Q3 2020 EDITION

Pursant
INSPIRED PURSUIT

DEAL insider

M&A and Strategic Transaction Insights

THE INVESTMENT BANK THAT ALSO BUILDS THE VALUE OF YOUR BUSINESS

Q3 2020 Highlights:

- M&A activity continues to rebound from the April low
- Valuations of businesses negatively impacted by COVID starting to be seen in average valuation multiples
- Credit markets have rebounded as well

Pursant's Thoughts on the Near Future

- Most operators that were acquisitive before COVID, resuming M&A activity; new Buyers entering the market as well
- COVID fatigue persists for Baby Boomer business owners, prompting them to exit
- Virtual deal processes are the norm for the foreseeable future

Q3 2020 – Middle Market M&A Activity Continues its Recovery Towards Pre-COVID Levels

Transactions completed in the third quarter of 2020 show that dealmaking recovered in that period, making Q2 the trough of this year's M&A activity. As the back half of the year continues to unfold, we see an M&A market struck by the pandemic punch, but not knocked out—staggered but regaining its footing.

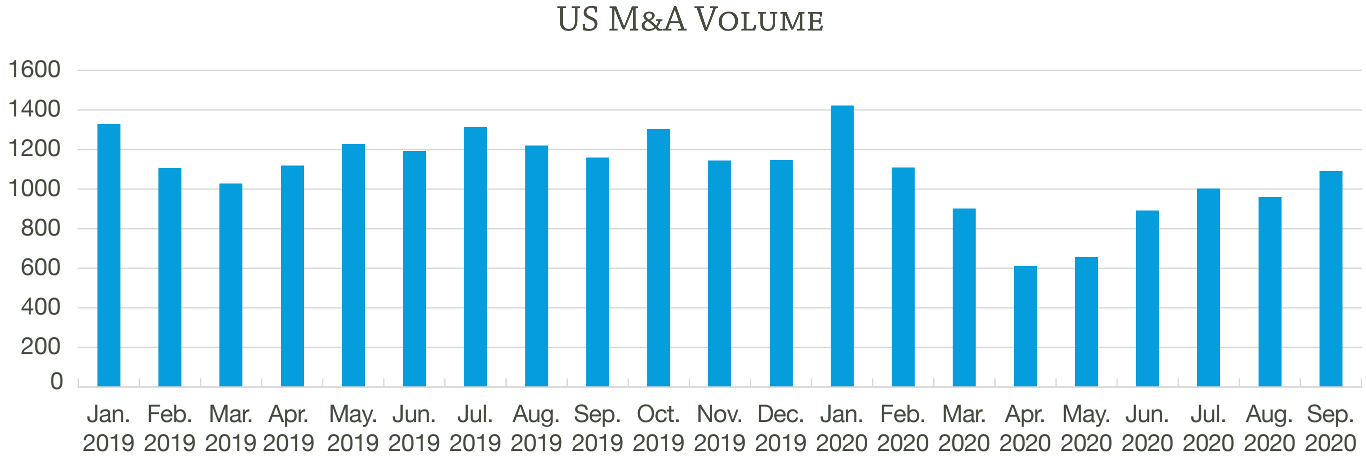
While Q3 marked a return to M&A activity, we are still in rough waters until the economy reopens. Many businesses are still very much in limbo and the closure of businesses continues to surge. To add to the turmoil, Congress was unable to pass a fourth Relief Act in Q3 to help businesses stay afloat.

With billions of dollars of dry powder remaining in Private Equity (PE) funds that needs to be deployed, it's no surprise that PE-backed M&A activity has continued to roar ahead, especially in the case of add-on deals making up 73.4% of PE transactions in Q3 2020—the highest number on record according to Pitchbook. Add-on deals are generally smaller than platform acquisitions. These deals involve smaller companies that are more likely to be struggling from COVID-19-related effects, making them especially attractive to PE firms. We also have continued to see corporate Buyers return to M&A in Q3. The stronger operators have regained peace-of-mind that there is a visible end to this storm in 2021.

(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®

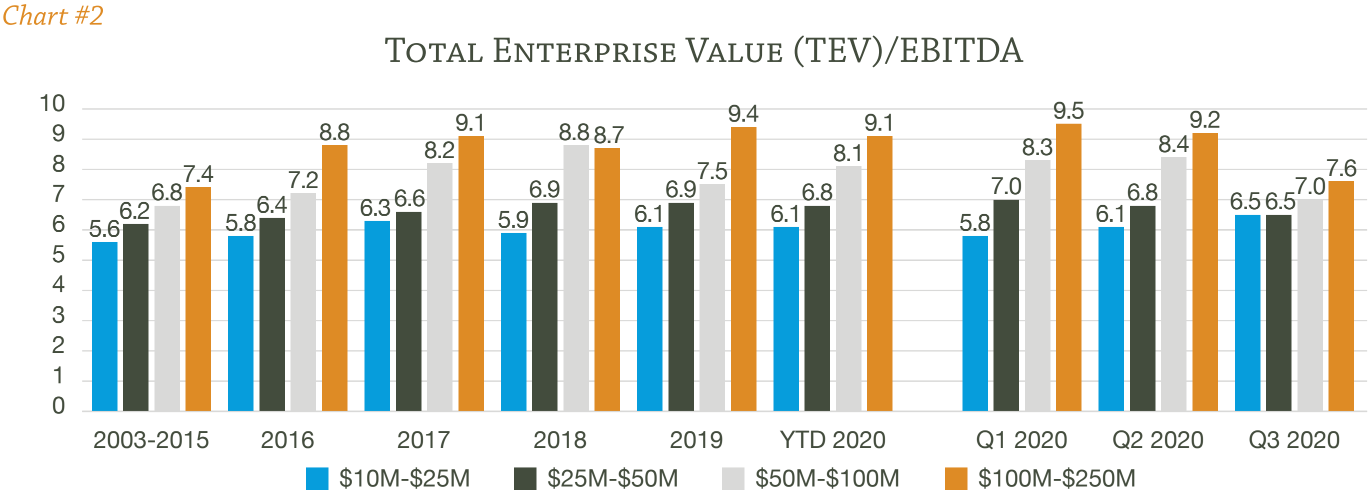
Q3 Valuation Multiples

At first glance, Chart 2 shows that for the full year of YTD 2020, there was no significant change in valuations when compared with those in 2019. However, when looking closer at the quarterly splits, we see a clearer picture of how the ebb and flow of the pandemic has affected valuations—most notably in larger transactions that likely required more financing.

In our last issue of the Deal Insider, we noted our belief that the small cohort of deals that found the finish line in Q2 was characterized by survivorship bias—in industries that appeared viable in the face of an unprecedented public health event, offering investment propositions already digested by prospective Buyers, and/or able to be financed with little or no debt. In other words, valuations held steady in the second quarter on an atypically attractive, resilient group of businesses sold.

As these unusual conditions progressed, closed deal volume was bound to include less favorable companies as well. We are mindful that many sectors experienced no diminution in value, and that some sectors were even enhanced by the changed dynamics. In aggregate, the net "COVID effect" on valuations is more fairly represented by an average of the last two periods, rather than by the drop from Q2 to Q3, which equates to an average downward adjustment in valuation multiples of .3-.4x overall.

Chart #2



Source: GF Data®

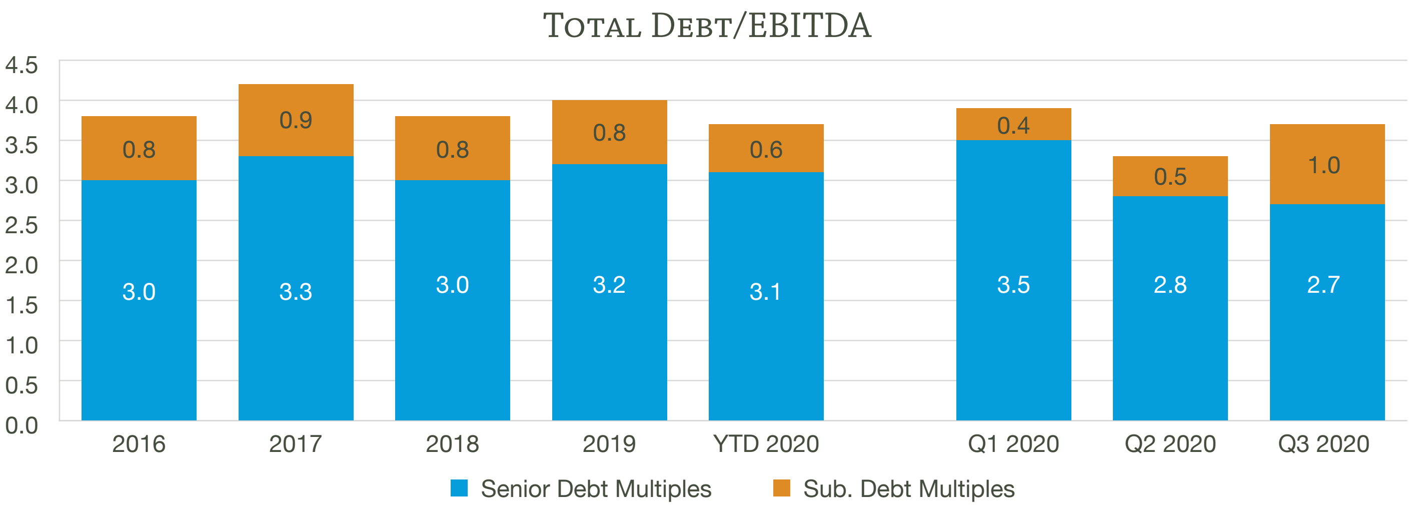
EBITDA Defined *– For most middle-market businesses, valuation is typically expressed in the form of a multiple of EBITDA (earnings before interest, taxes, depreciation and amortization)—a measurement of a company's ability to generate cash flow. EBITDA figures also serve as a barometer of the company's 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.*

Borrowing to Get Deals Done – Chart 3 reminds us of the immediate pullback we saw in debt utilization in Q2, especially by senior lenders. We thought borrowing might return, as economic stimulus proved to minimize the pandemic's impact on the economy and as there were so many sectors showing COVID resilience. That is exactly what happened: borrowing did return.

Senior debt continued to reflect lender caution, remaining essentially unchanged at 2.7x and continuing at an elevated 5.5% spread over 90-day LIBOR of 0.2%

Sub debt lenders stepped in to fill the void, but at a cost, with the average sub debt coupon being L+11.2%, up from 10.4% in Q2 and up from 9.8% in Q1.

Chart #3



Source: GF Data®

The US Macroeconomic Picture for Q3 2020 and its Impact on M&A

GDP – The US economy expanded by an annualized 33.1% in Q3 2020. It is the biggest expansion ever, following a record 31.4% plunge in Q2, as the economy rebounds from the coronavirus pandemic. Upward revisions to business and housing investment and exports were offset by downward revisions to personal and public consumption and private inventory investment. Still, personal spending was the main driver of growth, helped by checks and weekly unemployment benefits from the federal CARES Act. This macroeconomic rebound fueled the recovery of M&A activity in Q3. However, GDP is still 3.5% below its pre-pandemic level. Although a coronavirus vaccine is expected to be ready soon, the pandemic is far from controlled. Also, only around half of the 22 million jobs lost were recovered so far and as of the writing of this newsletter, a new stimulus bill hasn't been approved.

Inflation – The annual inflation rate in the US edged up to 1.4% at the end of Q3, up from 0.6% at the end Q2. Inflation has been rising consistently since hitting 0.1% in May, the lowest level since September of 2015, due to the coronavirus crisis. Still, it remains well below the 2.3% inflation rate in February before the pandemic. Cost for vehicles (especially used) surged. Inflation for food, shelter and medical care commodities slowed and deflation deepened for apparel and transportation services.

Business Confidence – The Institute for Supply Management's Manufacturing (ISM) Purchasing Managers Index (PMI) in the US finished Q3 at 55.4, up from 52.6 at the end of Q2. The reading pointed to the 4th consecutive month of expansion in factory activity, although the growth rate eased from August's near 2-year high. A slowdown was seen in new orders, production and supplier deliveries. Inventories contracted at a slower pace and new export orders rose faster. Price pressures intensified. Survey Committee members reported that their companies and suppliers continue to operate in reconfigured factories and are becoming more proficient at maintaining output. Panel sentiment was optimistic. 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 Q2: 0-0.25 percent. Fed officials continued to see the uncertainty surrounding the economic outlook as very elevated, with the path of the economy highly dependent on the course of the virus, according to minutes from the September 15–16, 2020 meeting. Also, with inflation running persistently below its longer-run goal, the Fed judged that it would be appropriate to aim to achieve inflation moderately above 2 percent for some time. The federal funds rate will likely remain unchanged until labor market conditions have reached levels consistent with maximum employment and inflation has risen to 2 percent, although the latter was on track to run moderately in excess of 2 percent for some time. Regarding fiscal stimulus, the Fed added that absent a new stimulus package, growth could decelerate at a faster-than-expected pace in the fourth quarter.

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 trending more neutral to Buyer-favorable for many sectors.*

COVID Increasing the Utilization of Earnouts

Continuing with our theme of how the health crisis has affected dealmaking, Earnouts are now being used more than ever to help bridge the valuation gap for Buyers and Sellers. When structured properly and involving the right parties, earnouts can help a Seller capture maximum valuation while protecting a Buyer from the risk of overpaying for a business that fails to return to pre-COVID levels post close.

As the Coronavirus pandemic evolves, the performance and profitability of many organizations has and will continue to be directly or indirectly impacted. Many industries and businesses suffered hardships including lost revenue and supply chain disruptions, while others were able to capitalize on unexpected opportunities. Whether a business was positively or negatively impacted, Buyers and Sellers today (and for the foreseeable future) are wrestling with valuation and deal structuring to reflect the impact on a particular business (negative or positive) from COVID-19.

As we have discussed, this struggle has given rise to a new financial metric referred to as EBITDAC, which we discussed in last quarter's issue of the Deal Insider. As a refresher on this metric, the acronym EBITDA stands for Earnings Before Interest, Taxes, Depreciation and Amortization. EBITDA is widely recognized as a proxy for a business's sustainable free-cash generating ability. EBITDA

is commonly used as a metric against which a multiple is applied to determine the valuation of an enterprise.

The health crisis has resulted in some parties expanding EBITDA to EBITDAC—many doing so without explicitly labelling it as such. The addition of the "C" at the end is intended to capture adjustments specific to Coronavirus. In some cases, those adjustments are addbacks for a company's losses and hardships. In other cases, the "C" reflects a reduction (also referred to as a negative addback) to remove positive spikes in a company's profitability resulting from unexpected and/or non-sustainable opportunities.

It is believed that the first use of EBITDAC was by a German company, Schenk Process Holding GmbH. Given the subjectivity of making adjustments for Coronavirus, EBITDAC (whether labeled as such or conceptually, without the label) has not and will not be generally accepted as a reliable performance metric.

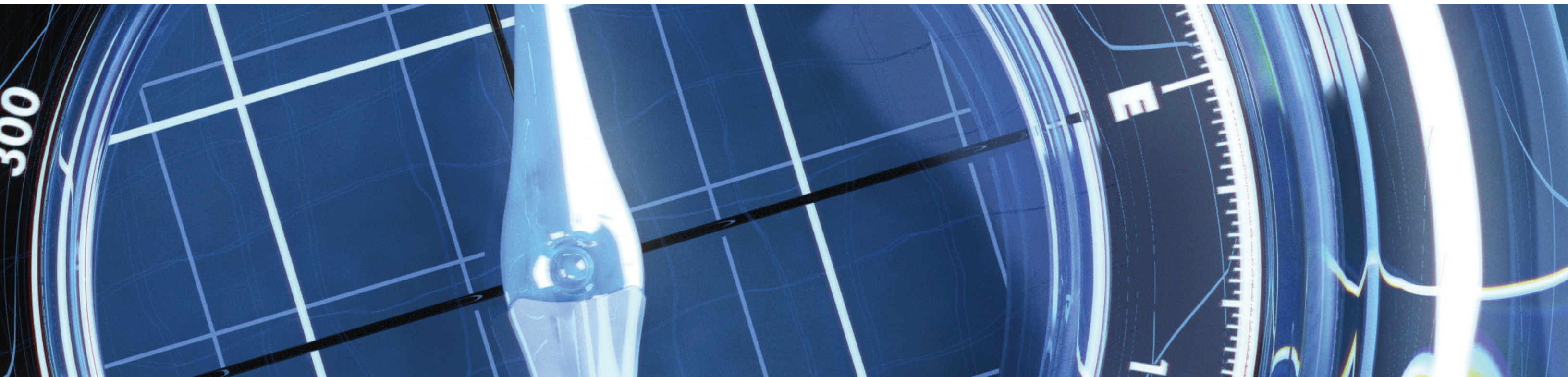
Without a reliable performance metric, the common question is *"How do you value a business and put together a deal structure during these unprecedented times?"* For businesses in sectors significantly and adversely impacted by COVID-19 (e.g., event organizers, hospitality companies, dine-in services, entertainment firms), the answer to that question is "you don't," as M&A activity has come to a screeching halt for companies in such sectors. Conversely, businesses that have been able to demonstrate their resilience and ability to sustain (or even thrive) through these challenging times, are in high demand and are being aggressively pursued by Buyers.

In these cases, Buyers often approach valuation by applying pre-COVID valuation multiples to full year 2019 EBITDA or in some cases to projected 2021 EBITDA ("Valuation EBITDA"). From a deal structure perspective, the cash payment at close ("CaC") uses the same valuation multiple but applies it to the most recent trailing twelve months ("TTM"). The delta between the Valuation EBITDA and the CaC represents the deferred purchase price, essentially an "Earnout." A timeframe is set for earning the deferred purchase price (typically a year), and the deferred purchase price is earned if/when the business returns to the Valuation EBITDA.

As a simple example, assume the (i) full year 2019 EBITDA is \$5M; (ii) TTM EBITDA is \$3M; and (iii) pre-COVID market multiple is 5x. In this hypothetical example, valuation is \$25M, whereas the cash at close is \$15M. At the one-year anniversary, the TTM EBITDA is calculated and is typically capped at the 2019 EBITDA, which is \$5M in this example; the delta between the one-year post closing EBITDA and the \$3M is multiplied by 5x. This results in the payment of the deferred purchase price. In this example, the Seller receives valuation and proceeds based on pre-COVID benchmarks even though it takes an extra year to realize that full value. But there is more to creating a win-win earnout than just agreeing on the formula. There are other factors to consider:

Get visibility into post-close life together
When agreeing to an earnout, the Buyer and Seller are agreeing to be partners in spirit for the length of the earnout period. Picking a good transaction partner involves more than just price and terms. The parties need to be aligned on the vision of a post transaction entity and the role of the former owner. Have the parties been respectful, honest and considerate of each other's time and resources during the process to date? If you are a Seller and the Buyer has done previous transactions, ask if you can speak to other Sellers to understand how they were treated after the sale.

Earnouts must be customized to meet the unique needs of every deal and Seller
Each transaction needs to be evaluated on its own merits. Consider key attributes such as the industry, financial performance and Seller's role post transaction; weigh risk factors including customer concentration, retention of employees with unique skills, expiring contracts and new



product launches. These are other driving factors when structuring an earnout. Note, earnouts are often more effective and palatable when the former owner(s) remains involved in the business and has influence over the key metric on which they will be paid out. An approach to consider is to allow a former owner to win new business on behalf of the company that replaces any lost revenue/profit that was part of an earnout calculation and next serves as a potential upside incentive.

Simple is better

Consider an easily identifiable performance metric that you can record, measure, calculate and report on. Some relatively clean performance metrics that should be less open to manipulation: revenue, customer retention and the completion of specific projects or milestones. Be aware that when selecting performance metrics for an earnout (i.e., EBITDA, Pre-tax Net Income, Gross Profit), you invite more complexity and potential issues as you work your way down the P&L.

Use examples in purchase agreement language

Whatever the final earnout formula is, use examples in the purchase agreement to illustrate the calculation of the earnout. An effective way to document a common understanding is to create an exhibit or supplement to the purchase agreement that contains multiple sample earn-out calculations under hypothetical scenarios. Failing to do so will most certainly lead to misinterpretation and, potentially, litigation. Also expected in the agreement is verbiage that restricts the Buyer from changing anything during the earnout period that alters the EBITDA of the business or adjusts for those changes in the EBITDA calculation.

Compromise – win/win approach

Think about who has the risk and who receives the benefit of post-close wins when you construct an earnout. Is the earnout one-sided or do the parties share the risk and reward? Consider which party will be investing resources (dollars, time, effort) to accomplish the underlying deliverables of the earnout. For example, if the Buyer will be the one investing in new machinery or new human capital to execute an opportunity, it may be more difficult to argue that they should share the rewards of that opportunity with the Seller. But, if the opportunity was "turnkey" or if there was pre-close investment by the Seller, the discussion shifts to hitting agreed upon margin thresholds and balanced sharing of rewards.

Understand expectations and effectively communicate

Understand the expectations of the parties before, during and after the transaction. How will each react to full or partial payment of the earnout? As noted earlier, one way to gauge is to provide example calculations early in the process, to begin the dialogue. If the post transaction operating plan (even if high level) will impact the earnout, make sure it is discussed.

Given that COVID is unchartered waters, earnouts have increasingly become the norm and are often necessary. Quantitatively, determining valuation and deal structure will be determined case-by-case and deal-by-deal. But be mindful of other important factors as well. Where there is a will, there is a way: motivated Buyers and Sellers will continue to get deals done during these unique times.

Other Deal Terms in a COVID Environment

There has been a lot of discussion about the impact COVID has had on valuations and deal structures (i.e. cash vs. deferred or contingent payments (earnouts)), but what about the other "terms" parties should expect to encounter? A few of the major terms are as follows:

Indemnification Caps

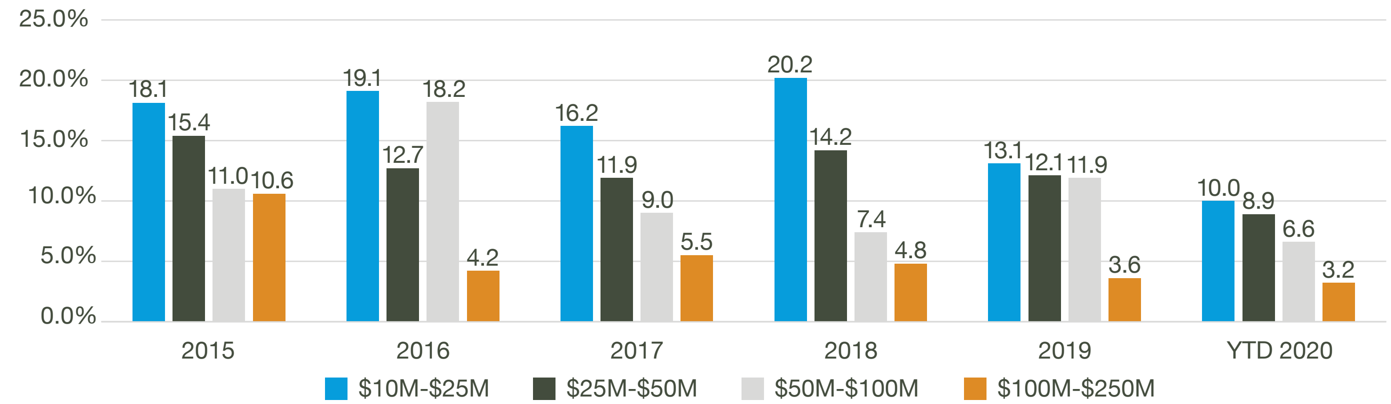
Chart 4 shows that the general cap on indemnification against breaches of reps and warranties continued to decline from 11.6% in 2019 to 8.2% YTD. However, this year-to-date figure encompasses a first quarter average of 8.6% and a second quarter average—on reduced volume—of 6.7%. While there was little movement in valuation from quarter to quarter, this observed lower indemnification cap may speak to the favorable risk profile of the lower number of deals that have closed YTD.

Also note that the general trend of indemnification cap percentages continues to decline, especially in larger transactions as a result of the increased utilization of rep & warranty (R&W) insurance. For a refresher on R&W insurance, see our Q2 2017 issue of the Pursant Deal Insider.

Average indemnification periods have remained largely unchanged for the last five years at a range of 18-20 months.

Chart #4

INDEMNIFICATION CAPS - % OF TOTAL ENTERPRISE VALUE



Source: GF Data®

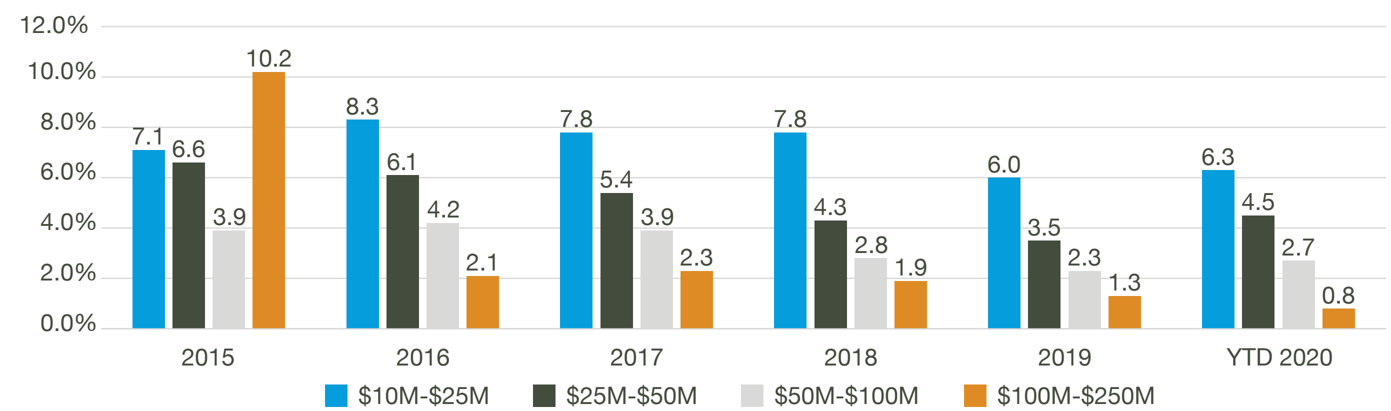
Escrows

Chart 5 shows that, like Indemnifications, the escrow percentage has declined over the last 5 years, gradually dropping from an average of 6.7% of Total Enterprise Value in 2015 to 4.1% YTD in 2020. Again, the decline is most pronounced in larger transactions as a result of the increased utilization of R&W insurance.

Average escrow periods have remained largely unchanged for the last five years at a range of 15-16 months.

Chart #5

ESCROW PERCENTAGE - % OF TOTAL ENTERPRISE VALUE



Source: GF Data®

Pursant’s Expectations for the Near Future

Despite the persistence of the pandemic and the turmoil it has caused, there are signs of positive things to come: the rebound in M&A activity in Q3, continued favorable valuations for better businesses and the increasing number of active lenders.

As of the writing of this newsletter, we now know the outcome of the presidential election. Keeping a Republican in the White House was thought to be the most favorable scenario for business and dealmaking. But it seems the business community has now warmed to the fact that there will be a Democratic administration. There is growing optimism that having the Democratic party in charge may bolster economic health as well through federal stimulus that would likely be part of a larger spending agenda. The M&A community is also optimistic, especially since it seems more likely that there may not be higher taxes related to sale transactions until 2022, setting the stage for a favorable taxation environment for those looking to exit in the next 12 months.

As we mentioned in recent Pursant Deal Insider newsletters, the broader M&A market has shifted to favor Buyers, but that has not been the case across the board —nor is it expected to be the case in the near future. Industries that are enjoying more certainty in their operations and outlook have kept and should keep healthy valuations and will 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 softer valuations and more contingent payment in deal structures.

We expect the credit markets to continue their ramp-up in lending activity as the economy moves closer to pre-COVID performance levels, with rates falling a bit.

We continue to see a significant uptick in the number of business owners looking to exit as the ongoing pandemic-driven fatigue persists. As for Buyers, according to a recent Deloitte survey of 1,000 US executives, more than half expect M&A activity to return to pre-COVID levels in the coming months. Not only are Buyers optimistic about the continued improvement of M&A activity, but the sentiment is also that activity will be more US-focused due to the country’s continued economic resilience.

The virtual workplace is not expected to negatively impact deal management and execution. It has now become the norm. Organizations are effectively managing deals in a purely virtual environment.

The philosophy for M&A this year has been “if there is a will, there is a way.” Whether you are a Buyer or Seller, if you have a business that is performing well, right now is a great time to be in the market.

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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