SEPTEMBER 2020 UPDATE:

Middle Market M&A Conditions and Outlook

Dunn Rush & Co. commissioned a survey conducted online by Just Jump Marketing in April 2020 among more than 1,100 of the Firm's contacts in the private equity sector across the U.S., in an effort to better understand how the uncertainty surrounding the COVID-19 pandemic is impacting the M&A activity and outlook in the middle market (companies valued under $250 million). In September 2020, we surveyed this same audience to gain insight into how their opinions may have changed given their experience over the past 6 months. Some of our key takeaways and findings follow:

What Happened to Deals In-process as of Mid-March?

Our survey indicated that approximately 25% of the transactions that were in-process in March have now successfully closed, mostly on terms consistent with what had been discussed in the weeks running up to the emergence of the pandemic. Many of these transactions were in sectors such as software and technology that have been largely unaffected by, and in some cases benefitted from, the conditions created by COVID-19. Approximately 30% of transactions that were in-process have now restarted activity after a delay, but have not yet closed. Roughly 20% of transactions have not yet restarted their process but are anticipating doing so in the coming months, and the remaining 25% were pulled off the market.

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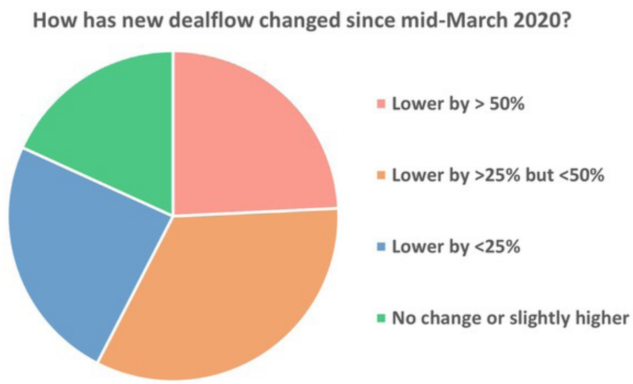
Deal Flow Trends:

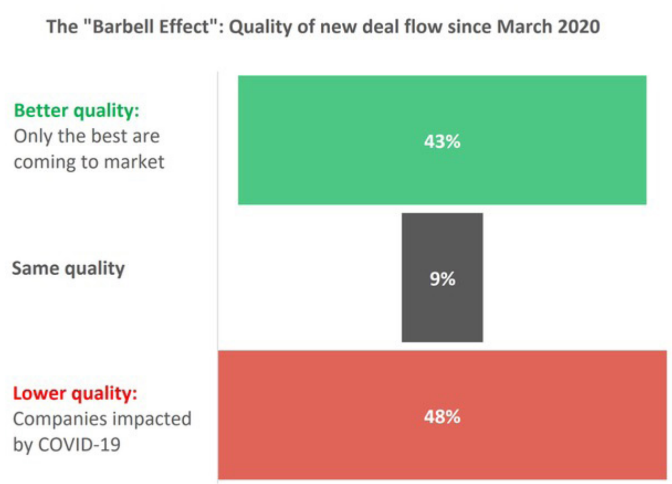
As was indicated in our earlier survey, new deal flow in general fell off dramatically after the emergence of COVID-19 shelter-at-home mandates in mid-March. **During this timeframe, more than 80% of respondents reported a decline of greater than 25%; one-third of those were down by more than 50%**. Those who indicated steady or in a few cases increased deal flow were specialized in industries where demand remained stable or increased due to the impact of COVID-19, such as technology, food distribution and certain healthcare products and services. This slowdown in new deal flow over the past 6 months is a leading indicator for what we expect to be a significantly lower number of closings that will be reported in the coming months in comparison to prior year volume.



While troubling on the surface, there were some positive trends developing in August and September (starting to see seasonally strong new deal volume, potentially caused by pent-up demand) as compared to April and May (which experienced a historically unusual drop-off). We believe this indicates the start of a recovery in the trends of new deal flow, which points to closing volumes potentially rebounding 6 to 9 months out.

Quality of New Deal Flow:

Some respondents indicated that it remains too soon to tell what the impact of COVID-19 has been (and will be) on the quality of the deals they are seeing. However, two-thirds of respondents split their opinions evenly between Lower Quality (businesses impacted by the pandemic) and Better Quality (only the best companies were well positioned to start a process). This "barbell effect" is consistent with what we believed would unfold based on the responses in our first survey earlier this year. We will be monitoring the market closely in the coming months to see indicators for the market starting to pick up for the more mainstream companies somewhere in between the ends of the barbell.



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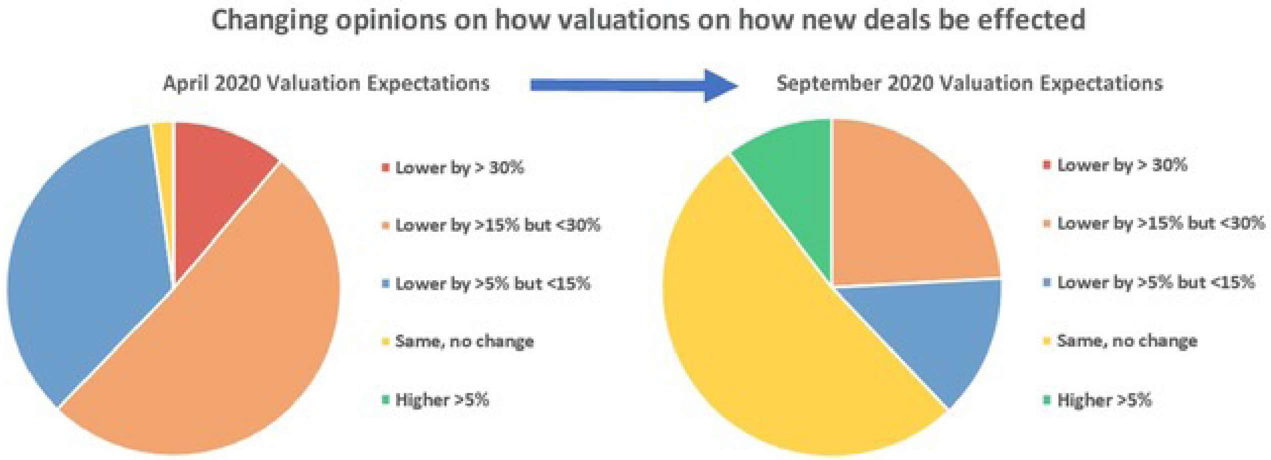
How Will COVID-19 Impact Valuations?

This is one of the most interesting findings from our survey, although somewhat intuitive in the context of the responses above. Forty five percent (45%) of respondents saw no change in valuations during the past 6 months, and 9% actually saw slight increases in value. Thirty three percent (33%) saw a decline in valuations, and two thirds of those were lower by more than 15%. These might appear to be polar opposite indications of what is happening in the market, but we believe logical given two points made by responses to earlier survey questions:

1. Transactions that were able to be close after mid-March were either in attractive industries only made more so by the effect of the pandemic (maintaining strong valuations); or
2. Troubled situations (resulting in low valuations).



Very few new deals have been launching across the range of industries and situations that do not fit into these two categories (i.e., manufacturing, distribution and B2B service businesses, for example). Almost all businesses impacted financially by COVID-19 have been forced to evaluate the impact, implement a strategy to respond, and work to produce data that can demonstrate a recovery of financial performance so as to be armed with the information buyers and financing sources will require in any transaction. So all the companies in the middle of the barbell will need to wait until they have this evidence, while monitoring industry conditions that impact buyers and the lending market, before determining an effective time to launch a transaction process.

How Have/Will Transaction Structures be Impacted?

In stark contrast to the evidence that nominal valuations for growing, profitable companies have not necessarily declined since March, is the opinion of buyers that **transaction structures will in almost all cases be modified to reflect risks associated with COVID-19**. The vast majority of these structural modifications will **shift greater percentages of total deal value into contingent forms of consideration** (such as an earnout, seller note, etc.).

At the risk of stating the obvious, it is worth noting that a **seller's ultimate realized "value" of a $50 million all cash offer can be a very different thing than a $50 million offer with 20% of the price payable in an earnout** only if certain financial targets are hit over a future time frame. In the context of the prior survey question, both examples are $50 million valuations; however no one would consider the second option as attractive as the first if there is a meaningful risk that some or all of the 20% earnout may not eventually be paid.

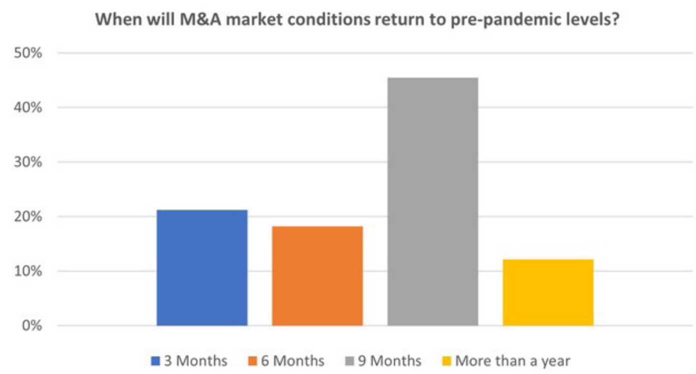
Survey respondents believe the most frequent modification to deal structures will be greater use of earnouts, followed closely by private equity buyers requiring that sellers roll over a higher percentage of their equity into a meaningful ownership stake in the acquiring entity. Expectations for lower valuations and increased use of seller notes were considered less likely but potentially useful deal structure modifications that may be required by buyers for the foreseeable future.

What are the Biggest Challenges to Closing Transactions Going Forward?

Consistent with our findings from our April survey, respondents indicated that the most important factor in closing a transaction in the coming months will be gaining a clear understanding of the impact COVID-19 had, and will continue to have, on a business. Other challenges in closing transactions continue to be bridging the gap in valuation expectations between buyers and sellers given new risks posed by the pandemic, and continuing concern about uncertainty in the debt financing market.

When Will Activity and Valuations Return to Pre-Pandemic Levels?

In our April survey there was really no consensus on when the M&A market would return to pre-pandemic conditions, although the middle of the bell curve predicted mid-2021. It now appears clearer that the majority of respondents expect this to occur, with approximately 85% of respondents expecting a more normal transaction environment before mid-2021.

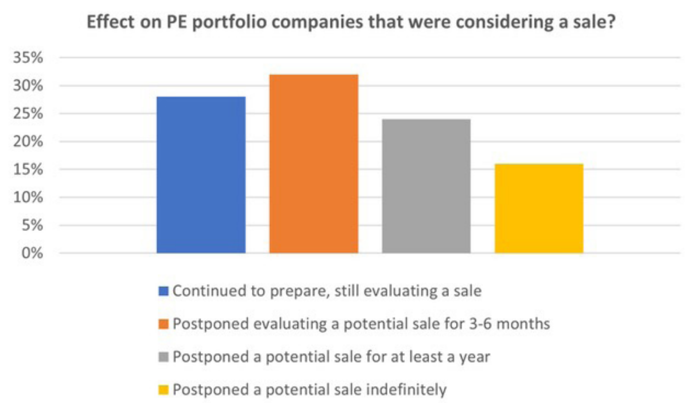


Will Buyers Consider the Financial Impact of Covid-19 to be an Add-Back?

Our April survey indicated that 85% of those who answered the question expected to consider the impact of COVID-19 to be a non-recurring event or add-back when looking at new deals. In September this percentage remains the same, although almost every respondent now answered the question more definitively (whereas almost 40% had indicated it was “too soon to tell” in April). However, several respondents commented that a seller must be able to clearly quantify the impact COVID-19 had during the period and that the business must be able to prove it has rebounded/ recovered from any negative impact before they could or would do so.

How Are Pe Firms Thinking About The Potential Sale Of Their Own Portfolio Companies In This Environment?

Consistent with the findings of our April survey, the pandemic has caused most PE firms to postpone the timing of the sale of their existing portfolio companies who may have considered a near-term sale process. Interestingly, despite the passage of about 6 months since our last survey, results now remain similar to before (in other words, timetables appear to have just shifted forward rather than progressed in any way). A similar number of companies are continuing to prepare and are monitoring market conditions, but more have shifted their timetables outward to a year or more and/or postponed the decision indefinitely.



Final Question we Asked: are you More or Less Optimistic About the Outlook for M&A

First, the raw data: 60% of respondents were more optimistic, 30% were less optimistic, and 10% felt the same way they did 6 months ago. Are you a glass half full, or glass half empty person? The prevalence of general optimism is a good sign, and below is a sampling of some specific comments highlighting several points of interest:

- Optimism for "good" deals in strong sectors; concern for "all the deals not getting done";
- Concern that the "bifurcated market" that has been evident since March will only become more so (strong market for strong companies, high volume of troubled deals, minimal activity for the vast number of businesses in between the two);
- Pleasantly surprised by how the market appears to be opening back up in recent weeks, distinct difference in new deal flow since Labor Day;
- Pent-up demand will likely drive booming volumes in late 2021 and 2022;
- Huge unknowns today that should become clearer in the next couple months: namely the results of the presidential election and whether/when there is an announcement about a potential vaccine (and subsequent widespread availability);
- Significant and meaningful questions around impact on the M&A market based on the tax implications of the presidential election (capital gains rate in particular);
- Pessimism about forward-looking business environment because programs like PPP loans kept many businesses afloat;
- Concern about looming increases in bankruptcies, and the potentially disastrous impact of another shutdown from a "second wave";
- The economy needs more time to process the damage done;
- Optimistic that processes are narrower and more sellers are seeking financial partners to help grow their businesses out of the pandemic impact; and
- Belief that aging population of Baby Boomer business owners, combined with backlog of deals "benched" during the past 6 months, will drive solid activity going forward.

SUMMARY

Our second market survey in many ways solidified some of the conclusions we drew from the initial survey 6 months ago. The COVID-19 pandemic has created a barbell market with three distinctly different segments: continuing strength in deal volume and price for those companies whose financial performance was positively impacted by the pandemic; a significant number of troubled transactions at very low values and challenging terms for those businesses impacted most negatively by the pandemic; and a broad group of businesses in-between that have been impacted in some way but are on the path to recovery and in the process of compiling the data necessary to prove that recovery. The vast majority of the companies in this last category have been in a holding pattern during the past 6 months, and there is optimism that those who can provide ample credible data to evidence their recovery may be able to access the M&A market more regularly in the coming months.

Overall, due to the relative lack of new deals being launched over the past six months, we continue to believe that there will be a significant drop in the number of transactions completed between now and the end of 2020 in comparison to the prior year. The possibility of significant shifts in the tax code based on the outcome of the presidential election could be a factor that drives more activity in the M&A market in the next 6 – 9 months (i.e., ahead of any passage of tax reforms). But in general, we continue to believe the middle market M&A transaction environment should recover to a more "normal" environment by mid-2021.

We continue to see evidence that distressed businesses will likely see significant declines in value due to the compounded effect of lower multiples on weaker financial results, and that stronger companies whose financial performance has benefitted from the conditions created by the pandemic will likely continue to command high valuations.

We anticipate the M&A market will begin to open up again in Q4 2020 for those businesses that can present the data to support their recovery and/or return to pre-pandemic performance run-rates. We expect there will be a modest decline compared to 2019 in valuations for companies in more "mainstream" industries that experienced some negative financial impact from the pandemic. The prevalence of contingent payments will increase significantly if not become a factor in almost all transaction structures for some period of time going forward.

We hope that you found this report and its findings useful. We will continue to monitor and track the M&A market and welcome the opportunity to talk with you about our insights and commentary on the business climate and economic implications. Regardless of when or whether you might be interested in considering a sale, it is always a good business practice to understand the factors impacting the value of your business and ways you can create value and be best positioned to take advantage of any opportunities in the future.

* Survey Method:
This survey was conducted online within the United States by Just Jump Marketing from September 17-22, 2020 among approximately 1,100 U.S. adults ages 18 and older. This online survey is not based on a probability sample and therefore no estimate of theoretical sampling error can be calculated.

DUNN RUSH & CO.

Dunn Rush & Co. LLC | 101 Federal Street, Suite 1900, Boston, MA 02110
(617) 451-0001 | dunnrush.com

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