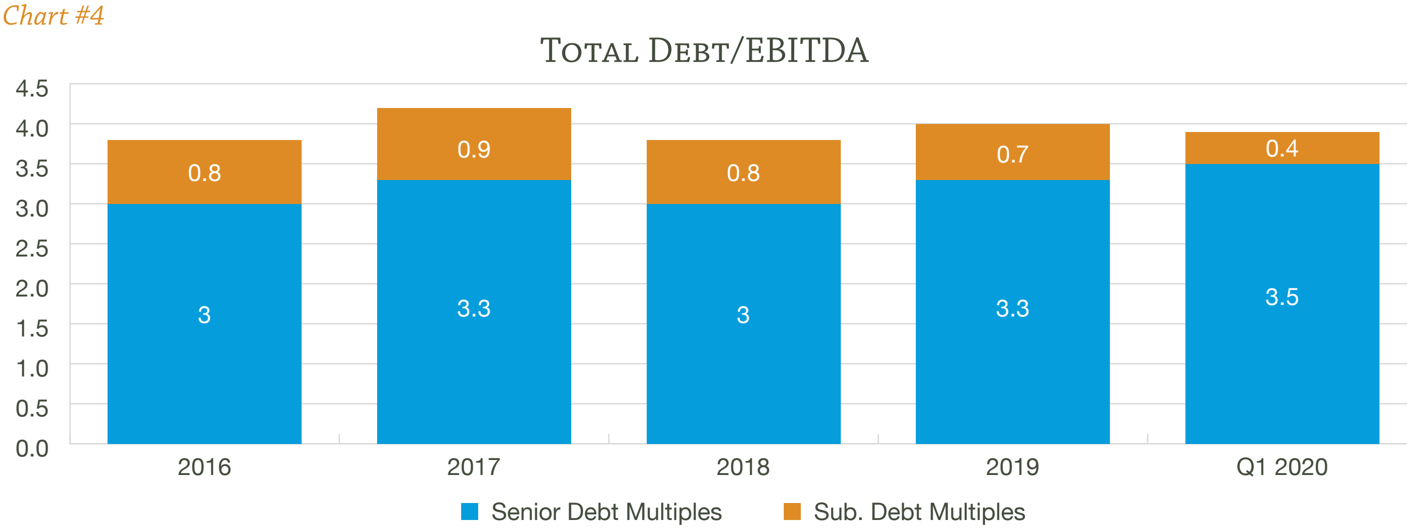
Business Confidence – The Institute for Supply Management's Manufacturing (ISM) Purchasing Managers Index (PMI) in the US finished Q1 at 49.1, down from 50.1 in February. The reading pointed to a contraction in the factory sector, as the coronavirus pandemic and shocks in global energy markets have impacted all manufacturing sectors. Declines were seen in new orders, production, employment, inventories and new export orders. A PMI above 50 represents an expansion when compared to the previous month. A PMI reading under 50 represents a contraction, and a reading at 50 indicates no change. The farther the number is from 50, the greater the level of change.

Fed Lending Rate – On March 15 the Federal Reserve lowered the target range for its federal funds rate by 100bps to 0-0.25 percent and launched a massive $700 billion quantitative easing program in an emergency move to protect the US economy from the effects of the coronavirus. When M&A returns in a meaningful way, this lower cost of capital will help further bolster borrowing for deals and afford better valuations.

Pursant watches these macro-economic indicators because the direction and performance of the greater economy gives us an indication of where the Middle Market is heading as it relates to favorable or less favorable phases of the business transfer cycle. The business transfer cycle is continually moving through periods that do or do not favor Sellers. *The pandemic and its macroeconomic impacts have triggered a shift from a prolonged Seller-favorable cycle to a period that is neutral to Buyer-favorable.*

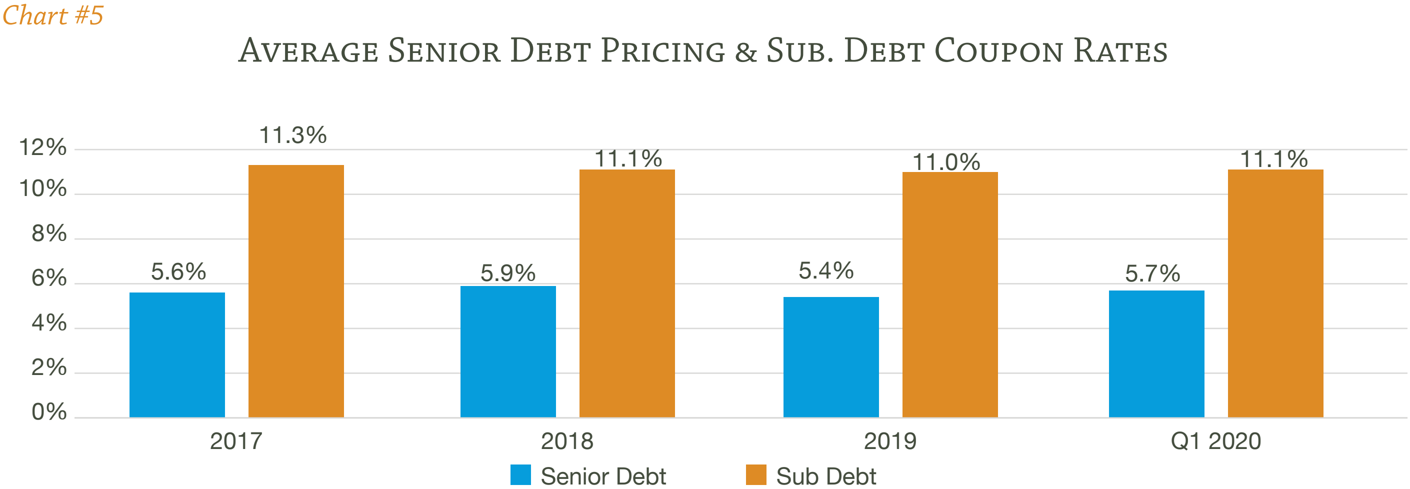
Borrowing to Get Deals Done – Chart 4 shows how debt availability for deals and usage remained intact for much of Q1 and how senior debt providers have been lending more for deals over the years (3x in 2018, 3.3x in 2019 and 3.5x in Q1 2020) in order to compete with the unitranche lenders offering multiple debt products. Combined senior and sub debt multiples in the first quarter of 2020 averaged nearly 4x EBITDA. Chart 5 shows the continued reasonable cost of capital that remains in the market.

Chart #4



Source: GF Data®

Chart #5



Source: GF Data®

The Seller's Market Has Come to an End for Many—Now What?

In recent years, Middle Market Sellers often were called into the market, meaning that Buyers sought them out and compelled them to act. Many potential Sellers held the belief that the favorable environment was not going to go away anytime soon. They remained unmotivated due to favorable macroeconomic conditions, and instead waited until their own circumstances dictated that it was time to sell. For the first time in nearly a decade, we are seeing the shift away from a Seller's market and sidelined fatigued business owners are now motivated to act.

Here are ten things you can do to make your business more valuable in a recessionary environment:

1. **Recurring Revenue**
   The more revenue you have from recurring contracts or subscriptions, the more valuable your business will be to a Buyer. Even if recurring revenue is not the norm in your industry, try to find creative ways to command some form of it. It will make your company much more valuable, especially in a recessionary environment.

2. **Sell Something Different**
   Buyers buy what they cannot easily replicate, which means that companies with a unique product or service that is difficult for a competitor to knock off are more valuable than those with a commoditized offering.

3. **Growth**
   Buyers looking to fuel top line revenue growth through acquisition will pay a premium for your business if it is growing much faster than the rate of your industry growth overall. For example, if your industry grows at 2-3% a year, make sure you are growing at 5% or better a year.

4. **Caché**
   Tired old companies often try to add sex appeal by acquiring a trendy young company. If you are the darling of your industry trade media, expect to get a premium acquisition offer.

5. **Customer/Product Diversification**
   Acquirers pay a premium for companies that naturally hedge the loss of a single customer or product. Ensure no customer or product amounts to more than 10 percent of your revenue and your company will be more valuable than an industry peer with just a few big customers or products.

6. **Predictable Revenue Growth**
   If you've mastered a way to win customers and can predict the conversion rates throughout your sales funnel, your secret customer-acquiring formula will make your business more valuable to an acquirer than is an industry peer who doesn't have a clue where its next customer will come from.

7. **Clean Books**
   Companies that invest in "reviewed" or "audited" financial statements as opposed to simply "compiled" have financial profiles that are generally viewed by acquirers as more trustworthy, which lowers a Buyer's perceived risk in your business and increases their willingness to pay more.

8. **A 2iC, Management Depth and Promotable Teams**
   Companies with a second-in-command who has agreed to stay on post-sale are more valuable than businesses in which all the power and knowledge rests in the hands of the owner. Additionally, companies with multiple talented managers and developable teams underneath them are viewed as more scalable and thus more valuable.

9. **Happy Customers**
   Being able to objectively demonstrate that your customers are happy and intend to re-purchase in the future will make your business more valuable than an industry peer that does not have a means of tracking customer satisfaction.

10. **Portable Customer Relationships**
    Be sure to demonstrate that your customers are with you because of your product, service and relationships with multiple people in your organization. If customer relationships are concentrated with a few key people—or worse yet, ownership—this jeopardizes the transferability of these relationships to a Buyer and negatively impacts enterprise value.

Like a rising tide that lifts all boats, your industry typically defines a range of multiples within which your business is likely to sell. Whether you fall at the bottom or the top of the range comes down to factors that have little to do with what you do, but instead are tied to how you do it.

Pursant's Expectations for the Near Future

For years now we have been repeating a theme in this section of the Deal Insider that revolves around the dynamics of a continued Seller-favorable market—in other words, the notion that the protracted 10+ year economic expansion has helped businesses thrive, making owners less motivated to transact, thus creating a continued shortage of good acquisition opportunities for Buyers, despite the ballooning number of baby-boomer age business owners. We also noted that those conditions will not persist indefinitely.

Those who live in the deal world are acutely aware of the natural Business Transfer Cycle changes. For the last forty years, the M&A world has moved through fairly predictable shifts in the M&A market that move between Buyer-favorable to Seller-favorable to Neutral. These cycles largely have been driven by the natural leveraging and deleveraging behaviors of those that borrow for M&A. As rates rise and fall and debt loads rise and fall accordingly, parties increase or reduce what they are willing to pay to acquire a business. Human beings have a very predictable pattern of borrowing and spending when debt is cheap until they reach their maximum level of risk tolerance and then begin paying down debt, only to repeat the pattern.

The Business Transfer Cycle

Deal Recession (Buyer's Market)	Prime Selling Time (Seller's Market)	Uncertainty (Neutral Market)
1980 – 1983	1983 – 1988	1988 – 1990
1990 – 1993	1993 – 1998	1998 – 2000
2000 – 2003	2003 – 2008	2008 – 2010
2010 – 2013	2013 – 2018	2018 – 2020

Source: Rob Slee - Private Capital Markets

For the last forty years, the M&A world has moved through fairly predictable shifts in the M&A market that move between Buyer-favorable to Seller-favorable to Neutral.

We have now officially entered the "Uncertainty" phase of the Business Transfer Cycle. To be clear, the pandemic did not cause this. It merely accelerated a shift that was already underway, much like the sub-prime crisis accelerated the shift of 2008-2010.

The macroeconomy has officially entered a recession phase and with that, all of the drags on business will come into play for most sectors. This will result in an increase in the number of distressed company acquisitions. Recession resistant sectors could see increased activity, as they are viewed as a safe haven for investing. Those that seek acquisitions will continue to see affordable capital for doing deals, as the expectation is that the Fed will leave rates at or near zero until 2022.

We will see more business owners becoming motivated Sellers. Many were on the fence when times were good. Business owners spend their lives getting punched in the face by one challenge after another. The pandemic was a knock-out blow for many, and they have raised their hands signaling retirement—especially the baby-boomers that were holding out longer than expected.

Overall M&A volume will remain down for Q2 and much of Q3 while parties digest the impact on businesses and sectors. Q4 will likely see a surge of activity as deals that were on pause resume, much like water flows after a dam is lifted.

We stated in our last issue of the Deal Insider that historically, markets do not like uncertainty, but in spite of our country's 2019 issues including China supply chain challenges, impeachment proceedings and other drama, the M&A world continued to perform well. The health crisis has taken uncertainty to a whole new level for 2020. What is certain, though, is that the demand to do deals remains, so we will see a slow shift out of this stage of uncertainty.

Pursant is an investment banking, financial and management consulting firm that supports and executes middle market M&A related initiatives and helps business owners grow enterprise value.

Our Financial Consulting practice delivers the strategy, skills and brainpower needed, in the form of advisory or interim financial professionals, to support and augment finance teams with needs often related to strategic transactions.

Our Management Consulting practice provides customized solutions designed to re-shape conventional thinking about leadership performance, profitability and growing enterprise value.

We use a deep immersion process, our expansive networks and experience as owner/operators, dealmakers and sector experts to effectively deliver on these critical initiatives for which most companies do not have the time, manpower or expertise.

To learn more about how Pursant can help you, send an email to Info@Pursant.com, call 847.229.7000 or visit www.Pursant.com.

Pursant

INSPIRED PURSUIT