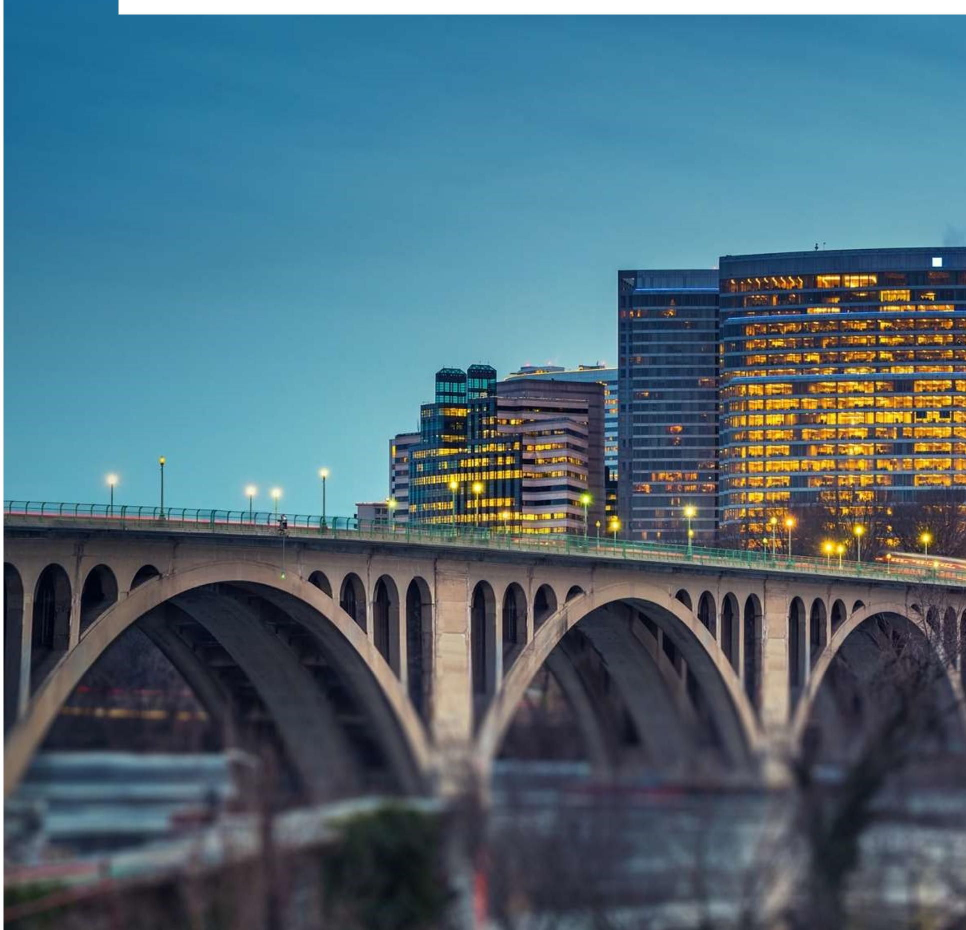
INSIGHT and PERSPECTIVE

Middle Market M&A Activity in the Current Environment

April 2020



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01.
INTRODUCTION

FOCUS Investment Banking has been asked by several partners to provide insight and perspective on the current state and future outlook for middle market M&A given the current market environment. FOCUS gathered the questions and then engaged with its team of over 40 bankers and senior advisors, across its ten industry practices, gathering responses to the questions posed. The firm's CEO, Chairman and Research Director compiled the answers and developed the answers provided below, reflecting the real-time experience and current outlook of its M&A practitioners.

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SUMMARY

It is no surprise that middle market M&A has not escaped the current economic crisis—as it is filled with companies across a wide array of industries that have been seriously impacted by the country's abrupt slowdown. However, the effect has not been uniform across industry sectors and the stage in the process. Some sectors continue to press ahead (albeit at a little different tempo) while others have halted altogether. The same is true for companies considering a transaction—we continue to sign up new clients but not at the same pace as in 2019.

Lenders are cautious but still participating; private equity groups (PEGs) have plenty of cash and are considering how and when to best deploy it. Timing (of many things) is uncertain and until that uncertainty recedes, we will not see the activity levels and valuations of 2019. Transaction valuations for 2019 were at or near historic levels, so it should be no surprise to sellers to see buyers seeking a downward push on valuations of at least 10-15% in the coming 24 months.

Our overall view is that when the market rebounds (and rebound it will) there will be buyers seeking good companies at fair prices. There will also be a lot of damaged assets for those buyers to sort through. Different sectors will come back at different times, but what should sellers be doing now? Get prepared. Be the company that stands out in the middle marketplace, with strong marketing materials, due diligence work complete, and a management program demonstrating strength in the face of a truly unseen market.

02.
QUESTIONS AND ANSWERS

1. Are you seeing deals already in your pipeline being put on hold, or are they advancing towards closing? What are challenges you are facing? Which types of deals are moving forward?

The short answer is yes.

Most of the deals that were already in progress are still in progress, but at a much-reduced pace and level of urgency. A few deals that were in progress have either closed or are close to closing. And a few deals have been put off for the foreseeable future. Many of these decisions have to do with what industry deals are in—for example: automotive aftermarket deals are basically on permanent hold, while IT and "last mile" supply chain deals are moving forward with enthusiasm.

In addition to the industry that deals are in, stage in the process is the most influential.

- Near closing—the deal is probably still headed there, albeit with some hiccups and slowdowns, and possibly some last minute repricing or reconfiguration of deal terms. Buyers know enough about the target and their industry to be able to make a guess—at least as good a guess as they are making about their own prospects—as to how they can manage through this. As long as their bank remains on board.
- Recently launched sell-side clients are getting a more lackluster reception as many strategic buyers are refocusing their efforts internally right now; private equity buyers are still buying, but may have to spend some energy and cash on keeping their portfolio afloat.
- Pre-market clients are understandably wary, and we are advising them based on their business performance in this environment and what we are hearing from the buyers we speak to. Strong government contractor, for example, with a healthy backlog in desirable agencies, are going to market and being well-received.

Uncertainty is the root of the challenges we are facing. The standard phrases—"uncharted territory," "unprecedented," "extraordinary times"—may be overused but that doesn't make them any less true. Timelines. Global and local impacts. Policy efforts… there is a lot of new risk floating around that buyers, sellers and lenders are trying to assess if they choose to stay in the game. The resulting challenges we have seen in the last few weeks? They include:

- Hesitant lenders—but they have come through on deals already papered and set to close. Others are so preoccupied with PPP loans they are out of bandwidth to even consider a financing.
- Some portion of cash deals moving to earnout—pegged to a return to pre-COVID performance/projections

- Slow due diligence process inhibited by no travel and no face-to-face meetings
- Buyers hitting the pause button as they seek to shore up their own positions first

2. To help focus our lead generation efforts for you, which industries are "hot" now and which ones are not?

The shakeup of the U.S. economy has revealed strengths, weaknesses and, of course, opportunities – and it is in this last group that "hot" is probably the most accurate word. Surging demand for specific products and services (think disinfectants, grocery/last mile delivery, toilet paper, and videoconferencing) is very real, but cannot overshadow the far larger parts of the economy that have slowed or stopped. Hot today might be a trend with staying power or it might recede as the "new normal" is established. Until that becomes clearer, we don't believe "hot" necessarily indicates a broadly active M&A market.

Each of our teams has identified pockets of relative strength within their areas, but overall the most robust ongoing actual deal activity is in the government and information technology sectors, as well as the "last mile" of supply chain delivery – this is measured by deals that continue to progress forward and by inbound activity.

Good companies with good stories will always have a market, we believe, and there are plenty of them out there. Growth sectors attract robust investment and M&A activity, and as the path through the current crisis is charted and the way out becomes clearer, some of today's newly "hot" sectors will likely prove to the have staying power to demonstrate that. Other well-established sectors, like supply chain/logistics, are likely to see significant M&A activity as they confront weaknesses exposed by the crisis and take advantage of emerging opportunities and new technologies.

Some of the hot and cold sectors mentioned by our bankers:

HOT	COLD
Government contracting	Automotive
Federal aerospace & defense	Retailers and supporting services
Supply chain/delivery/logistics and related technology	Oil & gas and supporting services
High end and outsourced IT services and products, including SaaS and cloud products. Recurring revenue	Discretionary healthcare
Selected, essential healthcare	Travel & leisure

3. What is your view of financial buyers versus strategic buyers in this market?

Our experience over the last few weeks indicates that across most sectors strategic buyers are primarily looking inward, dealing with immediate and near-term issues around business operations, staffing, cash flow, etc. With the exception of deals already well along or specific sectors relatively unscathed, they are not thinking today about M&A. How quickly they return to the market – we expect that to be a function of their industry and relative position, as well as general reduction of uncertainty about the future. Those who do will be targeting assets that improve their strategic position as the economy emerges from the crisis, and seeking better value for their dollar as they do. Those relying on stock as currency may find their capacity reduced, and those relying on bank financing may find their banks preoccupied with PPP loans. Debt is likely to be more expensive, wherever it comes from.

PEGs are facing some of the same issues, as many are deploying their (well-publicized) cash reserves to shore up their portfolio companies. But as a group they do have cash, and we have spoken to a number that are active and eager to continue buying. We expect PEGs overall will return more quickly to the market, and we have already seen some evidence of shifting appetites and approaches caused by the current environment:

- Deal terms structures to share risks
- Valuations lowered to reflect risk and uncertainty
- Shopping for distressed assets
- Predicting what COVID-19 market disruptions will have lasting impacts (still early in the game on this one!)

Both strategic and financial buyers are and will be affected by the lenders' ability to support them, unless they are in the enviable position of having enough cash and being willing to spend it this way. We have, in the last few weeks, seen a wide range of responses from the lending community, from completion of deal financing as expected, to changing terms, to simply being unable to help business customers at this juncture. There is some availability in the market, but it is more expensive and harder to come by than it was six weeks ago.

4. What would you say to business owners who are hesitant about entering into a sell-side engagement at this time?

Preparation generates options. When things begin to turn around, you want to be ready and first in line to deal with buyers. We expect that those buyers, especially PEGs with cash to spend, will be sorting through a lot of damaged companies. Good companies prepared to go to market will stand out.

While there are a lot of unknowns about the marketplace, including the timing and character of the economic recovery, we do know that being ready to go when the signals look good is a huge advantage. For most clients, the reasons they were considering a sales process in January are unchanged, even if the environment has altered. For some, the environment may affect valuation metrics, or post-crisis positioning, but not the sale rationale. For others, the (possibly significant) implications of tax code revisions, likely given the debt related to federal relief packages, may spur them to achieve a 2020 deal closing.

For all, priority business activities are clearly to take care of the health and wellbeing of employees, customers and suppliers; and to manage cash flow and business operations to keep the business on firm footing. As far as these are achievable, business owners that were considering an exit should work now with an M&A advisor to get “market ready”(a process that typically takes a couple of months), with the marketing materials ready to go – whether “go” is in two months, twelve months or somewhere in between.

We expect different sectors to “open up” at different times, with some, like government contracting and IT, staying active throughout this period. Bankers across our industry practice areas are close to their markets and talk each day with buyers and sellers, assessing the mood and evaluating the environment. We do believe that once things start to move, they will move quickly in most sectors.

Be prepared and have the option.

QUOTES FROM BANKERS

“There are always buyers in the market and if you have a good company… there are buyers who will pay a fair value.”

“At some point the crisis will pass, and the companies that get out to market quickly will likely have an advantage because buyers will be hungry for deal flow.”

“The viability of sell-side execution is not a question of if, but when.”

“It’s a tougher market than we’ve seen in the past ten years. Having a robust process and a seasoned advisor is more important than ever.”

“Prepare today to get tomorrow’s payoff.”

"Key question: Post COVID, am I going to be able to compete and grow faster as an independent entity, or as a partner in something larger? If the latter, you need to be either buying or selling."

"High quality assets will always be in demand."

"With the election in November and uncertain tax environment in 2021, buyers may be looking to close transactions in 2020. If engaged in H12020, there is still enough time and buyer capital available for a favourable outcome in 2020."

5. Access to capital beyond PPP/EIDL type loans - What type of financing are you able to provide clients at this time?

The abrupt course change of the U.S. (and global) economy has changed the environment for raising capital – just as the reasons that companies seek financing have likely also changed. CEOs and business owners are facing unexpected and immediate challenges directly affecting the near-term well-being of their employees, their customers, their suppliers – and possibly the long-term profile of their organization. There is no real historic precedent for today's events to which we can refer for answers – yet we all seek a path that can support our strategic goals for the future.

We continue to be working with clients to raise all kinds of capital for all kinds of situations. Capital outside of the Government Loan programs is available; it is just being committed much more cautiously and at slightly higher rates than we saw in early 2020. Below is a summary of Deal Types and Capital Types we remain involved in at the firm.

DEAL TYPES

Refinancings

Recapitalizations

Acquisition financing

Turnaround/bridge loans

Management buyouts

Equity raises

CAPITAL TYPES

Asset backed loans

Senior debt

Unitranche debt

Mezzanine debt

Convertible debt

Common equity