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M&A Insights: May 2021

M&A THROUGH A PANDEMIC AND WHAT'S AHEAD IN 2021

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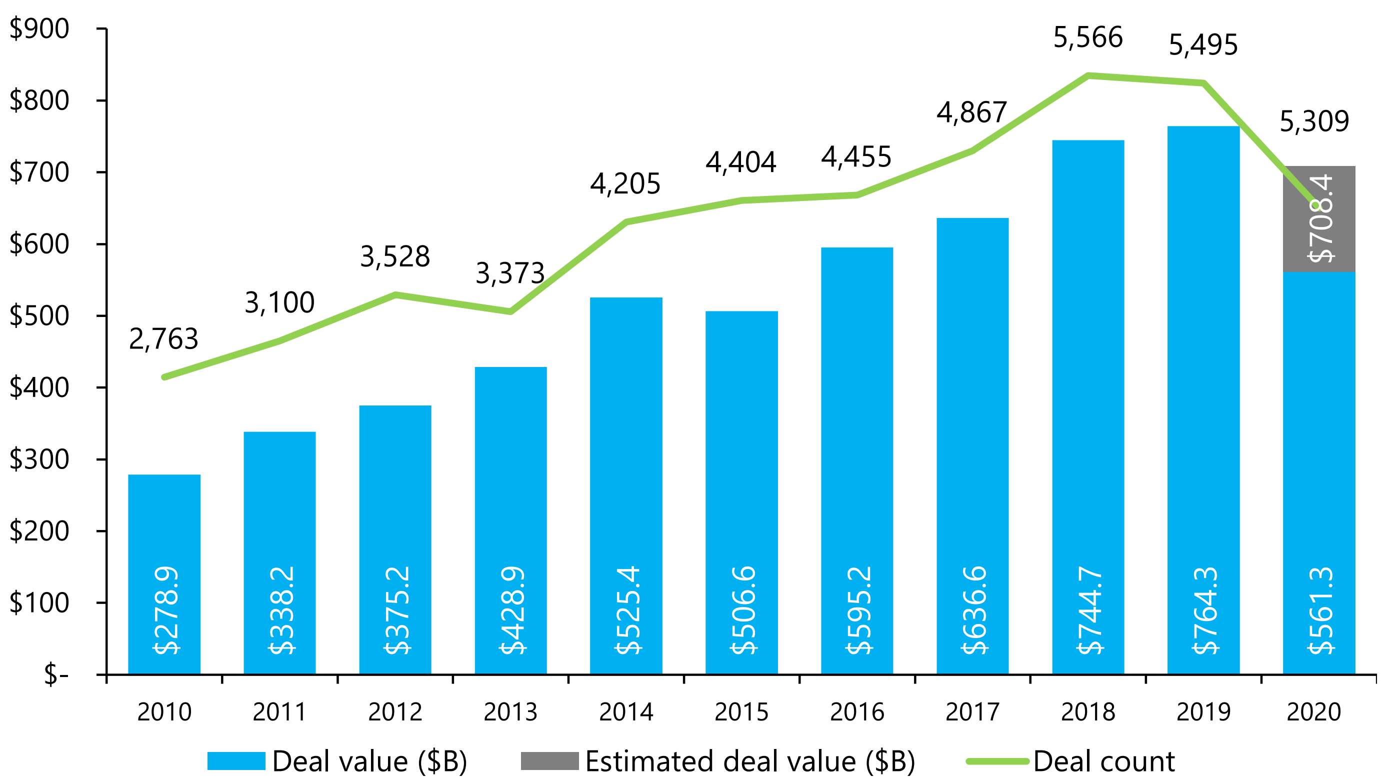
One year ago, none of us could have predicted how the world of M&A would unfold in 2020. Heading into the year, most in the industry were predicting the momentum of the past decade to continue. Aided by nearly 110% growth in Private Equity (PE) and venture related capital, a market full of cash-rich strategic buyers, and debt providers eagerly awaiting to lend, M&A deal volume increased by an average of over 11% annually from 2010 to 2019, with average deal valuations rising 55% over the same period. Life was good, especially for sellers, and after a strong start to 2021, another record year looked to be on the horizon.

Then came COVID, and seemingly overnight, the M&A market effectively shut down. Buyers put deals on hold to better understand the long-term impact of the pandemic and to focus on their existing businesses. Lenders with-drew financing offers for the same reasons. Sellers pulled deals off the market in fear of lower valuations, and deal activity over Q2 dropped to levels not seen in over a decade. By April of 2020, global deal volume declined by approximately 60% compared to just three months earlier.

However, as the collective population learned more about the pandemic, and buyers with large amounts of com-mitted but unallocated capital became more comfortable with their existing portfolios' exposure levels, the M&A market roared back with volumes and valuations in Q3 and Q4 nearing pre-COVID levels. And by the end of the year, the volume of deals was the third highest on record.

US PE DEAL ACTIVITY



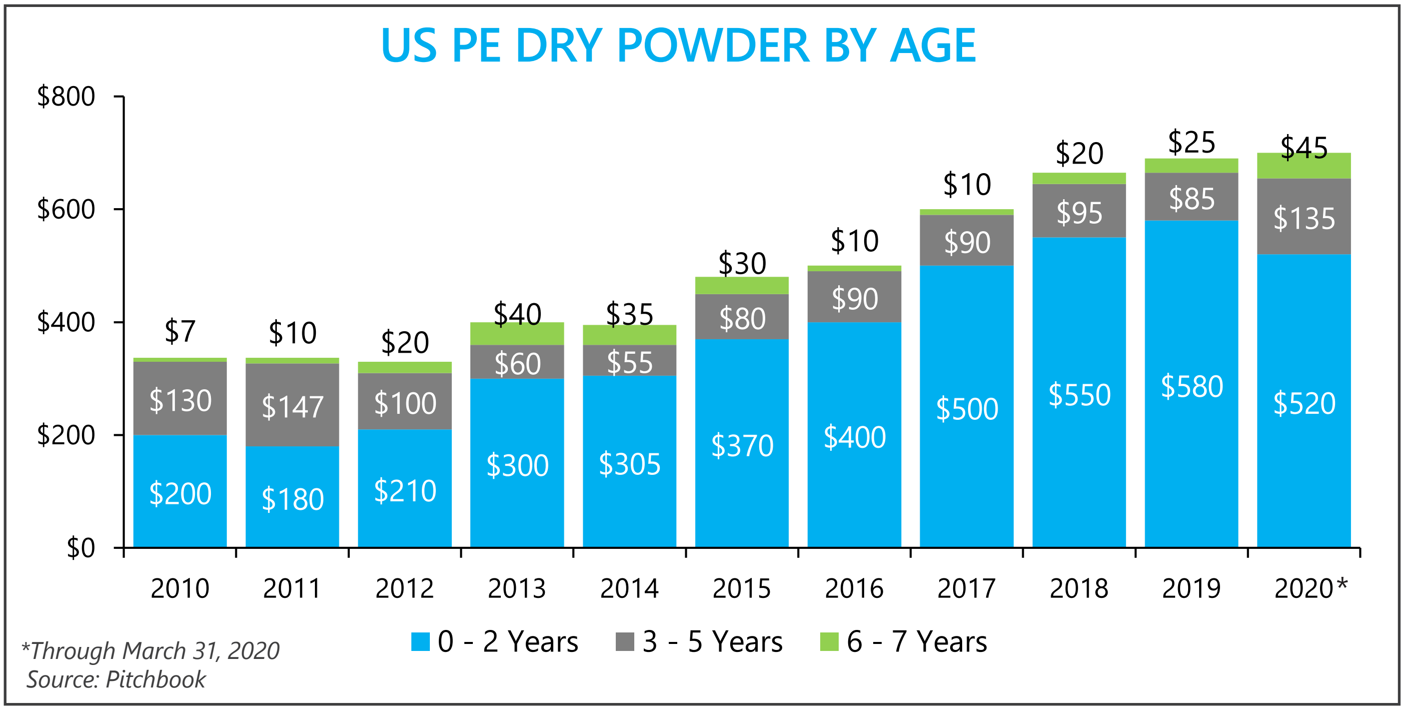
Source: Pitchbook

However, questions remain. How will COVID continue to play out, and what does that mean for businesses? Will the super-charged political atmosphere cool off, and what impact will the newly Democratic majority have on taxes, economic policy, and the overall M&A market? These are just a few of the critical factors poised to drive M&A trends in 2021.

Capital Availability

A primary factor in sustained M&A activity is the availability of capital necessary for buyers to execute transactions. While some might expect the economic impact of the pandemic to have had a negative effect on capital availability, it's quite the opposite.

- **Strategic Buyers:** Many corporations around the globe are sitting on record amounts of cash after intentionally bolstering balance sheets to protect against unforeseen COVID related impacts. According to the Wall Street Journal, cash holdings of nonfinancial companies in the S&P 500 was at a record $2.1 trillion as of June 30, 2020, up more than 30% year over year, and higher than the previous 2017 peak of $2.0 trillion.
- **PE Buyers:** As of March 31, 2020, Pitchbook reported US PE committed but unallocated capital of $700 billion, up $10 billion from the end of 2019. And while immediately following the pandemic many PE firms shifted focus from deploying new capital to shoring up their existing portfolios, priorities are shifting again. In fact, a Lincoln International study of US PE firms found that 88% of PE investors reported their highest priority objective in 2021 is to deploy capital on new platforms and add-ons to existing platforms.

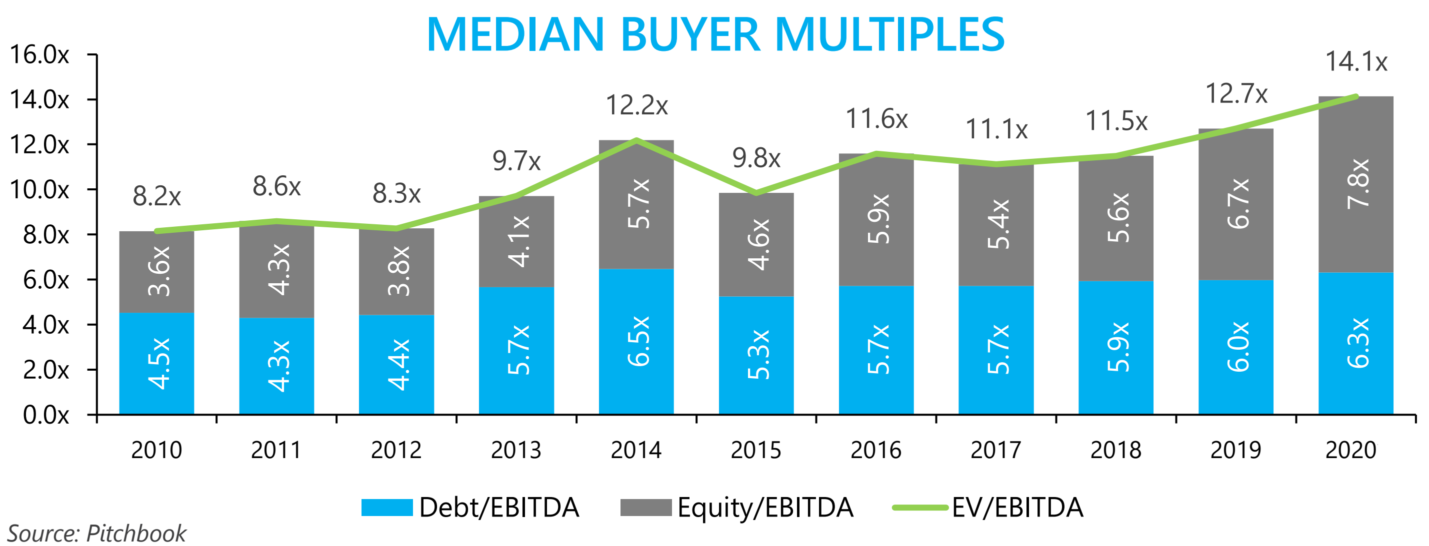


- **Debt Lenders:** While some lenders have been utilizing increased debt pricing to account for future unforeseen COVID risks, historically low interest rates and more rigorous due diligence practices have driven lenders back into the M&A market.

Business Valuations

Many are surprised to learn that in the end, the pandemic has had a minimal impact on the valuations of healthy businesses, and even a positive impact for best-in-class companies. That was not necessarily the case in the early stages of the pandemic. In data published by the IBBA, average EBITDA multiples for deals closed in Q1/Q2 of 2020 between $5 million and $50 million of enterprise value were over 25% lower than deals closed in Q4 of 2019.

Since then, however, the bounce back in valuations has been swift, with that same study reporting EBITDA multiples in Q4 of 2020 returning to levels almost exactly equal to those seen in the year prior. The recovery for larger deal sizes has been even more dramatic, with Pitchbook reporting an average valuation increase of nearly 11% across all PE deals from full year 2019 to 2020.



Source: Pitchbook

While those trends may seem counter-intuitive to the broader economic market, the reasoning is simple: supply and demand. With record amounts of capital availability, the demand to deploy it has never been higher. Yet, the supply of companies to purchase is still well below pre-pandemic levels. Why is that? First, there are still a large number of business owners who are apprehensive to bring their company to market in this pandemic environment, even though their business may not have materially suffered. They prefer to let the pandemic and related economic environment to stabilize before they sell. There are also companies that may have been planning to sell that were materially impacted by the pandemic. In those cases, business owners who are not willing to sacrifice value may decide to wait to sell until financial performance stabilizes. For these reasons and others, the supply and demand mismatch is being felt throughout the market, and subsequently valuations for healthy companies are continuing to rise to record levels.

Industry Winners and Losers

In any M&A cycle, there are inevitably going to be winners and losers. The COVID-related cycle is no different and given that certain industries were more directly impacted by the pandemic than others, it is not difficult to determine which industries fall into each category.

Winners

1. **Technology, Media, and Telecommunications:** With the various national, state, and local lockdowns, businesses and individuals have turned to technology to work, study, shop, and stay entertained. As such, companies centered around remote working technologies, media, software security, and network infrastructure, who have more predictable revenue streams than some other business models saw increased M&A activity relative to other sectors.
2. **Healthcare and Life Sciences:** Rapid adoption of virtual health and telemedicine, which it appears will continue even post-COVID, has seen extremely positive momentum in the M&A markets. Separately, rapid ramp-up of testing, treatment, and vaccine related therapies has driven collaboration and M&A activity within the pharmaceutical industry.

3. **Business Services:** Buyers looking for the revenue predictability of the technology sector can also find similar revenue characteristics within business services, especially with companies who have proven to be historically "sticky" with their customers. Technology-enabled business services have been of particular interest of PE buyers.

Losers

1. **Leisure and Hospitality:** Arguably the hardest hit sector of all, most companies and buyers in this sector have focused on positioning for the future as opposed to growth, leading to a 49% reduction in deal volume from 2019 to 2020.
2. **Energy:** Although prices have recovered from the depths of the spring, they remain 15% below 2019 levels. These headwinds combined with the impacts of the pandemic, resulted in a drop in deal volumes of 43% in 2020 vs. the previous year.

Predictions for 2021

For those involved in M&A, 2020 was nothing short of a roller coaster. Starting strong, many had high hopes for the year that were seemingly dashed as the pandemic swept the globe. But after a few months of stagnation and uncertainly, the year ended strong, and many have renewed optimism as 2021 begins. While much is still uncertain, here are a few predictions for the year:

1. **Another strong year in M&A is ahead, powered by strategic acquirers:** After shoring up balance sheets and cash positions in the early stages of the pandemic, many strategic buyers felt satisfied with the way 2020 played out. However, the pandemic forced these same organizations to deeply analyze and consider large-scale strategic changes, many technology-driven, aimed at positioning the company for the post-pandemic growth. According to an EY Global survey of more than 2,300 C-suite executives, the preferred method for implementing these changes is through M&A, with nearly half planning an acquisition in the next 12 months. Increased strategic buyer desire for M&A will force those buyers to compete with PE at price points strategics have not historically been willing to pay. This is good news for business owners looking to sell.
2. **Political agendas will drive increased deal volumes:** With a Democratic government now in place, many feel that a tax increase for business owners is not a matter of if, but when. Some are also concerned that tax increases passed towards the end of the year could apply retroactively to deals already completed. While precedent for retroactive tax adjustments points only to the Clinton Administration, the timing and specifics of any tax legislation remains unclear. For business owners considering a sale in the short term, we believe that uncertainty will be a powerful catalyst to transact quickly to take advantage of the existing tax environment.
3. **Minority recap structures will see an uptick:** As more and more businesses realize the need to reinvent aspects of their business model to drive growth in the post-pandemic market, many will realize they need help. For those not ready for a full exit, a minority equity or debt recap can provide both the capital and outside business expertise to help execute on those changes. And as competition for deals heats up, PE groups who have historically focused on control investments may be more willing to do minority deals to deploy capital.

Whether or not these predictions hold true, 2021 is lining up to be another fascinating year in the world of M&A. An eager buyer market with a lot of cash means a strong opportunity for sellers looking to make a move. Will that continue? If any lesson is to be taken from 2020, it is to expect the unexpected. Whatever plays out, the Charter Capital Partners M&A advisory team looks forward to helping business owners successfully navigate this ever-changing market.

CHARTER Capital Partners

About Charter

Founded in 1989, Charter Capital Partners is a premier investment banking firm headquartered in Grand Rapids, Michigan. We offer a comprehensive range of investment banking advisory services, including buy-side and sell-side M&A, succession planning, business valuation and capital raise.

Charter was named one of the top 100 most referred middle-market advisory firms in the US, according to a survey of 1,000 private equity firms, strategic acquirers, and family offices compiled by Axial, a network of middle market investors, advisors, and CEOs. Our mission is to deliver superior professional guidance throughout the complete business lifecycle.

About the Authors

Mark Streekstra, Director

Mark has more than 12 years of diversified financial and advisory experience across a variety of industries, including manufacturing, professional services, and various technology sectors. Through his career in investment banking, corporate development, and corporate finance, he has developed a reputation as a trusted business advisor who prides himself on delivering results through a client focused approach. Prior to joining Charter, Mark helped identify and execute M&A transactions with total enterprise value in excess of $600 million.

Mike Welch, Associate

Mike's experience includes M&A advisory, strategic consulting, and valuation execution. His expertise spans industries including business services, transportation and logistics, diversified industrials, light manufacturing, furniture, and staffing. Mike's background includes both public and private accounting, providing him with a strong foundation in both accounting and finance.

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