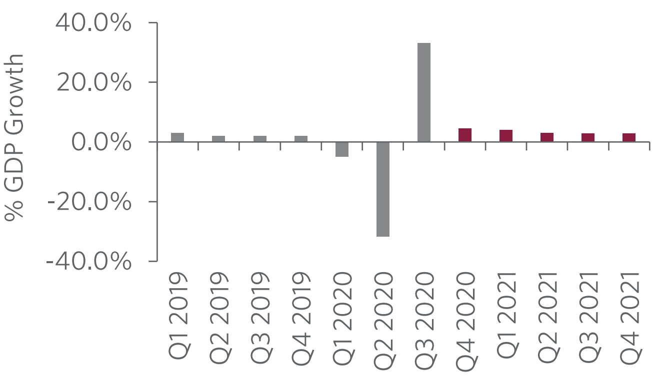
MARKET MONITOR

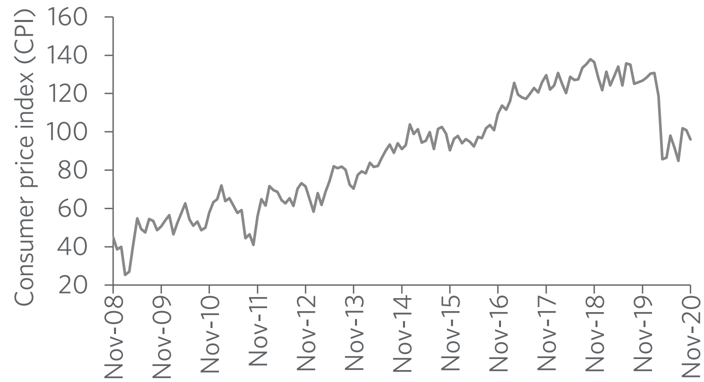
M&A and financing update
4th Quarter 2020

Quarterly U.S. gross domestic product



Source: U.S. Department of Commerce and Wells Fargo.

Consumer confidence



Source: The Conference Board.

Growing optimism for 2021

With December marking the 9th month in a work-from-home environment, many have a better appreciation of the volleyball named "Wilson" that was a key supporting actor in the movie, *Cast Away*. Although the physical isolation has been taxing, capital markets professionals have been able to adapt to the new norm and in many cases thrive during the pandemic. An unexpected benefit of the pandemic was the opportunity for businesses to test their contingency plans and fix minor glitches that were never considered, such as remote networking bandwidth and connectivity for the entire workforce.

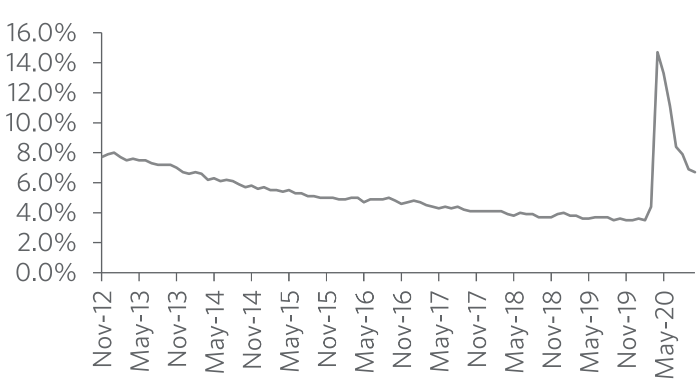
The cold weather has brought a second wave of COVID that has motivated several American states and European countries to reinstate operating restrictions and close offices, restaurants, and gyms. While these shutdowns are having a demoralizing impact on the economy, they are not sending the same economic shockwaves that we felt in the spring.

The renewed "shelter-in-place" orders have driven a slight uptick in unemployment and a modest slowing of economic growth still exists. The short list of negative economic indicators is being outweighed by a growing surge of positive indicators as businesses discover new ways to survive and thrive. Some highlights include: the approval and initial distribution of a vaccine; equity markets posting an 11.7% return in Q4 2020; the continued monthly growth of PMI for both the services and manufacturing economies; and the credit markets have rebounded to almost pre-pandemic levels of support for LBOs.

As we head into 2021, many business owners are becoming increasingly optimistic and a path forward is emerging. Congress negotiated a new $900 billion round of stimulus. GDP and PMI reports continue to signal growth, and consumer confidence remains stable. The growing optimism is fueling a resurgence in M&A activity beyond the "COVID winners" which is causing M&A professionals to prepare for a surge in new deal volume in Q1 2021.

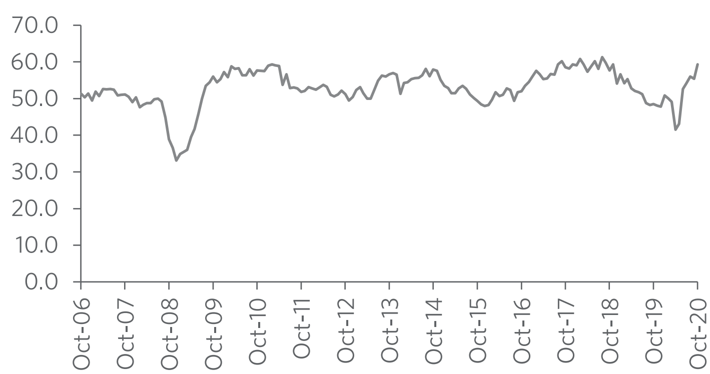
2020 brought us a multitude of lessons learned and unprecedented occurrences, but as the calendar turns to 2021 the market is anticipating a happier new year!

U.S. unemployment



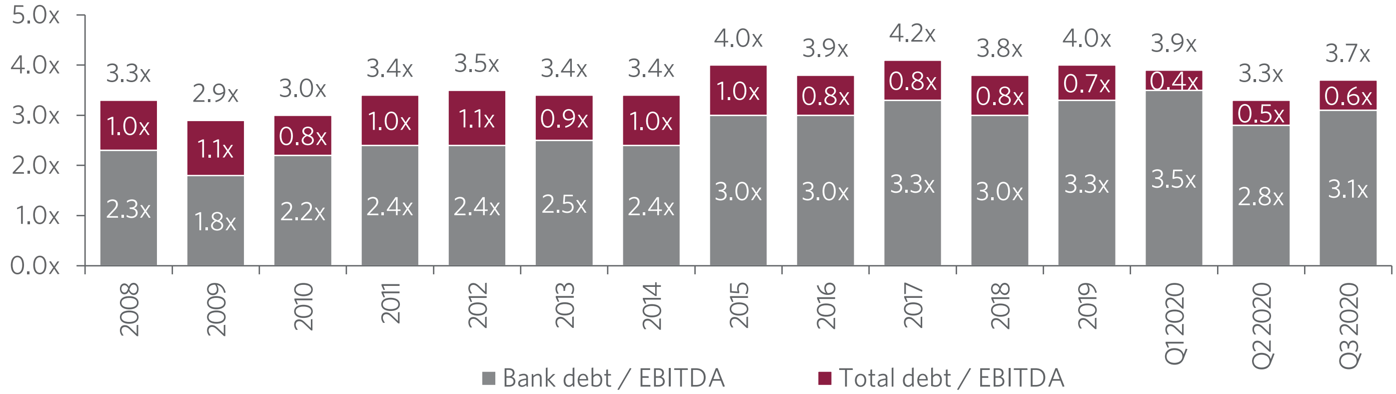
Source: Federal Reserve Bank of St. Louis.

Manufacturing PMI



Source: Institute for Supply Management.

Average platform LBO debt multiples for deals with $10mm – $250mm of enterprise value



Source: GF Data®.

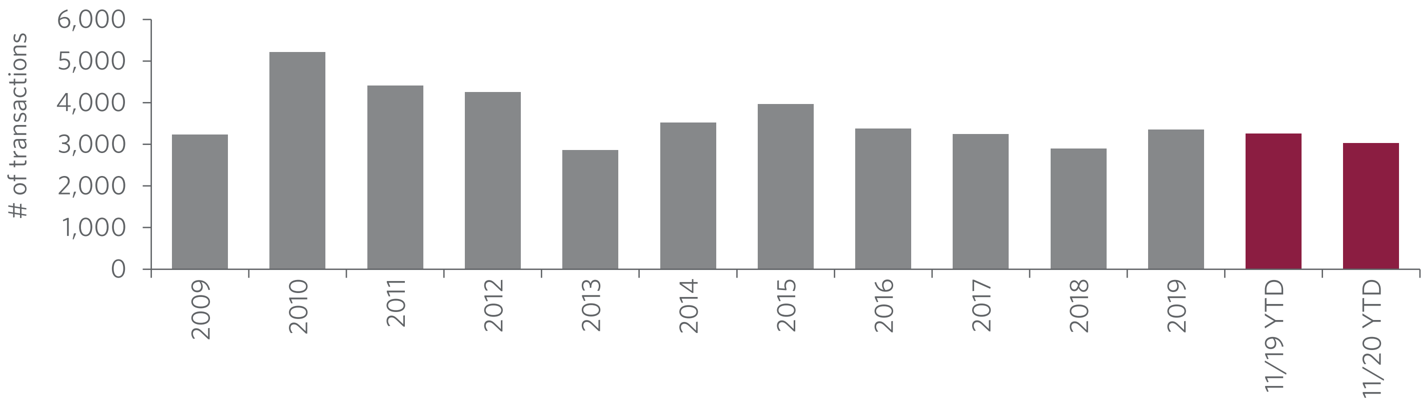
Was that a debt market correction or just a pause?

The debt markets may have just experienced the shortest correction in our lifetime, measured in quarters instead of years. According to GF Data®, the average total debt/EBITDA multiple for private equity-based leveraged buyouts ("LBOs") of platform companies with $10 to $250 million enterprise value was 3.7x for Q3 2020, which was a 0.4x increase from Q2 2020 and a 50% recovery in debt availability comparing the Q2 2020 trough to the 2017 peak. For reference, it took more than five years for the credit markets to rebound after the Great Recession a decade ago.

Comparing 2020 to 2009, we find that the health of companies and lenders is much stronger today than it was a decade ago. While "covenant lite" deals have been readily available over the last five years from direct lenders, credit standards, in aggregate, are much tighter today and lender balance sheets are stronger. When action was needed, the credit teams within banks and direct lenders responded quickly to assess the situation, pause new deal activity, and focus on existing clients and their current portfolios. Once this assessment was complete, lenders selectively resumed lending to their long-standing relationship customers. As a result of these quick actions, lenders are back supporting LBOs with the same vigor that existed in late 2019.

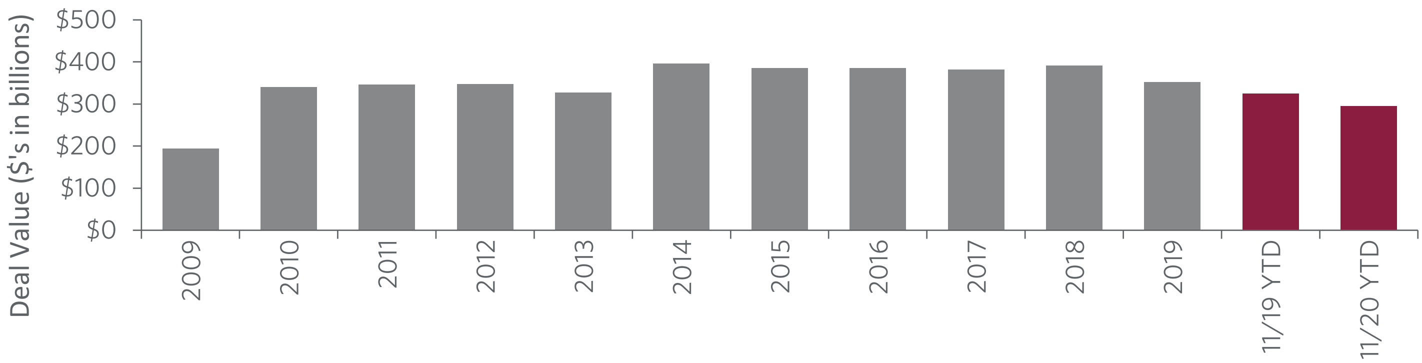
A portion of the lending market resembled 2009 in March and April. In the direct lending market, there was a need to call capital from Limited Partners ("LPs") for liquidity and a brief period of panic occurred because of an unforeseen "run" on revolvers and cash hoarding by many borrowers in a short period of time. Many revolver draws were delayed by a week or two as direct lending funds called unexpected levels of capital to support their clients. Most of this "rainy day" capital has been returned and direct lenders are aggressively trying to grow their loan portfolios in late 2020 with LBOs again closing with over 6.0x leverage.

U.S. M&A deal volume for transactions under $500MM



Source: Robert W. Baird & Co.

U.S. M&A deal value



Source: Robert W. Baird & Co.

Deal volume gaining momentum

In November, the number of completed transactions under $500 million declined 14.4%, compared to November 2019 and 2020 year-to-date volume remained 7.1% behind 2019, according to Robert W. Baird & Co. The reopening of the M&A markets across a wider spectrum of end markets continues to accelerate as pockets of visibility return and quality deal flow reemerges from a COVID hibernation. During the summer, buyers appreciated the flood of COVID winners with outlier performance but they longed for the return of high-quality businesses with great management teams and sustainable growth.

The mega deal market has historically served as a leading indicator for middle market deal volume. Under this theory, the November 2020 record of 41 $1.0+ billion transactions predicts strong middle market deal volume in 2021. The "tone" of the middle market is that private equity firms and investment banks are bullish about Q1 deal volume, which also portends robust deal announcements in mid-2021.

Average U.S. M&A EBITDA multiples

Source: PitchBook.

Avgerage EBITDA multiples for $10mm – $250mm PE-backed LBOs

Source: GF Data®.

LBO multiples decline in Q3 2020

After an increase in Q2 along with average valuation multiples for all U.S. M&A transactions, one sector of the M&A market, the mid-market, experienced a decline in valuation multiples during Q3 2020. According to GF Data®, the average enterprise value/EBITDA multiples for $10 to $250 million enterprise value LBOs in Q3 declined to 6.7x from 7.4x in Q2. This decrease in mid-market LBO multiples, a relatively small portion of the overall M&A market, may reveal a trend in valuation that also may be just a "blip" in the quarterly data. The year-to-date averages remain strong with GF Data® reporting an average enterprise value/EBITDA multiple of 7.2x through Q3 2020 for LBOs and Pitchbook® reporting an average enterprise value/EBITDA multiple for all U.S. M&A transactions through Q2 2020 of 10.5x.

Many transactions closing in Q2 2020 involved companies believed to be "pandemic resistant" and already engaged in M&A processes. GF Data® noted that LBOs completed in Q3 also included a high proportion of businesses that were engaged in M&A processes in early 2020 that were restarted in industries that were negatively impacted by the COVID shutdown. GF Data also noted many of the Q3 closed transactions had sellers that valued closing in 2020 over maximizing their equity and a buyer that could underwrite the COVID risk to accommodate the seller's exit timeline by offering a lower valuation or offering the seller a contingent compensation in the form of an earnout.

We are expecting Q4 2020 to reflect a quick "V" recovery for valuation multiples due to: 1) new M&A processes that have launched in the second half of 2020 that are heavily weighted towards pandemic-resistant businesses; 2) debt availability and covenant structures returning to pre-COVID levels for companies with strong financial performance; and 3) a continuing imbalance of supply and demand for companies reflecting scarcity value for businesses in sectors that have proven to be pandemic-resistant and vast amounts of uninvested capital driving valuation multiples to new heights.

Common sales and cost COVID-related adjustments

Category	Adjustment description	Seller position	Buyer position
Sales	• Shutdown - End market or Company deemed "non-essential" • COVID "winners" - (examples: cleaning products, building products, home office products • COVID "losers" - (examples: travel, leisure, restaurants, commercial aerospace)	• Adding back 100% of normalized revenue taking into consideration historical sales trends for Q2 and Q3 sales declines • Trying to capitalize on sales windfall and taking a position on percentage of new business that management believes is sustainable • Adding back 100% of normalized revenue taking into consideration historical sales trends	• Providing minimal to no credit to seller's sales adjustment and/or to the 2020 "run rate". Buyers are looking for multiple quarters of performance to understand what "normal" will be in 2021 and beyond. Buyers are willing to share the risk by offering sellers earnouts or contingent seller notes that extend three to five years
Expenses	• Headcount and compensation modifications • Sales and marketing expense savings (travel, tradeshows, commissions) • Non-recurring COVID specific expenses (examples: additional cleaning, COVID testing, process or facility reconfiguration, lost productivity, additional freight due to supply chain disruptions)	• Adding back annualized savings for headcount reductions and taking more aggressive positioning on permanent versus temporary department reductions • Developing pro forma expense profiles for what the company expects to spend going forward with or without a change in go-to-market strategy • Adding back 100% of non-recurring expenses	• Providing credit for permanent headcount reductions that do not negatively impact growth. Buyers are not giving credit for temporary reductions that positively impacted EBITDA, but prohibit achieving the growth plan • Scrutinizing these expenses and giving little credit for temporary costs reductions that will return once COVID restrictions are lifted • Giving 100% credit for non-recurring expenses that were tracked separately and quantifiable that are no longer part of the standard operating procedure

Source: CIBC Cleary Gull insights with input from various transaction advisory services firms.

Seller and buyer positions on COVID adjustments

The market saw deal flow restart in early summer with a mix of deals in process that were paused in March, technology companies benefiting or at least unaffected by the pandemic and some opportunists that were attempting to capitalize on COVID-inflated LTM sales and EBITDA. For the processes that restarted, sellers and their advisors leveraged the addback playbook to analyze 2020 monthly sales and expense trends to uncover positive EBITDA adjustments. Sellers attempted to retain as much pre-COVID equity value as possible without waiting for financial performance to normalize. For businesses in recovery mode, the desire to find a path to facilitate a near-term exit created a highly-negotiated mix of acceptable and aggressive addbacks and pro forma adjustments in the LTM EBITDA presented to buyers. For technology companies and other COVID "winners", there was a careful examination of the sustainability of favorable results and trends.

For companies negatively impacted by COVID, buyers and sellers have been willing to engage in processes, sign LOIs, and begin due diligence based on the COVID-impacted pro forma financial results. Many of these deals entered diligence with buyers taking a "trust but verify" approach to addbacks and adjustments presented by the sellers. Buyers took the perspective that they would receive some additional clarity about the sustainability of COVID-related pro forma sales and expense addbacks with the passage of time during a 30- to 90-day due diligence period. However, as the pandemic has continued, few buyers or their diligence providers were able to gain a high enough level of conviction to validate what "normal" sales and expenses would be under their ownership to underwrite 100% of the risk associated with the seller's pro forma EBITDA adjustments.

Apart from technology and certain other sectors, throughout the second half of 2020, we learned that there are many companies and industries that still do not have great visibility into 2021 performance. As a result, management teams are facing a significant challenge to produce a forecast they can confidently achieve. To cope with this, buyers of these companies are seeking to shift transaction structures from all cash at the time of LOI to earnout structures during a "re-trade" to share the COVID sales and expense adjustment risk with the seller and find a path to close the transaction. In response, some sellers valued time and closing the deal as soon as possible over cash. Others that valued maximizing shareholder proceeds over time were more likely to put their process on hold. We expect the market will see many of these "on hold" deals return in late 2021 or beyond, once they are able to replace the underperforming quarter in their LTM sales and EBITDA results and achieve their valuation and liquidity objectives.

Firm overview

CIBC Cleary Gull is a nationally recognized boutique investment banking firm with a global reach. We advise private equity funds, entrepreneurs, and small publicly traded companies on mergers and acquisitions, private debt and equity financings and recapitalizations and other transactions.

Our talented team has completed hundreds of middle market transactions delivering more than $8 billion in value. With an average of more than 20 years of deal experience, our skilled senior investment bankers bring knowledge, integrity and relentless determination to deliver great outcomes for our clients.

CIBC is a 150 year-old financial institution that provides US clients with tailored commercial banking, wealth management, personal and small business financial solutions, as well as cross-border banking services to clients with North American operations.

Global reach

CIBC Cleary Gull is a member of the International Association of Investment Bankers. The IAIB (iaib.org) is a global network of investment banking firms in Asia, Australia, Europe, and North and South America working together to broaden their reach and leverage their expertise.

Contact us for more information on CIBC Cleary Gull and our Investment Banking services.

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