2021 Mid-Year M&A Outlook

Canadian Mid-Market: Road to Recovery

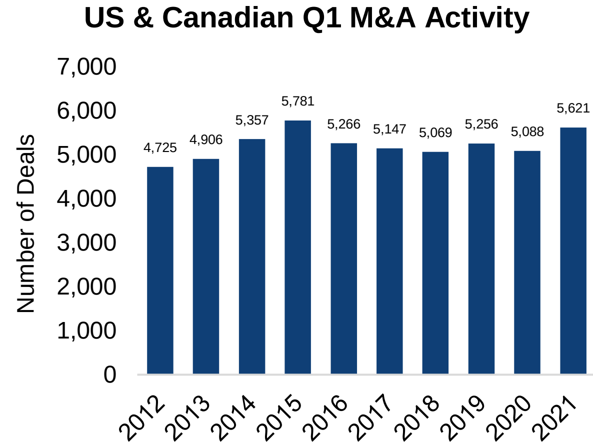
BEACON
MERGERS & ACQUISITIONS

The Road to Recovery

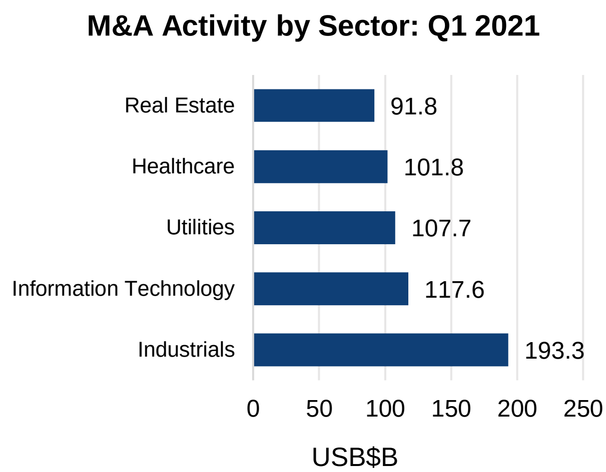
2020 was a challenging year for the private lower middle market and widespread operational disruptions, liquidity constraints and lay offs, pushed M&A activity to a six-year low. Companies' executives were forced to prioritise the immediate health of their own businesses and put long-term acquisition plans on hold. Similarly, private equity firms focused on strengthening their current portfolio at the expense of new deal activity.

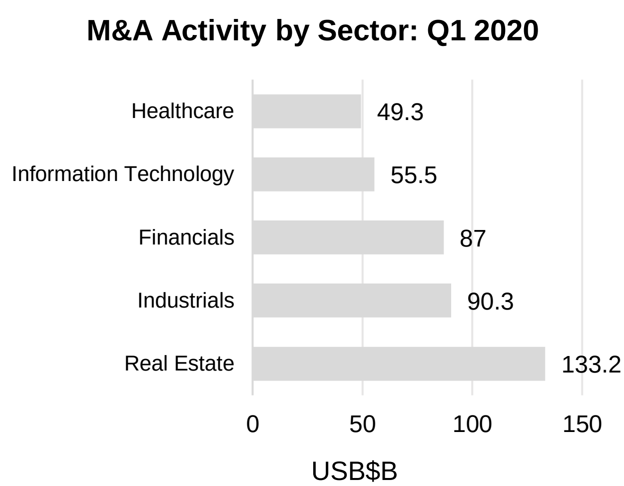
Despite these headwinds, the economy has shown resilience and M&A activity came roaring back in 2021. A total of 5,621 deals targeting companies in the U.S. and Canada were announced between January and March of this year, the second highest first-quarter total behind 5,781 deals in 2015, according to S&P Global Market Intelligence data. This strong quarterly performance extends a recovery period that began in Q3 of 2020 as companies were able to weather the storm more easily than anticipated due to accomodative monetary policy and fiscal stimulus.

What's more is that the total value of M&A deals announced in Q1 of 2021 was $409.13 billion, almost double the $218.04 billion total in the first three months of 2020. This surge in activity is expected to continue for the rest of 2021 as businesses focus on deploying capital to accelerate growth, scale up, and digitize their operations all while cost of borrowing is cheap.



Source: S&P Global Market Intelligence





Source: S&P Global Market Intelligence

The Asymmetric Impact of the Pandemic

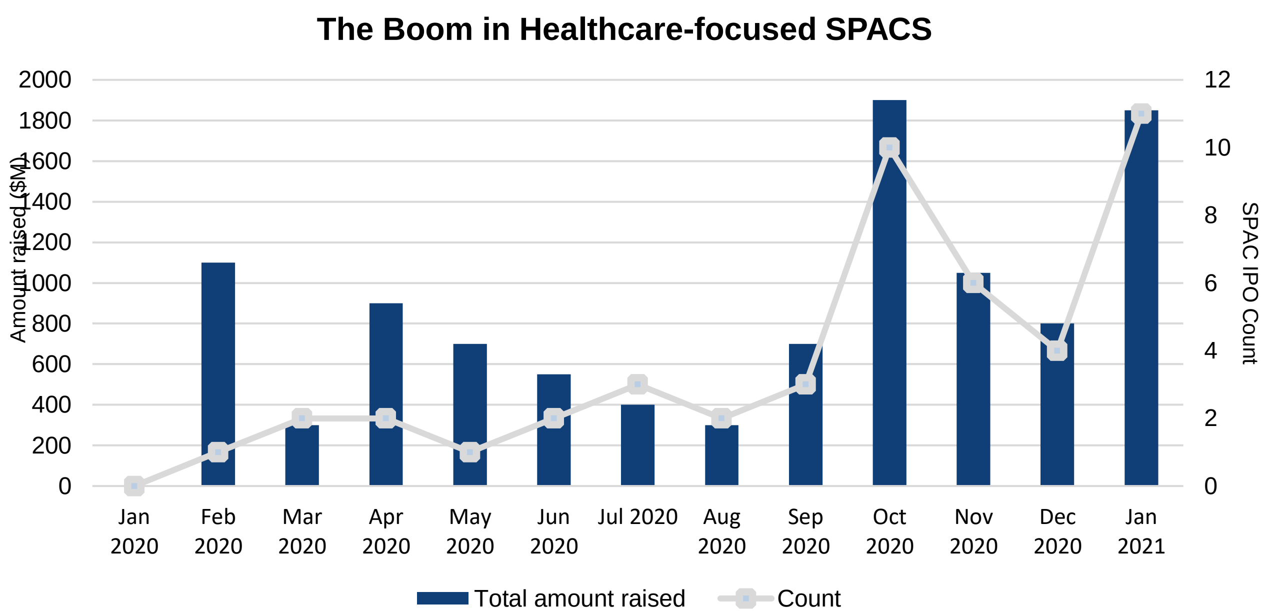
The pandemic has impacted all industries, but some businesses and sectors have been hit harder than others. The impact of the restricted traffic and consumption on direct demand, regulatory restrictions and the ability to adapt to virtual environments have been key factors in determining the severity of the impact on businesses.

The industrials sector, responsible for the manufacturing and distribution of capital goods used in construction and engineering, made up 939 of first-quarter M&A deals, an increase of 63.3% over the first quarter of 2020 total. Meanwhile deals in the information technology sector totaled $117.6 billion USD in value as the pandemic boosted demand for improved cybersecurity and supplementary cloud computing and digital services.

Investors have also shown a keen interest in the healthcare services market where deal volume increased by over 106.5% compared to Q1 of 2020. What is driving this uptick in healthcare M&A besides the obvious need for virtual healthcare? Special purpose acquisition companies (SPACs) – “blank check” shell corporations designed to take companies public without going through the lengthy traditional IPO process. More digital health firms have completed or declared public exits in the first quarter of 2021 than in the entire year of 2020. There are two reasons why this is happening:

1. SPACs are drawn to **high-growth markets**, and digital health is expected to expand rapidly beyond the pandemic as at-home care is normalized.

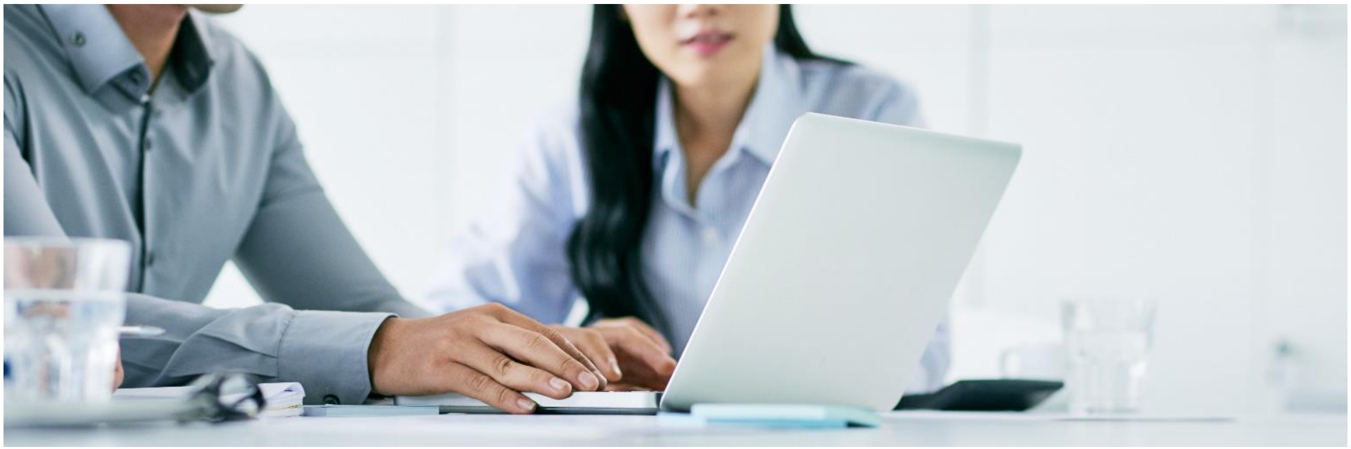
2. SPAC deals are identified ahead of time, and valuations are agreed upon by both parties – they are also done a lot **quicker** than traditional IPO’s.



Source: SPAC Insider

The asymmetric consequences of the pandemic are highlighted when we look at the industries that have not fared as well as the industrials, IT, and healthcare sectors have. The COVID-19 pandemic had the greatest impact on economic activity in Canada's housing, restaurant, and food service; hospitality and tourism; and entertainment and lifestyle industries. Through 2021, mandatory shutdowns, border closures, and stay-at-home guidelines have prevented businesses in these industries from operating at full capacity. Airlines have trimmed down capacity, due to a considerable drop in travel demand and strict government mandates. This has directly impacted tourism revenue and demand from international travellers. While the industry has tried to cushion the blow by supporting growth in e-commerce and targeting other revenue streams, core business demand remains weak and many small businesses that did not have resources to adapt have failed.

By the end of 2020, the food and beverage industry had adjusted to the new reality by operating at reduced capacity, turning to take-out and delivery services, laying off employees, and seeking out government subsidies. With continuing restrictions placed on in-person dining, businesses have shifted to contactless delivery and take-out while making investments to expand their online sales capabilities. According to a survey conducted by Statistics Canada, nearly 55% of business owners expected their profitability and employee headcount to decrease over the next three months despite numerous efforts by the government to provide emergency funds and wage subsidies. On a larger scale, food and beverage M&A deal activity in the U.S. and Canada made a significant recovery in the second half of 2020 with transaction volumes in Q4 2020 up just over 5% from the previous year. Given strategic buyers' large cash reserves, private equity funds' dry powder, low interest rates, and the vaccine rollout timeline, the outlook for M&A activity in 2021 is robust.



The Transaction Advisory Process

It is important to note that unlike in past crises that have merely affected M&A deals and activity, this pandemic has also triggered change in the way M&A transactions are executed. Buyers and sellers are each adjusting to this changed environment to minimize their exposure to business risks resulting from the pandemic. Prolonged market volatility means any amount of certainty is key. Innovative mechanisms to align incentives, including the use of earnouts and tiered working capital arrangements, are being employed more heavily to bridge the valuation gap.

Earnouts and Balance Sheet Adjustments

An earnout refers to a post-closing increase in the acquisition purchase price which is earned if an acquired business's meets benchmarked performance expectations (e.g., EBITDA, gross revenue, or an industry-specific performance metric). In doing so a buyer can transfer some amount of risk to the seller and ensure that management is motivated to maintain the company's performance and profitability. Before the COVID-19 crisis, data showed that roughly one-third of earnouts had durations of one year or less. Recent earnout conversations show a shift from these shorter duration earnouts to longer durations of one or two years – in line with the expected end date of the pandemic. These mechanisms are particularly useful now when buyers cannot easily assess whether the impact from the pandemic will be temporary or long-term.

Most acquisition agreements contain provisions allowing for adjustments to the purchase price after closing, particularly in the form of net working capital adjustments. Using a normalized level of working capital, this adjustment is set at the time of signing and based on historical information. However, the question of what level of working capital is appropriate will likely be subject to new levels of scrutiny by buyers; they may seek greater levels of normalized working capital to ensure sufficient working capital for the continued operations of the acquired business considering reduced revenue and new categories of expenditures.

Timing and Delay

COVID-19 may have slowed M&A activity, but there are ways to make transactions work, even if they take longer. Firms are adopting creative solutions to establish and maintain relationships with buyers and sellers throughout the negotiation process which is no longer done in person. As a result, each stage of a transaction, including preliminary discussions between the parties, the negotiation of a letter of intent, due diligence, and the formation of a purchase agreement, is taking longer to complete. Acquirers are undertaking additional amounts of due diligence to assess the effect of the coronavirus crisis on the seller's business. As issues unique to the pandemic arise, more time is needed to address questions like:

1. How has the seller's workforce been impacted by the pandemic?
2. Has the business followed all laws, orders, and guidelines implemented in response to COVID-19?
3. Have any covenants, obligations, or other contract terms been, or are they likely to be, breached by the target?
4. Is there material credit risk relating to a particular customer?

Moreover, because internal justifications for deal making in this tumultuous environment will need to be more compelling, buyers are extra cautious and taking all the time they need.

Tighter Lending Restrictions

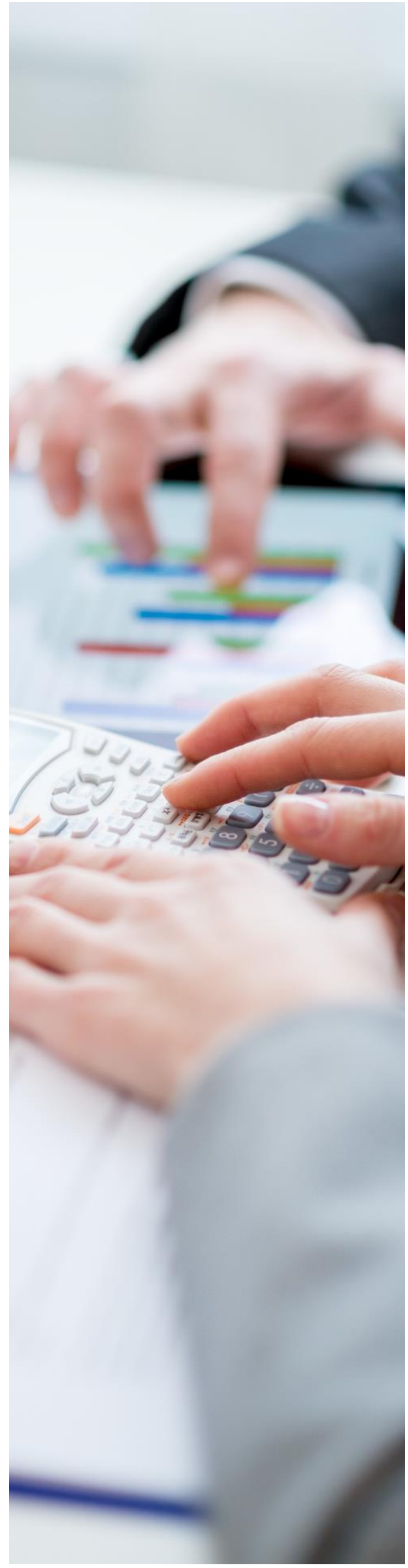
Historically, many M&A acquisitions, particularly in the private equity, have been partially financed by debt. The coronavirus outbreak has led banks to exercise caution before lending, creating additional process related delays for transactions that rely on acquisition financing. From the lender's point of view, supporting existing borrowers seemed to be the top priority at the beginning of 2020 – offering their clients some flexibility and additional liquidity where possible. Meanwhile, non-bank lenders saw an influx of financing opportunities from mid-sized companies that would normally qualify for bank financing but did not given tighter restrictions. In general, lenders continued to originate new loans – though premiums increased, and due diligence is now more detailed. According to a report by Morgan Stanley, sponsor-backed transactions comprised 26% of overall M&A activity in 2020, the highest proportion since before the global financial crisis.

Emerging Valuation Trends in M&A

Among drastic changes in deal making, unsurprisingly, mid-market valuations have seen a tremendous amount of change as well. Companies in every single industry were forced to adjust due to the pandemic, and the resulting shifts in strategy, cost cutting measures, and safety concerns have caused company valuations to vary substantially, creating new challenges in forecasting profitability in a volatile environment. Key trends have emerged despite the extreme variety however, and the resulting changes in valuation of mid-market businesses are likely to remain a consideration through 2021.

Valuation Gap

In many cases 2020 has been an outlier for financial performance and aggregate revenue. Companies within industries like construction and manufacturing, saw minor changes due to revenue backlog, however, as essential services operations were quick to catch up to prior levels. Some companies saw a dramatic change in margins depending on their exposure to residential and non-residential construction and effects on project timelines, creating a "valuation gap" due to expectations based on an anomaly year. The valuation gap is caused by unsymmetric buyer and seller opinions on a company's value based on the outlier year.



If 2020 was an underperforming year for a company, a seller may claim that the loss is non-recurring, and thus should be adjusted for when considering true profitability. Whereas a buyer may believe that 2020 performance is the new normal and seek to value to company based on this performance (vice versa for companies that outperformed in 2020). The resulting gap in valuation can be mended through research into the company's potential recovery path, strategy change, and industry to identify the trend going forward. This data is crucial in preparing an accurate forecast of future profitability and baseline EBITDA calculations. These additional considerations have led to longer timelines for valuations as well as due diligence and deal negotiations.

In 2020, nearly 445,000 businesses, received the Canada Emergency Wage Subsidies (CEWS) which largely offset the decline in revenue and profitability from the pandemic. If the pandemic is considered a non-recurring event in the short-term, these wage subsidies may be considered a onetime offset without the need for additional adjustments. However, a counter argument to this would be that certain industries would face a long-term impact due to behavioral shifts from the pandemic and wage subsidies should be excluded from EBITDA calculations as they are temporary in nature. Additional consideration would have to be made into whether these subsidies should be excluded from normalized EBITDA and SDE all together or be included depending on the nature of the industry and duration of impact of the pandemic on the business.

Impact on Profitability and Margins

To adapt to the pandemic, companies shifted potential revenue streams by putting more focus on products and services that were doing better during lockdown restrictions or creating entirely new lines of revenue all together. The new and focused revenue streams will have different margins to the company's regular mix of offerings however, some may require more investment to get started while others take less profit on each individual transaction. Although these pivots in strategy might offset losses in revenue, profitability will likely vary compared to previous years; a change that may be permanent going forward.

Core costs for operation, including materials, have recently seen large increases. Raw material shortages caused by supply chain issues and increased demand from the reopening have pushed up commodity prices, cutting into the mid-markets bottom line. Further, auxiliary costs such as insurance, occupancy, and bad debt expenses that rose due to safety risks and closures, dropped profits as well. As businesses tried to stay afloat, advertising, promotions, and R&D expenses had to increase to pivot into new revenue streams and stay connected with clients. The result of all these changes is significant downward pressure on profitability across multiple industries. This consequently has a steep impact on valuations due to absolute declines in profit as well as multiple compression.

Working Capital and Debt

For businesses negatively impacted by the pandemic, in contrast to the inevitable decline seen in profits, the effect on working capital varied case by case. Some businesses which rely on high inventory to maintain fill rates have boosted on-book inventory balances to historic highs to mitigate risk of lost sales due to supply shortages. As other accounts remained stable, increased inventory bolstered net working capital creating a high surplus. In other cases, failure to meet current obligations led to a higher payables balance, thus creating a working capital deficit. One commonality among all changes is that working capital values have varied from previous years. Consequently, buyers have focused their attention on historical working capital averages and WIP schedules to determine adequate inventory levels required to sustain operations.

Low interest rates have created favorable borrowing conditions. Many Small and mid-market players entered into long-term debt agreements to cover additional one-time costs incurred during the first year of the pandemic. Additionally, and especially within the small business market, companies took advantage of the Canada Emergency Business Account (CEBA) loans. Several companies have taken on additional leverage which will impact the valuation and affect operating cash flow due to higher interest expense.

Valuation Takeaways

The varying effects that the past year have had on valuations have caused M&A advisors and valuators to get creative and find innovative ways to perform primary and secondary research. Different opinions regarding valuations, multiples and baseline profit have put significantly more pressure on deal negotiations. These factors will likely continue to add layers of complexity in deal negotiation through the second half of 2021. Moving into the second half of the year, positive developments on the vaccination front and gradual relaxation of regulatory restrictions will alleviate some of these pressures through better clarity on future performance and cash flows.

Economic Landscape and Emerging Trends

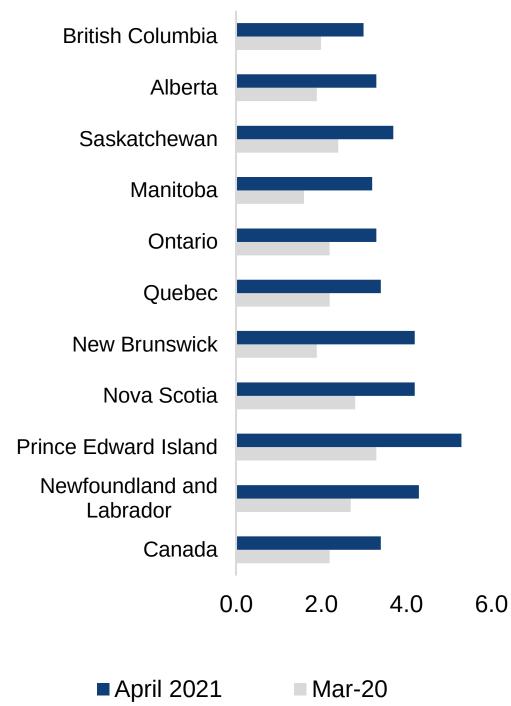
As we get through the second quarter of 2021, data on economic trends and behavioral shifts has helped us identify key trends in the private market. Some key themes that will be in the spotlight for the second quarter of 2021 include growing evidence that inflation is around the corner. As inflation expectations heighten, we begin to see the impact on small and medium businesses in the short-term and discuss how it will affect profitability. In addition, we identify some industry verticals that have benefited from asymmetric shifts in demand benefiting certain industry verticals and demographics while hurting others. Beacon expects commodity prices to continue to show strength. Being a resource-based economy Canada and the Canadian dollar will benefit from this strength, however, export-oriented businesses with exposure to the USD might witness impacts on margins.

Historic Shift Away from Inflation Targeting

Following, an unprecedented amount of fiscal and monetary stimulus, and amidst growing concerns of rising national debt, in August the U.S. Federal Reserve announced a historic shift away from inflation targeting. As per this new guidance it indicated that it would allow inflation to run beyond the 2% target and continue to keep interest rates at the front end of the curve low to stimulate the economy. This move has been interpreted by several economists as pro-inflationary which will allow the U.S. to monetize its debt and lead to a weaker U.S. dollar due to heightened stimulus measures on an ongoing basis.

In the first quarter of 2021, we saw several indicators that suggest that inflation is on the horizon and this will have major implications on buying power, consumer spending and trends in discretionary spending. Inflation over a long period erodes the value of money and decreases the buying power of consumers. Consequently, rising inflation expectations will reduce consumption and discretionary spending as consumers seek to save a larger portion of their income. This can hurt retail demand especially in discretionary sectors and industries that generate a sizeable income from low-income demographics. In addition, historically, consumers have shifted expenditure to real assets such as real estate and precious metals as an inflation hedge in an inflationary environment. Beacon expects companies with exposure to these industry verticals to perform well if inflation continues to rise.

12 Month CPI Percentage Change



Source: Bank of Canada

Unprecedented Fiscal Stimulus Resulting in the Highest M2 Base in Years

Another key theme going forward will be a shift from monetary to fiscal stimulus and a stronger focus on income inequality. The asymmetrical effects of the pandemic which have impacted low-income demographics have led administrations across the globe take concerted efforts to provide government aid and relief to small businesses and unemployed workers in the form of subsidies and grants. As of April 2021, Canada has deployed over $400 billion in fiscal aid, an amount equivalent to 18.5% of the country's GDP. Of this total, $207 billion went to households, small businesses, and workers in the form of wage subsidies, tax credits, and unemployment and childcare benefits.

The United States also ran a massive deficit, over the last twelve months, including an initial $1.8 trillion in covid relief and an additional $1.2 trillion in extended unemployment benefits, healthcare resources and funding for education. The Biden administration announced an additional $2.3 trillion in fiscal stimulus in the form of CARES Act which brings the total fiscal spending over the last twelve months to over 25% of total U.S. GDP.

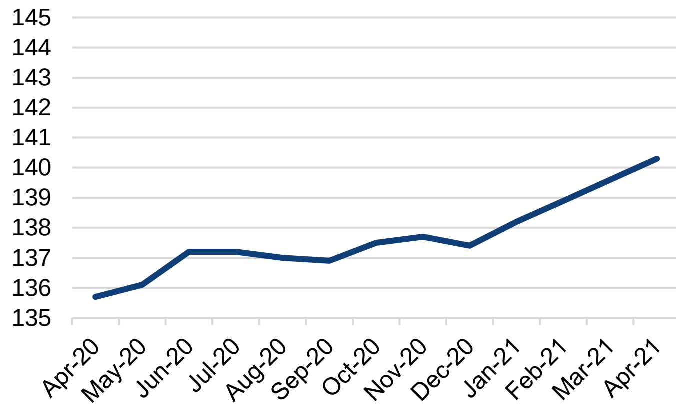
Similar coordinated fiscal stimulus measures have resulted in the global money supply rising to one of the highest levels in history and this can further escalate worries about long-term inflation. In the first quarter of 2021 we started seeing a slowdown in retail spending as a result. Moreover, the U.S. dollar has depreciated in value relative to the Canadian dollar, making Canadian goods less competitive, further affecting demand for companies with customers in the U.S.

Rising Commodity Prices and Supply Shortages

Inflation

Global supply chain disruptions have led to delays in shipping and longer procurement lead times. In addition, following shutdowns in the first half of 2020, refineries and upstream producers have been operating at lower capacity. As demand has slowly recovered following vaccination efforts, the supply side continues to lag. Coupled with an accommodative monetary and fiscal policy, these factors have driven up commodity prices which is evident from the twelve-month CPI data in the chart to the right.

Monthly CPI Data
(Not Seasonally Adjusted)



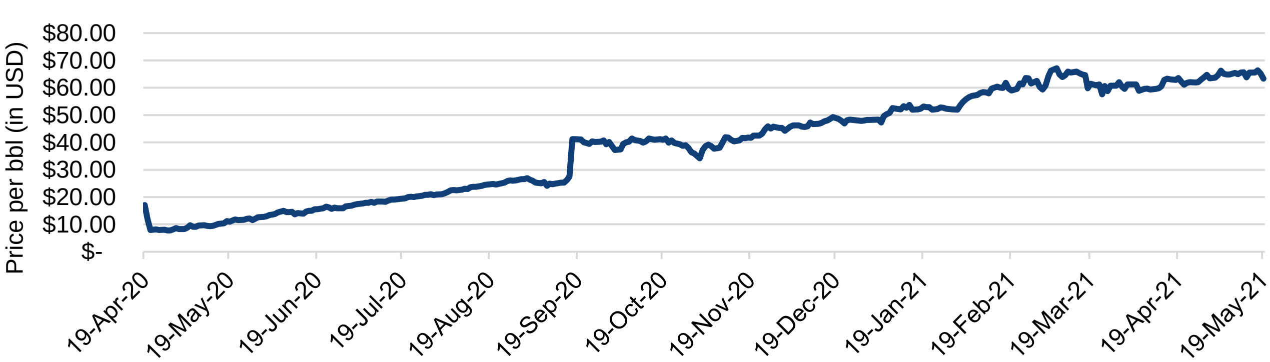
Source: Statistics Canada, base year 2002

Higher procurement costs and disruptions have proven to be a double-edged sword for companies that rely on international suppliers. Firstly, it has led to higher procurement costs and delays requiring them to make bulk purchases and carry larger inventory balances to maintain an adequate fill rate. This is especially true for smaller privately owned companies that do not have sophisticated inventory management systems. Secondly, project delays have increased revenue backlog and affected revenue and margins in the short-term. Consequently, we are already starting to see the effects of inflation hit the income statement and trickle down into profitability.

Crude Oil and Gasoline Prices

The total active rig count in Canada went down from a high of 203 in February 2020 to a low of 26 in late April 2020. Similarly, the total rig count in the U.S. went down from a per-pandemic level of 728 to 244 as the producing wells shut down due to lower anticipated demand. While more than 150 wells have come back online across North America since then, the number of active wells is still significantly lower than before. In addition, according to Baker Hughes, the international rig count is down by 220 over the twelve-month period as of April 2021. This clearly indicates that there was a huge decrease in global crude oil supply and as demand recovers, the supply will lag sending oil prices higher. As demonstrated by the graph below, crude oil spot prices have gradually increased to over $60 per barrel due to this supply demand dynamic. Higher oil prices have also been a contributing factor to an increase in CPI.

TTM Crude Oil Spot Price

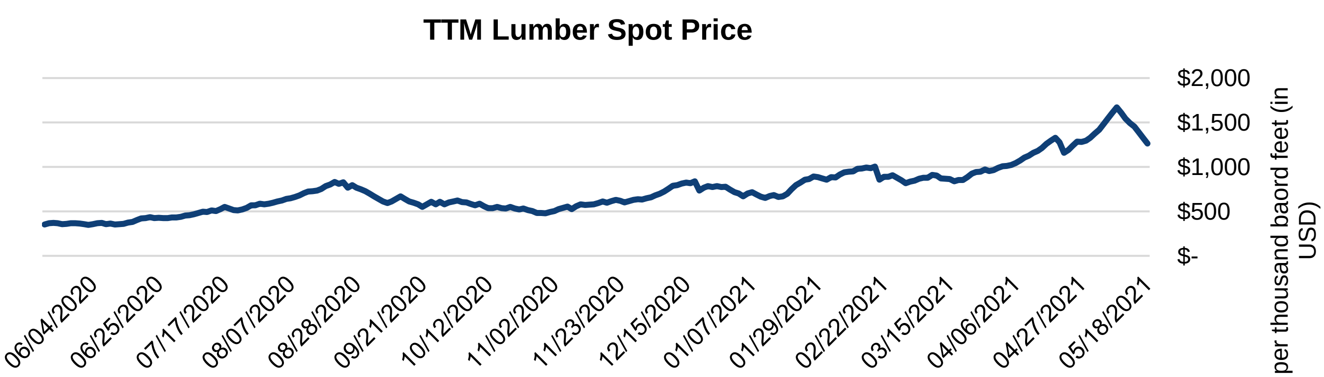


Gasoline prices rose 62.5% annually, recording the highest increase year-over-year in history. While prices are not at an all-time historic high, the steep and accelerated rise in gas prices has significantly affected transportation and logistics costs, thereby directly affecting businesses across multiple industries. Capital heavy industries with high dependence on heavy machinery such as construction and manufacturing are starting to incur higher costs. Due to this reason, contractors and manufacturing companies are placing a stronger emphasis on quoting and estimation to avoid cost overruns which can have a significant impact on already tight margins.

Investment in Residential Construction

Demand for residential construction has remained strong over the last year due to low mortgage rates and a shift to virtual workspaces facilitating migration away from cities. A surge in demand coupled with supply shortage sent lumber prices soaring in the first quarter of 2021. The price of lumber reached a high of $1,671 per thousand board foot in May 2021 before colling off due to supply shortage and speculation in the futures market. Despite the sell-off in May, the price of lumber has been increasing over the last year and this has led to an increase in home prices.

According to the CREA, home prices were up ~40% annually in February 2021. Total investment in building construction increased 4.2% to $16.8 billion in February, posting a record high for the second consecutive month because of continued strength in the residential sector. Approximately half of this gain was attributable to increase in material prices. Majority of growth came from the construction of single-family homes which has increased for five consecutive months. Investment in single family home construction was up 9.4% in February 2021 compared to a 1.6% growth in investment in multi-unit construction. This further highlights the asymmetrical impact of the pandemic which has disproportionately affected low-income groups. Additionally, it also demonstrates the fact that home buyers are willing to pay a premium for space and isolation in an environment where fear of the virus remains.

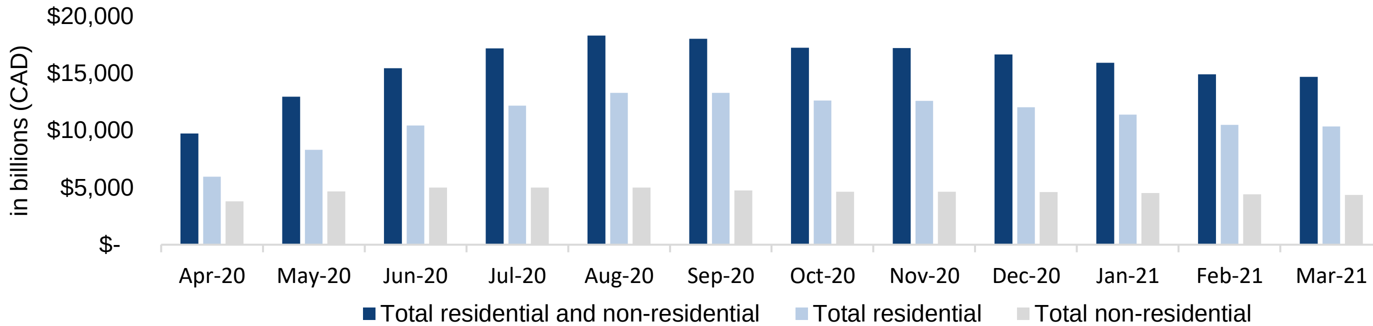


Source: Statistics Canada

Source: Nasdaq

In line with this data, we have observed strong demand for residential construction and contracting services over the last three quarters. Industry verticals with exposure to the housing market such as landscaping, building materials, building finishing, home appliances and home furnishing have experienced a surge in demand due to strong tailwinds. We continue to see companies in these industries perform well over the medium term, despite a slight slowdown in residential construction investment.

Monthly Construction Investment in Canada



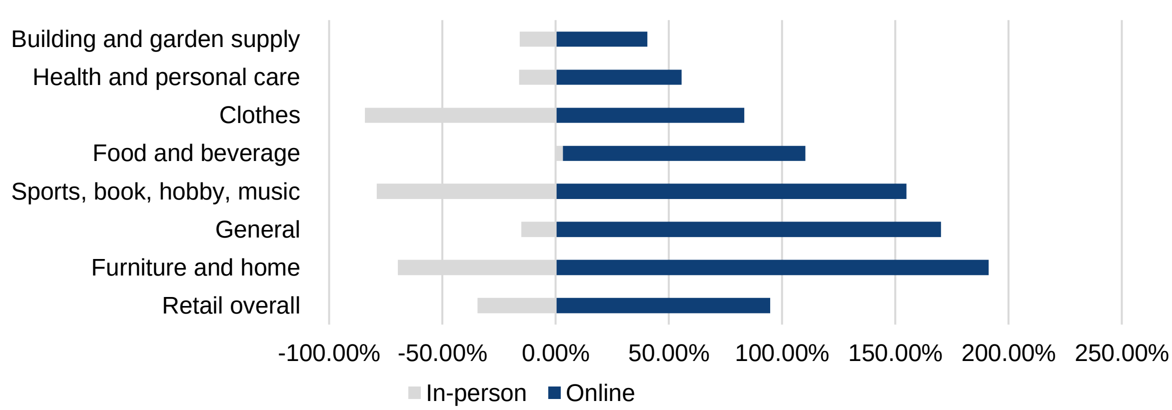
Source: Statistics Canada

Growth in Online Retail and E-Commerce

The behavior of consumers is rapidly changing with trends shifting towards shopping online, diversifying away from shopping in-person at brick-and-mortars. With in-person shopping being restricted during COVID-19 lockdowns, online shopping has increased more than ever before with a 110.8 percent increase in e-commerce sales since May 2019. According to CBC, within 11 retail subsectors, including clothes, furniture and home, food and beverage, all subsectors saw e-commerce sales increase. This shift to online shopping is expected to continue after the pandemic as consumers prioritize convenience and accessibility, albeit at a slower pace.

To successfully compete in the online market, e-commerce retailers must offer an agile and adaptive technological platform and superior customer service, emphasizing the importance of convenience quick delivery times. As online businesses observe the rising demand for e-commerce, they seek growth opportunities through mergers and acquisitions to achieve their growth targets. Consequently, M&A activity in this sector has been running hot.

In-Person and Online Shopping Expenditure Since Start of Pandemic



Source: CBC Survey

E-commerce platforms are being sought out by companies looking to take advantage of the disruptive trend of online shopping. Beyond the rise in online shopping due to lockdowns, businesses see long-term opportunity and are strongly incented by higher margins and increasing demand to invest in e-commerce platforms to competitively position themselves in the market. These companies include companies that already own e-commerce businesses within their portfolio as well as first-time entrants that have never previously acquired business in the digital space; the latter businesses are rushing to enter the e-commerce market and this trend is expected to continue throughout 2021. According to S&P Global Research, the total deal value from first-time strategic acquirers of online and digital businesses in 2020 was $34.3 billion USD globally, a 34.5 percent increase from the previous year. These first-time acquirers tended to purchase within classifieds, services, news, and games in the e-commerce market. COVID-19 lockdowns also accelerated trends within areas such as cloud computing, encouraging legacy companies – in addition to first-time buyers, to consider purchasing companies within the digital space despite previous hesitations and worries about disrupting themselves.

Shift to Digital and Virtual Models

Digital transformation is the process of integrating technology into all aspects of a business and weaving it into the business model. The COVID-19 pandemic has further accelerated digital transformations due to organizations shifting operations to a digital and virtual model, with many businesses working completely virtually and forsaking physical facilities. The initial virtual shift was deemed to be temporary but as organizations recognize the benefits of a digital business model, many businesses will continue operating virtually, either completely or partially online, post-pandemic. These benefits include lower overhead costs, greater work-life balance, more flexible work hours, higher employee satisfaction, and access to a broader talent pool with less geographic constraint.

This inorganic growth enables businesses to transform their business model and identify and pursue new streams of revenue. To utilize this growth strategy successfully, there are a few factors to consider:

- Digital transformation often takes time and requires multiple acquisitions to successfully reposition. Businesses must stay dedicated to the course-of-action and focus on post-merger integration.

- Businesses must address the knowledge gap. Most executive teams of businesses moving into the digital age, especially of first-time acquirers, are not thoroughly knowledgeable about content in the digital and advanced analytics world. This knowledge gap must be addressed and closed for executive teams to coordinate digital transformation.

- Valuation of these digital and virtual businesses is often more difficult; they do not follow the typical valuation framework that relies on deal synergies. The benefits of these businesses often come from strategic fit and the adaptation and transformation of business models.

Beacon Mergers & Acquisition

Toronto ◦ Washington, DC ◦ South Asia ◦

Beacon Mergers & Acquisitions is a full-service boutique M&A and business brokerage firm with headquarters in Toronto, Canada and offices across Southern Ontario, Washington, D.C, and the Pacific Northwest USA. Beacon also has a strategic partnership in the Asian subcontinent with Prime Bank Investment Limited.

Beacon’s services include M&A advisory, business valuations and debt financing advisory to companies in the lower mid-market. Beacon is a three-time recipient of the Consumer Choice Award for Best Business Brokerage Firm in the Greater Toronto Area, and a member of several international M&A organizations, including IBBA, M&A Source and IMAA.

Web: www.beaconadvisors.com

Tel: + 1 (844) 261-3677

Email: contact@beaconadvsiors.com

BEACON
MERGERS & ACQUISITIONS