Q2 2020 EDITION

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DEAL insider

M&A and Strategic Transaction Insights

THE INVESTMENT BANK THAT ALSO BUILDS THE VALUE OF YOUR BUSINESS

Q2 2020 Highlights:

- M&A activity returning, but still down 28% YTD through June compared with 2019
- Financial Buyers led the charge in M&A activity—more so than corporate Buyers
- M&A borrowing slowed and rates rose
- Deals that closed showed continued multiple strength

Pursant's Thoughts on the Near Future

- M&A activity will be hot in COVID-resilient sectors and at pre-COVID multiples
- Fatigued business owners, mostly Baby Boomers, will seek to exit
- Deals getting done, but with more rigorous diligence and longer timelines

M&A Activity Returns With Lower Middle Market Leading the Way

It's no surprise that M&A activity in the lower middle market hit a multi-year low in the first half of 2020 due to the health crisis and its significant impact on the economy. But a closer look at the data and overall market sentiment shows that while M&A activity was down across the board, valuations were not. For many, deal value has remained intact and, overall, deal activity began to rebound in Q2.

The data also shows that the Buyer mix changed significantly during Q2. Historically, financial Buyers have represented slightly less than half of all deals in the US. In the second quarter of 2020, private equity accounted for almost two-thirds of the deals. While for much of the period, corporate Buyers paused M&A activity to focus on business operations, financial Buyers focused on deploying capital—specifically, buying businesses expected to be COVID proof and recession proof. There are still record amounts of capital sitting on the sidelines ($1.7T as of July), credit availability is improving, and business is stabilizing; as a result, there are no signs that financial Buyers' M&A activity is slowing.

Toward the tail-end of Q2, we saw corporate Buyers begin to return to the M&A world. Operators gained peace-of-mind and a more optimistic outlook due to the unprecedented amount of liquidity pumped into the economy by the Fed and access to PPP funds and other programs. Not wanting to miss the long-awaited shift to a Buyer-favorable market, those that were well capitalized began to engage in M&A initiatives again. Many also realized that the

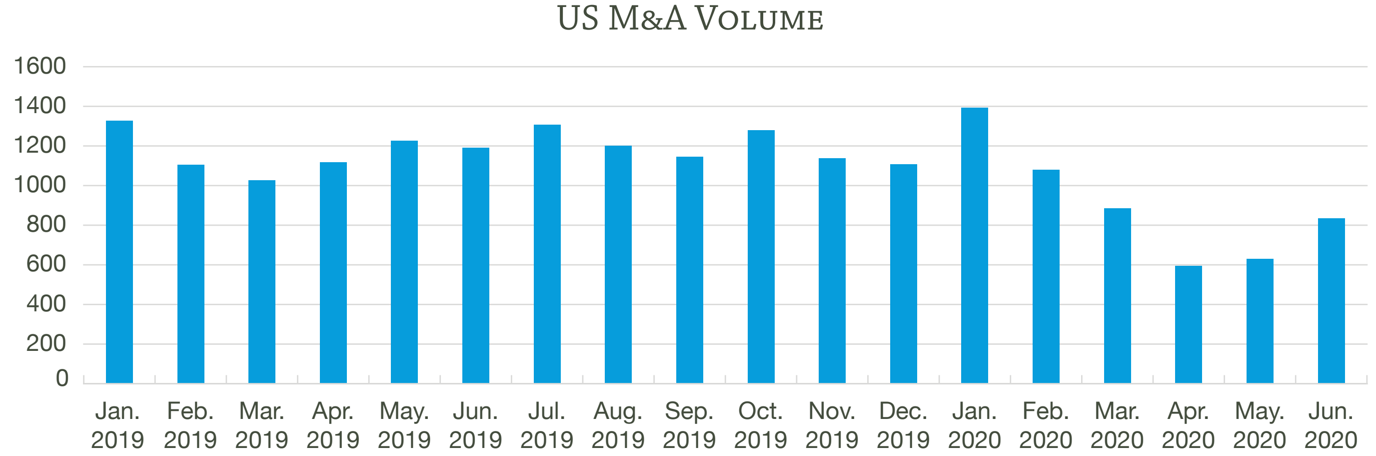
(Continued...)

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.

fastest way to pivot their business models to capitalize on the new norm is to make acquisitions.

According to Factset, and as illustrated in Chart 1, Q2 marked a reversal of the downward trending M&A activity seen in Q1. Q2 closed with June US M&A activity increasing by 32.58% over activity in May. However, lower middle market deal activity in the first six months of this year is down 28% versus the same period last year.

Chart #1



Source: Factset®

Q2 Valuation Multiples

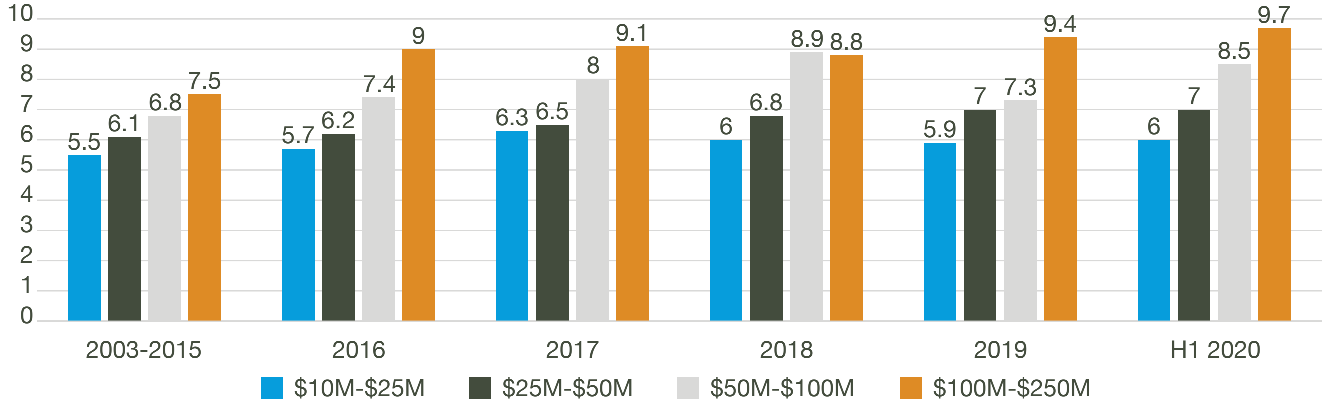
Completed deal activity in the second quarter of 2020—the first period bearing the full brunt of coronavirus—left a surprisingly clear imprint on the marketplace: there was virtually no change in valuations on dramatically reduced volume and dramatically less debt usage.

Chart 2 shows that valuations averaged 7.4x TTM Adjusted EBITDA—unchanged from Q1 despite significantly less volume. Valuations remained aloft on the transactions that were completed in the second quarter. It is safe to say these transactions involved some combination of: investment propositions fully digested by Buyers pre-COVID; industry sectors with decent visibility through the pandemic; Sellers with the leverage to resist draconian prices re-trading; and Buyers willing to employ more equity than in the past to reach a close.

But what happened to the other transactions that presumably would have closed this spring had there not been an extraordinary public health event? Will they appear as completed deals in coming periods, as Sellers accept reduced or more highly structured economics? Will change of control transactions be recast as minority recaps? Or will they not figure in the data for years because owners chose to ride out the pandemic and re-focus on running their businesses for the immediate future? The answer is certainly "All of the Above," but in what proportions, we don't yet know.

Chart #2

Total Enterprise Value (TEV)/EBITDA
Buyout Transactions Only

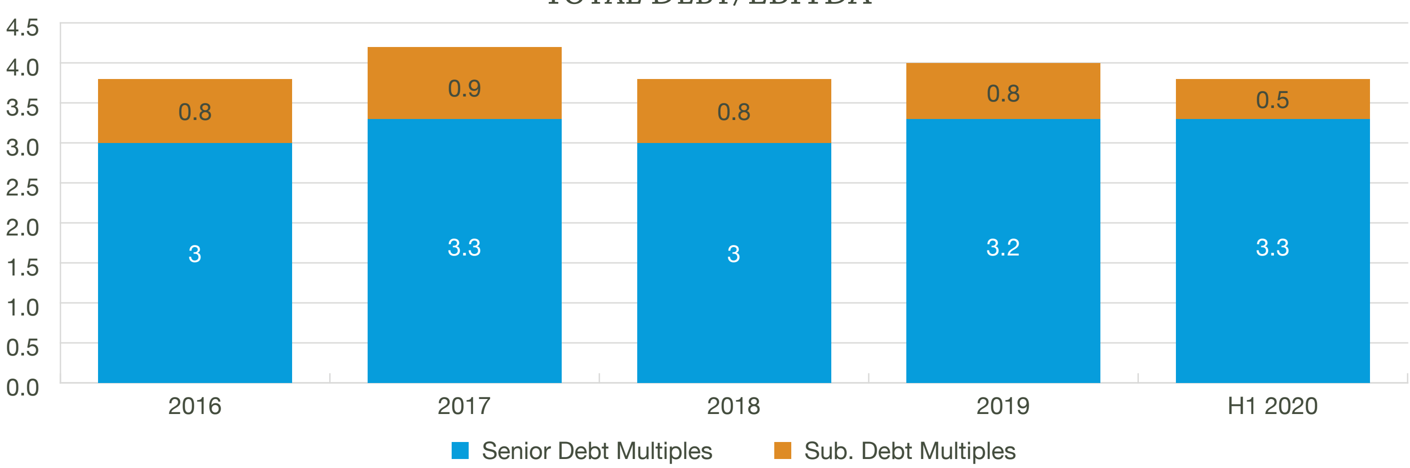


Source: GF Data®

Borrowing to Get Deals Done – At face value, Chart 3 shows a slight drop in borrowing to get deals done, but when *comparing Q1 2020 to Q2 2020 we see total leverage dropping from an average 3.9x TTM Adjusted EBITDA to 3.3x,* demonstrating an immediate retrenchment in leverage. To fill the debt void, average equity contribution in the second quarter was 56.5%—a jump from 48.7% in Q1. Even as 90-day LIBOR tumbled to .3%, spreads against the base rate swelled. Average senior pricing jumped from LIBOR plus 4.2% to LIBOR plus 5.7%. Average sub debt coupon rose 70 basis points to L+10.3%.

Chart #3

Total Debt/EBITDA



Source: GF Data®

EBITDAC

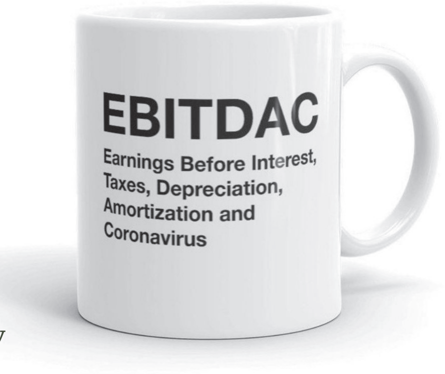
For years we included the following definition in the Pursant Deal Insider:

> ***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.*

As a result of the coronavirus pandemic, a new financial metric for measuring profitability has been created: EBITDAC (earnings before interest, taxes, depreciation, amortization and coronavirus).

EBITDAC has emerged as a valid metric for measuring a company's earnings, especially when a strategic transaction is being contemplated. The addition of the "C" to the traditional EBITDA metric is meant to quantify the impact attributed to the pandemic.

During the pandemic, the profitability of many organizations has been affected—most for the worse but better for others.



Many businesses were forced to close under government-mandated shelter-in-place orders, were unable to pivot to remote work models, struggled with supply chain issues, were unable to fulfill customer orders and as a result, suffered lost revenues and earnings.

Certain industries have performed better during the pandemic, seeing a temporary escalation in revenues and earnings due to a pandemic-driven increased demand of whatever product or service a company provided. It's important to look at how a company is positioned in the new normal. It matters less what it was doing before. When evaluating the quality of a company's earnings, care should be taken to evaluate both the positive and negative impacts of the pandemic and whether they truly amount to a "C" adjustment to earnings or are reflective of a new norm and unlikely to revert when we emerge from the worst of the pandemic.

The US Macroeconomic Picture for Q2 2020 and its Impact on M&A

GDP – The US economy shrank by an annualized 31.7 percent in the second quarter of 2020. It is the biggest contraction ever, pushing the economy into a recession as the coronavirus pandemic forced many businesses including restaurants, cafes, stores and factories to close and people to stay at home, hurting consumer and business spending. Private inventory investment and personal consumption expenditures (PCE) decreased. Business investment fell. The recovery will depend on the capacity of the country to control the pandemic and avoid more waves of infections. Fed officials expect the US economy to shrink by 6.5 percent in 2020. As the economy's trajectory turns, dealmaking will follow.

Inflation – The annual inflation rate in the US ended Q2 at 0.6%, down from 1.5% n Q1. June was the highest reading in the three months of the quarter, as businesses reopened after the coronavirus lockdown. Food inflation was at 4.5%, the strongest since December of 2011, with food at home prices jumping to 5.6%. Prices for medical care services also increased by 6%. Decreases were seen in gasoline costs (down 23.4%.), apparel (down 7.3%) and transportation (down 7%). In contrast, shelter costs rose slightly at 2.4%.

Business Confidence – The Institute for Supply Management's Manufacturing (ISM) Purchasing Managers Index (PMI) in the US finished Q2 at 52.6, recovering sharply from measures of 43.1 in May and 41.5 in April, and easily beating market expectations of 49.5. The reading pointed to the strongest expansion in factory activity since April 2019 after three straight months of coronavirus disruptions. New orders rebounded (56.4 from 31.8), as did production (57.3 from 33.2), prices (51.3 from 40.8) and employment (42.1 from 32.1). New export orders fell less (47.6 from 39.5) than in the previous month. "Demand, consumption and inputs are reaching parity and are positioned for a demand-driven expansion cycle as we enter the second half of the year", said Timothy R. Fiore, Chair of the Institute for Supply Management. 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 – The federal funds rate remained unchanged through Q2: 0-0.25 percent. Federal Reserve Chairman Jerome Powell said in remarks prepared for a Congressional hearing on June 30th that the US economy faces "extraordinary uncertainty," particularly in light of ongoing attempts to contain the spread of COVID-19. Powell also noted that the central bank's Main Street lending facility may prove helpful for firms hit by the coronavirus crisis. The best time to do a deal is when capital is available—and capital is available. Bank balance sheets are strong today despite the fact that they took huge reserves. This is driving lending and affordable borrowing rates.

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 for many sectors.*

Resetting Deal Process Expectations

For years, business owners have been told what to expect when they embark on a sale process, but given the uncertainly that has been created with the pandemic, there are new elements in the process that need to be planned for.

Here are five things you need to plan for when embarking on a strategic transaction in the COVID-19 environment:

1. **Impact of Reduced Travel**
   Historically, parties began serious discussions with face-to-face meetings. This personal interaction enabled parties to very quickly confirm if chemistry existed between Buyer and Seller. With travel now being extremely difficult or undesirable, parties have resorted to virtual meetings as a somewhat effective method for making connections, though not an exact replacement for in-person dynamics. For this reason, parties are taking much longer to build the emotional bond needed to consummate a deal. In many cases, deals will continue to be pushed off until travel has opened more widely. Such potential delays need to be accounted for when setting deal timeline expectations.

2. **Prove Out a Return to Pre-COVID Level Performance**
   With irregular recent prior periods and future economic uncertainty, Buyers will conduct a thorough investigation of how COVID-19 has affected a Seller's company. During traditional due diligence, Sellers can often demonstrate how their companies performed during a previous recessionary downturn, but this data is not necessarily an indicator of performance during a pandemic. This will put extra pressure on Sellers to show performance trend lines that are returning to pre-COVID levels and back that up with accurate sales, forecasts and pipeline data.

3. **More Contingent Payment Use (Earnouts)**
   Because the duration of the impact of COVID-19 is uncertain, it may be difficult to properly value the target company at the time of signing a transaction. For some, this will result in a deal not getting done. For more motivated parties, this uncertainty can be addressed in a variety of ways, including the use of contingent payment (earnouts) if the Buyer and Seller cannot agree on the value of the target company. Contingent payment involves future consideration being paid to the Seller upon the achievement of certain thresholds or other metrics relative to business performance. Many have heard the horror stories of

how contingent payment has played out. But often times, those difficulties are rooted in poor structure and documentation language. Earnouts and the like can be a viable bridge when there is a valuation gap, but they must be thoughtfully structured and documented to work for both parties.

4. **New Twists in Representation and Warranty Insurance**
   Parties looking to obtain representation and warranty insurance as a source of post-closing indemnity protection will need to focus on how new exclusions and limitations will apply as a result of the pandemic. Because COVID-19 is now a "known risk," it is probable that insurers will specifically carve out COVID-19 related losses from policy coverage. As such, it is vital that the exclusions set forth in the representation and warranty insurance policy be carefully addressed with counsel. Further, parties to an M&A transaction should expect that representation and warranty insurance providers will request substantial virus-specific and/or ancillary diligence to underwrite the policy. As a result, this may delay or lengthen the underwriting time needed to finalize the policy.

5. **Closing Complexity**
   Disruptions caused by COVID-19 (including travel restrictions, office closures, social-distancing and other government regulations) may complicate or delay closings of M&A transactions. For example, many state and county filing offices have been closed to the public and if now open, have long delays. Further, in-person filings in some locations have been suspended entirely. This affects closings that require a certificate to be filed (such as a certificate of merger) or a certificate to be obtained (such as a good standing certificate). In addition, third-party consents and signatures from officers/directors may take more time than usual. To address these realities, Buyers and Sellers should coordinate with the applicable filing offices early in the transaction and build likely delay time into the closing schedule. Further, the process for securing required consents and collecting signature pages should be started as early as possible.

What used to be a fairly straightforward path to getting a deal done has now turned into a labyrinth. The time between signing an LOI to close has increased significantly. Having realistic timeline expectations, patience and talented advisors on your deal team will increase the chances of a deal getting done in today's uncertain environment.

Navigating the Complexity of PPP in M&A Deals

In March 2020 and in response to the COVID-19 health crisis, the US federal government took unprecedented action to support the economy and US employees. Specifically, Congress passed several stimulus bills including the Coronavirus Aid, Relief and Economic Security ("CARES") Act.

The CARES Act created a new loan program called the Paycheck Protection Program, more commonly referred to as PPP. The spirit of PPP is to support small businesses and to allow them to continue to employ their staff through the health crisis. Loans are provided through the Small Business Administration ("SBA") and administered by the SBA network of almost 2,000 financial institutions across the US.

Eligibility criteria for PPP funding includes (i) being a small business with fewer than 500 employees; (ii) being in operation as of February 15, 2020 and having employees; and (iii) having economic uncertainty making the loan necessary to support ongoing operations. PPP included a very attractive loan forgiveness feature with relatively straightforward criteria (mostly related to employee retention).

In today's environment, completed deals generally have involved business sectors not adversely impacted by the health crisis. As a result, less time has been spent on determining add-backs or pro forma adjustments for items such as underutilized labor or lost revenue (which PPP loans were provided to offset). Instead, transacting parties are wrestling with how best to address the impact of outstanding PPP loans, particularly given that most if not all PPP loan funds remain outstanding and that up until the release of this newsletter, loan forgiveness applications were not yet being accepted by lenders or the SBA. The timing for accepting loan forgiveness applications remains uncertain. Once loan forgiveness applications are accepted, timing for a decision on loan forgiveness will range between two and six months. For these reasons, addressing PPP loans in a transaction has become a hot topic.

The following discusses the treatment for PPP loans in the context of an M&A deal under two scenarios:

1. **Seller Does Not Expect to Meet Criteria for Loan Forgiveness**
   The PPP loan should be treated as indebtedness no different from other indebtedness and retired at closing of the transaction, typically with proceeds from the sale. In rare instances, Buyers may be amenable to keeping the loan in place to take advantage of the favorable terms of the PPP loan, such as the low interest rate. See the discussion regarding SBA consent that follows.
2. **Seller Expects to Meet Criteria for Loan Forgiveness**
   If the Seller expects to meet the criteria for loan forgiveness (full or partial) and given that loan forgiveness will not occur prior to a transaction, then the loan will remain in place post-closing.

In this situation, SBA consent will be required to avoid an event of default. The PPP note stipulates that the borrower will be in default if it "...has any adverse change in financial condition or business operation that Lender believes may materially affect Borrower's ability to pay..." or "reorganizes, merges, consolidates, or otherwise changes ownership or business structure without Lender's prior written consent."

Given the broad scope of the events of default and that it is subject to Lender's belief, consent should be obtained regardless of the transaction type (sale/purchase of equity or assets). Lender consent includes SBA approval which can be a lengthy and inefficient process.

To achieve forgiveness in this scenario, the PPP loan must remain in place post-closing. Buyers will take the position that they are assuming debt and will seek to treat the PPP loan balance as a reduction to the purchase price—being handled no different than other Buyer-assumed debt. Since Sellers are expecting forgiveness, they would not expect the loan balance (or at least the portion to be forgiven) to reduce the purchase price. To address this, parties can agree to extend the deal timeline to allow for forgiveness of the loan prior to closing.

Given that the timing for closure on the status of forgiveness is uncertain and even once known will still require several months to process, extending the deal timeline it is not a desirable solution. A more common approach is that the PPP loan balance that is expected to be forgiven is paid by the Buyers at closing but held in third-party escrow. Upon a favorable forgiveness determination, escrow funds are released to the Seller. Any unforgiven amounts are returned to the Buyer.

The PPP loans with their attractive features, including loan forgiveness, made them extremely popular with approximately five million business accepting a PPP loan. As more transactions involving companies with PPP funds start to close, best practices for managing the implications on M&A will emerge.

Pursant's Expectations for the Near Future

As we mentioned in our last issue of the Pursant Deal Insider, the broader M&A market has shifted to favor Buyers— especially those that are flush with cash, given iffy capital markets. Industries which are enjoying more certainty in their operations and outlook will keep healthy valuations and have plenty of suitors, particularly the small- to mid-sized companies that are palatable tuck-ins for many. Sectors that are more negatively impacted by the future economic condition will see multiple compression and more contingent payment in deal structures. We expect more divestitures coming from larger companies looking to return focus to their core competencies.

At the start of 2020, many business owners assumed that longer-term growth would continue, as would ready access to ample capital. They are now dealing with an uncertain economy and limited access to credit. As a result, more and more business owners, especially the those in the Baby Boomer generation, will be looking to exit. Many lack an appetite for the risks and calamity of the future.

Sale process timelines will continue to be longer. Increased scope of due diligence, uncertainly in the financing market and travel restrictions are just a few of the drags on deal timelines. Preparing sales forecasts and predicting backlog and working capital are very challenging aspects of deals that used to be more routine. The traditional trailing twelve-month (TTM) analysis is no longer a straightforward exercise, nor is agreeing on the next twelve months (NTM). Parties are experiencing the need to take extra time to thoughtfully create deal structures that are fair to both parties.

All of this said, whether you are a Buyer or Seller, if you have a solid business, right now is a great time to be in the market. Challenges certainly exist for M&A, but it is not as bad as many had feared, and things are moving in the right direction for the back half of 2020.

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.

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