GulfStar Group

Investment Bankers

Middle Market Commentary – June 2020

The year 2020 started off promising but quickly morphed into a path of grave uncertainty as a global pandemic, economic crisis and tense political climate ensued. According to GF Data, the first quarter of 2020 was active, with two-plus months of normal activity prior to the onset of COVID-19 in early March. The favorable economic and financial market conditions that most merger and acquisition (M&A) practitioners enjoyed during a nearly 10-year expansion, came to an abrupt halt. The aftermath of the economic shutdown is still ongoing as companies struggle to stay afloat, keep workers employed and determine how to survive this new normal of social distancing. Certain pandemic-proof businesses have fared better than others, but many are struggling to survive the financial losses. Post-pandemic conversations with private equity groups revealed a new willingness to invest flexible capital for balance sheet repairs given the current situation. Buyers and sellers recognize that valuations will not be as competitive as previous years, so many deals have been placed on hold indefinitely. The long-lived seller's market is now marked with an abundance of caution, as business owners assess the damage and navigate through a difficult recovery period.

2020 Transaction Environment

Though M&A activity for Q1 2020 was active, it is now overshadowed by the tumultuous black swan event that hit towards the end of the first quarter. Valuation multiples and deal sizes remained elevated in Q1 2020. Most noticeable was the jump in the multiple differentials between smaller deals valued at \$10 – \$25 million (5.7x) and those at \$100 – \$250 million (9.6x). Demand for quality companies with \$10 million or more of EBITDA saw rewards both for their size and favorable pricing considerations, while sellers at \$10 – \$25 million also saw favorable conditions extended to them with a 0.7x increase in valuation. Overall, 62 deals with valuations between \$10 - \$250 million were reported closed in Q1 2020 with aggregate pricing in the 7.1x – 7.4x range, and total debt stayed at around 4.0x.

The impact of government-mandated lockdowns varied widely across industries. The benefits to technology and electronic commerce businesses are obvious and have been well-documented. Industry segments that one would expect to benefit, such as healthcare providers and equipment suppliers, suffered, as elective visits and procedures were abruptly canceled. Hospitals and doctors' offices were cleared to ensure capacity should COVID-19 cases spike. The outlook for other industries is much less clear. For instance, brick and mortar retailers lacking a robust online presence prior to the shutdowns likely face greater long-term challenges than ever before. Comfort with online shopping, even for large-ticket items, increased substantially as retailers offered simple and inexpensive return policies and free or subsidized shipping. Retailers that are currently reopening their doors are in some cases experiencing favorable year-over-year same store sales comps, but it is unclear if this pent-up demand after months of forced separation is a bankable trend. Buyers and lenders are almost certain to remain skeptical until longer-term patterns can be evaluated. Fortunately, most deal practitioners anticipate a gradual but full return to normalcy. Transactions involving distressed situations will offset a portion of this volume in the interim, but owners and lenders have been slow to act on these situations due to the perceived temporary nature of the crisis.

Buyers are signaling willingness to underwrite COVID-19 adjustments on a case-by-case basis. Private equity groups continue to command record levels of uninvested limited partner commitments and recognize that waiting for clean trailing 12-month financial statements is untenable, as it would sideline them into at least the fall of 2021. It will therefore be incumbent upon companies and their advisors to develop defensible quantitative analyses of the pandemic's impact, supported by a demonstrated recovery of revenue and profitability. Quality of earnings consultants are contributing to this effort by proactively compiling lists of income statement and balance sheet accounts that reasonably qualify for such adjustments.

Discussions with private equity buyers suggest that valuation multiples applied to "EBITDAC" will be lower in most cases, though there will likely be scarcity value in those companies that demonstrated resilience. Valuations among this cohort may thus actually experience upwards pressure. Regardless of how companies have been impacted, buyers are almost certain to require proof of perseverance or recovery prior to making bid determinations. Structures such as earnouts and contingent seller notes are likely to see a resurgence to bridge gaps in expectations.

Other common trends have emerged as well. In order to put money to work, many private equity groups that historically focused solely upon control recapitalizations or buyouts are flexing their mandates to provide support capital or partial liquidity via structured equity and mezzanine investments. The same is true of first-time forays into special situations investing. In all cases, conservatism in the capital structure is necessary to ensure adequate liquidity as companies recover or grow. Customer and vendor due diligence has taken on greater importance as buyers look through supply chains and into end markets to evaluate the financial health of a company's counterparties. Most management meetings are now hosted virtually, and some sellers have come up with creative solutions such as conducting facility tours using drone-mounted cameras.

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Certain buyers report a willingness to close transactions entirely virtually, without meeting ownership and management in person. A widespread expectation is a greater permanent acceptance of videoconferencing as a substitute for personal meetings.

The Lending Environment

During the first two calm months of Q1 2020, GF Data reports that total debt levels remained at 3.9x while the average senior debt multiple rose from 3.3x to 3.5x. Average equity share has remained fairly consistent at 53%, and subordinated debt providers continued to contribute 0.7x of leverage.

While a supportive lending environment continued to fuel buyout activity in Q1 2020, the pace of lending for deals slowed in early March as risks increased and traditional banks quickly shifted their focus to deploying Paycheck Protection Program loans and assessing the liquidity needs of their existing credits to weather the current situation. GulfStar's discussions with lenders have seen mixed reactions on the willingness to deploy new capital, which seem to be directly correlated to the performance of their underlying credits. While traditional banks' cost of capital has decreased significantly across the board, those who used a conservative approach to capital structure prior to the pandemic are stressing the willingness to look at new opportunities, while many who were more aggressive in prior transactions are not lending into new situations and have shifted their focus to deteriorating conditions and liquidity needs of their existing credits.

A consistent theme from discussions with traditional banks is a shift of focus to the balance sheet and lower-risk asset-backed structures, which could make cash flow loans more challenging in the near-term. For years prior to the pandemic, non-bank, unitranche, and mezzanine lenders competed aggressively with traditional banks to lend into quality situations, making it difficult to deploy as much capital as they desired. It is likely that a combination of these lenders will bridge the gap in situations that traditional lenders may now be avoiding. While this gap may be bridged, discussions with lenders across the spectrum suggests that pricing spreads will likely increase by 1.0% – 3.0% with a reimplementation of pricing floors, and total leverage will likely decrease by 0.5x – 1.0x EBITDA to accommodate for the more uncertain nature of the world ahead.

While some traditional banks may be temporarily sidelined, there remains a tremendous amount of debt capital that needs to be invested and lenders across the board have become accustomed to finding opportunities to deploy capital even during difficult economic times. Adequate equity contribution to a transaction (cash is king) and borrower-specific evaluation of debt service capabilities should enable access to financing for healthy businesses.

Representation & Warranty Insurance

Representation & Warranty Insurance (RWI) is evolving as a result of COVID-19 and will start to include COVID-19 losses (including an exclusion for losses in supply chain) and require more due diligence to provide coverage. A seller that needs an exit plan in next few years may need to make concessions with these new indemnifications. Deal protection will now include a Material Adverse Effect clause that incorporates a pandemic. RWI is expected to be constructive with respect to distressed M&A activity, where speed of execution and isolation of risk are fundamental to successful closings.

Middle Market Outlook

No one knows exactly when the economy will recover and if the bull market will resume; however, it is clear that the economic fallout from COVID-19 will touch every business and sector. Social distancing protocols will reshape how businesses operate. Products and services will adapt to shifting attitudes and consumer demands. A resurgence of bankruptcies or restructurings will likely occur. Virtual deals may become the wave of the future. As the "new normal" is established, business owners will take a cautious approach to selling their businesses and may decide to wait until there's more market certainty. Others who had delayed a sale under the impression that revenue growth and the seller's market would continue indefinitely will be compelled to initiate processes as their businesses stabilize. On a positive note, debt remains readily available at favorable rates for healthy companies, private equity capital is plentiful and strategic buyers are willing to invest in companies with a strong track record despite losses suffered from the pandemic. Now everyone finally knows how this perpetual boom market comes to an end, but businesses will recover and trusted advisors like GulfStar will be there to help clients navigate through these uncertain times and prosper once again.

About GF Data® – GF Data provides data on private equity sponsored M&A transactions with enterprise values of $10 to $250 million. GF Data gives private equity firms and other users more reliable external information to use in valuing and assessing M&A transactions. GF Data collects transaction information from private equity groups on a blind and confidential basis. Two hundred and fourteen private equity firms have provided information on deals included in this report. Market data is proprietary to GF Data and may not be reprinted, reproduced or used without the permission of GF Data Resources LLC or GulfStar Group.

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