CIBC CLEARY GULL

MARKET MONITOR

M&A and financing update
4th Quarter 2021

U.S. labor force participation rates by age

Age Group	Jan-20	Aug-21	Change
16 to 19	36.0%	36.7%	0.7%
20 to 24	**72.6%**	**70.2%**	**-2.4%**
25 to 34	83.7%	82.3%	-1.4%
35 to 44	83.5%	82.1%	-1.4%
45 to 54	81.7%	80.9%	-0.8%
55 to 64	65.1%	64.7%	-0.4%
65 to 69	33.4%	32.1%	-1.3%
70 to 74	**20.6%**	**17.7%**	**-2.9%**
Total (16 & Over)	**63.4%**	**61.7%**	**-1.7%**

Source: Wisconsin Department of Revenue

Drops in labor force participation rates affecting M&A

In 2020, business owners talked about COVID policies and procedures. In 2021, the headline topic for business owners is still human resource focused, but the critical issues are recruitment and retention. Many management teams have a common observation: "We have the business to grow, but we can't find employees".

The disruption in labor supply started with the COVID shutdown of "non-essential" businesses, layoffs, and employees being asked to work from home. That resulted in a 1.7% decline in labor participation rates for those 16 and over. The displaced employees adapted to their new reality by eliminating non-essential expenses, increasing savings, and finding reasons to enjoy the flexibility. As we approach the two-year mark of work-from-home, increased virtual or home school learning, and continued restrictions on social gatherings, employers discover that many employees have permanently left the workforce or redefined their criteria for employment with a desire for more work/life balance.

The two most notable declines have occurred in the 20 to 24 and 70 to 74 age groups. Both age groups had a high participation rate in hospitality and retail deemed non-essential during COVID. Many of these young adults and retirees exited the workforce instead of finding another job. Consequently, your favorite local restaurants are now half full because of staffing challenges. The employees in the 70 to 74 age group that left the workforce are permanent losses. Furthermore, those in the 20 to 24 age group are now not geographically constrained and are more likely to be "job hoppers" capitalizing on lucrative signing bonuses and higher compensation as employers compete for talent.

The labor force disruption has also been impacted by workers that have left the workforce during COVID including:

- *4.5 million married persons* – Equally split between men and women who prioritized their children's education and quality of life over dual income lifestyles.
- *1.1 million multiple jobholders* – Many of these second jobs were also second shift in hospitality and retail, so post-COVID fill rates will remain a challenge.
- *2.0 million more people are now self- employed* – COVID has created numerous "contract" employees that can work when they want, where they want, and on their own terms.

The labor shortage is even more alarming beyond 2022. A recent study by the Gates Foundation highlighted the pending decline in global population growth during the second half of this century. The population decline is expected to be led by China from 1.4 billion to 732 million by 2100.

As a result of the global labor shortage, culture and employee retention and recruitment have already become critical issues during M&A due diligence. It would not be surprising to see companies that excel at employee recruitment and retention become more valuable.

2021 valuation premium drilldown for PE-backed above average platform companies

Total EV (millions)	All	Buyouts only	PE/Corp seller	Above average	Post-Close Mgmt	All three
$10-25	6.0x	5.9x	5.6x	6.4x	5.9x	6.0x
$25-50	7.1x	7.1x	8.6x	7.6x	7.2x	7.8x
$50-100	8.2x	8.3x	8.1x	8.5x	8.3x	6.8x
$100-250	8.9x	8.9x	10.1x	9.4x	8.8x	9.8x
Total	**7.2x**	**7.2x**	**8.1x**	**7.8x**	**7.3x**	**8.4x**

Source: GF Data®

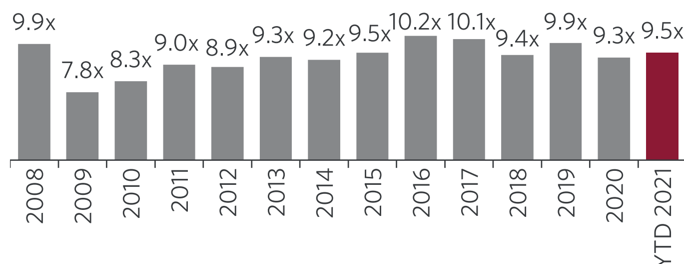
Growth platforms attracting higher valuations in 2021

The goal for certain private equity ("PE") funds and corporations is to invest in businesses with great management teams executing on a differentiated go-to-market strategy and driving annual double-digit sales and EBITDA growth rates, even though typically companies with these characteristics have higher purchase multiples than companies without them. According to GF Data®, $10 to $250 million enterprise value companies that had private equity ownership, above-average financial characteristics and continuing management were valued at an average EBITDA multiple of 8.4x in YTD 2021. This is 1.2x EBITDA higher than the YTD 2021 average EBITDA multiple of 7.2x for all private equity-backed leveraged buyouts ("LBOs") and 2.4x EBITDA higher than businesses with lesser growth rates and undifferentiated go-to-market strategies.

The allure of the PE-backed above-average platform company is the application of the "time value of money" investing principle. As a result, buyers are willing to pay a significant valuation premium to purchase a team and business that can continue or begin executing an organic or acquisition growth strategy immediately instead of year two or three after a management transition. Buyers flock to these high-quality assets because larger funds and corporations use acquisitions to drive growth. These growth platforms are often the companies you hear about selling multiple times in a ten-year period and each time delivering an exceptional internal rate of return ("IRR") and multiple of invested capital ("MOIC") for the owner. Each sale creates a bellwether transaction for the seller to raise its next, significantly larger fund. The buyer selected by the sellers is typically the one that pays the highest price and has the best "angle" to deliver more resources and capital to help these high-performing businesses accelerate their growth trajectory.

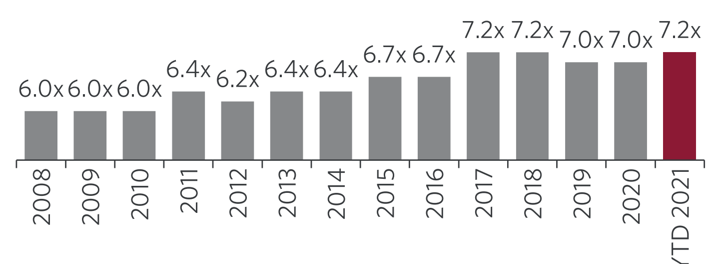
As 2022 approaches, valuations for PE-backed above-average platform companies should continue to trade at premium valuations. Historically, investments that were "winners" for PE fund buyers would still have been rewarding even if the PE fund had paid a higher multiple for the acquisition. This sort of calculus will continue to drive premium valuations for growth platforms.

Average U.S. M&A EBITDA multiples



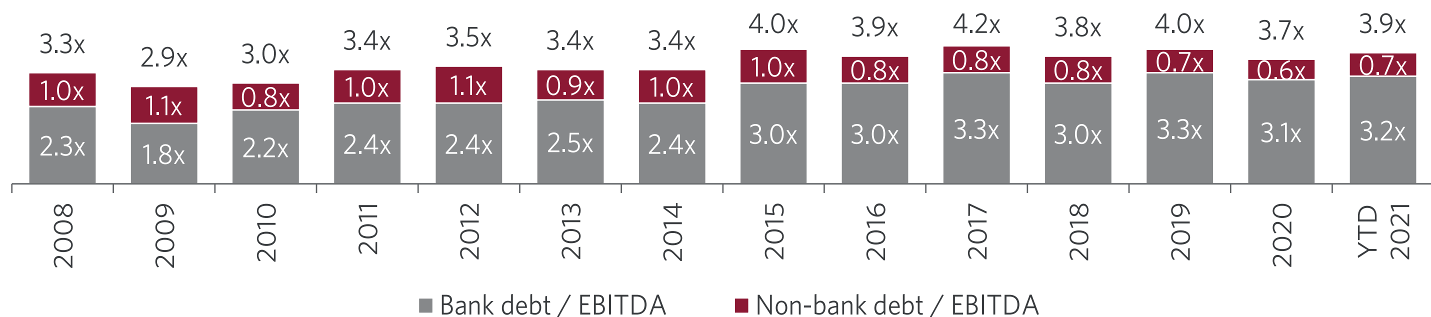
Source: PitchBook

Average EBITDA multiples for $10mm - $250mm PE-backed LBOs



Source: GF Data®

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



Source: GF Data®

Debt remains available and "cheap"

According to GF Data®, the average total debt/EBITDA multiple for LBOs with $10 to $250 million enterprise value was 3.9x through Q3 2021, essentially unchanged over the last seven years other than during the COVID shutdown in 2020. The one issue that has emerged during the second half of 2021 is the reemergence of the use of non-bank debt ("mezzanine") to support LBOs. For transactions that utilized maximum leverage in 2021, mezzanine debt averaged 1.0x EBITDA, compared to 0.6x in 2020. It is hard to tell at this point whether this shift is a signal that buyers have a higher level of confidence in seller forecasts and this certainty is leading to increased leverage to support the LBO and a smaller equity contribution or buyers are looking to mezzanine for their willingness to pair their mezzanine debt with an equity co-investment to provide buyers with a moderate amount of risk sharing with a partner.

Senior debt pricing has also continued to tighten post-COVID. According to GF Data®, the average senior debt pricing declined from 5.7% in Q3 2020 to 4.6% in Q3 2021. Lenders continue to compete aggressively on price and terms to win new business and grow loan portfolios. In addition to price, lenders are continuing to use low amortization and covenant "lite" structures to appeal to private equity buyers looking for inexpensive financing options for new LBOs that provide the company with the maximum amount of flexibility in their senior loan agreement. PE owners are using flexible debt structures and limited covenants to enable them to easily adjust the existing debt facility through an accordion feature or delayed draw term loan in order to facilitate an acquisition or return capital to shareholders via a dividend recapitalization.

As we enter 2022, most economic and Federal Reserve forecasts are predicting rising interest rates in the coming year in response to inflation concerns and the reversal of quantitative easing strategy. Hopefully, they will be right this time. In any event, even with the expected increase in interest rates in 2022, rates will still be near historic lows.

Senior debt pricing – split by period

Total EV (millions)	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020	Q1 2021	Q2 2021	Q3 2021
$10-25	4.9%	5.4%	8.3%	5.5%	4.2%	5.1%	4.1%	4.1%
$25-50	5.5%	5.2%	5.3%	4.5%	5.3%	5.5%	4.3%	4.8%
$50-100	5.8%	6.1%	4.2%	6.6%	5.2%	5.4%	5.0%	4.1%
$100-250	6.4%	5.7%	4.4%	8.0%	7.0%	5.2%	5.7%	5.5%
Total	**5.4%**	**5.5%**	**5.7%**	**5.7%**	**5.2%**	**5.3%**	**4.6%**	**4.6%**

Source: GF Data®

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