THE ROAD AHEAD: OBSERVATIONS ON M&A ACTIVITY IN A COVID-19 WORLD

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David has over 20 years of experience advising middle market companies across a broad range of industry sectors, with a particular focus on business and technology-enabled services. David began his career with Harris Williams & Co., where he spent 12 years and completed numerous sell-side merger and acquisition assignments for clients in a variety of industries, including advanced manufacturing, business services, consumer products, mining and minerals, chemicals, and healthcare. Before joining Harris Williams & Co., David worked as an associate with Prairie Capital, a private equity group in Chicago.

David earned an M.B.A. from Booth School of Business at the University of Chicago and a B.S. in Business Administration from the University of Richmond.

Janney's Investment Banking Team shares their recent experience in the market and how to navigate M&A activity going forward.

When COVID-19 arrived in the U.S. earlier this year, the resulting public health crisis and government-mandated shutdowns changed life in many ways. Suddenly, we were all faced with navigating a starkly new and different environment for our families, businesses, and social lives. Many business owners and management teams spent weeks focused on triaging the operating environment and shoring up cash reserves to support their businesses in a period of widespread state closures.

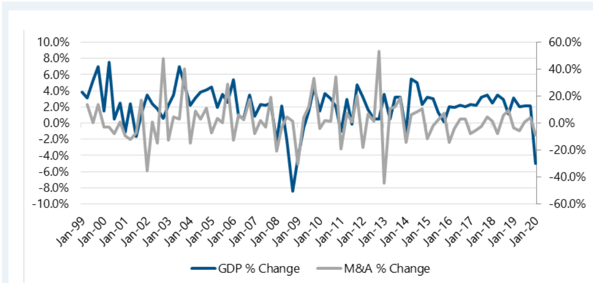
Not surprisingly, M&A activity across sectors was curtailed dramatically through this period. Uncertainty about the length and depth of the economic impact of the shutdowns, and the resultant lack of visibility into future financial results, made pricing M&A transactions nearly impossible. This, coupled with the logistical challenges of performing due diligence on operations and employees, makes it understandable that parties largely tabled M&A activity. However, as the nation adjusts to its new and evolving COVID "normal," we have begun to see an increase in the willingness of buyers and sellers to pick up M&A discussions.

While appetite for new investments and acquisitions is steadily improving, navigating today's market requires an understanding of several factors that will impact how transactions will be completed for the foreseeable future. In this article, we summarize our recent experience in the market and observations on what the coming months may bring for M&A.

IMPACT ON M&A TO DATE

As shown in Exhibit A, M&A activity has historically tracked the overall economy, with M&A volume showing a strong correlation to GDP.

Exhibit A: Real GDP vs. M&A Volumes-Quarterly Changes

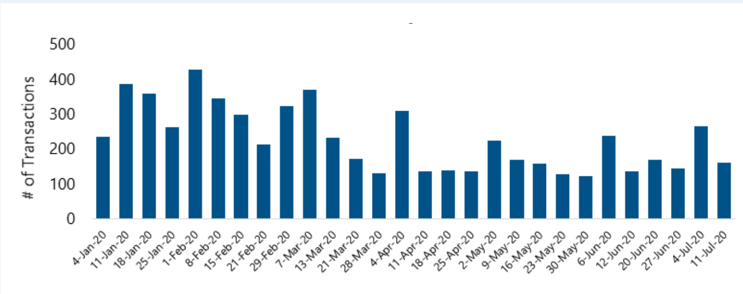


Source: *Federal Reserve Bank of St. Louis and S&P Capital IQ*

The recessions of 2001 and 2008-2010 saw sharp declines in M&A volume in line with GDP contractions. The current recession, which is estimated to have begun in March of this year, is no different. Exhibit B shows 2020's weekly M&A volume through the week of July 11. As shown, M&A volume decreased precipitously when the nationwide shutdowns began in March and have remained stable at a relatively low level since. The length of the current economic downturn will likely dictate the timing of a recovery in overall transaction volume.

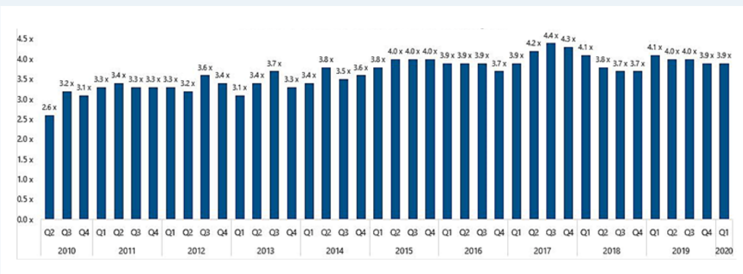
In our view, a key difference between the 2008-2010 recession and the current recession is the cause. Lax lending standards and a resulting crisis in subprime mortgages in 2008 caused a ripple effect through the financial system that dramatically reduced the availability of financing for M&A transactions. This, in turn, reduced valuations across sectors. In contrast, the 2020 recession was triggered by the global COVID-19 pandemic, an exogenous factor that hit a market otherwise healthy at its outset.

Exhibit B: M&A Volume by the Week



Source: *S&P Capital IQ*

Exhibit C: Debt/EBITDA Transaction Multiples

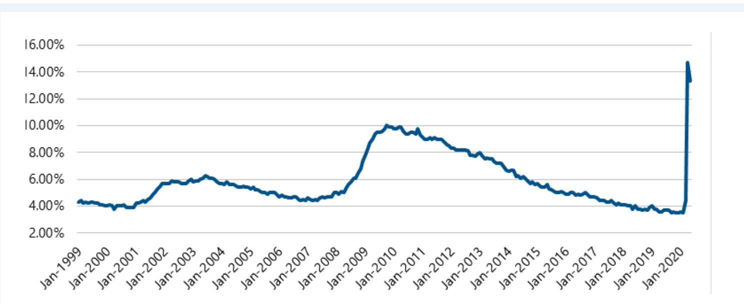


Source: *GF Data*

Exhibit D: U.S. Manufacturing PMI

Source: *IHS Markit*

Exhibit E: U.S. Unemployment Rate



Source: *S&P Capital IQ*

As shown in Exhibit C, leverage multiples for middle market transactions through March 2020 remained relatively high historically. This recession features not a dearth of available capital, but rather a lending environment in which financing sources are: 1) more focused on monitoring their existing portfolios and the impact that the collapse of demand for a wide range of goods and services will have on various sectors of the economy; and 2) taking a conservative approach to new credits in a transitional period as states begin to reopen from their respective shutdowns. Based on our conversations in the market, most lenders are "open for business," but the standards for new loan facilities in support of M&A transactions are higher. As companies find stability and visibility through the reopenings this summer, we expect the financing market to steadily improve.

"GREEN SHOOTS" OF IMPROVEMENT

By early April, all 50 states had implemented some level of shutdown measures to slow the spread of COVID-19, ranging from restrictions on business operations to full stay-at-home orders.

Some states' restrictions remained in place for only several weeks, while other states are still in the process of reopening. The shutdown measures had a dramatic impact on the economy, resulting in steep drops in GDP and employment.

As states steadily ease restrictions, economic output and employment should continue to improve. According to the U.S. Census Bureau, retail sales increased by 17.7% in May, the highest monthly increase in history, and a further 7.5% in June, returning to near pre-pandemic levels. Manufacturing activity has also largely rebounded, reflecting the ability of manufacturers to reopen manufacturing facilities and a recovery in demand. As shown in Exhibit D, the IHS Markit US Purchasing Managers' Index (PMI) increased from a low of 36.1 in April to 49.8 in June.

The unemployment picture improved in step in May and June as well, with the unemployment rate declining to 11.1% in June, down from a record 14.7% in April. As shown in Exhibit E, however, unemployment in the U.S. remains at historically high levels, which will continue to be a drag on the economic recovery.

STRONG APPETITE FOR NEW TRANSACTIONS

Investors and buyers see opportunity in this market. There is more than $2.4 trillion in private equity and venture capital dry powder available, according to PitchBook. This capital needs to be deployed, and investors will be eager to find investment opportunities as we move through this recession. Indeed, one of the lessons learned by private equity from the 2008-2009 recession is the cost of missing the window to deploy capital in a down market. According to PitchBook, the median IRR for a 2006 vintage private equity fund (at the height of the market pre-financial crisis) was 8.1%. For 2009 vintage funds that were investing in the downturn, the median IRR was 13.9%.

While investment strategies will shift to focus on the most attractive opportunities in this market, we anticipate a recovery in M&A activity once COVID-19 containment measures run their course and the crisis reaches an end. In our estimation, this portends a recovery in the second half of 2020 and into 2021. Conversations tell us that investors are eager to see new transactions and deploy capital in this environment, a message that has gained momentum over the past several weeks. While we expect a wave of restructurings and distressed companies needing capital over the next several months, healthy companies that have weathered or even benefited from the COVID-19 shutdowns will garner significant attention in the market.

THE DEAL PROCESS WILL BE DIFFERENT

Janney's Investment Banking Team has remained very active throughout the downturn, closing 22 transactions since mid-March, including M&A and capital raise assignments. We've observed several trends that we expect will remain for some time in the way deals get done.

- **Diligence of Performance is a Critical Focus.** Investors and buyers are scrutinizing performance through the shutdown very carefully. Daily and weekly sales, pipeline, and profitability metrics are a key part of maintaining transparency and trust. It is difficult at this stage for investors to underwrite whether the impact (positive or negative) of the past several months is sustainable for businesses going forward.
- **Changes in Transaction Structure to Mitigate Risk.** Driven by the challenges associated with assessing performance expectations in 2020 and 2021, buyers are frequently requesting that a portion of consideration be structured as an earn-out or other form of contingent payment based on future performance. This mechanism can be useful in "bridging the gap" to seller valuation expectations that may have been formed prior to the COVID-19 crisis. Transactions are also increasingly being structured with the sellers taking part in the capital structure through retained equity and/or seller financing in cases where third-party bank financing is limited. We expect these to be common components of transactions in the near-term.
- **Virtual Process Dynamics.** The travel challenges and social distancing measures resulting from virus mitigation efforts make it difficult to conduct the level of onsite and in-person due diligence that buyers and investors rely on to complete transactions. Sale processes need to adapt to accommodate this shift. We have seen an increase in the use of videoconference technology in place of management meetings and facility tours in the earlier stages of processes. However, for many buyers and investors it remains critical that in-person interaction take place prior to the closing of a transaction. As a result, timelines have generally been extended and staged, with an understanding that an onsite meeting will likely be required before deal completion.
- **Pre-Process Preparation is More Important than Ever.** In this environment, based on the factors mentioned above, it is crucial that sellers are fully prepared before entering the market. This includes assembling detailed support for the weekly and monthly operating results, and developing in-depth commentary around the condition of the business pre-COVID, how it has performed through the shutdowns, and support for the outlook for 2020 and 2021 in a variety of potential scenarios. In addition, we're counseling clients to consider pre-market quality of earnings reviews and assemble robust data rooms that will facilitate remote due diligence for buyers and investors. Proper preparation will enable a process to move forward as quickly and efficiently as possible in light of the various challenges presented.

The COVD-19 pandemic changed the M&A market dramatically almost overnight. Our experience shows, however, that transactions are still viable and the reception for new opportunities is improving steadily.

Please contact us if you'd like to discuss our findings in more detail or if we can be helpful as you navigate this unique period.

ABOUT JANNEY INVESTMENT BANKING

Janney's Investment Banking practice is a leader in middle-market M&A and financing solutions for public and private companies. We place a high value on their consistent track record of delivering solutions to clients. Since 2009, Janney's Investment Banking team has completed 605 transactions aggregating $85B in transaction value, working with clients on a highly-personalized basis, providing exceptional service, commitment, and senior level attention.