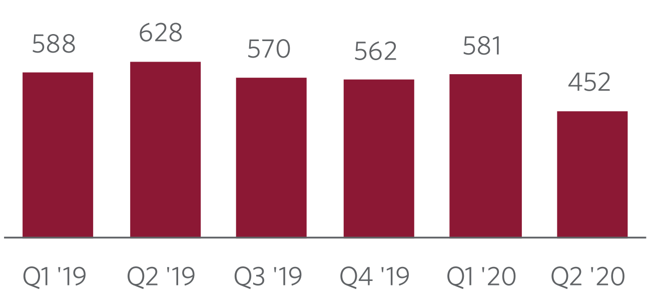
MID-MARKET INVESTMENT BANKING

Fall 2020

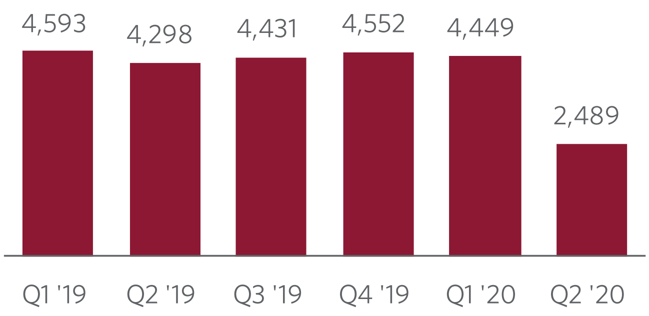
The new normal: is the M&A Market emerging from quarantine?

When North America went into "lockdown" mode to flatten the curve of the spread of the COVID-19 virus, it had a dramatic effect on the M&A market. Most transactions came to a halt, at least temporarily, while management teams, lenders, and equity investors all tried to assess the short and longer-term impact of the virus. This was evidenced by an approximately 60% drop in M&A deal volumes in April, as compared to the same period a year earlier. Activity started to rebound slightly through the remainder of Q2 as buyers and sellers began to emerge from lockdown, with U.S. M&A transaction volume down 42% over the previous year, and Canadian M&A transactions down 28%. We experienced similar dynamics in our transactions, with 75% of active transactions being put on hold in March. Since that time, approximately half of those transactions on hold have re-started.

Canadian transaction count (Q1-19 to Q2-20)



U.S. transaction count (Q1-19 to Q2-20)



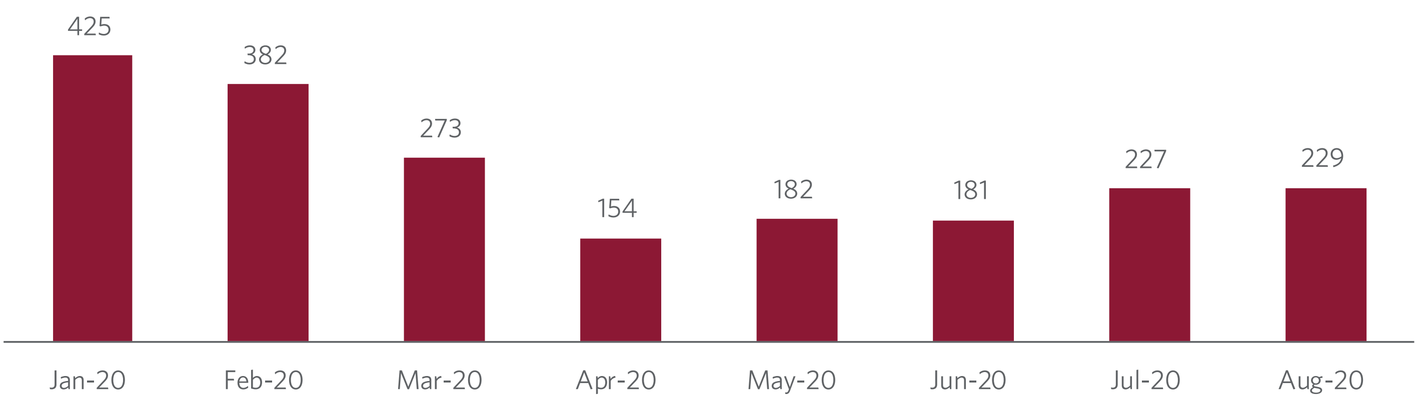
Source: Capital IQ.

The transactions completed in Q2 were largely well-advanced in the M&A process prior to the onset of the pandemic. Going into the second half of 2020, there remains a backlog of transactions at various stages of negotiation that have experienced slowed or halted progress as a result of the uncertainties. We expect these to continue to be completed as we move through the remainder of 2020.

Overall market sentiment in the private company M&A market has improved significantly from March and April. Strategic buyers and Private Equity investors alike have emerged from a head down, value preservation mode to an openness to look at new opportunities, and creative approaches to deal process and structure provide new ways to get M&A deals done in this environment.

We expect that deal volumes will continue to rebound in H2 2020, although they are unlikely to reach historical levels in the near term. Activity will be driven by the continued churn through the pipeline of stalled transactions along with new deal activity primarily in targeted sectors. This trend is clearly on display when we look at North American Private Equity deal activity on a monthly basis in 2020 deal volumes bottomed out in April, and have experienced a steady rebound since.

North American Private Equity transactions



Source: Capital IQ.

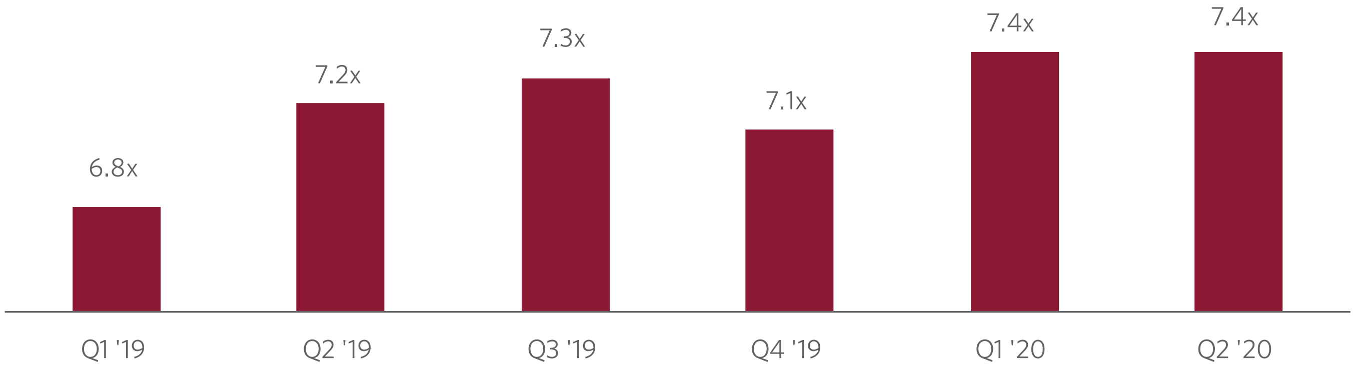
Uncertainty surrounding the timing of the economic recovery coming out of COVID-19, the expiration of government assistance programs to business and the consumer, the impact of a second wave, border restrictions, and expected future performance of companies will continue to impact private company M&A volume in the near term. We expect the recovery to historical norms in terms of volume to take some time, as there will be a lag in closing newly marketed transactions coming out of the Q2 quarantine.

That said, demographics underpin the Canadian private company M&A market, with the decision to transact often based more on personal circumstances than pure economic drivers. A CFIB survey completed in late 2018 indicated that 72% of business owners intended to exit their business over the next decade. So while the pandemic has had a short-term impact on the market, it has also created pent-up demand amongst private business owners seeking to exit when the timing is right. The good news for private business owners is that capital is available and a willingness to transact remains from Private Equity and strategic buyers for quality opportunities.

How has the pandemic impacted valuations?

So, what types of transactions are getting done and are valuations lower? The first thought of many business owners we speak to, is it must be only those desperate to sell that are still transacting in these uncertain times as buyers must be looking for bargains. In fact, that is not the case. Valuations for North American mid-market private company transactions remained consistent in Q2 at an average of 7.4x TEV/EBITDA, and represent elevated metrics compared to historical levels. This suggests that the numbers reflect a survivorship bias in the short-term valuation observations; companies whose financial performance were less affected were more likely to continue on with a transaction already in progress. Those that were forced to shut down for extended periods or that have seen a negative impact have chosen to put a transaction on hold for the time being.

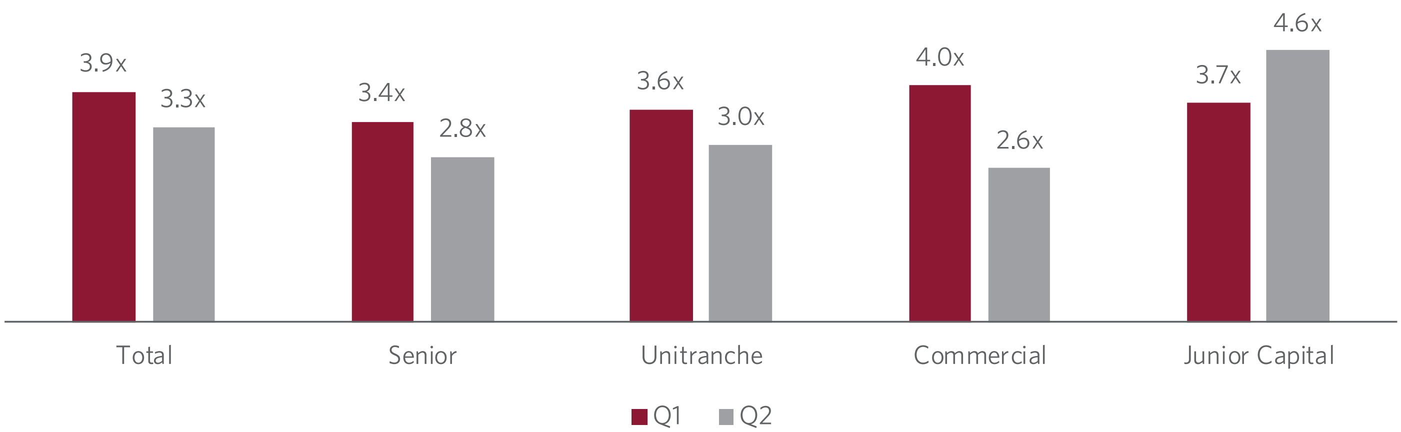
Private company average TEV / EBITDA multiples – Last six quarters



Source: GF Data.

There will continue to be volatility in M&A valuations as the economic impact continues to evolve over time. Lender appetite for new transactions has been negatively impacted, both in terms of lower leverage levels and increased pricing, which will impact equity returns for investors, putting pressure on short term valuations. This, combined with uncertainty surrounding the economic recovery coming out of this pandemic, are expected to temper short term valuations.

North American leverage levels – Q1 and Q1 2020



Source: GF Data.

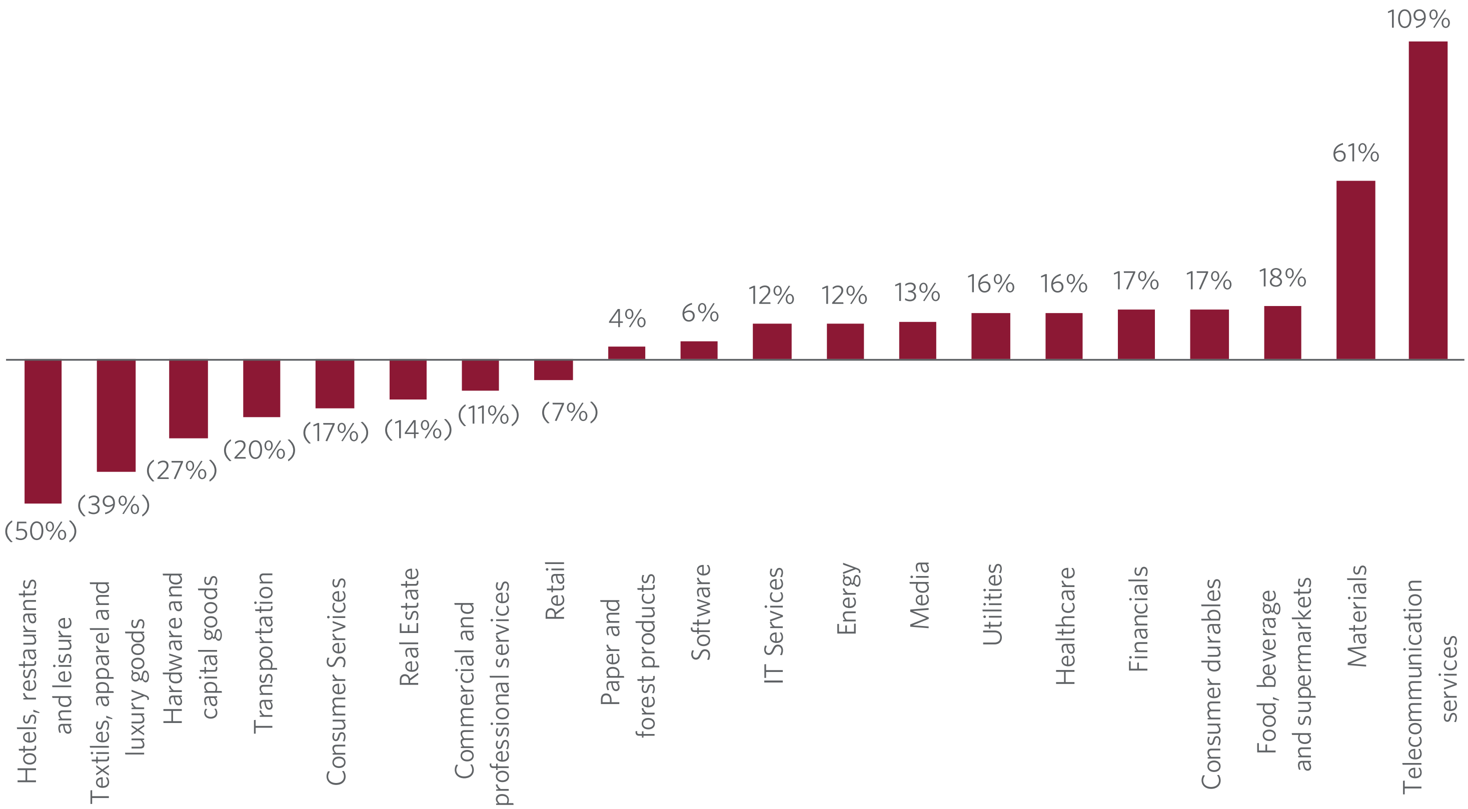
In our view, however; a window of opportunity exists for business owners whose companies have fared well over the past six months and are considering a liquidity event. Private equity remains very well funded, with approximately US$1 trillion in dry powder to deploy, and a relative dearth of high-quality new opportunities in the market. Thus, it is our belief competition will drive attractive values for well performing companies in the near term.

The “haves”, the “have-nots”, and the “rest”

The COVID-19 pandemic has not treated all sectors and companies equally. It has left devastation in its wake amongst the hardest hit sectors such as hospitality and travel, while it has created opportunities in other sectors such as telecom, technology, e-commerce and food processing. Companies in sectors that have been resilient through this period, and companies that have differentiated themselves through innovative strategies to pivot quickly in response to a rapidly changing environment will find themselves to be attractive targets to private capital in a time where there are less high quality opportunities available. There are several company specific attributes that have gained importance to buyers, some of which include supply chain security, technology enabled workforce and delivery of services, and the ability to scale operations quickly in response to changing conditions and regulations.

M&A activity in Q2 relative to a year prior mirrored the thesis that more than ever, activity levels are sector specific based on the ability to thrive in a post-COVID environment. Sectors in the "haves" category such as telecom, food and healthcare have seen a significant increase in share in overall M&A activity, while on the opposite end of the spectrum, hospitality and travel have experienced a sharp decline in deal activity. We expect this trend to continue in the short to medium term, until the effects of the pandemic stabilize.

YoY change in sector volume as a % of total M&A - Q2 2020



Source: Capital IQ.

Where there's a will, there's a way: evolving deal process & structures

Perhaps the biggest impacts on the private company M&A environment have been on deal process and deal structures. Private capital investors, buyers, sellers and advisors have all been forced to get creative in order to get transactions completed, and on terms all parties are willing to accept in an environment of safety for employees, restricted movements and a closed Canada-U.S. border.

Deal process

Now, more than ever, properly preparing and positioning the financial results of a company are key to a successful deal process. Often, when we speak of valuations, we focus on the multiples of EBITDA being paid for businesses; however, equally or more important is what EBITDA the multiple is being applied to. The new M&A buzzword is "EBITDAC", or Earnings before Interest, Depreciation, Amortization, and COVID Impact. There are many approaches for normalizing the impact of COVID when positioning a business as part of an M&A process, and it is important that the methodology makes sense in the context of the industry and the individual company performance and response. Working closely with an advisor in order to properly position the business and have a defendable rationale for any normalizations is key to delivering value in an M&A process.

In person management meetings and site tours have been an integral part of the traditional M&A process. Corporate travel restrictions and the closure of the U.S.-Canada border to non-essential travel have forced M&A professionals to continue to innovate the deal process. We have seen a number of private investors, particularly in the technology sector, get comfortable closing a transaction without in person management meetings, differentiating themselves in a competitive investment environment. In more traditional industries, virtual site tours and zoom management meetings have provided a useful stop-gap solution until travel restrictions loosen. We have also seen buyers rely on local service providers for more technical due diligence, such as inventory counts, environmental audits, or appraisal activity. Again, being prepared and agile in order to adapt to quickly changing circumstances is an important key to successful transactions in today's environment.

Deal structures

Transaction structures are really about sharing risk between buyer and seller in order to find deal terms that work for both sides. We are dealing with unprecedented times, and with that comes heightened awareness of risks by buyers in the M&A market. Finding ways to bridge the gap in terms of value and risk appetite of buyers and sellers is critically important to successful deals in such an environment.

We expect to see tools such as earn-outs, vendor equity roll-over, and vendor financing being used more often to share risks in transactions. We have seen earn-outs, or consideration contingent on future performance, increasingly used to bridge a gap in value expectations. In our experience, we have seen earn-outs increase as a percentage of the total deal value in recessionary economic times, such as the 2008/09 financial crisis, and expect this trend to repeat itself. In the case of private equity led transactions, vendor equity roll-over is also expected to increase as a percentage of transaction value, allowing the private equity buyer to de-risk the transaction upfront and the vendor to share in the future upside of the business. At the smaller end of the mid-market, an increased use of vendor financing is expected as lenders at that end of the market are expected to be more cautious lending to M&A transactions.

For private business owners today, there are more variables than ever that will determine whether an M&A process is successful. Proper preparation, timing of the process, positioning the impacts of the pandemic, and being creative in response to process challenges and deal structures are all elements that need to be considered. Now, more than ever, having an experienced, capable advisor to navigate the process with you is key to a successful outcome.

About us

CIBC Mid-Market Investment Banking is a leading M&A advisor, providing services to private companies:

- Divestitures
- Acquisitions and management buyouts
- Raising equity capital and securing debt financing

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