CIBC
Cleary Gull

MARKET MONITOR

M&A and financing update
1st Quarter 2020

“There are decades where nothing happens; and there are weeks where decades happen” said Vladimir Lenin

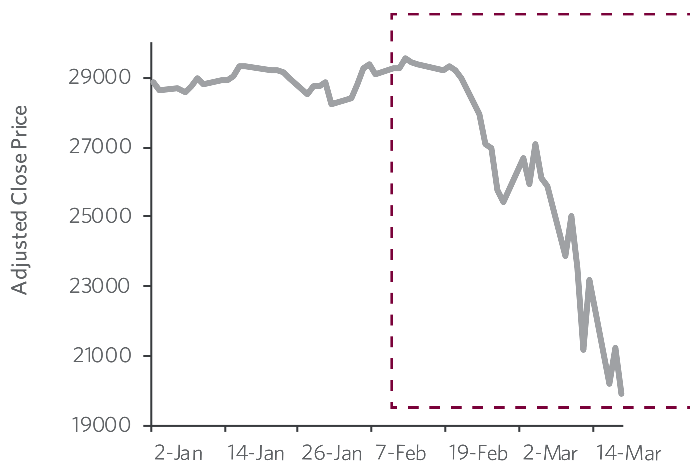
Indeed for many of us, the last few weeks of “interesting times” seemed undoubtedly like decades. We are hearing “unprecedented” as often as “coronavirus”. An increasingly common sentiment is that “this time is different.” Lately, the comparisons to past events such as the Great Recession, September 11th, and Black Monday have been questioned. But, relatively little attention has been given to the oil price shock that may have more significant long-term economic implications than COVID-19. The lack of precedent, or our ability to recognize precedent where it’s relevant, will test leadership at all levels of the U.S. economy as monetary, fiscal, and regulatory policy levers are being pulled to create a baseline and a path forward.

From February 11th to March 12th, the Dow Industrial average dropped 28%, sending the U.S. into a bear market. On March 9th the stock market experienced its first trading halt when the S&P 500 declined 7%. The capital markets took notice and continued forward. On March 12th when the second trading halt occurred the gravity of the situation intensified and the capital markets began to pause. By noon, almost every M&A sale process was stopped due to the very real threat of COVID-19 on the U.S. economy as the hospitality industry closed its doors, social gathering was restricted by local governments, and employers quickly shifted to work from home models.

The week of March 16th brought daily and sometimes hourly changes to the capital markets and the U.S. economy. Discussions with business owners have since shifted from growth and prosperity to liquidity needs, business continuity plans, human resource policies, and the adequacy of the technology systems to support the flood of remote workers in need of connectivity. As shelter-in-place spread across the nation, many businesses and private equity groups drew down their lines of credit to assure they have the liquidity they need for the next 30 to 60 days.

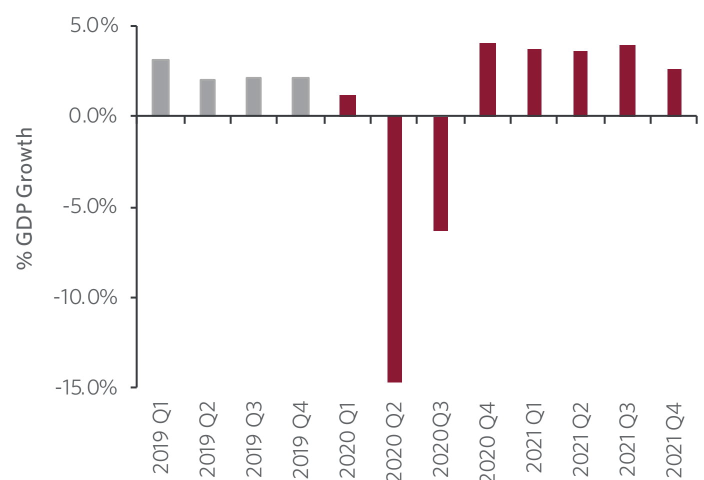
It is safe to assume that uncertainty and concerns about liquidity will dominate the M&A market for the next few months as the government and businesses work collaboratively to slow the spread of the virus and lower the number of new reported cases of COVID-19 as social distancing guidelines are followed and shelter-in-place orders are enacted. China and Italy are two examples. It took 3 months for the first 100,000 cases of COVID-19 to be reported but only 12 days for the next 100,000 cases. Here is the timeline of key events in China, the first case was reported on December 10th, mandatory quarantines implemented on January 23rd, and March 19th was the first day that no new cases were reported. If the U.S. follow the social distancing rules, the economy could see some stability return in 30 to 60 days and business owners could return to making decisions about the right time to sell their businesses in order to capitalize on the $1.2 trillion of private equity “dry powder” waiting to be put to work.

Dow 30 2020 Performance



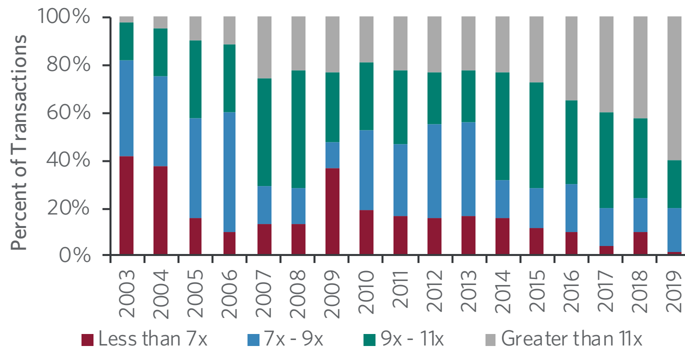
Source: Yahoo Finance

Quarterly U.S. Gross Domestic Product



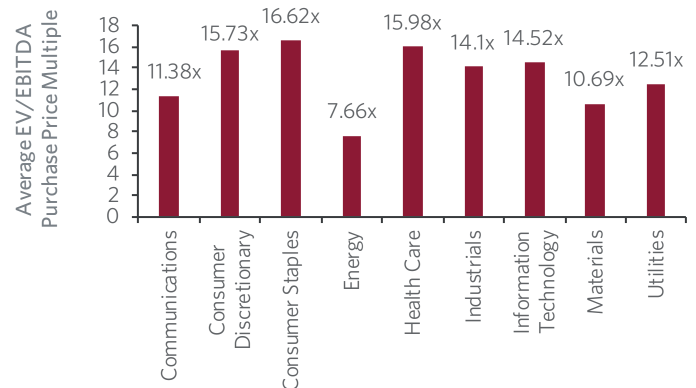
Source: U.S. Department of Commerce and Wells Fargo

Average EV/EBITDA purchase price multiple for US LBOs



Source: Thomson LPC

Average EV/EBITDA purchase price multiple by GICS sector as of 6/30/2019



Source: Siblis Research

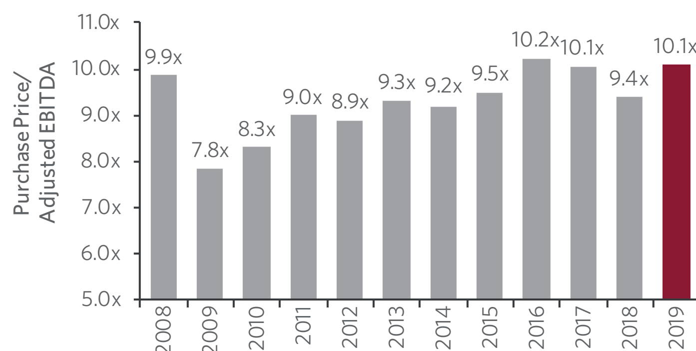
LBO valuation multiples trend towards public sector multiples

The multi-year trend of private equity firms and strategic buyers paying "frothy" valuation multiples continued in 2019 at least for companies serving recession resistant markets. For the year, GF Data® put the average enterprise value/EBITDA multiples for $10 to $250 million enterprise value leveraged buyouts ("LBOs") at 7.2x EBITDA, while Pitchbook reported the average enterprise value/EBITDAmultiple for all U.S.M&A transactions was 10.1x EBITDA.

Over the last 15 years, the market for LBOs has become more efficient due to the increasing amount of capital allocated to private equity by endowments and pension funds, private equity funds evolving to more of a sector-specific focus creating deep pockets of expertise to support their investment strategies, and a more active "secondary" market (sales between private equity funds). The seventeen year trend of purchase price multiples in the chart above illustrates the maturing of the LBO market with 2006 LBOs that transacted at 11.0x EBITDA or greater, representing approximately 10% of all transactions and 2019 LBOs that transacted at values in excess of 11.0x EBITDA representing over 50% of all LBOs. A decade ago, there might have been one outlier strategic buyer in excess of 11x EBITDA, but today it is not uncommon to have multiple bidders at this type of valuation in recession-resistant, recurring revenue industries.

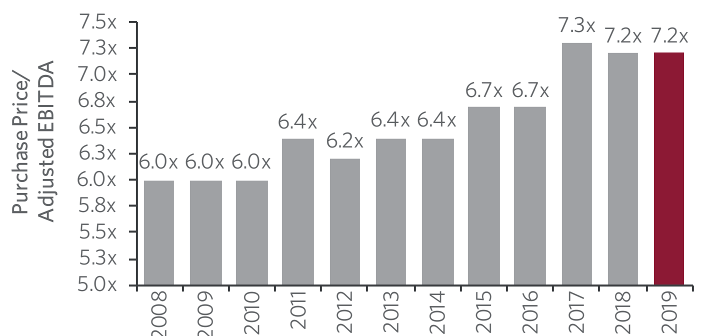
Historically, there was a significant enterprise value/EBITDA multiple disparity between the 500 largest U.S. publicly-traded companies in a GICS sector and private company valuations in the same sector. Today, it is narrow and, not surprisingly, this trend is also leading to the convergence of equity returns for the two asset classes. It will be interesting to watch whether the valuation trends over the last four years represented a valuation bubble or a maturing of the private equity market as the COVID-19 pandemic is contained and M&A market is reopened.

U.S. M&A transaction multiples



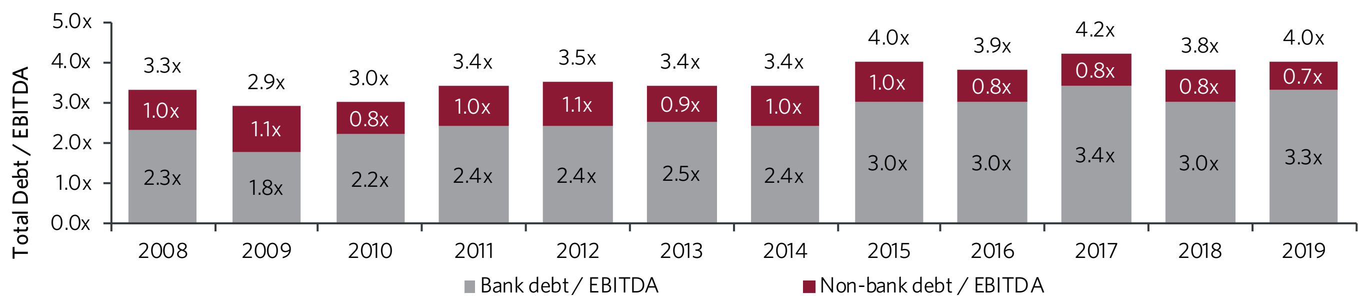
Source: PitchBook

Average purchase price/adjusted EBITDA multiples for private equity-backed LBOs with $10mm - $250mm of enterprise value



Source: GF Data®

Average platform LBO debt multiples for deals with $10mm – $250mm of enterprise value



Source: GF Data®

Debt availability remains strong for the 5th-consecutive year but uncertainty is here

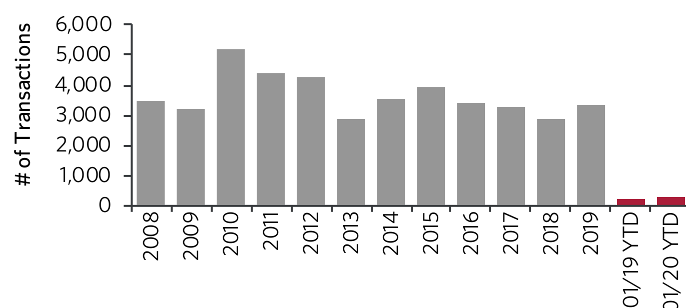
In 2019, the average total debt/EBITDA multiple for private equity-backed LBOs from $10 to $250 million was 4.0x, according to GF Data®. The bank debt portion increased to 3.3x EBITDA. A key driver of the bank debt availability expansion was competition from non-bank lenders, which continued to take market share from traditional banks for LBOs in desirable sectors. Uni-tranche lenders supported LBOs with an average total debt/EBITDA of 4.0x and BDCs supported LBOs with an average total debt/EBITDA of 4.7x. This is nearly a full turn of additional debt availability beyond the regulatory threshold comfort level of 3.0x senior/4.0x total debt that typically restricts bank lenders. However, GF Data® anecdotally noted that traditional lenders continue to win their share of LBOs for borrowers focused on a broader relationship with their lender or serve traditionally cyclical markets. Nonetheless funded total debt/EBITDA remained near record levels despite financial sponsors deciding over 50% of the time to fund their transactions with less than the maximum amount of available debt. In the current COVID-19 environment, banks are open but credit leadership is urging lending officers to pause or "slow play" new commitments for 30 days hoping that the economy will exhibit some sign of stability.

The velocity of 2019 deal volume has continued into early 2020

As we mentioned in the Q4 2019 Market Monitor, the market finally saw the link between increased deal volume and high prices in 2019. For the year, the number of completed transactions under $500 million rose 16.0%, compared to 2018, according to Robert W. Baird & Co. The three industries that dominated the deal flow and drove the increased deal volume were technology, healthcare and business services. By contrast, these are the three industries most often cited as outperforming the general economy during a recession. January 2020 deal volume had a strong start with the number of completed transactions under $500 million increased by 10.2%, compared to January 2019.

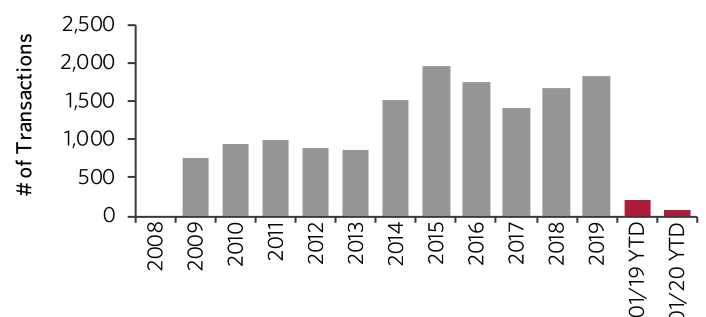
At this time, it is safe to assume that very few deals will be completed in Q2 and Q3 2020 because of the uncertainties surrounding COVID-19 and the oil price war between Russia and Saudi Arabia.

U.S. M&A deal volume for transactions under $500MM



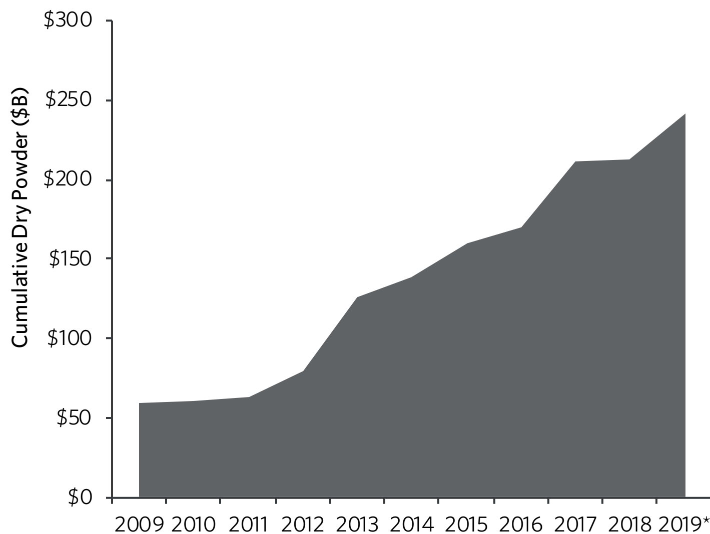
Source: Yahoo Finance

U.S. M&A deal value



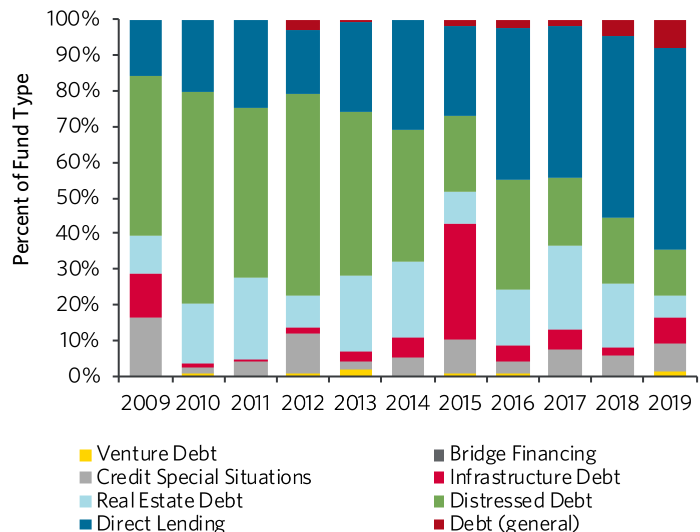
Source: U.S. Department of Commerce and Wells Fargo

Private Debt Overhang ($B)



Source: Thomson LPC

Global Fundraising by type



Source: Siblis Research

Private debt fund expansion fueled by regulation and appealing returns for LPs

Enterprising firms have always created new financial products to capitalize on market inefficiencies born from new regulations or changes to existing regulations. Private debt funds began to gain relevance in the late 1980s with the emergence of special situation lending vehicles and mezzanine debt. Bank consolidations in the 90s and 2000s shifted the primary focus of the largest banks from "main street" and lower middle market borrowers to large corporate borrowers that presented the greatest opportunities for them to cross-sell products and services. Then in 2013 the Leverage Lending Guidance ("LLG") rule was enacted to deter traditional banks from engaging in risky leverage lending activities. While the definition of leveraged lending in the LLG is complex, the key factor is a threshold of senior debt in excess of 3.0x EBITDA and total debt in excess of 4.0x EBITDA ("3x/4x debt"). Coincidentally, the timing of the enactment of the LLG standards is approximately when private equity-backed companies exceeded the number of public companies for the first time in history, thereby increasing competition among large banks for a dwindling supply of "strategic relationship" public companies.

In 2019, according to Pitchbook, direct lending funds raised $74.5 billion or 56.9% of the capital raised for all private debt strategies, which was a significant increase, compared to the $15.4 billion raised in 2013. Recently, notable Limited Partners ("LPs"), such as Arizona's State Retirement System and the Teacher's Retirement System of the State of Illinois, have increased their allocation to direct lending funds from 13% to 17%. CalPERS, a major LP, announced in December 2019 that it plans to allocate $5.0 billion to direct lending funds, which it noted was a previously overlooked asset class.

In Q2 2019, the top five lenders to LBOs were all direct lending funds: Antares Capital, Ares, The Carlyle Group, Churchill Asset Management, and Twin Brook Capital Partners. Additionally, multi-strategy asset managers Cerberus, Apollo, and BlackRock also raised private debt funds. The attributes of direct lending that appeal to these anchor LPs are: high-single-digit to low-doubledigit returns (which have eluded investors in traditional fixed income and high-yield markets), fairly constant capital calls despite the capital overhang increasing to $241.4 billion, regular distributions, and a more conservative position in the capital stack. Several LPs noted their concern about the frothy multiples for LBOs in today's "priced to perfection" market, saying they prefer the safety of senior debt over equity this late in the economic cycle. Direct lenders have begun to dominate the LBO market as a result of the strong funds inflow to the asset class, their ability to underwrite total/debt EBITDA in excess of 3x/4x total debt and in many cases 6.5x EBITDA, the lack of regulatory requirements, which increases speed and certainty to close and allows for flexible structures and terms (low or no amortization term loans, covenant-lite terms, etc.). With the recent disruption in the equity and debt markets, it will be very interesting to see how direct lending funds handle our uncertain times as companies seek liquidity and trip covenants in Q2 2020.

Firm overview

CIBC Cleary Gull is a nationally recognized boutique investment banking firm with a global reach. We advise private equity funds, entrepreneurs, and small publicly traded companies on mergers and acquisitions, private debt and equity financings and recapitalizations and other transactions.

Our talented team has completed hundreds of middle market transactions delivering more than $8 billion in value. With an average of more than 20 years of deal experience, our skilled senior investment bankers bring knowledge, integrity and relentless determination to deliver great outcomes for our clients.

Global reach

CIBC Cleary Gull is a member of the International Association of Investment Bankers. The IAIB (iaib.org) is a global network of investment banking firms in Asia, Australia, Europe, and North and South America working together to broaden their reach and leverage their expertise.

Contact us for more information on CIBC Cleary Gull and our Investment Banking services.

Contacts:

Kevin Li
Managing Director and Head,
U.S. Investment Banking
312 564-2957
kevin.li@cibc.com

Ronald Miller
Managing Director and Head,
CIBC Cleary Gull
414 291-4528
ronald.miller@cibc.com

Patrick Bremmer
Managing Director
414 291-4548
patrick.bremmer@cibc.com

Ryan Chimenti
Managing Director
414 291-4531
ryan.chimenti@cibc.com

Rob Gjerlow
Managing Director
312 564-2785
rob.gjerlow@cibc.com

Gregory Gorlinski
Managing Director
414 291-4559
gregory.gorlinski@cibc.com

Ryan Olsta
Managing Director
414 291-4555
ryan.olsta@cibc.com

John Peterson
Managing Director
414 291-4551
john.peterson@cibc.com

Eric Reuther
Managing Director
312 564-2786
eric.reuther@cibc.com

Christopher Larsen
Executive Director
414 291-4547
christopher.larsen@cibc.com

James Olson
Executive Director
414 291-4552
james.olson@cibc.com

Patrick Ringsred
Executive Director
414 291-4553
patrick.ringsred@cibc.com

CIBC
Cleary Gull

This presentation does not constitute a solicitation, an offer to buy or sell any security or a commitment to underwrite any securities or to arrange or provide any equity, debt, credit or other financing. CIBC Capital Markets employees are prohibited from offering to change or otherwise influence any research report, rating or price target to any company as inducement for the receipt of any business or compensation.

All values are expressed in U.S. dollars, unless otherwise noted.

CIBC Capital Markets is a trademark brand name under which Canadian Imperial Bank of Commerce ("CIBC"), its subsidiaries and affiliates (including, without limitation, CIBC World Markets Inc., CIBC World Markets Corp. and CIBC World Markets plc) provide products and services to our customers around the world. In the U.S., CIBC Capital Markets also provides investment banking services under the brand name CIBC Cleary Gull. Securities and other products offered or sold by CIBC Capital Markets are subject to investment risks, including possible loss of the principal invested. Each subsidiary or affiliate of CIBC is solely responsible for its own contractual obligations and commitments. Unless stated otherwise in writing CIBC Capital Markets products and services are not insured by the Canada Deposit Insurance Corporation, the Federal Deposit Insurance Corporation, or other similar deposit insurance and are not endorsed or guaranteed by any bank.

CIBC Capital Markets and the CIBC Logo Design are trademarks of CIBC, used under license.