CALABASAS CAPITAL

2nd Quarter 2020 M&A Market Update

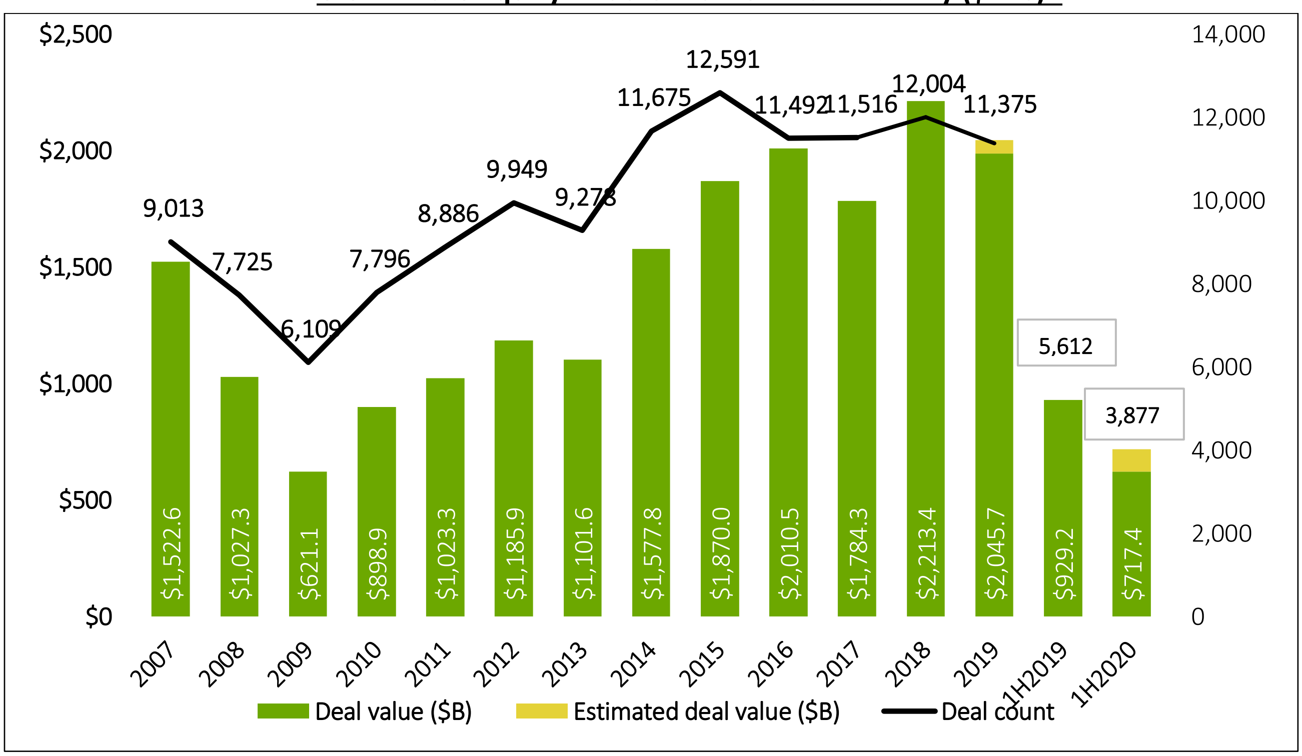
About Us

Calabasas Capital is a boutique investment banking firm focused on serving lower middle-market privately held companies and their business owners. We specialize in representing and advising businesses on sell-side and buy-side mergers, sales and acquisitions and we raise private equity and debt capital.

M&A Activity Dives in the 2nd Quarter

It is certainly no surprise that with U.S. GDP down by a rate of 33% in 2Q 2020 because of the unrelenting pandemic, U.S. M&A activity was also down considerably. According to PitchBook Data, in 2Q 2020 the value of U.S. M&A activity dropped 42% and the number of deals dropped 33% on a year-over-year basis compared to 2Q 2019. For the first half of 2020, since Q1 was relatively stable as Covid-19 had not kicked in until the second half of March, the comparison was still down but not quite as bad. In 1H 2020, the value of U.S. M&A deal flow dropped 23% and the number of deals dropped 12% on a year-over-year basis compared to 1H 2019.

U.S. Private Equity Middle Market M&A Activity ($Bns)*



*Source: PitchBook Data 2nd Quarter 2020 Private Equity Middle Market Report.

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On a brighter note, while everyone's priority continues to be the health and safety of family and business colleagues, anecdotal evidence reflects a slow but steady uptick in deal flow since about the beginning of June despite the troubling resurgence of the virus. That said, all bets are off if the entire country must go back into a complete lockdown again. Fingers crossed that will not happen.

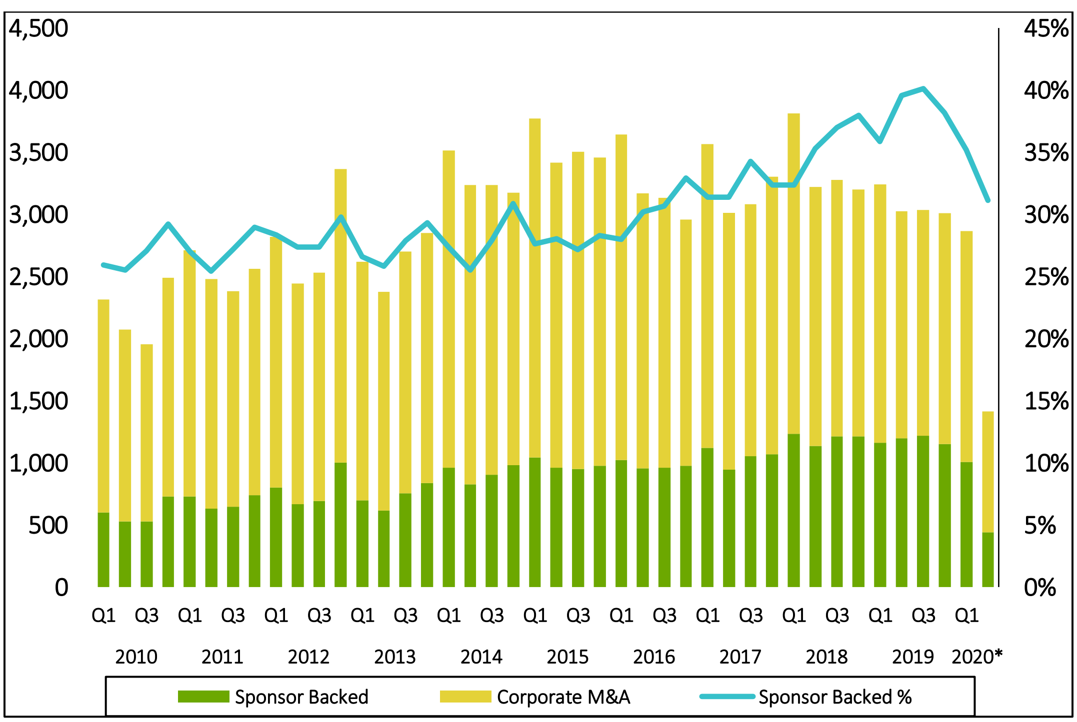
Winners & Losers

Despite the overall slowdown in deal flow, certain sectors such as technology, direct-to-consumer ecommerce, software, and healthcare represent pockets of stable deal-making. Many companies in these sectors have benefited from COVID-19 side effects and have opportunistically sought out M&A transactions in times of volatility. There are also certain sectors that have neither benefitted nor been hurt by the impact of Covid-19, such as the defense industry and certain services sectors like home services (plumbing, HVAC, etc.) and B2B services like environmental or maintenance services including landscaping and janitorial. Deal flow has also been stable in these sectors.

In the hardest hit sectors, however, such as travel and leisure, restaurants and oil and gas, any deal flow has primarily been distressed. Distressed deal flow has not spiked yet however largely because of government assistance. This seems likely to change once these lifelines are depleted and more companies in these sectors are forced to liquidate or reorganize in bankruptcy.

Strategics vs. Sponsors

Transaction Volume by Buyer Type



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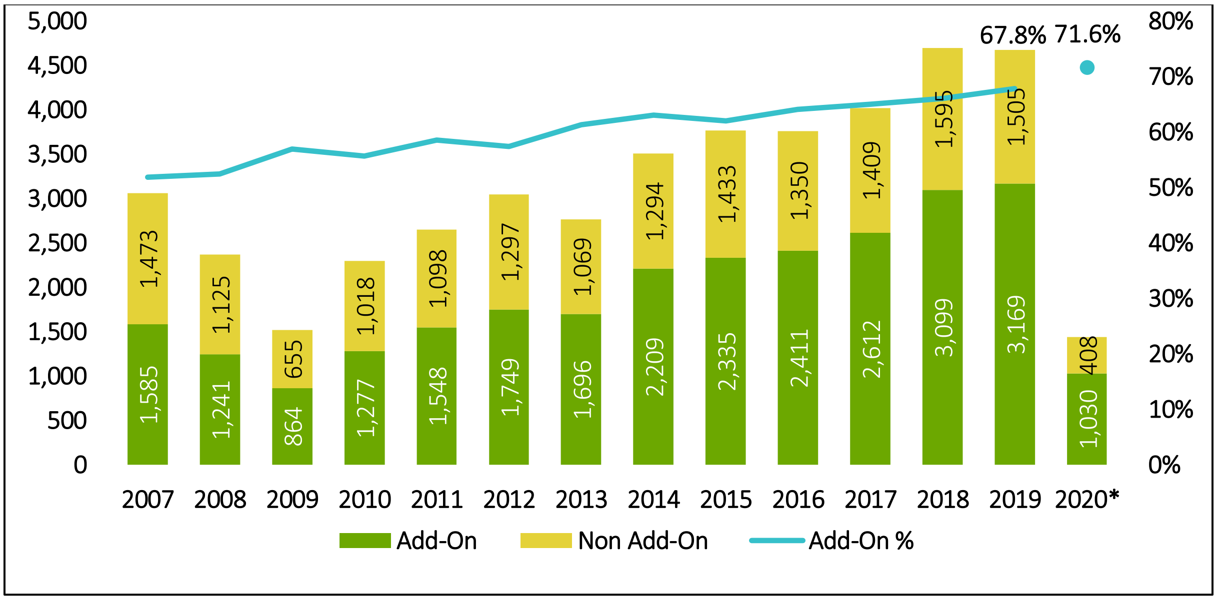
According to PitchBook Data, the percentage of deals completed by financial buyers dropped from a recent peak of 40.1% in 3Q 2019 to a four-year low of 31.1% in 2q 2020 while the percentage completed by strategic buyers increased. We have heard from some sponsors that in certain cases they have had the upper hand as strategic buyers remain internally focused. However, the data tells another story. Many sponsors have said it has become a challenge in the era of Covid-19 to secure the level of debt financing that was available pre-pandemic, thus making it harder for sponsors to pay a high enough price to win deals, especially as it pertains to large platform acquisitions. Our recent experience indicates that large growth-hungry strategics are in fact looking to engage in M&A even involving small targets.

Add-Ons More of a Focus Than Ever



According to PitchBook Data, the percentage of private equity deals representing add-on acquisitions by existing portfolio companies as compared to acquisitions of new platforms has accelerated during the pandemic to nearly 72% in 1H 2020.

We believe this is a result of a number of factors including lack of availability of ample financing for larger platform acquisitions and the lower risk associated with supporting an existing, well understood portfolio company as opposed to the higher risk associated with making a new platform investment. Lenders are also more inclined to support an existing borrower as compared to underwriting an entirely new business especially in the context of a highly leveraged loan with no personal guaranty.

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Valuations & Structure

We have not observed any meaningful declines in valuation multiples (other than a modest decline in some sectors and for some companies on a case-by-case basis). However, what has changed is structure. For the past several years, it was uncommon to see deals, especially large deals, with structure. This has changed and has changed dramatically. Deals that have been completed during the pandemic have often included structure, most notably earnouts, to compensate for uncertainty. Even if a company's performance has been stable so far this year, the pandemic nevertheless creates uncertainty surrounding future performance, so buyers are compelling sellers to take on more risk by accepting earnouts. This is especially true of deals involving targets who have either seen a large increase or sharp decline in business because of Covid-19. This is not as much true for those sectors which have seen little if any impact from Covid-19.

The decline in the availability of bank financing for M&A transactions is also impacting valuation and structure. Most financial buyers will not pay as a high multiple if they cannot get their target level of debt financing. Some will put in more equity to get a deal done but not many based on our experience. As a result, strategic buyers have had the clear upper hand at least in our deals recently. In some cases a tranche of seller financing is being used to plug the gap in debt financing, often in lieu of higher cost third party subordinated debt as sellers most often will accept a more modest return than the cost of capital from mezzanine funds.

Market Outlook & The Election

Currently, there is no indication as to when the virus will moderate (or as some say "disappear") or when the country will be fully up and running, and thus M&A activity is likely to be subdued. Buyers and sellers will continue to grapple with the lack of accurate earnings forecasts, leading both parties to shy away from sitting at the deal table.

The uncertainty created by the election may also have an impact on deal flow as the election gets closer. So far, we have not heard too much about this being a concern given everything else going on around us but that will change. If Biden wins, he has pledged to reverse the Trump tax cut so taxes will increase. One proposal being bounced around is eliminating the long-term capital gains rates for those earning over $1 million. This would essentially double the tax on selling a business from 20% to the top marginal ordinary income rate (which is currently 37% but would likely be increased to nearly 40%). On top of that those of us in budget-constrained states like California and New York are also likely to get hit with much higher state income tax rates in the not-to-distant future.

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Our comprehensive services include:

- Sell-Side and Buy-Side Mergers & Acquisitions Advisory
- Private Equity & Debt Capital Raising
- Acquisition Financing
- Financial Restructuring

Our industries of expertise include:

- Consumer Products & Services
- Business Services
- Aerospace & Defense
- Software & Ecommerce
- Industrial Manufacturing & Distribution

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