GulfStar Group
Investment Bankers

Middle Market Commentary – First Half 2021

Middle market merger and acquisition (M&A) deal activity made a sizeable comeback in 1H 2021. The frenetic pace of dealmaking is being driven by continued economic recovery, even in the face of the Delta variant of COVID-19, strong demand from buyers of all types with ample dry powder to invest, buoyant public market valuations, the return of inexpensive debt, and sellers motivated by the possibility of capital gains tax rate increases. The Q2 2021 data for lower middle market deals (<$250 million total enterprise value) indicates that deal volume, valuations and use of leverage have all returned to pre-pandemic levels (Source: GF Data's August 2021 M&A and Leverage Reports).

Middle Market Transaction Environment

The runaway deal flow numbers posted in Q2 2021 are largely attributable to activity in the middle market, per Pitchbook's recent U.S. PE Breakdown Report, and primarily deals under $500 million. Those transactions accounted for 64.8% of overall private equity deal count in the first half of 2021. If that momentum persists, the percentage of middle market deals completed in 2021 would represent the highest annual proportion on record. GF Data's M&A Report tracked a similar increase in middle market transactions for companies with enterprise values between $10 - $250 million (81 in Q2 2021 versus 36 in Q2 2020), a pace more consistent with the same periods in 2018 and 2019.

Average valuation in the sub-$250 million deal cohort rebounded in Q2 2021 to 7.2x EBITDA after hovering around 6.6x - 6.9x for the past three quarters. The typical impact on valuation of company size, industry of operation and financial performance relative to peers was magnified in the first half.

All Transactions	1Q 20	2Q 20	3Q 20	4Q 20	1Q 21	2Q21
# of Deals	95	36	59	131	95	81
TEV/EBITDA	7.3x	7.3x	6.6x	6.9x	6.9x	7.2x
Total Debt/EBITDA	3.9x	3.3x	3.7x	3.7x	3.9x	3.7x
Senior Debt/EBITDA	3.5x	2.7x	2.7x	3.1x	3.6x	2.9x

GF SOURCE: GF DATA®

Not surprisingly, quality businesses that proved the most resilient during the COVID-19 recession continued to command higher multiples. In Q2 2021, this quality premium (as quantified by GF Data) was nearly double the long-term average at an unprecedented 33% difference in enterprise value multiple. The percentage of deals involving these high performers was also considerably higher this quarter (62% versus the long-term average of 56%), a sign that quality deal flow is returning more broadly to the market.

Investors likewise continue to pursue businesses in less-cyclical industries with minimal or temporary disruption from COVID-19. The Q2-Q3 2020 effects of the pandemic on any given company's performance is now distant enough history that buyers can assess its near-term trajectory as well as underwrite a downside case in the event continued variants of the virus emerge. Predictably, sellers in the technology (8.2x) and distribution (7.6x) industries fared best for the quarter. A more telling comparison between YTD 2021 and pre-pandemic 2019 indicates renewed private equity interest in manufacturing and distribution/logistics.

Meanwhile the size premium (as defined by the spread in multiples across $10 - $50 million and $50 - $250 million enterprise value cohorts) was largely consistent with the historical average at approximately 2.1x EBITDA (8.5x versus 6.4x). For the time being, the industry in which a company operates, and its specific financial performance, are of greater influence than differences in company size.

The pursuit of strategic advantage is becoming a determining force in many acquisitions and divestitures. Businesses across all industries are acquiring new digital capabilities, reorganizing supply chains and modifying work functions to achieve competitive advantages in the post-pandemic world. Bids increasingly reflect a buyer's confidence in its ability to contribute to these transformations.

The combination of a highly competitive market and buyers seeking opportunities to leverage such strategic advantages is

Middle Market Commentary – First Half 2021

manifesting itself in greater self-selectivity. Increasing industry specialization is seemingly driving a greater proportion of passes on marketed transactions, likely under the assumption that there are other groups possessing deeper industry or operating knowledge that will permit them to outbid more generalist investors. A highly non-scientific survey of recent processes at GulfStar indicates that lack of ever-elusive "angle" is the reason for 25% or more of pass decisions. The situation is exacerbated by the massive amount of current deal volume, requiring buyers to make quicker decisions about time and resource allocation.

Combined with the "quick no" philosophy, private equity groups increasingly appear to forego submitting indicative bids under the preemptive assumption that they will not be competitive (or if they are, it is because there is a flaw they do not recognize). In GulfStar's experience, uptake on signing NDAs and reviewing transaction materials has increased in 2021, while conversion to indications of interest has lagged. This trend is compounded by owner concerns over a capital gains tax increase in 2022 that has introduced even greater urgency than normal for year-end closings. This crush of activity is straining buyer resources for processing new opportunities and likely contributing to selectivity.

The Lending Environment

Availability and terms of transaction financing seem to have normalized across credit markets with Q2 2021 total average leverage of 3.7x returning to pre-pandemic levels (Source: GF Data's August 2021 Leverage Report). Senior debt settled a bit to 2.9x from 3.6x in Q1 2021, which had been in line with Q1 2020 senior leverage prior to the widespread impact of COVID-19. After being squeezed in late 2021, subordinated debt providers returned to their normal role in the buyout capital structure with an average 0.8x leverage contribution. Record-low LIBOR base rates and tightening spreads pushed all-in senior debt pricing to its lowest since 2015.

After being shut out for much of Q2 and Q3 2020, banks are aggressively seeking to backfill origination of new loans. This will likely result in greater competition for non-bank debt funds given traditional lenders' substantial cost of capital advantage. While it is possible banks may see an uptick in restructuring or distressed M&A as borrowers suffering long haul effects of COVID-19 become evident and government support is phased out, surprisingly, not much of this activity has resulted from the pandemic thus far.

Middle Market Outlook

Thankfully, 2021 is shaping up to be a record-setting year for middle market M&A activity. The feverish pace for private equity groups and lenders alike will almost certainly continue unabated through year-end ahead of the risk of capital gains tax increases. Private equity investors have triaged the effects of COVID-19 on companies in their existing portfolios, returned attention to the market, and implemented new strategies to differentiate themselves. Strategic buyers, meanwhile, are sitting on record amounts of cash. Public and private companies alike are feeling good about their own valuations and becoming substantially more aggressive spending cash and stock on acquisitions. Even the long-dormant energy market is showing signs of life on a combination of favorable commodity prices; emergence of Environmental, Social, and Governance (ESG) as a key operating consideration; and the ongoing electrification of the United States economy. GulfStar continues to represent middle market businesses in consumer products and services; energy, power and infrastructure; healthcare; industrial and manufacturing; software, technology and IT services; specialty distribution; business services; environmental and sustainability and more.

About GF Data® – This commentary and all associated charts cover middle market deals completed through June 30, 2021. The key lower middle market information source, GF Data, provides quarterly reports covering M&A, leverage activity and key deal terms. GF Data collected data from 243 active private equity groups on 81 transactions completed in the $10 - $250 million value range in Q2 2021 and adjusted EBITDA 3.0x -– 15.0x. GulfStar actively monitors valuation metrics to provide business owners and clients with a current view of market conditions and their transaction options.