GulfStar Group
Investment Bankers

Middle Market Commentary – September 2020

Middle market merger and acquisition (M&A) deal activity continues cautiously as owners wade through the aftereffects of COVID-19, Paycheck Protection Program (PPP) loans, and the tax implications of an election year. Market data through June provides an unsurprising view of the M&A environment in the months following the onset of the pandemic – flat valuations, dramatic decrease in deal volume, and less available debt. It will likely take another two or three quarters for market data to reflect transactions that would have closed this spring yet went on hold as a result of unfavorable market conditions related to COVID-19. Meanwhile, M&A practitioners continue to monitor client performance on a situational basis as they weigh which deals to bring to market.

1H 2020 Transaction Environment

Overall, M&A activity for Q2 '20 was down significantly (only 31 completed deals compared to 80 in Q1 '20 and Q2 '19, per GF Data's August 2020 M&A and Leverage Report). Valuations remained flat, averaging 7.4x TTM Adjusted EBITDA in Q2 '20 (unchanged from Q1 '20).

Most closed transactions in Q2 '20 were some combination of deals fully vetted by buyers prior to COVID-19; industry sectors with strong performance through the pandemic; sellers with the leverage to resist fierce purchase price re-trading; and buyers willing to employ more equity than previously to close. The market is ascribing scarcity value to businesses that held up despite the obvious headwinds, with ever-increasing amounts of private equity dollars, in particular, now chasing a smaller universe of attractive acquisition candidates. Buyers also appear largely willing to accept COVID-related EBITDA adjustments, provided they are readily quantifiable and the affected periods temporary. Conversations with strategic buyers, however, suggest that many are presently more focused on watching their balance sheets than pursuing near-term acquisition opportunities.

Several scenarios exist for deals pushed out of the market in Q2 '20. Some will close in subsequent periods, with sellers accepting new deal terms or reduced purchase prices. Minority recapitalizations are also becoming more prevalent as private equity groups have pivoted rapidly to these structures in response to substantially reduced control recap deal volume. Business owners formerly considering full or partial sales are understandably hesitant to pursue such transactions at lower valuation points, instead seeking smaller liquidity events while partnering with investors to support growth or opportunistic acquisitions. The rest will unfortunately remain in deal limbo as they wait for revenue and earnings to rebound and general market conditions to improve.

The expected surge in distressed opportunities has yet to emerge, likely in part due to the government's PPP and Main Street Lending Program as well as general patience among the lender community. According to a recent S&P Global article, an analysis of 450 middle market companies showed a jump in leverage covenant breaches in Q2 '20, but only one instance when lenders took ownership of a troubled company. In general, lenders and private equity sponsors have helped sustain the businesses through this challenging period. The impact of PPP loans on M&A closings is still somewhat uncertain. Many banks that facilitated these loans for their customers are not yet processing forgiveness applications, forcing sellers to consider interim alternatives. The most common approach has been to place purchase proceeds in an escrow account in amounts consistent with the loan balance, while some companies elect to simply repay the loan if the amount is minor relative to valuation. Considerations such as selling assets and the termination and rehiring of employees by new legal entities have so far been largely unexplored.

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 Q2 '20 average multiple for each are manufacturing (7.2x), business services (7.2x), healthcare services (7.0x), and distribution (8.5x). According to the Lincoln Middle Market Index, consumer companies continue to rebound in Q2 '20, and healthcare and technology segments recovered nearly all Q1 '20 declines.

The current "size premium" – the spread in valuation multiples on deals completed between $10 – $50 million and $50 – $250 million transactions – is 2.2x, corresponding with the historic average (see chart below).

TOTAL ENTERPRISE VALUE (TEV)/EBITDA

TEV	2003–2015	2016	2017	2018	2019	YTD 2020	Total	N =
10-25	5.6	5.8	6.3	5.9	6.1	5.9	5.7	1399
25-50	6.2	6.4	6.6	6.9	6.9	6.8	6.4	1067
50-100	6.8	7.2	8.2	8.8	7.5	8.3	7.3	728
100-250	7.4	8.8	9.1	8.7	9.4	9.5	8.2	379
Total	6.2	6.7	7.2	7.2	7.1	7.4	6.5	
N =	2361	243	267	288	301	113		3573

Please note that N for 2003-15 encompasses thirteen years of activity. SOURCE: GF DATA®

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Companies valued in the $10 – $50 million range sold in Q2 '20 at an average of 6.7 times EBITDA (6.4x for 2019), while those in the $50 – $250 million range sold at an average of 9.0 times EBITDA (8.3x for 2019), a sizeable gap. Company size is consistently a material factor in valuation, but the flight to quality occurring in the current environment may push spreads even further.

Buyout transactions involving quality premium firms – those with above-average financial performance – constitute more than half (57% historically) of the entire GF database. These quality premium firms exhibit greater EBITDA margins and revenue growth rates than similar size firms in the database. While the average quality premium in the full period (2003 – Q2 '20) has been 13%, it has consistently risen in recent years. In 2016, 2017, 2018 and 2019, quality premium firms sold for multiples that, on average, were 22% greater than other firms with similar EBITDA. The premium recorded in the first half of 2020 was 18%, a decline too modest to suggest any thematic conclusions.

The Lending Environment

While valuations stayed flat in Q2 '20, there was an immediate reduction in the availability of debt due to the uncertainty around deal financing and the treatment of PPP loans and forgiveness in the deal structure. GF Data reports that total debt levels averaged 3.3x, a decrease from the 3.8x – 4.0x range that prevailed from 2017 through Q1 '20. Average senior debt fell from 3.4x to 2.8x, and subordinated debt providers contributed 0.5x of leverage, which is down slightly from 0.7x. Unsurprisingly, average equity share jumped from 48.7% in Q1 '20 to 56.5% in Q2 '20 as buyers contribute more equity to close.

Commercial bank lenders continue to strain to compete with non-bank lenders to deploy debt capital. Average debt provided by commercial banks dropped significantly from 4.0x in Q1 '20 to 2.6x in Q2 '20. In addition, the average debt in unitranche deals has continued to decline, from 3.6x last quarter to 3.0x this quarter. Conversely, average debt involving mezzanine and junior capital providers increased from 3.7x in Q1 '20 to 4.6x in Q2 '20, pointing to the ability of this class of capital providers to provide leverage more easily in uncertain times.

Although much of the lending market tightened considerably in Q2, GulfStar is seeing a significant loosening in Q3. Many of the large money center banks remain on the sidelines with either limited or no lending to new credits. Conversely, regional banks, non-banks, unitranche and mezzanine lenders continue to show a willingness to deploy new capital and remain active. As expected, lenders are approaching deals more conservatively with respect to total leverage and pricing levels have increased in comparison with pre-pandemic levels.

While this more conservative approach is likely to be seen for some time in the broader market, there continues to be a more aggressive view for businesses with consistent performance throughout the pandemic, visibility of future performance and either a balance sheet with considerable assets and/or a business model with high cash flow characteristics. In a recently marketed GulfStar Debt Advisory assignment with a business demonstrating these particular characteristics, GulfStar received multiple term sheets with pre-pandemic pricing, terms, covenants, and flexibility. GulfStar expects this trend to continue for high-quality businesses.

Middle Market Outlook

From the market's current uncertain state, there is little direction to go but up. Most private equity firms and lenders expect recovery by Q2 '21, and in certain pandemic-proof markets, by the end of 2020. There are signs that deal activity is starting to pick up and the upcoming election is motivating many business owners to complete the sale process before 2021. Potential sellers will continue to be categorized in one of three primary ways: unaffected or benefited, temporarily affected, or long-term impaired. Even with the financial shocks of recent events perhaps leaving more owners motivated to sell their companies, it is difficult to expect this phenomenon to offset the overall downdraft. However, pockets of optimism continue to expand, and consensus is that more healthy companies will be arriving at market during the second half of 2020. GulfStar continues to actively represent middle market businesses in energy, power and infrastructure; industrial and manufacturing; specialty distribution; consumer products and services; software, technology and IT services; healthcare; and business services.