Q4 2020 EDITION

Pursant
INSPIRED PURSUIT

DEAL insider
M&A and Strategic Transaction Insights

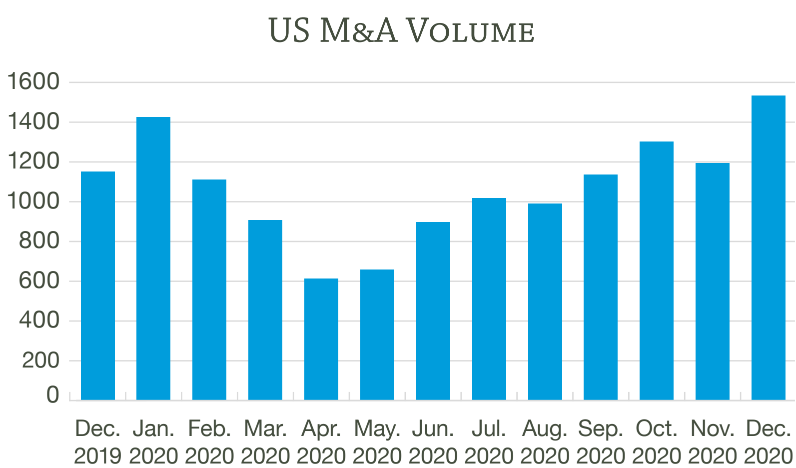
THE INVESTMENT BANK THAT ALSO BUILDS THE VALUE OF YOUR BUSINESS

The Big Picture:

1. Deals slowed significantly or stopped with US shutdowns in March 2020.
2. M&A activity hit bottom in April and bounced this summer.
3. Many deals went completely virtual, closing with minimal or no in-person meetings.
4. Financial buyers outnumbered Strategic buyers during the summer.
5. Many strategic buyers abandoned M&A for much of the year to focus on their business, but have returned in earnest!

Q4 2020 Deal Insider – 2020 Overview

2020 was a year like no other for us all, professionally and personally. It was also an unprecedented year for M&A, a roller coaster starting on a high, crashing into a mid-year low with many months of uncertainty, finishing strong with a surge of activity. Our year-end issue historically focuses on key strategic transaction metrics, largely centered around lower middle market M&A. Some of the exact data is still a bit murky, but the general themes are quite clear.



Source: Factset®

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.

Some Notable Changes We Are Seeing in the M&A World

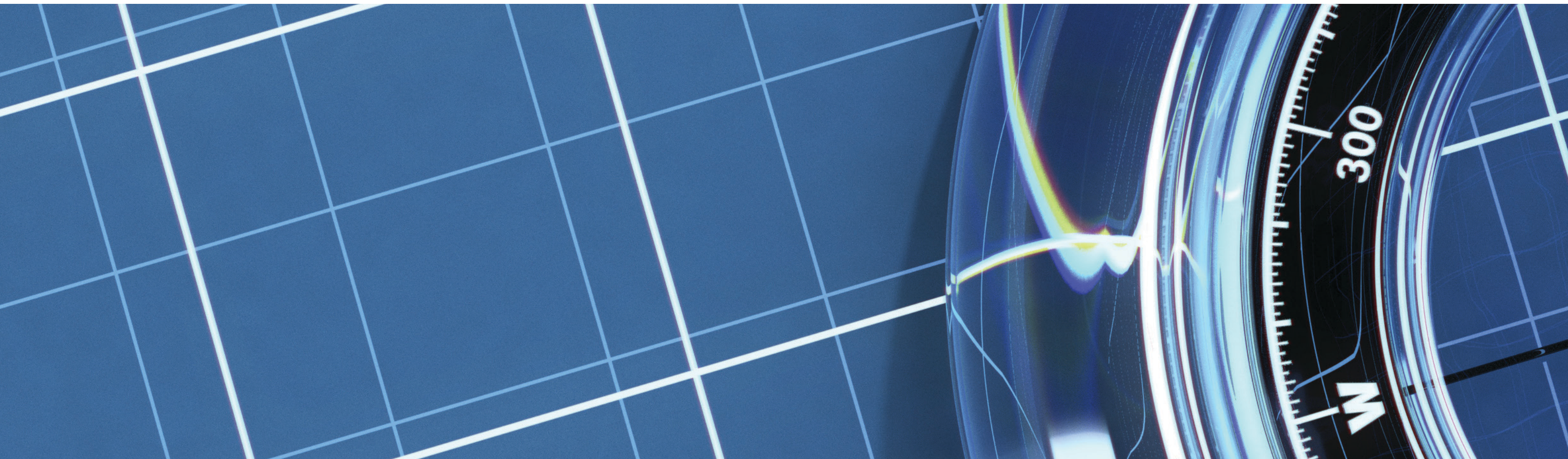
- Business owners (especially baby-boomers) have shown fatigue as a result of managing through the health crisis, whether their business faired well or not. The pandemic has served as a catalyst to stimulate business sale and liquidity event activity.
- COVID-related earnings bumps and COVID-related earnings reductions creating extra diligence challenges for parties.
  - Proven temporary earnings reductions often being adjusted out of valuations and accounted for through structured payment.
  - Earnings increases must be sustainable to be factored into valuations.
- Biden administration's plan to increase Capital Gains tax increase from 20% to 40% motivating business owners that were considering selling in the next few years to sell in 2021.

Macroeconomic Indicators

Pursant looks at a number of macroeconomic indicators that may impact deals in order to gain insight into M&A and strategic transaction trends. What happens at the global and macro-economic levels eventually impact the Middle Market and Main Street.

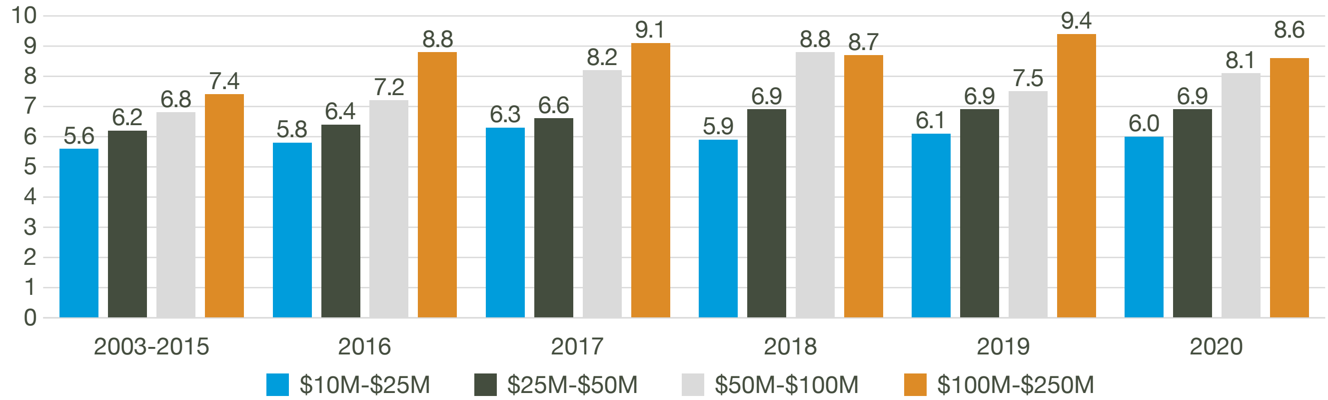
5 Deal-Impacting Macroeconomic conditions we watch:

1. **GDP** - The US economy expanded an annualized 4.1% in Q4 2020. Healthy GDP growth bodes well for M&A activity.
2. **Unemployment** – Finished the 2020 year at 6.7%. In any other recent year, this would not be a favorable number, but given where we were early in 2020 at nearly 15%, 6.7% is the right direction, good for the economy and good for M&A.
3. **Inflation** – Ended 2020 at 1.4%. A lower inflation rate helps keep interest rates and related M&A borrowing costs low.
4. **Interest Rates** – The Fed Funds rate finished the 2020 year at .25% vs. 1.75% at year-end 2019 and 2.5% in 2018. This lower rate environment fuels lending of all types, including M&A.
5. **ISM Purchasing Managers Index (PMI)** - The PMI for the US jumped to 60.7 in December of 2020. The reading pointed to the 7th straight month of rising manufacturing activity and the strongest growth rate since August of 2018. A PMI reading above 50 percent indicates that the manufacturing economy is generally expanding; below 50 percent indicates that it is generally declining. Again, another positive indicator for M&A.



Following a dip in aggregate deal pricing in Q3, average valuations for deals under $250M in enterprise value bounced back in the fourth quarter to allow 2020 to finish out consistent with recent years historical average of 7.0x TTM Adjusted EBITDA.

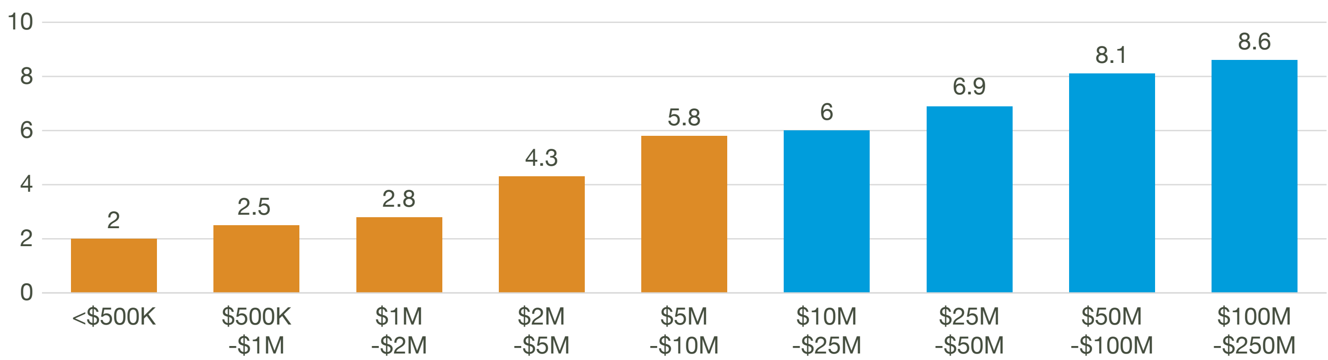
Total Enterprise Value (TEV)/EBITDA



Source: GF Data®

The chart below shows how average valuation multiples increase when moving from small businesses (<$10M in Purchase Price) to the lower middle market (>$10M in Purchase Price).

Small Business and Lower Middle Market EBITDA Multiples by Transaction Value

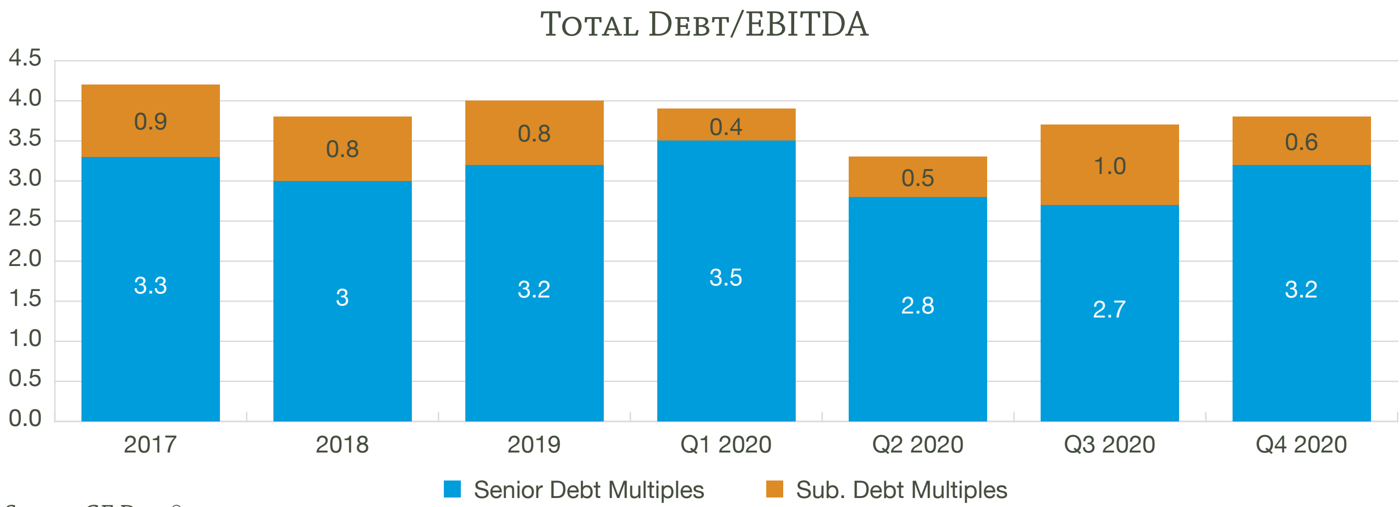


Source: Pepperdine Private Capital Markets Report & GF Data®

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.*

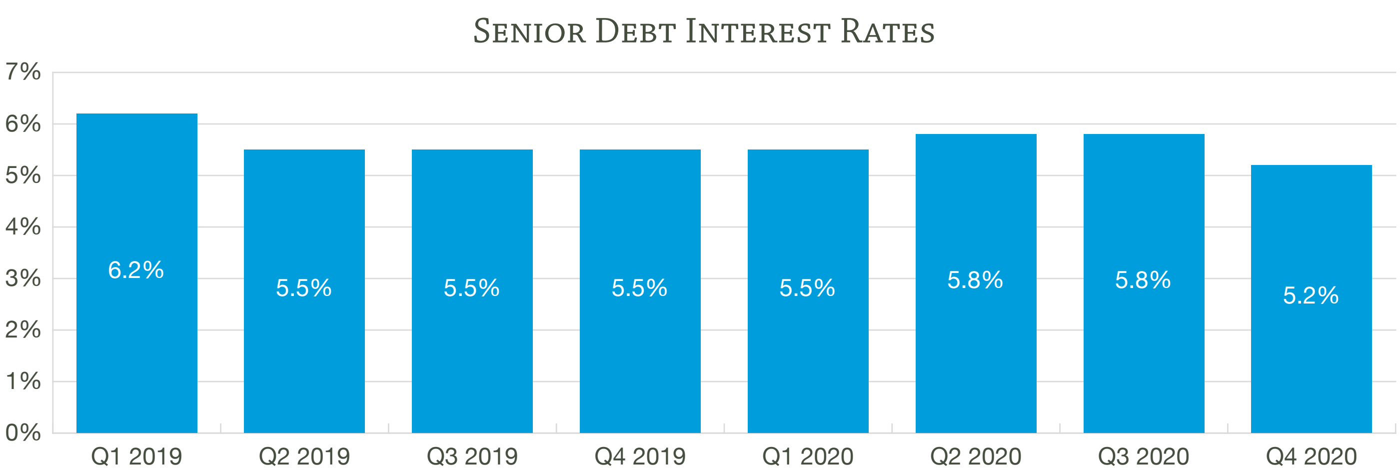
The chart below depicts the turns (multiples) of EBITDA senior and mezzanine lenders will lend on average in lower middle market M&A transactions.

M&A related lending was more conservative during Q2 and early Q3 as lenders focused on stimulus lending and gauged economic impact of the health crisis and then rebounded to near pre-pandemic levels by year-end.



Source: GF Data®

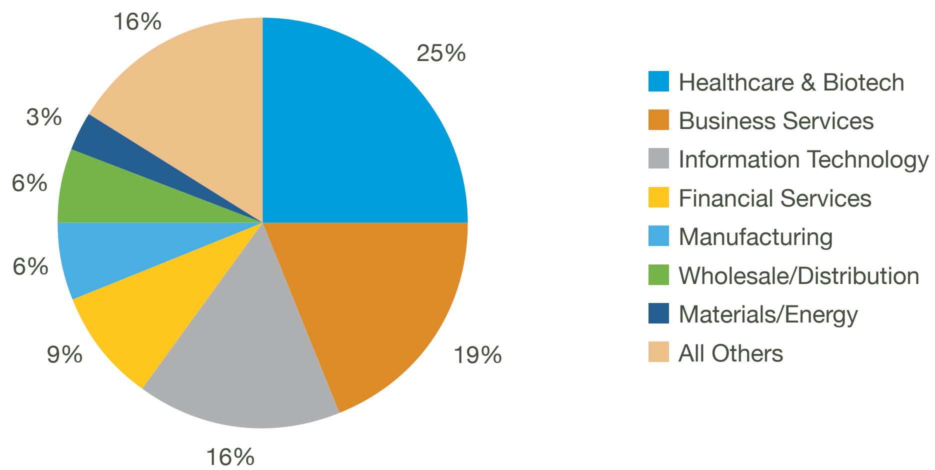
The chart below shows the more conservative pricing lenders charged for M&A lending during the peak of the pandemic, now making up for lost ground by offering more attractive lending rates.



Source: GF Data®

It's too soon to know how the full 2020 year played out, but the following chart ranks most attractive to least attractive by percentage for M&A risk/return trade-off according to a recent Pepperdine Private Capital Markets investor survey.

Sectors with Best Risk/Reward Trade-off



Overall, retirement remained the #1 reason to sell in 2020, but the health crisis definitely increased business owner burnout as well. With 10,000 baby boomers retiring each day, the retirement trend is expected to continue in 2021.

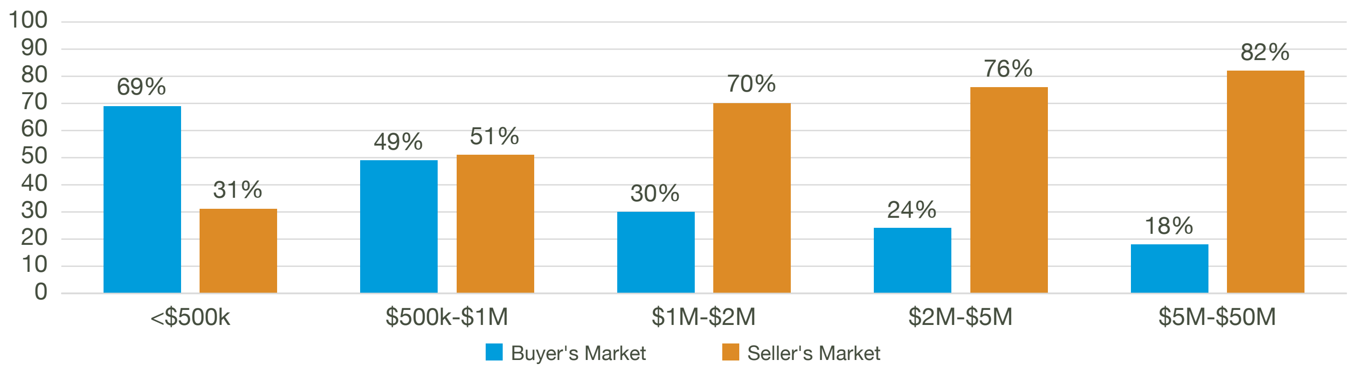
Why People are Selling

Deal Size	#1 Reason	#2 Reason	#3 Reason
<$500k	Retirement	Burnout	New Opportunity
$500k-$1M	Retirement	Burnout	New Opportunity
$1M - $2M	Retirement	Burnout	Recapitalization/Relocation/ Family Issues
$2M - $5M	Retirement	New Opportunity	Burnout/Family Issues
$5M - $50M	Retirement	Recapitalization/ New Opportunity	Other

Source: Pepperdine Private Capital Markets Report

Pandemic or no pandemic, size of transaction generally dictates who has the upper hand in deals. Supply and demand plays a major role here. Demand for good, larger-sized businesses exceeds the supply and the opposite holds true for smaller businesses.

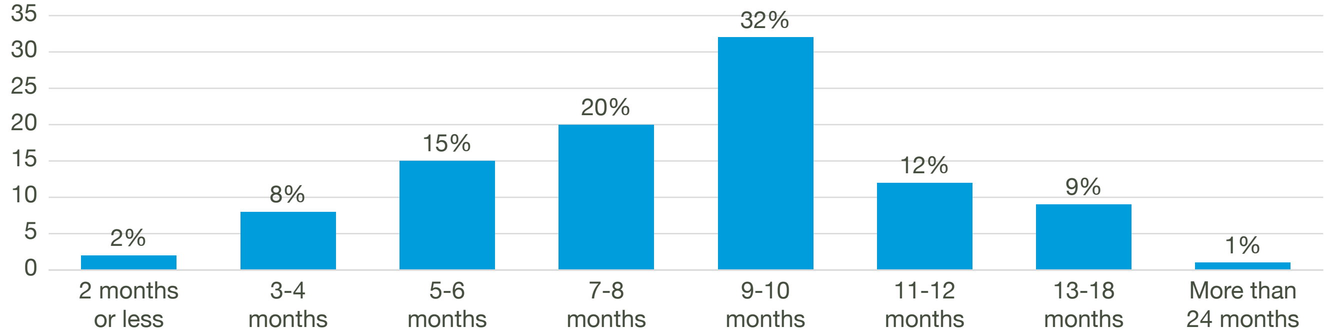
Buyer's or Seller's Market (by Transaction Value)



Source: Pepperdine Private Capital Markets Report

The chart below depicts largely pre-pandemic time frames to close a deal. During the Q2 and Q3 2020 timeframes, it was common to see timeframes extended by a few to many months due to travel restrictions, broader economic uncertainty, dynamic changes in the financial performance of businesses and added complexity for completing due diligence. Normalizing for the process hurdles created by the pandemic, 5 – 10 months continues to be the prevailing time span from the time one goes to market to closing.

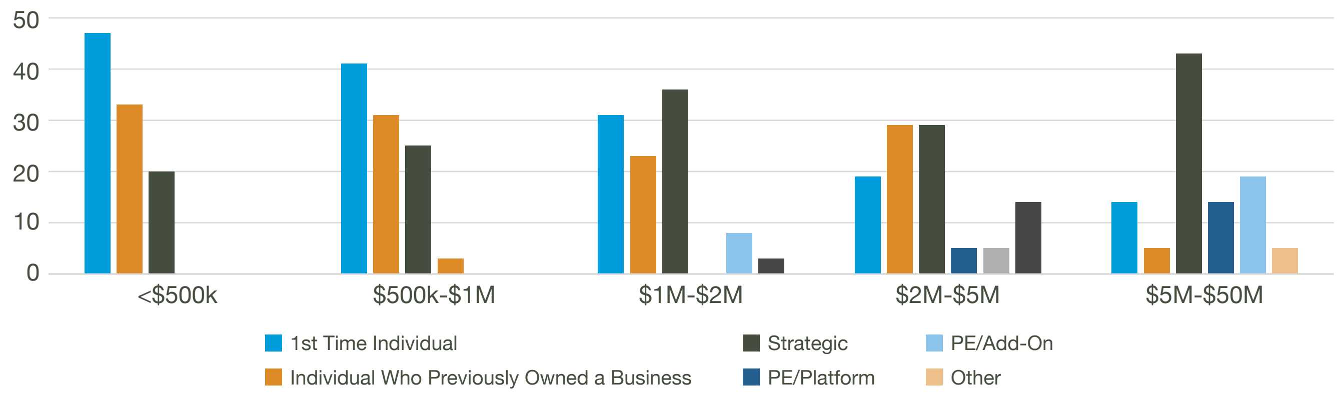
How Many Months To Complete a Deal



Source: Pepperdine Private Capital Markets Report

Eager to grow top-line revenue, Strategic buyers appeared all across the deal size spectrum. With higher transaction costs and the need for bigger returns, PE buyers generally don't take interest until purchase prices exceed $5M. As expected, individual parties are the most prevalent buyer type for small businesses.

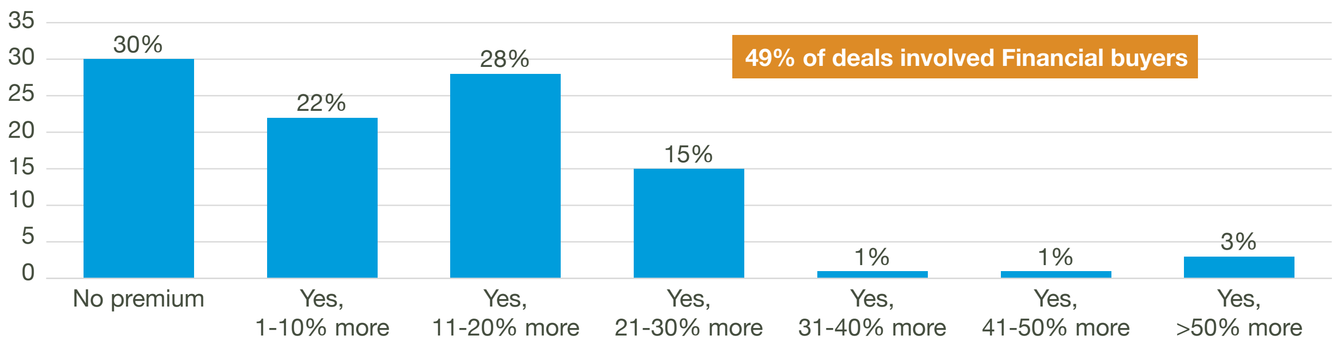
Who are the Buyers (sorted by TEV)



Source: Pepperdine Private Capital Markets Report

70% of the time, Strategic buyers were willing to pay more than Financial buyers. Strategic buyers generally have more synergistic opportunities, industry experience and operational experience to leverage in the valuation model, improving their proforma return.

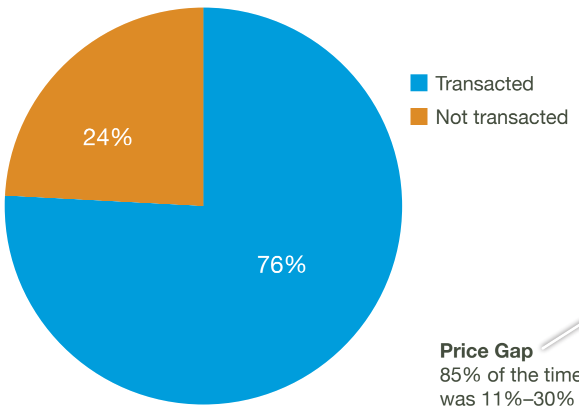
Premium Paid by Strategic Vs. Financial Buyers



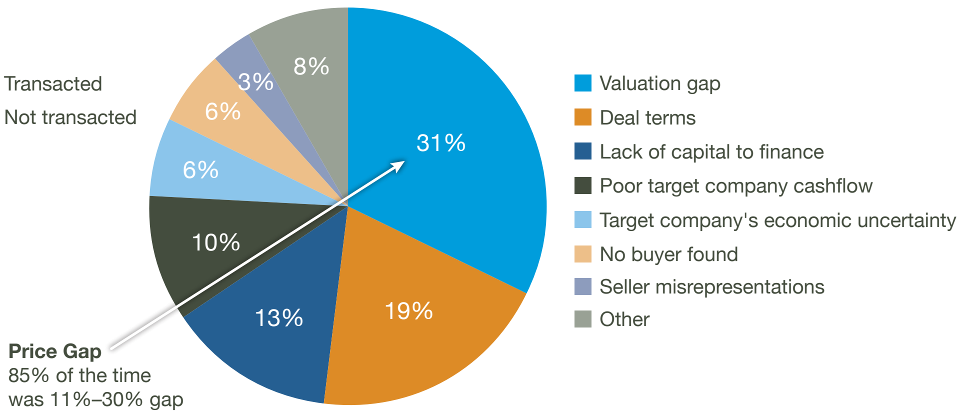
Source: Pepperdine Private Capital Markets Survey

If you embarked on a sale or acquisition process in 2020, putting COVID reasons aside, odds are that the transaction did not close a quarter of the time. The predominant reasons for deals not closing were buyer/seller misalignment on valuation expectations and deal terms, which generally occurs pre-LOI.

Deals Closing (post LOI)



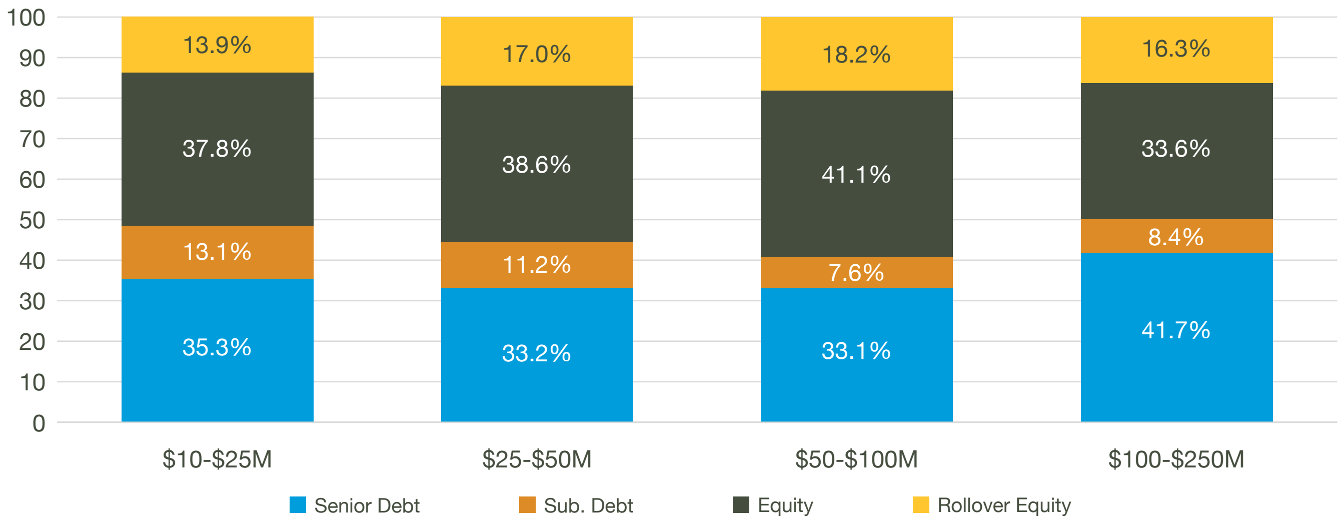
Reason for not getting to LOI



Source: Pepperdine Private Capital Markets Report

If you sold your company to a Private Equity (PE) buyer in 2020, the chart below reflects the common breakdown for how PE funded the transaction. Based on the leverage percentages seen here, we again see the benefits to the low cost of capital. We also see the necessity for buyers being willing to stay invested in their business (roll equity) in most cases when they transact with PE.

M&A Deal Funding Structures by Transaction Value (Platform Acquisitions Only)



The table below depicts how the pandemic has triggered the overdue but natural shift in the business transfer cycle from Seller-favorable to Neutral/Buyer Favorable. This means that not ALL businesses will trade at premiums, only the better businesses. A business with suboptimal performance can expect softer valuations.

A SHIFT IN THE PHASE OF 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
2021 – 2023	2023 – 2028	2028 – 2030

Source: Rob Slee - Private Capital Markets

What to expect in 2021

1. M&A activity to be at very high levels, still making up for lost ground in 2020.
2. More buyers with healthy stimulus-fed balance sheets.
3. More 2021 sellers due to eminent 2022 tax increases.
4. Macroeconomic M&A drivers mostly positive, creating a favorable M&A climate.
5. Continued affordable M&A borrowing costs.
6. PE still pushing hard to do more and smaller deals.
7. Significant continued virtual vs. in-person meetings regarding M&A events.
8. Valuation multiples holding strong for better businesses and softer for those that are not in optimal condition.
9. Challenging due diligence as buyers and sellers sort through the temporary versus long term impacts of COVID.
10. Companies Optimizing in anticipation of a liquidity event.

2020 had a significant amount of uncertainty and M&A dislikes uncertainty, but it has learned to live with a lot more of it than anyone would have expected. Uncertainty has become a certainty.

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 monetize their business, manage acquisition initiatives and source the capital needed to fund strategic transactions.

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

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