Q1 2021 EDITION

Pursant
INSPIRED PURSUIT

DEAL insider

M&A and Strategic Transaction Insights

THE INVESTMENT BANK THAT ALSO BUILDS THE VALUE OF YOUR BUSINESS

Q1 2021 Highlights:

- M&A activity continues to be extremely high—higher than before the pandemic
- Valuation multiples are frothy for better performing businesses, but slightly lower for the balance
- M&A borrowing is high, matching banks' appetite to lend

Pursant's Thoughts on the Near Future

- Many business owners are moving to transact in 2021, ahead of imminent tax increases in 2022
- With people returning to work, along with travel and social activity rapidly increasing, there will be better visibility into the new earnings norm

Q1 2021 – Middle Market M&A Activity Returns to Pre-COVID Levels

Middle Market M&A activity has returned to pre-COVID levels (see Chart 1), but the drivers of this activity are very different than they were pre-pandemic. The drivers of robust M&A activity in Q1 were:

- A backlog of imminent deals that had paused in 2020, now closing
- COVID-fatigued business owners motivated to exit
- Business owners looking to close before the likely increase in capital gains in 2022

Chart #1

Source: Factset®

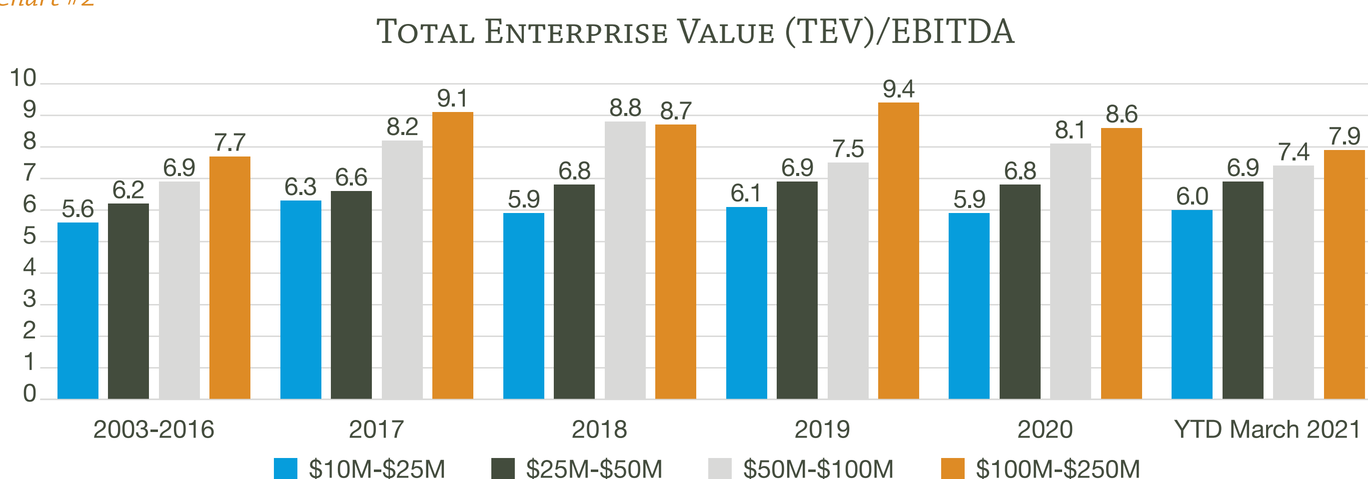
(Continued...)

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.

What is also very different from pre-COVID M&A is the valuation landscape. Prior to Q1 2020, with all cylinders firing in the economy, virtually all valuations were at some premium, like a rising tide lifts all boats at sea. COVID rectified that situation. Now, only businesses and sectors that are truly performing well are commanding premiums, creating an environment in which Buyers can now be more selective about when they pay premiums, while Sellers with better businesses are still able to attain attractive liquidity events.

The now uneven valuation environment is best described by GF Data as "clear skies, muddy waters." It used to be that we could look at macro middle market valuation data and be comfortable with how companies would likely trade. That is no longer the case. For example, at first glance, Chart 2 shows that Valuations in Q1 averaged 6.8x TTM Adjusted EBITDA. This is the third post-Covid quarter in which aggregate pricing has been ***slightly*** below the 7.0-7.2x range that had characterized the market since 2017. This dip also departs from the widely held sense that valuations have risen, not fallen, over the past nine months. Hence the reference to "muddy waters."

Chart #2



Source: GF Data®

A substantial subset of deals are being valued at or above pre-pandemic levels, but several factors are obscuring these deals in the overall data:

- An unprecedented gap between "haves" and "have nots." Pursant has spoken about the "quality premium"— the reward accorded to Sellers with above-average TTM EBITDA margins and sales growth. ***In Q1 2021, the premium was 34%***, compared to a historic average of 14%. The higher performers were valued at an average of 7.6x, in line with recent experience. However, the "other" deals came in at an average of 5.7x, about a half turn off of recent norms.
- More deals completed with Seller financing or earnouts (SFEs). In 2018-19, these valuation-bridging mechanisms appeared in about 39% of reported deals. The figure rose to 42% in 2020. In Q1 2021, it was 43%. Note that deal values on these transactions are reported net of the post-closing consideration.

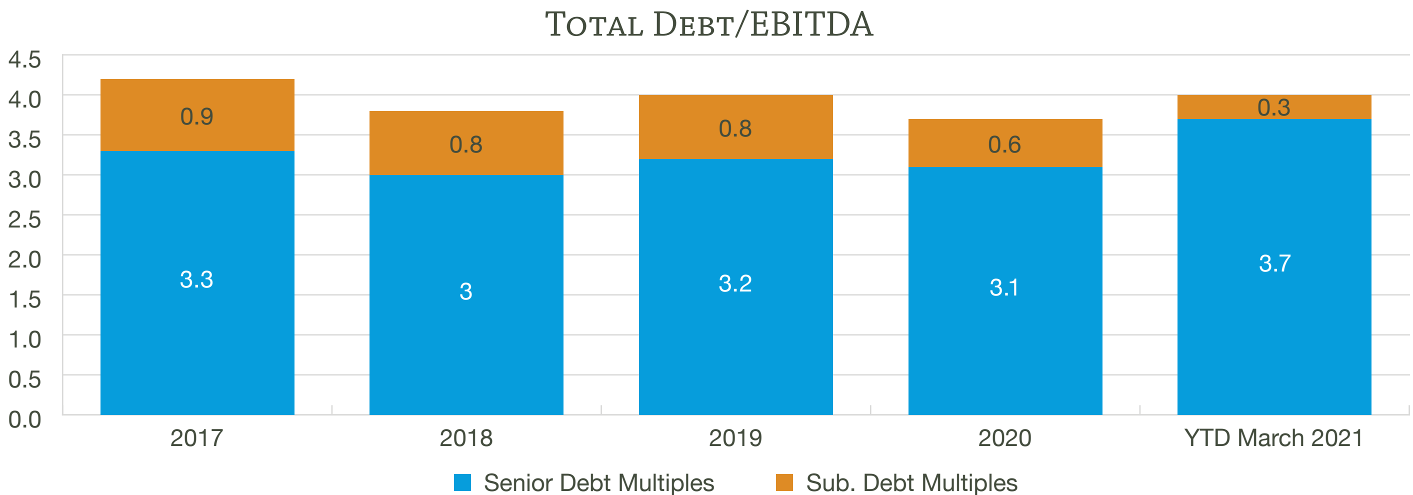
Given the widespread perception that federal taxes are likely to increase in 2022, we see more Sellers remaining at the table to negotiate gaps between bid and ask.

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.*

Very Strong M&A Borrowing Activity – Chart 3 shows us that debt utilization to get deals done has certainly returned to pre-COVID levels in Q1, continuing a progression from the third and fourth quarters of last year. Overall, total debt averaged 4.0x for the quarter, with senior debt accounting for 3.7x. The narrow swath of subordinated debt (.3x) is a result of the increased percentage of add-ons as opposed to platform deals in this data sample, as there is traditionally little to no sub-debt utilized in an add-on acquisition when compared with a platform acquisition.

The relevance of monitoring debt utilization in M&A is that Buyers—financial buyers in particular—virtually always utilize debt to fund acquisitions, and the more they are able to borrow, the higher multiples tend to be.

Chart #3



Source: GF Data®

The US Macroeconomic Picture for Q1 2021 and its Impact on M&A

GDP – The US economy grew by an annualized 6.4% in the first quarter of 2021, following a 4.3 percent expansion in Q4 2020.

From a global standpoint, The Organization for Economic Cooperation and Development expects the global economy to expand 5.8% in 2021 and 4.4% in 2022, as vaccinations gather pace, allowing authorities to ease restrictions and economic activity to accelerate while the US pumps trillions of dollars into the world's largest economy. Still, the organization warned that the recovery is uneven across countries, with many emerging market economies being held back by slow vaccination deployment and new COVID-19 outbreaks. The US economy is forecast to grow 6.9% this year. China is expected to grow 8.5%, the UK 7.2% and the Euro Area 4.3%.

Inflation – The annual inflation rate in the US jumped to 2.6% at the end of March 2021 from 1.7% in February. It is the highest reading since August of 2018 with main upward pressure coming from energy (13.2% vs 3.7% in February)—namely gasoline (22.5% vs 1.6%), electricity (2.5% vs 2.3%) and utility gas service (9.8% vs 6.7%). Prices also accelerated for used cars and trucks (9.4% vs 9.3%), shelter (1.7% vs 1.5%) and new vehicles (1.5% vs 1.2%), while inflation slowed for medical care services (2.7% vs 3%) and food (3.5% vs 3.6%). Also, the cost of apparel continued to fall (-2.5% vs -3.6%). The effects of the coronavirus pandemic have weighed on prices, since in March 2020 many businesses closed and lockdowns were imposed, denting economic activity. Also, a jump in commodities and material costs, coupled with supply constraints, are pushing producer prices up and some companies are passing on those costs to customers.

Business Confidence – The Institute for Supply Management's Manufacturing (ISM) Purchasing Managers Index (PMI) jumped to 64.7 at the end of Q1, up from 60.7 at the end of Q4 2020. ***It is the highest reading since December 1983.*** Faster increases were seen in production (68.1 vs 63.2 in February), new orders (68 vs 64.8, the highest since January 2004)

and employment (59.6 vs 54.4, the highest since February 2018) and inventories rebounded (50.8 vs 49.7). Meanwhile, both new export orders (54.5 vs 57.2) and supplier deliveries (76.6 vs 72) slowed a bit and price pressures remained elevated (85.6 vs 86). The manufacturing economy continued its recovery in Q1; however, Survey Committee Members reported that their companies and suppliers continue to struggle to meet increasing rates of demand due to coronavirus impacts limiting availability of parts and materials. As a reminder, a PMI™ reading above 50 percent indicates that the manufacturing economy is generally expanding; below 50 percent indicates that it is generally declining.

Fed Lending Rate – The Federal Funds Rate remained unchanged through Q1 2021 at 0-0.25 percent. The Fed stated that the COVID-19 pandemic is still causing tremendous human and economic hardship across the United States and around the world. Amid progress on vaccinations and strong policy support, indicators of economic activity and employment have strengthened. The sectors most adversely affected by the pandemic remain weak but have shown improvement. Inflation has risen, largely reflecting transitory factors. Overall financial conditions remain accommodative, in part reflecting policy measures to support the economy and the flow of credit to U.S. households and businesses.

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.

ESG – From Buzzword to M&A Value Driver

ENVIRONMENTAL Environmental issues such as climate change & pollution

SOCIAL Social issues around workplace practices & human capital

GOVERNANCE Governance issues such as executive pay, accounting & ethics

ESG is an acronym that stands for Environmental, Social and Corporate Governance. It has evolved from a buzzword to a central business practice, particularly within the investment and M&A communities.

ESG is rooted in the belief that while pursuing profits, companies should act with a strong sense of morality and with the highest ethics. In part due to the COVID-19 health crisis, climate change, social movements and a re-emphasis on employee health and safety, ESG is gaining momentum across business, investment and mainstream communities.

ESG encompasses a wide range of corporate concerns such as sustainability, including climate change, greenhouse gas emissions and other environmental risks and impacts. Other areas impacting employers include human rights (use of forced, trafficked or child labor), labor matters (abusive labor practices, pay equality), employee safety, workplace diversity, data security/ protection and customer privacy.

While ESG principles have always existed, the ESG movement gained recognition during the 1970s when activists for responsible corporate practices began to have louder voices and bigger platforms. By the 1990s there was a global call to action focused on improving the planet, which resonated with ESG philosophy. Over the past decade, mainstream popularity of ESG has grown. It is now a common discussion topic at Board of Director meetings, is embedded in strategic and operational business plans and even is a subject taught in academic environments. Corporate codes of conduct and integrity guidelines have become increasingly aligned with ESG tenets. Accountability for meeting ESG priorities is reflected in companies' corporate performance scorecards and executive compensation decisions.

Today, commitment to ESG is driven in part by the realization that investment in ESG initiatives can enhance financial returns. A recent global study by Fidelity shows that in 2020, companies with better ESG ratings generated higher returns when compared to their peers. According to Morningstar, in 2020, investment in ESG-related funds exceeded $1 trillion. Even the cost of and access to capital for businesses has been increasingly linked to their ESG ratings and performance.

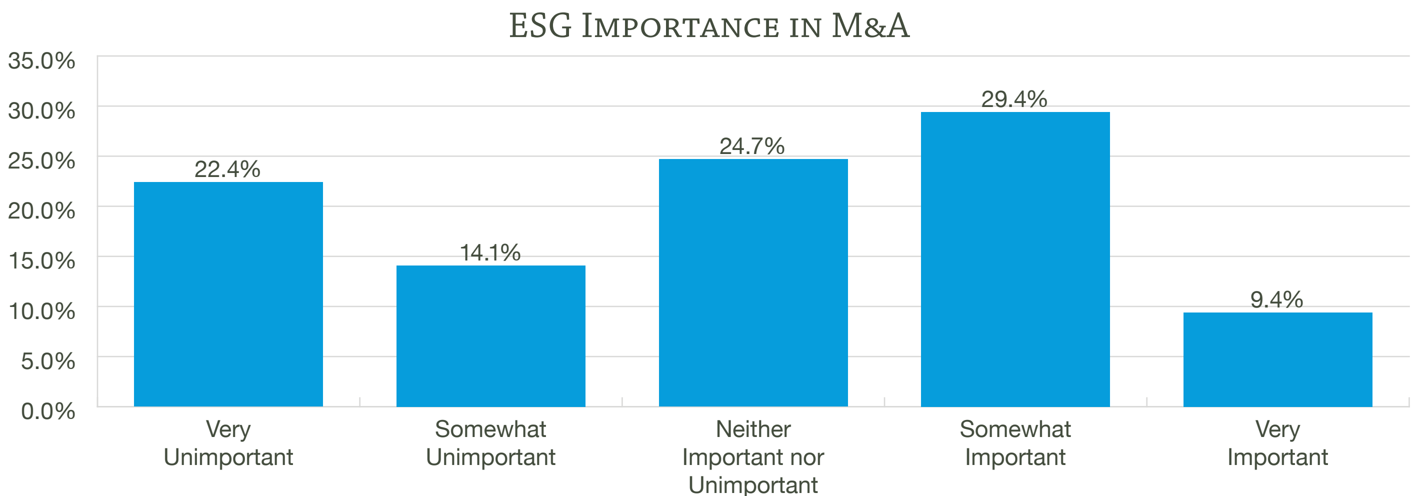
Degree of commitment to ESG is part of a company's culture and sense of social responsibility and can directly reflect core corporate values. This means that failure to take appropriate steps to address ESG factors can have a disproportionately negative impact on an organization's reputation. While it can be difficult to directly measure the return on ESG investment, it is widely believed that neglecting ESG will negatively impact the valuation of an enterprise.

ESG in M&A Transactions

As ESG factors are now viewed as essential to corporate values and reputation, they are a growing focus for companies and their stakeholders. For this reason, companies are investing in ESG frameworks. As a result, ESG has become an increasingly important consideration in M&A transactions; there will remain a growing emphasis on ESG in investment decisions and deal making.

SRS Acquiom recently performed a survey on how ESG influences M&A activities. One of the key questions was "How important to your current M&A strategy are ESG factors?" Chart 4 below shows that more than a third of Buyers view ESG to be important to some degree and this percentage continues to grow.

Chart #4



Source: SRS Acquiom®

To read the full SRS Acquiom ESG M&A report, go to https://www.srsacquiom.com/resources/esg-factors/.

For Buyers, ESG considerations are viewed as potential value drivers for executing a deal. ESG evaluation of a target acquisition helps Buyers assess the attractiveness of the Seller. It also serves to identify risks and opportunities within the deal process. Buyers' due diligence workplans should address ESG metrics/ benchmarks and future ESG risks and opportunities.

For Sellers and potential Sellers, having a well-designed and executed ESG platform is key to maximizing value. Sellers without a formal ESG plan should be prepared to discuss ESG factors impacting their business and potential ESG initiatives.

Hopping Off the Fence?

The end of the pandemic is in sight and business owners are fatigued. As we saw at the end of the 2008/2009 recession and other major macroeconomic downturns, business owners question whether or not they have another round of ups and downs in them. For many, the resounding answer is "no." Many owners that have been on the fence for years are now driven to hop off, which is driving up M&A activity in 2021. The imminent 2022 tax increases are adding even more of a sense of urgency for business owners to transact this year.

With the choice to exit, a whole new set of questions arise, with the major one being:

Should I sell to a strategic or financial Buyer?

Here are five things to consider when trying to answer this question:

1. **Return Motivations**
   A financial Buyer's (investor's) job is to buy low from you in order to generate a targeted return within a certain timeframe to other investors and then ultimately sell at a higher price to somebody else. A strategic Buyer is not typically under the same return and timeline pressures. A strategic Buyer can usually decide its own proforma return and timeframe. However, under the right conditions, a financial Buyer can deliver a compelling offer, especially if that Buyer already has a presence in your industry.

2. **Monetization Considerations**
   Financial investors are less willing to value your company competitively unless they've already identified their investment exit strategy—and that often involves selling to other strategic Buyers. If you can demonstrate the investment appeal and growth/return metrics of your industry, this can pique the interest of a financial investor. Strategic Buyers immediately know how you fit into their growth strategies and often have no exit expectations to meet.

3. **Seller's Post-Sale Involvement**
   Going the financial investor route comes with conditions. You often will be required to continue working for the new owner(s) for 3-5 years post-close and continue building the business according to their return models. This is not a favorable choice if you are looking to exit soon after a sale and have no transaction proceeds wrapped up in the business. However, this works well if your plan is to remain with the business, as you will often have equity in the business and likely will have another "bite at the apple" when the investor sells. A recent Harvard Business School study showed that businesses owned by financial Buyers performed better long term than those owned by strategic Buyers, so sticking around for that second bite could be a profitable investment of your time, if your passion still remains in the business.

4. **Leveraging Synergies and Strategic Benefits**
   If you have significant strategic business drivers and operational redundancies, a strategic Buyer is usually in a position to value the deal more aggressively. Unless a financial investor has a platform in your space or adjacent to it, synergies and strategic opportunities are often off the table.

5. **Due Diligence**
   Financial investors generally have an extremely rigorous due diligence process. This is a must because without it, they run the risk of losing credibility with current and future limited partners that fund investments. Strategic Buyers generally have less rigorous due diligence processes, as they are not usually accountable to parties outside the corporation. Factor in how prepared your company is to survive a rigorous due diligence process.

In short, there is a place for both strategic and financial Buyers in every exit strategy. Make sure your Buyer pool is filled with parties that align with what is best for you post-close, and parties that stand to benefit most from what your company offers.

Not Hopping Off the Fence Yet?

If you have chosen not to exit now and feel like you have another cycle of macroeconomic ups and downs in you (translation: many years), now is the perfect time to begin planning for a sale down the road.

For the vast majority of business owners, their companies usually are their largest asset—and not a liquid one. Oftentimes their businesses aren't even ready to be sold, so if you have more runaway left in front of you, use the time wisely.

Exit planning involves running a business in such a way that maximizes its value and provides a means to achieve the owner's personal and financial goals. Note the emphasis on "maximizing enterprise value." This definition incorporates the thinking of people like Peter Christman and Rob Slee, the fathers of the Exit Planning Institute and Private Middle Market Finance Theory. Both tout the tremendous benefits of a focus on enterprise value. They believe that a successful exit plan provides the following benefits:

1. Maximizes the value of the business.
2. Enables one to be personally and financially prepared.
3. Ensures planning for the third act of life.

The process of maximizing value is simply implementation of good business practices—nothing more. Exit planning cannot be separated from business planning. Looking at what drives value in a business and what a business strategy addresses, you won't see any difference.

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Ten Things to Expect in the Near Future

1. Very high levels of M&A activity continuing through year-end.
2. Numerous Buyers with healthy stimulus-fed balance sheets.
3. Mostly positive macroeconomic M&A drivers, creating a favorable M&A climate.
4. Continued affordable M&A borrowing costs.
5. PE still pushing hard to do both platform and add-on deals.
6. M&A activity returning to “normal” for those industries beat down by COVID.
7. Valuation multiples holding strong for better businesses and remaining softer for others.
8. Challenging due diligence as Buyers and Sellers sort through the COVID earnings noise.
9. SFE (Earnouts) remaining common as a result of #8.
10. Companies optimizing in anticipation of a liquidity event.

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 Investment Banking practice helps business owners make a profitable exit from the company they have built or launch and manage acquisition initiatives that will take their business to the next level.

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 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, email info@pursant.com or visit www.Pursant.com.

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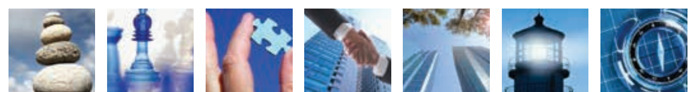

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