Deloitte.

Middle Market M&A Outlook

August 2020

Potential Second Wave

As the economy continues to reopen through the summer months, the US has seen a resurgence of COVID-19 in a number of states, while others seem to be on the path to recovery. Despite this, US equity markets have sharply recovered from March lows as investors pinned to the sidelines during one of the longest bull runs in recent memory celebrate better than expected economic news.[1]

By April, global buyout deal volume had declined ~60% from January's levels. Surveyed in March, 78% of responding middle market companies with annual revenues between $10M and $1B noted they expect growth will decline in 2020, while 66% said that they would delay capital spending.[2]

As a result, we are seeing many creative strategies implemented by sellers, lenders, and acquirors as they look to identify and capitalize on the next normal. We, as well as other stakeholders, anticipate a continued decline in deal volume throughout the summer months while participants continue to keep in-flight deals on hold and rethink their value creation plans.

However, we are also seeing a limited number of processes begin to ramp up, driven by a number of trends. Massive federal intervention for payroll protection, main street lending, and other stimulus programs have helped support existing lending relationships and calm the credit markets, with ongoing processes focused on acquirors that won't need funding contingencies.

In this report, we will explore a number of emerging trends in lending, diligence, deal structuring, go-to-market strategies, and timing considerations. We close with key takeaways from recent observable activity in the industries of coverage in Deloitte's Corporate Finance practice.

Election Year Implications

Presidential elections typically dominate headlines throughout an election year, driven by tax and regulatory considerations. Despite the confluence of other events discussed in this piece, uncertainty surrounding the tax implications of a new White House occupant could motivate actors on both sides of the M&A equation. Based on information released to date, Biden's tax plan would impose increases in both ordinary income and capital gains tax rates on high earners.[3,4]

Accordingly, Deloitte anticipates an uptick in conversations with sellers about getting to market in advance of these changes.

Sources: 1 "Stock Market Recovers after Fed Announces It Will Buy Corporate Bonds", The Washington Post. 2 National Center for the Middle Market, "COVID-19 and the Middle Market, 3 "Has the Pandemic Changed Biden?", The Wall Street Journal. 4 "Potential Impact if the Biden Tax Plan", Houlihan Lokey.

Lending | Key Trends[5]

Based on feedback we have received from several lenders in the market, many will likely be cautious to underwrite new deals as they continue to focus on the liquidity of existing investments.

Lenders will likely be particularly hesitant regarding companies that have been severely impacted and will favor highly-equitized sponsored deals, or large, well-capitalized strategics until the broader impact of the pandemic is known.

As a result, transaction leverage may decrease as pricing increases of approximately 100-200 basis points have emerged along with elevated LIBOR floors. For new relationships with non-sponsored companies, lenders will likely seek to limit exposure through more conservative leverage and more restrictive terms.

Despite rising spreads, the cost of funds for banks is very low, potentially creating more opportunities to invest at reasonable spreads alongside reputable sponsors.

The Federal Reserve moved aggressively in early March to support financial market functioning and the flow of credit to businesses. This support, which includes reducing federal funds rates to zero, aggressive purchases of government and some corporate bonds, and grants and/or loans to troubled businesses. We expect this to continue to support the proper functioning of credit markets.

After a rollout of the popular Paycheck Protection Program (PPP) targeting smaller businesses, the Federal Reserve's midsize-business initiative—the Main Street Lending Program—opened for lender registration in June 2020. Even after multiple revisions incorporating feedback from commercial banks, it remains unclear how extensively the program will be used. Many lenders report that they are hearing of only limited borrower interest in the program.

We expect increased scrutiny in terms of both preliminary and confirmatory diligence regarding the impact of the pandemic as well as the ability to develop credible near-term forecasts, resulting in longer confirmatory diligence periods.

Diligence Environment | Key Trends[6]

Throughout much of the middle market, deal timelines have been extended as additional diligence is requested on COVID-19-related pain points, companies look to address internal matters, and the markets try to adjust to the next normal. From a diligence perspective, we are seeing a heighted level of scruitiny on near-term financials, especially 2021 forecasts, including lenders demanding three-statement modeling.

Almost all in-person diligence meetings have been postponed or cancelled, unless there has been no interaction between parties in the past. As a result,

we have seen a sharp increase in companies utilizing video conferencing for virtual diligence discussions, management presentations, site tours, and online storage sites with more detailed videos and other information.

Various technologies and advanced visualization/analytics tools are being utilized broadly, as both acquirors and sellers leverage advanced analytics and modeling techniques to rapidly plan various scenarios and respond to the increasing importance of clear and accurate analytical insights during every phase of the deal.

As acquirors wrap their heads around the seemingly endless effects of COVID-19 on industries of interest, we are observing more industry consultants and analysis related to the post-COVID-19 next normal.

During this time of uncertainty, acquirors will likely place significant focus on cash flow and working capital management, evaluating and stress testing sellers' businesses under various scenarios with a heightened focus on run-rate performance, and stabilization into 2021.[5]

Deal Structuring | Key Trends[6]

For deals moving ahead into closing, conservative deal structuring has become more prevelant. This is evidenced by an increased use of earnouts (focused on 2021 and 2022) and higher rolled equity requirements.

Many firms are still looking to acquire relatively "cheap" assets, likely expecting a significant recovery similar to the 2008-2009 rebound. For those large private equity funds with significant dry powder, we are seeing diminished funding contingencies and over-equitized initial considerations, with an expectation of refinancing at a later date.

From a process perspective, "fireside chats" are becoming the primary mechanism for higher quality assets entering the market, with much smaller, targeted processes consisting largely of large private equity funds with the ability and willingness to stroke a significant initial equity check and push financing to the back burner.

We are seeing a slew of in-flight deals under exclusivity extend exclusivity periods to take a deeper dive into COVID-19-related points, or simply to allow the process pace to slow while both sellers and acquirors look for solutions to the slew of novel challenges they are facing as a result of the pandemic.

Sources: 5 Max Hughes and John Deering, Deloitte Corporate Finance LLC ("DCF") Capital Markets Leads. 6 Deloitte Corporate Finance Market Observations.

Go-to-Market Timing | Prerequisites

As both sellers and acquirors consider when to enter the market, there are several key prerequisites and milestones that could provide market participants with more confidence and certainty, including:

- Private equity groups accustomed to significant leverage, as well as sellers looking for premium valuations, are waiting for the credit markets to expand issuances, with a critical mass of lenders ready/able to deliver term sheets.[6]
- As evidenced by a recent Deloitte poll, 31% of market participants expect delayed timing on near-term deal activity.[6] In subsequent client conversations, DCF professional have observed that much of this delay is due to continued uncertainty in the market.

Due to the material turbulence caused by COVID-19, before entering into a marketing process, both acquirors and sellers alike may be looking for business activity to return to a steady month over month state. This may be evidenced by:

- Strengthened forecastability to reasonably support 12-month projections.
- Elimination of potential backlogs causing inflation of "post-reopening" earnings.
- Adaptation to new workforce models like telecommuting, digital solutions, working in shifts, etc.

Shifting Client Priorities

The current environment has required that almost all businesses make significant changes to their operations, the way they think about near and long term growth, and their positioning for future success.

As a result, 20% of Deloitte survey respondents expect to put all M&A aspirations on hold over the next twelve months.[7]

We are seeing a significant population of companies responding to supply chain disruptions both upstream and downstream as international travel and trade has been significantly interrupted.

Additionally, a number of respondents are rationalizing headcount in favor of leaner operations to respond to demand shifts and supply constraints. Companies are looking to preserve bottom lines and stay afloat amid market volatility.

While many companies shift their focus internally and address COVID-19's financial impact to liquidity, cash flow, asset prices, and working capital, we are also seeing accelerated adoption of digital technologies and operating models as companies look to capitalize on new opportunities to bolster their technology portfolios, drive customer stickiness, and coordinate workflows in an "out of office" environment.

Potential M&A Implications

A delay among in-flight deals has spurred many companies to reevaluate their value creation assumptions as supply chains have been disrupted, consumer demand has shifted, and prior workforce models become unattractive.

As a result, strategic acquirors are looking to initiate small strategic partnerships to bolster operational and supply chain resilience. We expect this to lead to a rise of new ecosystems to enable reconfigured supply chains and address transformed demand patterns and customer interaction.

Many respondents to a Deloitte poll identified a rising need for portfolio optimization, divestments, and new business models to better position themselves for success. This has led to an increase in strategic spin-offs and an uptick in buyside activity as companies look to act upon new opportunities resulting from sector convergence and capture additional revenue in attractive, adjacent markets.[7]

As companies look to pare down their exposure to risk, we are seeing certain market participants pursue co-investment opportunities for capital intensive projects and opportunistic deals to safeguard core markets.[6]

Acquirors looking to capitalize on recent market shifts may look to acquire high-growth businesses from the innovation ecosystem, while curating a portfolio of investments adjacent to their core business but well-positioned for future success in the post-crisis market.

Source: 6 Deloitte Corporate Finance Market Observations. 7 Deloitte Private Special Edition Dbriefs Series: "Private Company M&A in an uncertain economy: Is now the time?", Poll conducted during April 2020. https://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/april/2020/dbriefs-private-company-mergers-acquisitions-in-uncertain-economy-is-now-time.html

Industry Specific Trends

Business Services[8]

Globalization continues to drive M&A activity across the industry as service providers expand overseas to access and build market share in higher growth regions of the world.

Tech-enabled services continue to push up valuations within the industry as it is viewed to enhance the quality of delivery and create "sticky" integration with clients.

Outsourcing critical tasks has become increasingly more prevalent as companies look to lower risk while focusing on core services and growth opportunities.

Private equity groups are showing a high level of interest in the industry (as are lenders), particularly for companies with recurring/repeat revenue, scalable margins, high ROIC, and strong acquisition pipelines.

Coming out of the COVID-19 situation, we expect to see a wider bifurcation in investor interest between the larger/more specialized industry players that possess the aforementioned characteristics and the smaller/less differentiated ones.

Industrials[10]

Strong investor interest in growth capital opportunities and partnering with business owners that have the ability to take advantage of the current economic environment to grow.

Large industrial companies are still active in M&A, but largely focused on highly strategic investments and portfolio realignment.

Generally, it appears that strategic acquirors are more open to share strategy and thought process than previously. This may provide opportunities to discuss specific acquisition ideas before a seller makes a decision on how and when to go to market.

Many industrial sectors slowed in early Q2 and have started to ramp back up with notable resiliency,

We are observing a material emphasis being placed on a firm's ability to forecast with quality and predictability and run rate analysis

Life Science and Health Care (LSHC)[9]

COVID-19 has had diametrically opposite effects on different sectors of the LSHC industry:

For health care information technology and the pharmaceutical industry, it has been very positive with robust M&A and equity financing activity in both sectors:

- Rapid adoption of telemedicine and virtual health to replace physician visits.
- Rapid acceleration in clinical trials and vaccine development and testing.

For other health care provider sectors, it has had a significant negative M&A impact:

- Rapid decline in visits to physician clinics and the deferral of elective surgeries and diagnostic procedures has caused revenues to physician groups to decline 60+% in some cases
- Hospitals, outpatient and ambulatory clinics have been similarly impacted leading to minimal M&A in these sectors

Longer term M&A in the LSHC sector will likely rebound faster than others. There is a significant pent up demand for health care: physician visits, surgeries, procedures; health care in general has been deferred not cancelled.

COVID-19 has accelerated the requirement to digitally transform the health care industry. Digital transformation requires capital which will likely lead to consolidation and further M&A.

We anticipate further consolidation of:

- Physician groups
- Ambulatory and outpatient clinics
- Hospitals
- Healthcare Information Technology sector
- Medical distribution and equipment

Source: 8 James Miller, DCF Business Services Lead. 9 Simon Gisby, DCF LSCHC Lead. 10 Eric Andreozzi and Tony Blanchard, DCF Industrials Leads.

Industry Specific Trends, Continued

Technology, Media, and Telecom, (TMT)[11]

Software and Internet & Digital Media will likely continue to lead the charge and be resistant to short term disruptions.

In the medium term, there will likely be plenty of opportunistic deals in growth segments such as remote working technologies, fintech, content for media streaming, security software, network infrastructure and others.

Portfolio restructuring is expected to be a high priority post-crisis through which TMT may benefit.

Many TMT companies are considering the impact of changing input prices, as well as ways to increase demand amidst a recession. As a result, we expect that companies will likely be forced to revisit their pricing, promotion, and R&D plans.

Increased acquisitions from buyers outside the technology sector is expected. In 2019, around 56% of technology assets were acquired by non-tech buyers. With valuations down, there will likely be acquisitions in disruptive categories such as Automation, Robotics, Digital Transformation and others.[12]

These new normal conditions will likely provide opportunities for new innovative business models, alliances and strategic partnerships both with traditional competitors as well as broader innovation ecosystem players.

Consumer[13]

Consumer confidence shot up significantly in June to 98.1, from 85.9 in May.[14] Despite this rise, expectations on discretionary spending remain muted with consumers focused on essential goods.

For food and beverage businesses selling into grocery, club, and mass channels, those brands that are already on the shelves are doing exceptionally with some up 30%+ YOY; upstart brands on the other hand are struggling to make ends meet as new placements in these channels have stopped.[15]

Consumer packaged goods companies with strong direct-to-consumer (DTC) presences have more than held their own in the past few months, with some benefitting from higher margin sales mix that has shifted from the bricks and mortar to DTC environment.

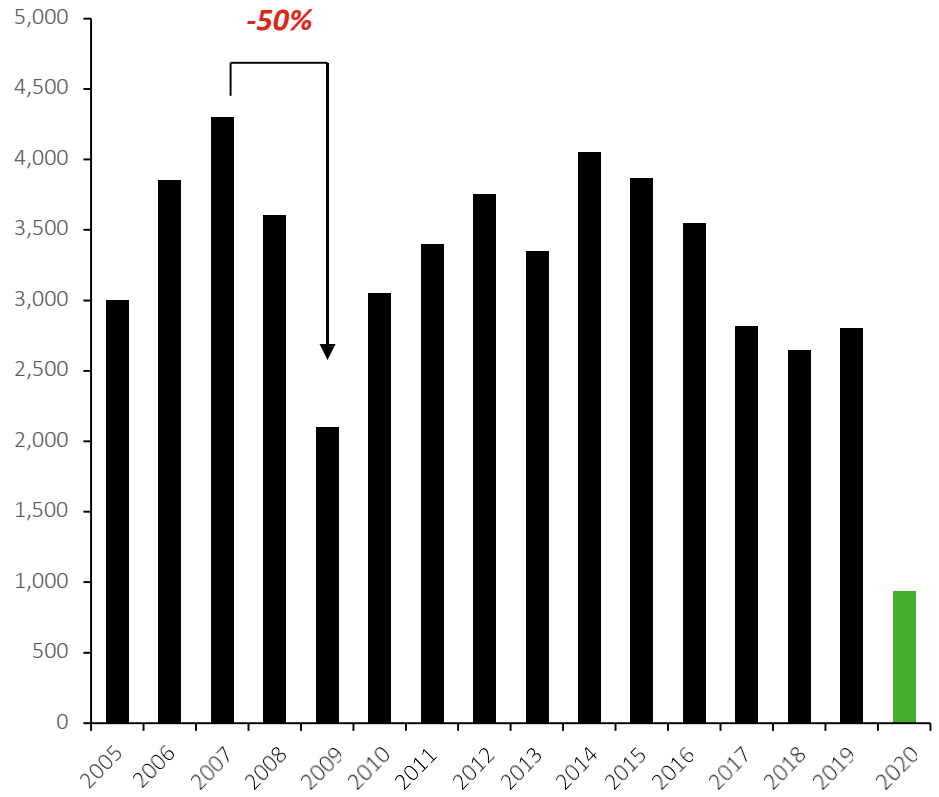
Food service businesses serving the restaurant and bar channels have been severely impacted by mandatory closures and limited capacity reopenings; many have shed significant headcount to weather the uncertainty.

Both strategic and private equity investors are attempting to assess medium term consumer purchasing behavior patterns as it relates to valuation implications; particular focus is on “pantry loading” and “panic buying” of essential items and to what extent demand levels are sustained into future.

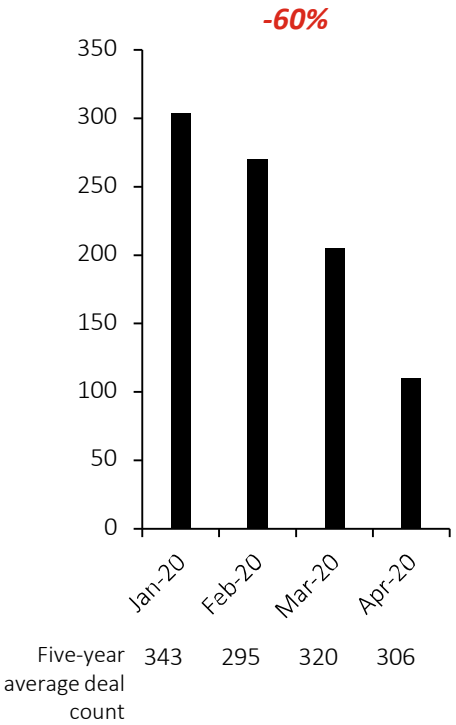
Source: 11 Byron Nelson and Mike Hakim, DCF TMT Leads. 12 “Small Gains, Big Wins: Disruptive M&A: Creating value through innovation-led growth acquisitions” Deloitte. 13 Lorin DeMordaunt and Rory Dineen, DCF Consumer Leads. 14 Marketwatch. 15 “Coronavirus Sales Boom Could Be Short-lived and Costly, Analyst Warns” Winsight Grocery Business.

Appendix

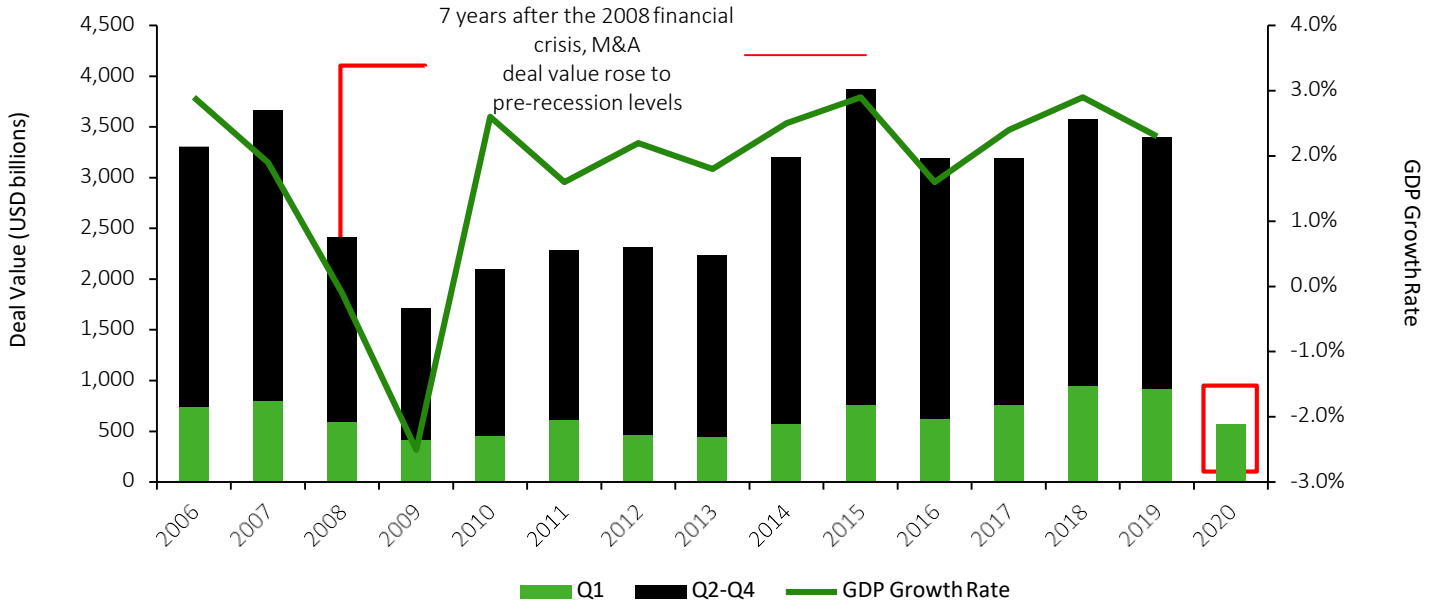
Annual Global Buyout Deal Count[1],17



Monthly Global Buyout Deal Count[1],17



Global Deal Value: Quarterly Breakdown[1],17



Footnote: [1] Includes add-ons; excludes loan-to-own transactions and acquisitions of bankrupt assets; based on announcement date; includes announced deals that are completed or pending, with data subject to change; 2020 results include data from January to April.
Sources: 17 LCD an Offering of S&P Global Market Intelligence.

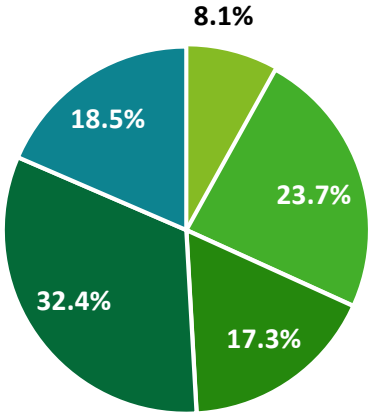
Appendix, continued

National Center for the Middle Market[(1)] Poll of Companies with Annual Revenues Between $10M and $1B[17]

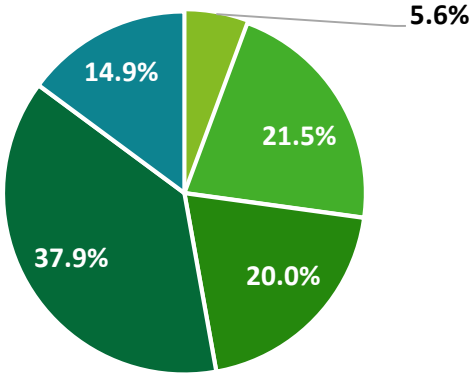
December 2019		March 2020	
5.8%	was the 12-month projected revenue growth rate	78%	say growth will decline
3.2%	was the 12-month projected employment growth rate	64%	say employment will shrink
51%	planned to enter new domestic or international markets	70%	will pull back on growth initiatives
24%	expected to build a new plant or facility	66%	will delay capital spending

Dbriefs Poll | M&A Expectations in the Next 12 Months

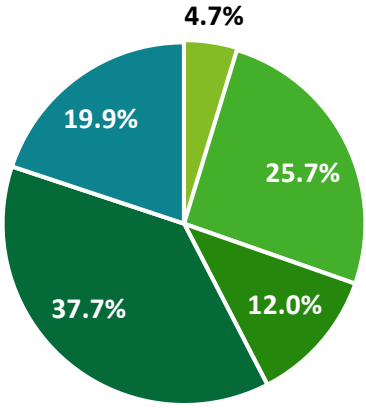
M&A Expectations (Companies with Rev < $250M)[17]



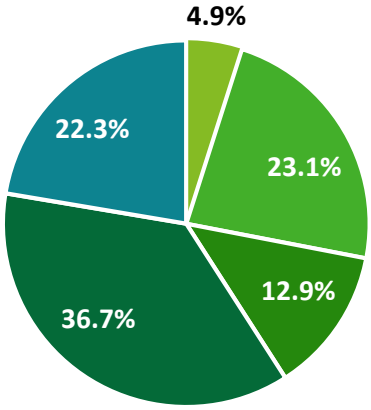
M&A Expectations (Companies with Rev $250M-$500M)[17]



M&A Expectations (Companies with Rev $500M-$1B)[17]



M&A Expectations (Companies with Rev > $1B)[17]



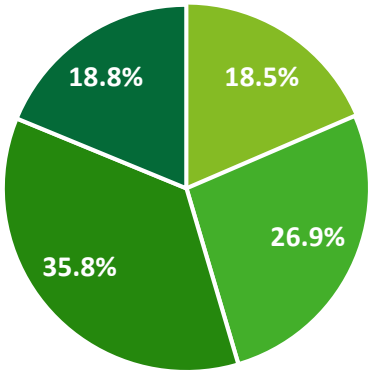
- Accelerated M&A activities—acquisitions and/or divestitures
- All M&A aspirations on hold
- Business as usual—no change in expectations
- Delayed timing on near-term deal activity
- Don't know/not applicable

Footnote: (1) Companies with annual revenues between $10M and $1B.
Sources: 17 National Center for the Middle Market, "COVID-19 and the Middle Market", 17 Deloitte Dbriefs Poll Conducted on April 20, 2020.

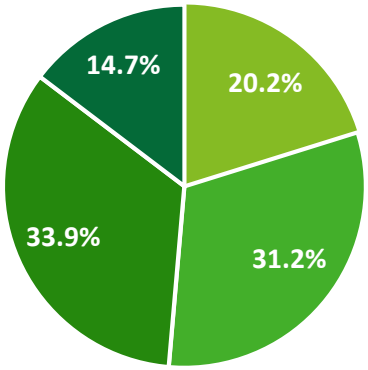
Appendix, continued

Dbriefs Poll | M&A Strategy in the Next 12 Months

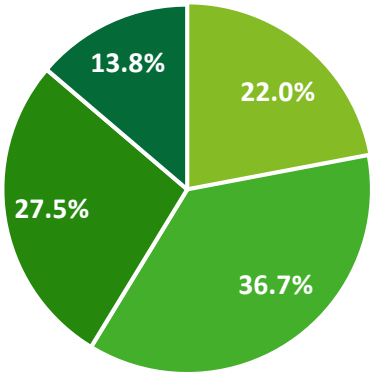
M&A Strategy (Companies with Rev < $250M) [17]



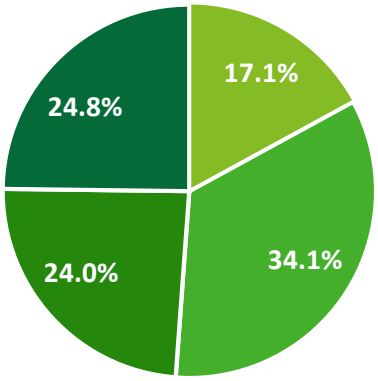
M&A Strategy (Companies with Rev $250M-$500M) [17]



M&A Strategy (Companies with Rev $500M-$1B) [17]



M&A Strategy (Companies with Rev > $1B) [17]



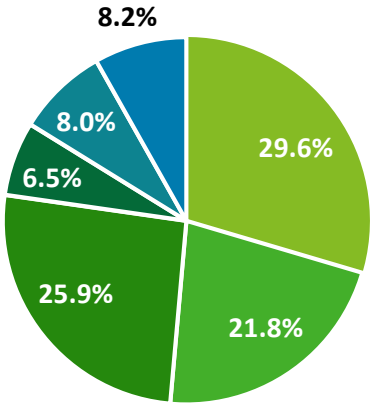
- Defensive—M&A activities to safeguard the company's future
- Offensive—M&A to accelerate business model transformation
- We do not expect to participate in any M&A transactions
- Don't know/not applicable

Sources: 17 Deloitte Dbriefs Poll Conducted on April 20, 2020.

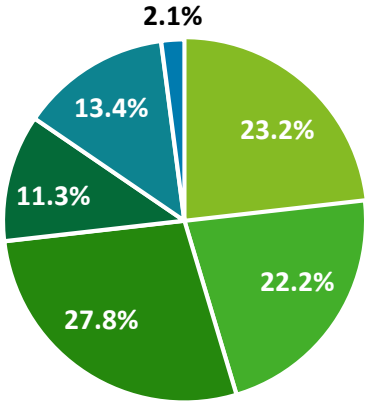
Appendix, continued

Dbriefs Poll | Operational Challenges Due to COVID-19

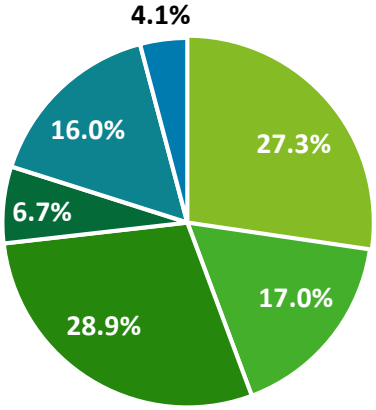
Op Challenges (Companies with Rev < $250M) [17]



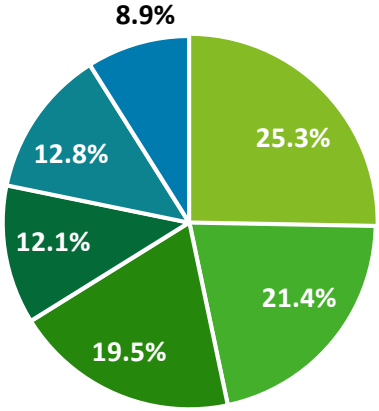
Op Challenges (Companies with Rev $250M-$500M) [17]



Op Challenges (Companies with Rev $500M-$1B) [17]



Op Challenges (Companies with Rev > $1B) [17]



- Cash flow and liquidity management
- Employees working remotely
- Forecasting demand
- Managing customer expectations
- Supply chain disruptions
- Don’t know/not applicable

Sources: 17 Deloitte Dbriefs Poll Conducted in April 20, 2020.

Contacts

Phil Colaco
CEO
Deloitte Corporate Finance LLC
philcolaco@deloitte.com
+1 704 333 0533

Rory Dineen
Managing Director
Deloitte Corporate Finance LLC
rdineen@deloitte.com
+1 704 333 0495

Steven Blaser
Vice President
Deloitte Corporate Finance LLC
stblaser@deloitte.com
+1 704 619 6418

Robert Matthews
Senior Analyst
Deloitte Corporate Finance LLC
romatthews@deloitte.com
+1 980 701 3233

Designed by CoRe Creative Services. RITM0516890