Middle Market Commentary – May 2021

Middle market merger and acquisition (M&A) deal activity began picking up steam in late 2020 after an unnerving period of broad market interruption brought on by COVID-related economic shutdowns. Since March, investment bankers had been monitoring the performance of their sell-side clients to assess in real time the impact of those conditions on companies' performance and marketability. While certain industries remained depressed, primarily those related to travel and hospitality, the prospect of vaccine rollouts, approval of a second fiscal package and a soaring stock market combined to reignite market activity by the end of 2020. For companies that shrugged off the effects of the coronavirus or had established a new baseline of activity, the buyer universe was increasingly undeterred by high unemployment rates, new COVID variants and the pandemic's substantial economic impact on small businesses. The Q4 '20 result was a rebound in deal volume, rising valuations, greater availability of debt, and (surprisingly) a decrease in utilization of representation & warranty insurance (RWI).

Year-End 2020 Transaction Environment

Tracing the pace of middle market M&A activity across the entirety of 2020 reveals a buyer universe eager to resume closing deals. The first quarters of 2019 and 2020 saw the exact same number of reported transactions for companies with enterprise values between $10 – $250 million, per GF Data's February 2021 M&A Report, despite postponements of closings beginning in early March 2020. Activity in Q2 '20 was off nearly 60% from the prior year period, which in retrospect was not as severe as subjective observation at the time would suggest. Given the timing, those Q2 '20 deals that did manage to close were with companies already under letter of intent and able to demonstrate continued performance through the teeth of waves of COVID shutdowns or where buyers and sellers were able to arrive at creative structuring solutions.

The third quarter witnessed small signs of recovery as an increasing number of businesses were able to prove their financial resilience, increasing by 50% over Q2 '20 (admittedly from a small number) but still down more than 15% from Q2 '19. Meanwhile, Q4 '20 posted an explosion of activity driven by pent-up buyer demand and the continued return of sellers to the market. The Q4 '20 deal volume within GF Data's $10 – $250 million valuation cohort was greater than that of the second and third quarters combined, and up a whopping 63% over the prior year period. This late-year surge pushed total 2020 closings close to a 2019 figure that had been established under Goldilocks conditions, falling just short at 297 versus 308.

Valuations likewise rebounded in Q4 '20 to 7.0x Adjusted TTM EBITDA after a small downtick in Q3 '20 (6.7x). Q4 '20 figures were slightly lower than a recent pre-COVID range of 7.1x – 7.4x, but anecdotal feedback from the marketplace is that by year-end, winning bid values were up substantially. Contributing factors included the lingering scarcity of quality companies, pent-up demand from private equity groups that had been largely locked out of the market for half the year, and strategic buyers experiencing record stock prices. The "size premium" (spread in valuation multiples on deals completed between $10 – $50 million and $50 – $250 million) was 2.1x, consistent with the historical average. Companies valued in the $10 – $50 million range sold in Q4 '20 at an average of 6.3x EBITDA versus 6.4x for 2019, while those in the $50 – $250 million range commanded an average of 8.4x EBITDA (8.2x for 2019). This sizeable gap persisted for the typical reasons of perceived safety, lack of customer concentration, and access to capital. The Q4 '20 valuation premium paid for companies exhibiting superior financial performance relative to their peers was nearly double the long-term average at an unprecedented 27%. This flight to quality is entirely unsurprising under the circumstances, and spreads may continue to widen in the near term.

Recoveries in middle market companies look different by sector. Approximately 80% of the transactions in the GF Database involve target firms in four industry groups, most of which have fared well during pandemic. These industries and the Q4 '20 average multiple for each are manufacturing (6.7x), business services (7.1x), healthcare services (7.9x), and distribution (7.7x). Investors will continue to favor businesses in non-cyclical industries with minimal disruption due to COVID. Furthermore, many businesses within these industries were deemed "essential" during the pandemic and have thus established track records that are reassuring to the market.

The use of RWI policies continues to permeate the lower middle market. While utilization for full-year 2020 was down very slightly from 2019 levels, more than 50% of transactions reported to GF Data utilized the tool. The decline was likely due to a rush of year-end closings that clogged underwriting processes rather than a lack of market interest, and practitioners expect a reversal in 2021. Likewise, underwriter comfort with RWI policies for smaller deals continued to improve. Indemnification caps increased across all deal valuation cohorts with no appreciable change in premiums.

The Lending Environment

Lending institutions largely spent Q2 '20 and Q3 '20 monitoring and quantifying their borrowers' COVID-related exposures. Most were highly patient with affected companies rather than forcing action that could compound already dire situations. M&A transactions involving the use of leverage were typically funded during this period by non-bank lenders. Most banks began signaling renewed appetite for new loan origination in the fourth quarter on increasing comfort with the stability of existing portfolios. This cautious optimism is supported by the economic effects of vaccine rollouts, the second government stimulus package and signals from the Federal Reserve that the current easing will persist well into 2022. Leveraged loan defaults peaked at 4.17% in September 2020 (Source: S&P Global Market Intelligence), settling at 3.83% by year-end and an estimated 3.15% at the time of this publication. Defaults are projected to remain above the 10-year pre-COVID range of 1.0 – 2.0% for the next year or so but should be concentrated among specifically impacted industries. Availability of credit has created a feedback loop with M&A activity, increasing the pace of dealmaking and thus the demand for additional borrowing.

As valuations rose back to pre-pandemic levels in Q4 '20, so did average total debt (3.8x), bringing it close to the pre-COVID range (3.9x – 4.1x). Commercial banks also regained their footing with average senior debt increasing from 2.7x in Q3 '20 to 3.2x in Q4 '20. Consequently, subordinated debt providers saw their slice of the average capital structure shrink from an outsized 14.4% in Q3 '20 to 8.5% in Q4 '20. They did, however, contribute 0.6x of leverage to the average buyout, a slight increase from previous quarters. Average equity share rose slightly from 51.7% in Q3 '20 to 53.7% in Q4 '20, remaining relatively flat compared to the spike in Q2 '20 (61.4%) when buyers were often required to over-equitize deals. Markets anticipate an increase in demand for refinancings among companies involved in equity-heavy 2020 buyouts.

Middle Market Outlook

Looking forward, there is no reason to anticipate any reduction in buyer demand. Private equity groups and lenders have triaged their portfolios and actively turned their attention back to new deal sourcing. Strategic buyers are experiencing near-daily records in public market valuations and in many cases are emerging from the pandemic with balance sheets stronger than at the onset. Buyers have largely demonstrated willingness to underwrite COVID-related adjustments to EBITDA or to evaluate companies on a current run-rate basis rather than the typical reliance upon trailing 12-month performance. Those unwilling to be creative in their analyses are likely to be shut out of competitive processes for the foreseeable future. A likely lingering effect is the evaluation of domestic political risk on a state-by-state basis. Companies located in states that have demonstrated a preference for more heavy-handed lockdowns will be viewed as riskier locations for investment, at least until the longer-term public health effects of COVID variances can be weighed against the benefits of vaccination and herd immunity. The ongoing migration of businesses and talent to states such as Texas and Florida is likely to accelerate, creating middle market opportunities specific to certain regions and industries.

In many cases, private company sellers have been motivated to action by the experiences of 2020. After several years of healthy growth, the year served as a stark reminder that risk is ever-present and typically manifests in unexpected ways. For owners considering liquidity events, achieving a certain dollar reserve price may be more important than absolute maximization of a valuation multiple. The likelihood of a federal capital gains rate increase in 2022 is also a catalyst to owners focused foremost upon after-tax cash proceeds from a sale.

Availability of financing should continue to improve as well. The lending data shows signs of normalizing across credit markets, with lenders gradually becoming less risk averse on borrower earnings stabilization and outlook. The competition for loan originations with high quality businesses continues to be fierce, particularly for borrowers with consistent performance throughout the pandemic, visibility into future performance, balance sheets with considerable assets and/or a business model with high cash flow conversion. Banks, like private equity groups, currently have substantial capital to deploy and are susceptible to the same competitive environment featuring more supply than demand. Quality borrowers are thus more likely to obtain loan pricing and terms that are in line with pre-pandemic levels.

Economic growth and M&A activity in 2021 will depend heavily on several variables: the speed and effectiveness of vaccine rollouts; potential tax policy changes; continued availability of debt; quantity of quality deal opportunities; and seller expectations. Deal flow is expected to remain strong in sectors that have become increasingly important since the onset of the pandemic, most notably those providing critical communications infrastructure and systems maintenance and repair; equipment, services and technologies that support physical distribution; consumer/residential products and services; and automotive, among others. GulfStar continues to actively represent middle market businesses in consumer products & services; energy, power & infrastructure; healthcare; industrial & manufacturing; software, technology & IT services; specialty distribution; business services; environmental & sustainability and more.