Q2 2021 EDITION

Pursant
INSPIRED PURSUIT

DEAL insider

M&A and Strategic Transaction Insights

THE INVESTMENT BANK THAT ALSO BUILDS THE VALUE OF YOUR BUSINESS

Q2 2021 Highlights:

- M&A activity continues to surge, with many trying to beat a year-end 2021 deadline
- Businesses that perform better than peers continue to trade at a premium
- M&A borrowing rates continue to fall as banks get more and more eager to lend

Pursant's Thoughts on the Near Future

- M&A activity in the second half of 2021 will easily eclipse 2020 and, most likely, 2019
- With lingering COVID concerns, supply chain issues and staffing shortages, dealmakers struggle to estimate future revenues and cashflows

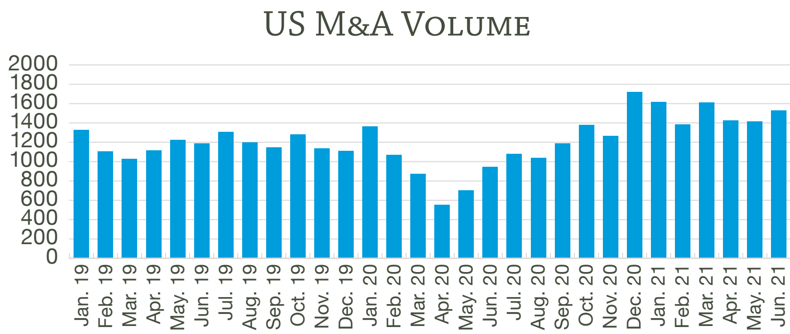
Q2 2021 Middle Market M&A Activity Now at Pre-COVID Levels

At a quick glance, it is evident that overall M&A activity for the first six months of 2021 has far outpaced the same period in 2020 (no surprise there) and even in 2019, well before COVID disrupted the market. Digging deeper into the numbers, though, it becomes clear that growth in larger deals is more meaningful than in lower middle market transactions. When comparing the first six months of 2021 to the same period in 2020:

- Transactions ranging from $250M - $1B were up 55%
- Transactions ranging from $10M - $250M were up only 4%

A key reason for this difference in transaction growth is that lending activity during the first half of 2020 slowed significantly, and leverage is essential to complete larger transactions, whereas smaller deals often require little or no debt.

Chart #1



Source: Factset®

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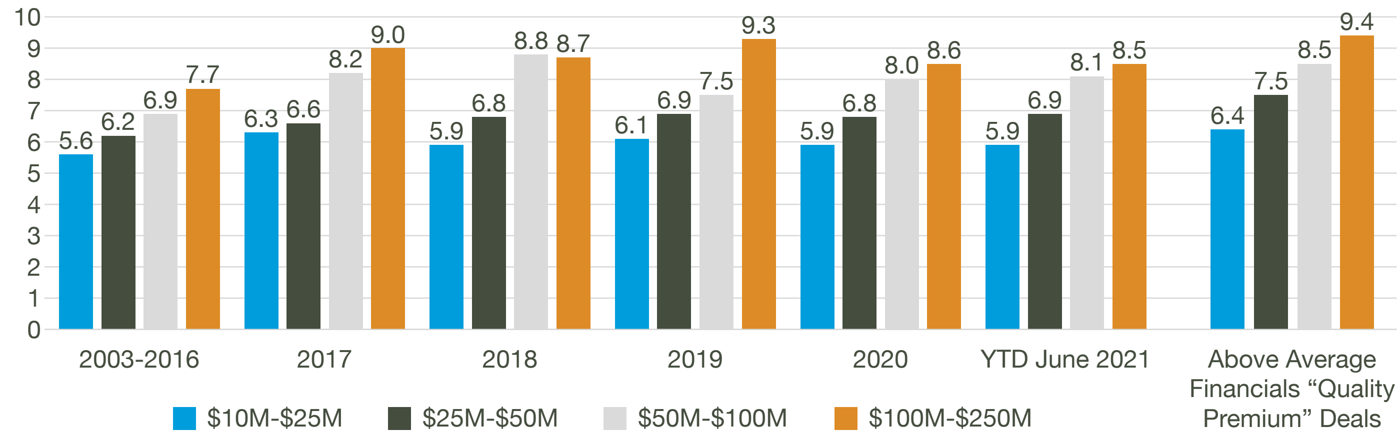
The Pursant Deal Insider is a quarterly publication offering analysis of the marketplace and climate for middle market mergers, acquisitions and strategic transactions. Our emphasis is on transactions with a total enterprise value of less than $250M. Our goal is to arm business owners and other parties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

Chart #2 shows that valuations averaged 7.2x, demonstrating continued overall strength in valuations; however, on closer examination, we see two worlds of "haves" and "have nots" created or exposed during the pandemic. More favored Sellers are capturing outsized results. ***The "quality premium"—our measure of the reward in valuation applied to firms with above average financial characteristics—was 33 percent in the first half of 2021***, compared to an average of 15 percent dating back to 2003.

The diverging valuations between the average and those outperforming confirms our position that it is no longer a Seller's market for all. Buyers are no longer required to pay a premium to be in the game, unless they wish to acquire the premium assets.

Chart #2

TOTAL ENTERPRISE VALUE (TEV)/EBITDA



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 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.

M&A Borrowing Appetite Remains High – Chart #3 shows us that debt utilization to get deals done remains at pre-COVID levels YTD. Overall, total debt averaged 3.8x YTD, with senior debt accounting for 3.3x and subordinated debt running at .5x. The high end of the total debt range YTD was 4.3x.

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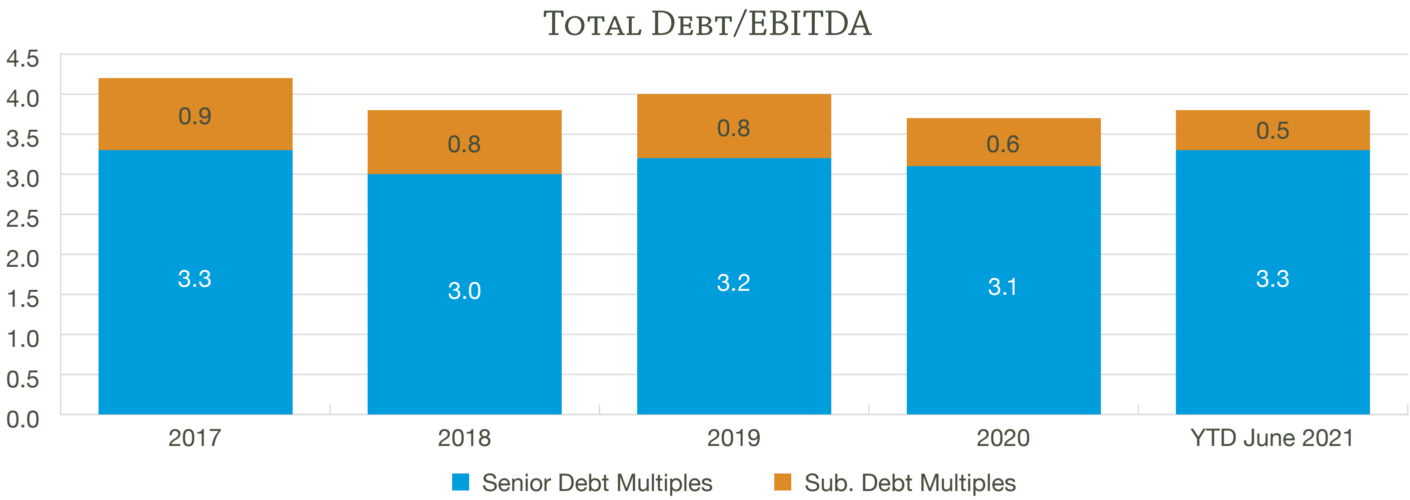
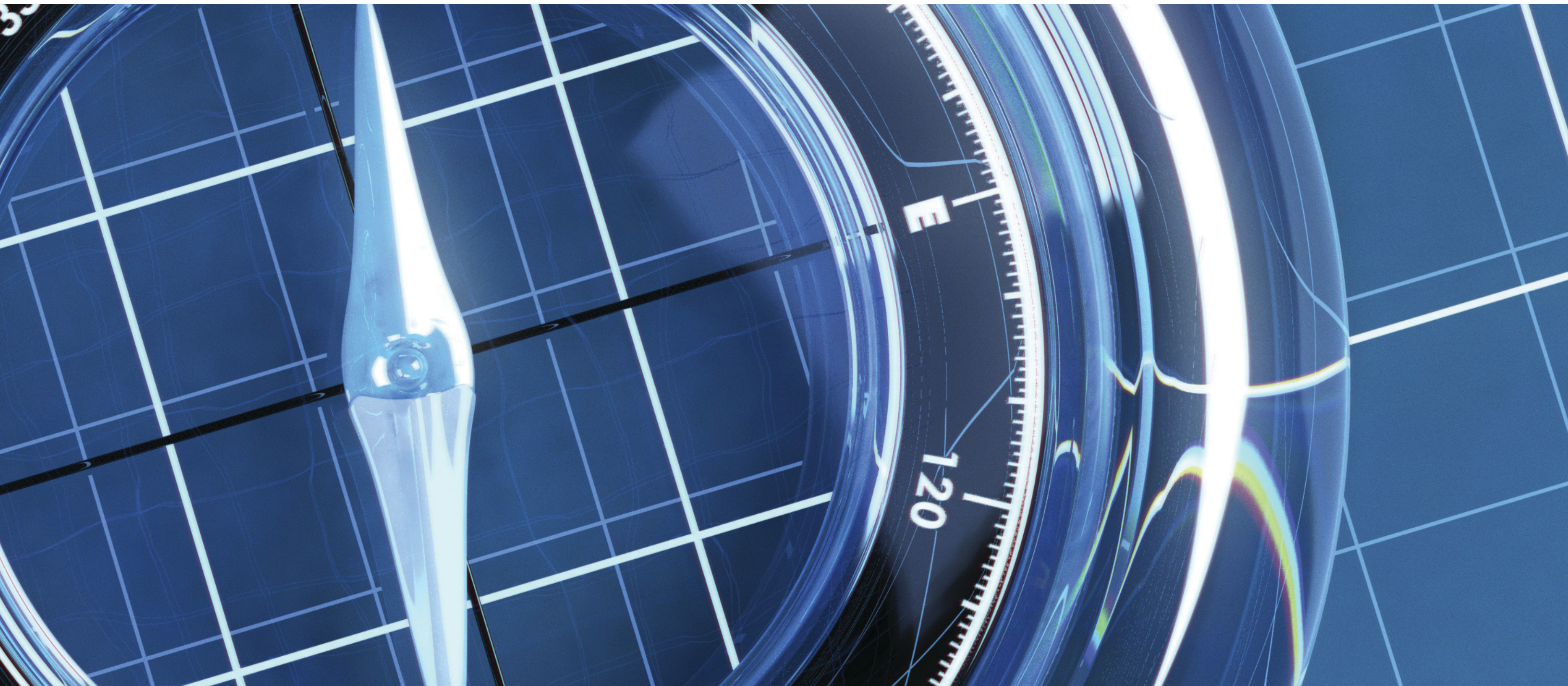
Chart #3



Source: GF Data®



Increasing Your M&A Purchasing Power with Debt Financing

In today's current M&A environment, investors remain eager to deploy capital. While this is true across various types of capital classes, lenders are particularly flush with capital and are seeking attractive lending opportunities.

Lenders, lending structures and lending opportunities come in all shapes and sizes. Lenders can be a local community bank solely focused on debt placement with small to medium sized businesses, a large multinational Wall Street firm, or the government via Small Business Administration programs. Lending structures vary significantly due to variables such as term, pricing, governance and risk tolerance. Lending opportunities are equally as diverse and help achieve different objectives. For this article, the focus will be on M&A debt financing.

M&A debt financing funds acquisitions. Compared to equity financing, debt financing is considerably more cost effective and doesn't dilute shareholders. Because debt financing needs to be serviced via interest and principal payments, it is best suited for businesses that generate positive cash flow.

In an acquisition, debt financing is usually structured as a term loan with set repayment terms (interest and principal) and other governing mechanisms such as financial covenants. This debt is typically referred to as the senior debt. As the name implies, the lender of the senior debt has priority with regard to repayment relative to other constituents such as other lenders, equity holders and vendors. The loan is often secured, which means there has been collateral pledged as a "backup" payment source. Interest rates typically are in the low- to mid-single digit range. Term and structures vary from very simple straight-line payments over a set period of time, to ones with periods of interest-only payments and a "balloon" payment which defers much of the principal repayment until the maturity.

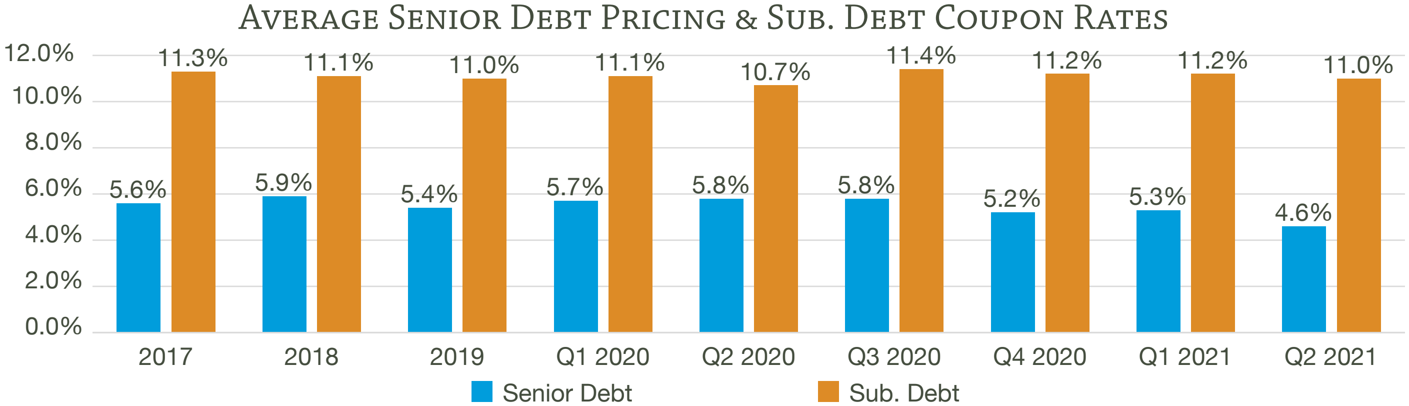
In addition to senior debt, there is often subordinated debt (oftentimes referred to as junior debt) which has lower priority to senior loans in a liquidation or default scenario. Effectively, subordinate debt takes a "back seat" to the senior lender but in return for the higher risk profile, earns a higher rate of return—typically north of 10%. In addition to having terms and structures that vary considerably, in some cases there may be an equity component related to the debt, which is usually in the form of a warrant allowing the debt holder the right to buy stock in the future at a negotiated price. This is referred to as mezzanine debt.

As reported by GF Data Resources (see chart #3), debt financing YTD 2021 averaged 3.7x the business' EBITDA. Senior debt accounts for a little over 3x the EBITDA amount, whereas the subordinated debt is about .5x the EBITDA amount.

Chart #4 shows the pricing trends for both senior and subordinated debt. We can see that overall, rates remained in a tight range during the periods between 2017-2019. When COVID hit in Q1 2021, it marked the beginning of the senior debt rate roller coaster ride, settling in during Q2 2021 at a very affordable 4.6% on average.

With today's attractive lending rates and for the right M&A opportunity, (the right deal with a financially sound Buyer), debt financing can be a great option for a Buyer looking to make a larger acquisition without tying up more cash than necessary.

Chart #4



Source: GF Data®

The US Macroeconomic Picture for Q2 2021 and its Impact on M&A

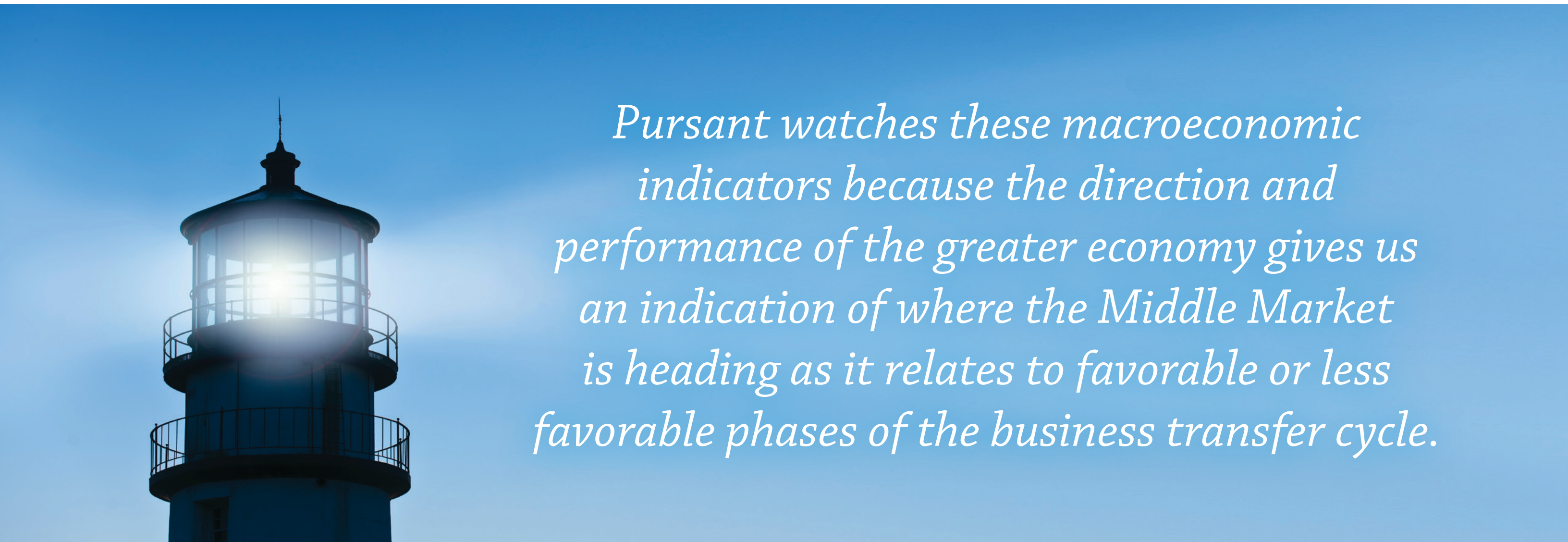
GDP Growth Rate Disappoints in Q2 – The US economy grew by an annualized 6.6% in Q2 2021, well below market forecasts of 8.5% and following a 6.4 percent expansion in Q1 2021. The rapid spread of the Coronavirus Delta variant, supply-chain disruptions, shortage of workers and a cooling housing market are foreseen to weigh down growth for the rest of the year.

Inflation at a New 13-Year High – The annual inflation rate in the US accelerated to 5.4% in June, a leap from 2.6% at the end of Q1. The biggest price increases were recorded for used cars and trucks (45.2%), gasoline (45.1%), fuel oil (44.5), utility gas service (15.6%) and transportation services (10.4%). Shelter costs were up 2.6% and food 2.4%. Inflation has been on the rise this year amid low base effects from 2020. As the economic recovery picks up, business restrictions will ease and demand will surge amid widespread vaccination and federal support. Meanwhile, high commodity prices, supply constraints and higher wages continue to weigh down the CPI as companies grapple with a labor shortage.

Business Confidence – The ISM Manufacturing PMI edged down to 60.6 in June of 2021 from 64.7 at the end of Q1. The reading still pointed to robust growth in factory activity, although a slowdown was seen for new orders (66 vs 67) and supplier deliveries (75.1 vs 78.8), while employment contracted slightly (49.9 vs 59.9) and price pressures intensified (92.1 vs 88). On the other hand, production (60.8 vs 58.5) and export orders (56.2 vs 55.4) rose faster. "Companies and suppliers continue to struggle to meet increasing levels of demand. Record-long raw-material lead times, wide-scale shortages of critical basic materials, rising commodities prices and difficulties in transporting products are continuing to affect all segments of the manufacturing economy. Worker absenteeism, short-term shutdowns due to parts shortages and difficulties in filling open positions continue to be issues that limit manufacturing-growth potential," Timothy Fiore, Chair of the ISM, said. 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 further the number is from 50, the greater the level of change.

Fed Lending Rate – The Fed left the target range for its federal funds rate unchanged at 0-0.25% in June 2021, but policymakers signaled they expect two increases by the end of 2023. The Federal Reserve said the standard of "substantial further progress" was generally seen as not having yet been met, though policymakers expect the American economy to continue to progress, minutes from the June FOMC meeting showed. Some officials expect the conditions that may begin to reduce the pace of asset purchases to be met somewhat earlier than anticipated, while others saw the incoming data as providing a less clear signal about the underlying economic momentum.

Pursant watches these macroeconomic 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 Complexities of COVID-Era Enterprise Valuation

It used to be that business owners understood the trajectories of their industries well, with a good grasp on how to sell and deliver their products and services. Pre-pandemic, the best business owners had a strong handle on their business' financial performance and earnings trajectory as well.

With most businesses still feeling the strain of the pandemic—whether decreased or increased volume, increased costs, supply chain issues, or all of the above—the task of predicting future financial performance is now challenging for most. What used to be straightforward financial statement evaluation has now become complex, making it tough for Buyers looking to estimate the future cash flows of an entity—the single greatest driver of enterprise value. Once, a would-be Buyer could collaborate with the Seller to agree upon future financial performance of a business and from there, could identify value drivers to bolster returns on investment. With Sellers struggling to defend forecasts, the quest for Buyers and Sellers seeking to find fair value can feel like an exercise in futility.

Following are two case studies illustrating what Pursant is seeing in sale transactions:

1. A client in the facility maintenance sector was providing services to the distribution sector. That sector had surges in volume during the pandemic as consumption increased, thus increasing the need for resources to service and care for facilities. While the facilities services provider welcomed the increased demand, it had limited visibility for forecasting whether service levels would rise or fall from or remain at this heightened level, and when and for how long. Each scenario would represent significant financial implications. The same service provider also had clients in commercial office space, a sector with decreased service level needs: a recent estimate put office occupancy globally at just 22%. How long would these lower occupancy levels continue, leading to lower demand for maintenance in this sector? What are the financial implications for our client? How to forecast performance? How to value the business?
2. Another client, in the restaurant linen and uniform business, experienced significant downturn during the Pandemic. Originally, it was thought that the industry would see a temporary drop in volume but that dining out would return to pre-pandemic levels when the pandemic "ended," boosting demand for services related to restaurants as well. What was not expected was that when restaurants reopened, they would face unprecedented staffing shortages, forcing owners to limit occupancy, hours and days of operation. When will restaurants be fully staffed again? That remains an unknown that greatly impacts financial projections for restaurant-adjacent services and supply businesses and, ultimately, the ability to estimate enterprise value. It was also not expected that 1 in 10 restaurants would permanently close due to the pandemic.

For a deal to get done, both parties will need to defend their positions on a business' future cash flows; most likely, both must accept contingent payment structures that protect the Buyer against a prolonged downturn and allow the Seller to capture fair value in the event that financial performance continues or improves in the near term. Agreeing on contingent payment amounts and terms is no simple task, as no one has a crystal ball to know when business owners will again be able to accurately forecast financials and when Buyers will be able to easily calculate returns based on financial statements and value drivers.

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Ten Things to Expect in the Near Future

1. Full court press to get deals done by year-end, ahead of potential tax increases.
2. Abundant Buyers in performing business sectors, not so much in struggling sectors.
3. Continuing positive macroeconomic performance, creating a favorable M&A climate.
4. Very low M&A borrowing costs.
5. Private Equity very busy - monetizing portfolio companies, aggressively raising funds and actively buying.
6. Supply chain and staffing issues continuing to disrupt M&A activity in certain sectors.
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. Earnouts remaining a common tool to bridge valuation gaps related to financial forecast uncertainty.
10. Next wave of Sellers preparing for 2022 liquidity.

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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