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North American M&A Report

Q1 2020

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Introduction

North American M&A activity reached $400.8 billion across 3,169 transactions in Q1 2020, a YoY decline of 25.1% and a gain of 2.6%, respectively. Deal value in the quarter fell precipitously due to a lack of multibillion-dollar deals, though the decline in activity was tempered by deals which had already been negotiated before the coronavirus began wreaking havoc. With most dealmakers working from home and valuation estimates varying widely in such a volatile time, M&A activity is set to decline further in the coming quarters.

The virus has led to a dearth of announced deals across all sectors. Healthcare was the sole sector to see a YoY rise in deal value—prolonging a multiyear trend—and with a global pandemic illustrating how recession-proof healthcare businesses are, deal activity in the space is likely to pick up throughout the year. The pandemic also softened broader M&A multiples.

We anticipate that investors will identify some profitable buying opportunities during the downturn. Credit flowing in the economy is important for financing the debt portion of deals, and many market participants have concerns surrounding a potential credit squeeze. However, the risk of a credit crunch may be slightly eased due to an unprecedented fiscal and monetary stimulus in the US, as well as non-bank lending options and availability. Still, minority investment techniques, such as PIPE deals, may come in handy if financing is otherwise unavailable.

Stephen-George Davis
Analyst, PE

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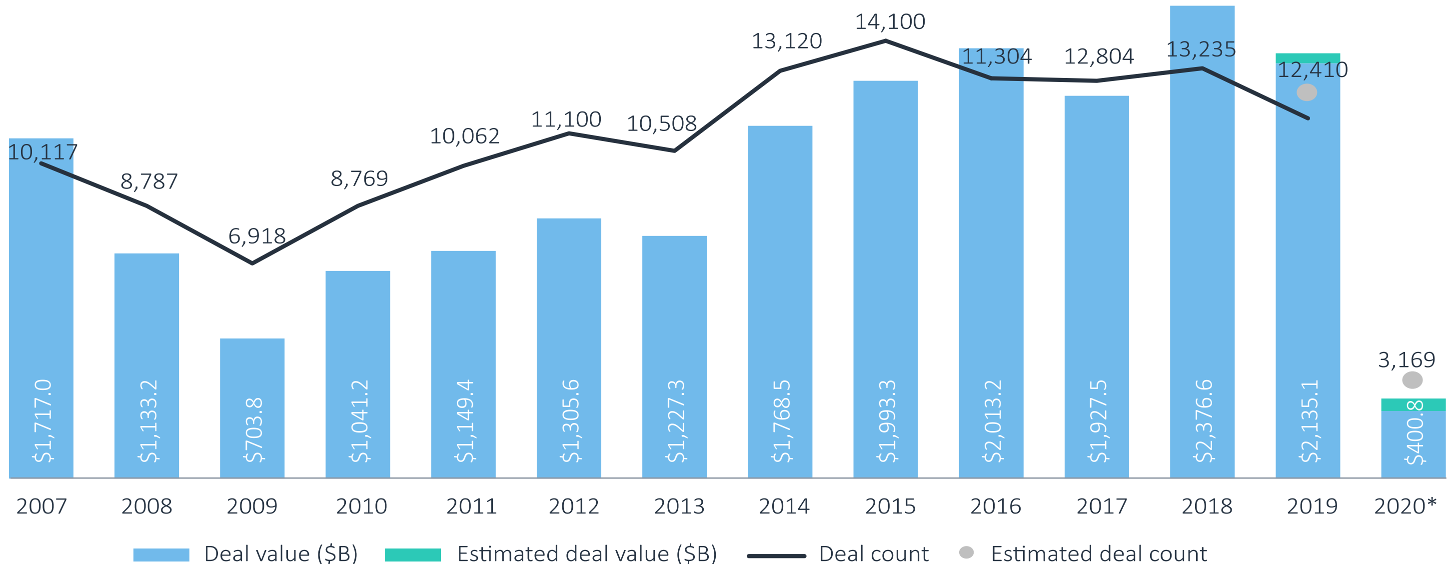
Overview

M&A activity



Source: PitchBook | **Geography:** North America
*As of March 31, 2020

North American M&A activity in the first three months of 2020 saw mixed results as the full impact of COVID-19 is yet to be felt. 3,169 deals closed for a total of $400.8 billion, YoY changes of 2.6% and -25.1%, respectively. The decline in value was mitigated by the fact that most of the deals that closed in Q1 had already been negotiated before the virus became a global albatross. For instance, one of the larger deals to close in the quarter, CPPIB's acquisition of Pattern Energy Group for $6.7 billion, was announced in November of 2019. We expect the true ramifications of the virus to be realized in the coming quarters as M&A activity steadily declined month over month in the first quarter.

The coronavirus backdrop has led to a sudden shift in the underlying macro dynamics influencing M&A activity. In February, the turmoil and mystery associated with the pandemic reached the seemingly indefatigable public markets, ending the longest bull market on record and leading to the quickest 20% drop to bear market territory since 1933. The trough of the bear market occurred in late March, and the S&P 500 tumbled 33.9% from February peaks. The plunge coincided with large drops in oil prices and an 80% spike in the VIX index, levels not seen since the great recession. Simultaneously, at least 26 million Americans have filed for unemployment since mid-March, figures not seen since the Great Depression.[1] In February, even before more daunting economic indicators were released, a study from MIT and State Street found a 70% chance of a US recession in the next six months.[2] In its April update, the IMF forecasts global GDP to fall by 3% in 2020.[3] For context, the global economy shrunk by 1.7% in 2009 during the global financial crisis (GFC). All these factors give way to a dim economic outlook and nebulous understanding of the virus' long-term impacts. We expect dealmaking to continue to wane as strategic and financial acquirers await more clarity on the future macro environment.

The repercussions of COVID-19 on the stock market are especially pertinent for M&A activity, which has historically been highly pro-cyclical. Many large deals involving public companies have already been called off due to the virus. Notably, Xerox Holdings Corp (NYSE: XRX) ended its five-month long quest to take over its larger rival, HP Inc (NYSE: HPQ) for $34 billion. HP advised its shareholders against the merger considering

1: "Unemployment Insurance Weekly Claims," Department of Labor, April 23, 2020
2: "A New Index of the Business Cycle: MIT Sloan Research Paper No. 5908-20," MIT, William B. Kinlaw, Mark Kritzman and David Turkington, January 21, 2020
3: "World Economic Outlook, April 2020: Chapter 1," IMF, April 2020

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the current climate. Similarly, 7 and I Holdings' (TYO: 3382) discussions with Marathon Petroleum Corp (NYSE: MPC) to acquire the latter's retail network, Speedway LLC, for $22 billion, broke down due to COVID-19 issues as well as valuation concerns.

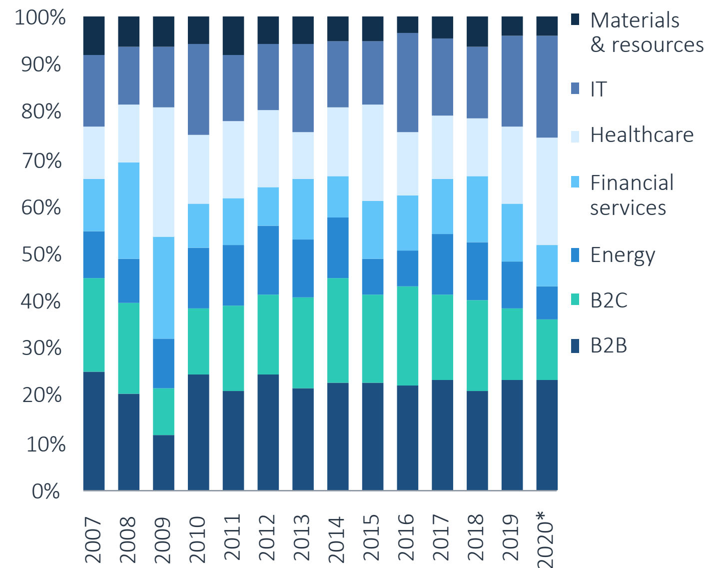
Other factors that influence M&A have also been in flux due to the pandemic. For example, financing availability and CEO confidence have diminished, the latter of which rebounded at the end of 2019 from decade lows in Q3 2019 and then dropped again in late March due to COVID-19.[4] Social distancing has also contributed to the decline in dealmaking, as face-to-face meetings are integral to the M&A process. Although it is difficult to ascertain how long this new normal will last, we believe deal activity will continue to slow, and the M&A environment will not stabilize until companies have somewhat accurate forward-looking earnings forecasts.

In contrast to recent quarters, Q1 declines in value can also be partially attributed to a shortage of large deals. Those larger than $1.0 billion combined for only $132.8 billion, marking the lowest figure since Q1 2014. M&A activity at the upper end of the range, over $5 billion, is especially vulnerable to a downturn as corporates pull back due to COVID-19 concerns. Financial sponsors are less likely to play a role in this sphere because the deals are often too large to be acquired by a sole financial sponsor and consortium deals can be logistically difficult to execute, especially in a recession.

Despite the dim economic/M&A outlook, there were bright spots within certain sectors in Q1. For instance, healthcare posted robust YoY growth in terms of deal value. The largest deal to close in the quarter was Danaher's (NYSE: DHR) acquisition of GE's (NYSE: GE) BioPharma business for $21.4 billion. The deal was announced in February of 2019 and still managed to close in the quarter despite pandemic concerns. The second-largest deal was also from the healthcare sector, where we will continue to see activity due to the recession-proof nature of the space. Centene (NYSE: CNC) acquired its managed care rival WellCare Health Plans for $15.27 billion in a stock and cash transaction. Centene is a good example of a healthcare company with recession-proof attributes, something that market pricing supports. Between February 2 and March 31, its stock price fell less than 4%, compared to the S&P 500, which declined more than 20% over the same period. This is one of the reasons that investors have flocked to the sector during times of uncertainty, when many are pricing in an impending downturn.

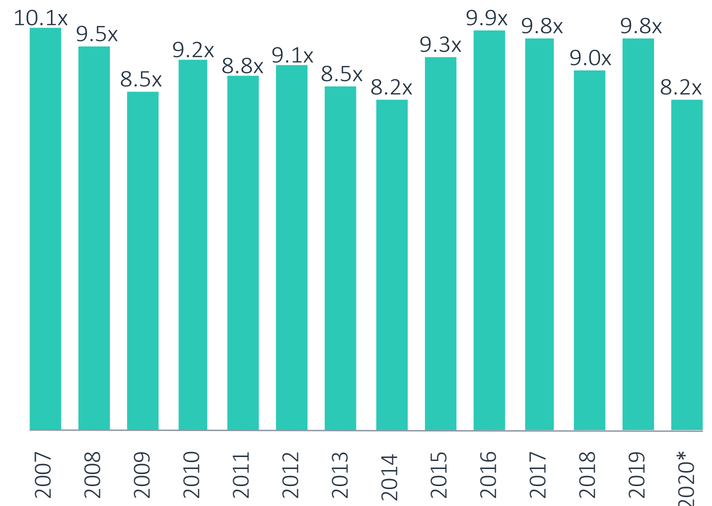
Another sector that had notable M&A activity in Q1 was IT. Although the industry saw YoY declines in both value and count, the declines were not nearly as steep as other sectors. IT comprised 21.7% of Q1 deal value

M&A ($) by sector



Source: PitchBook | **Geography:** North America
*As of March 31, 2020

Median EV/EBITDA multiples for strategic M&A



Source: PitchBook | **Geography:** North America
*As of March 31, 2020

4: "Measure of CEO Confidence™," The Conference Board

compared to 17.4% of deal value in Q1 2019. This is an indication that despite the virus, investors—especially PE firms—still see opportunity in the sector. The third-largest deal of the quarter was EQT and Digital Colony's buyout of fiber and bandwidth connectivity company Zayo Group for $14.3 billion. The deal is noteworthy as it closed on March 9, two days before the World Health Organization declared COVID-19 to be a pandemic, meaning that the transaction was able to close in spite of global turbulence. Looking ahead, notable large deals from the sector closed in the first few weeks of the second quarter, including Kronos' acquisition of Ultimate Software Group. That said, the deal was almost certain to close given that Hellman and Friedman is the controlling shareholder in both groups; other transactions will need to be done with far less certainty.

M&A multiples have softened as the markets anticipate and price-in dwindling earnings growth. In Q1 2020, the rolling four-quarter median fell to 9.8x from 10.1x in Q4 2019. We believe this decline will continue, partially because many CEOs and CFOs had already expected a downturn in 2020 and will prudently withhold from engaging in M&A activity. According to a survey from The Conference Board, a recession was the top concern for US CEOs in 2020, up from third place in 2019.[5] Most corporates are prepared to take a slight reprieve from M&A activity until market conditions improve or they find a substantially discounted asset. PE firms, on the other hand, work differently. Similar to the GFC, in the absence of cheap credit, PE firms have resorted to increasing the amount of equity used in buyouts.

Many analysts have compared the ongoing pandemic-induced crisis with the GFC. We may see some similarities in terms of declining deal flow, though our base case scenario does not anticipate a fall as steep as that particular recession. Like the GFC, this crisis has had a global impact and comes on the heels of a strong dealmaking year. Despite the GFC beginning in the final quarter of 2007, the year posted an annual M&A value that would not be eclipsed for another seven years. However, there are also fundamental differences between the two situations. The first is obvious: One was an economic crisis, based on financial institutions, and the other represents a global pandemic. Moreover, the GFC was a long-running event. The S&P 500 dropped more than 50% from 2007 highs to its 2009 trough. Comparatively, in Q1, COVID-19 led to markets falling more than 30% off highs in a matter of weeks, though they have since been rising. Lastly, the economic fallout caused by the virus is different than that of the GFC because large swathes of the population have been forced to stay inside; many are unable to work due to government legislation shutting down various industries.

As it stands, the regulations put into place after the GFC and current stimulus from the Fed have shored up the economy to the point where a summer-time end to the virus may be reasonable to believe that we'll see only a slight or brief dip in the year's overall dealmaking and the economy at large. However, the duration of the virus is of paramount importance. The crisis is affecting the real economy due to layoffs, and the longer a crisis sustains, the worse it becomes for consumer spending, which drives around 70% of GDP. If the pandemic continues for an unprecedented amount of time, the decrease in spending due to increased unemployment may be too much for the global economy to handle, and we would anticipate a large and prolonged drop in M&A activity for some years to come.

Looking forward, despite the deteriorating macro outlook amid a global pandemic, the reverberations from COVID-19 may unlock buying opportunities for sharp and well-capitalized corporate acquirers and financial sponsors alike. Corporate acquirers accumulated record amounts of cash on hand prior to the outbreak, while PE firms sit on over $1.5 trillion in dry powder. It is likely that entities from both groups are already gearing up to find deals in a downturn. We anticipate PE firms making alternative types of investments, such as PIPE deals and other minority deals, in lieu of buyouts due to tightened credit markets. Additionally, it can be a challenge for management and shareholders to agree on a price for a majority acquisition when stocks are down significantly. We do think these alternative deal structures could lead to majority acquisitions down the line. GPs will also find some solace in knowing that the Fed rate cut and other responses to COVID-19 in Q1 put the US near negative rates, making it more unlikely that a credit squeeze will occur.

5: "Survey: Business Leaders Start 2020 with Lingering Concerns About Talent Shortages & Recession Risk," The Conference Board, January 2, 2020

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Spotlight: Pandemic effect on allocations

The following is an abridged analysis of how allocators are reacting to this crisis. For a more detailed understanding of how COVID-19 is influencing LPs and private market strategies, please read our analyst note discussing the subject in full.

While we'll discuss some opportunistic ideas for LPs in the various strategy sections throughout this note, we wanted to explicitly discuss what the allocators are thinking and experiencing in this time of market upheaval.
One principle of which people took serious note in the last crisis was the "denominator effect." Nearly every LP operates within a target allocation framework for their selected asset classes. If the investor was at or above the 20% allocation target before the stock market drop, then the LP now finds itself overallocated.

This is a known phenomenon, of course. After the last crisis, some LPs made their investment policy statements more flexible. Instead of a hard 20% target with a tight allowable band of drift, ranges were widened. In some cases, a time element was added to allow for the portfolio to be outside of the targeted zone for two consecutive quarters before the investment staff must consider options for how to bring the portfolio back to the desired allocation. In addition to this new leeway, LPs as a group are better positioned to combat the denominator effect today because many entered the 2020 underallocated or at their targets to private markets.

LPs are, of course, not homogenous in their governance or objectives—both of which can have a significant impact on the reaction an investor may have to a crisis. An endowment or sovereign wealth fund (SWF) investing for perpetuity might be willing to take longer-term risks by doubling down on risky assets when they seem inexpensive, but a pension that was underfunded with a growing base of retirees going into the crisis is now in an even worse position. In the latter case, the company or public entity responsible for funding the pension may be extremely wary of assets perceived to be riskier when they are already being required to increase their contributions to the pool at a time when revenues may also be suffering.

Even when an investment committee is made up of savvy investors, they typically meet only quarterly. They are undoubtedly having ad hoc update calls, but scheduling conflicts and the need, at least for public pensions, to hold meetings in a public forum make it difficult to have off-cycle meetings where decisions can be made. It is highly likely that the agenda for the meeting scheduled in April or May is going to be focused on triage: What does the meltdown mean for funding ratios or spending/granting programs? What can they do to be opportunistic right now? What areas of the portfolio are most exposed to the worst part of the current crisis? New commitment recommendations are unlikely to make the next agenda unless the investment staff was far along in the diligence process and a final close was imminent. It will be another quarter or two before the committee is ready to consider changes or additions to the portfolio's asset managers.

In terms of partnership commitments already signed, some LPs seeing the dramatic decline in their portfolio may wonder what would happen should they find themselves unwilling or unable to meet capital call demands from GPs. Whether it be a cash crunch or a loss of confidence in the GP or the strategy, most LP agreements have severe penalties designed to deter defaults. Despite the potential consequences, some LPs still chose to default during the GFC because it was early in a fund's life and because some found allocating limited liquidity to a strategy that no longer seemed advisable to be anathematic.

One of the more specific impacts of the current crisis is the fact that working from home bars LPs from performing what for some is mandatory in-person due diligence.
This will have a number of follow-on consequences. First, beyond the logistical issues stated previously about packed agendas and distracted investment committees, the pace of commitments will slow from the record levels seen in 2019 if in-person due diligence requirements must be upheld. Second, funds for which the LP had already completed due diligence prior to the crisis may still be approved. Third, GPs coming back to market with strategies in which the LP has invested previously may require a lesser level of due diligence, so these "re-ups" may have a better chance of garnering commitments than strategies new to an LP. Finally, GPs with poor performance histories or ones hoping to start a new fund or broaden their investor base will be disadvantaged, as their targeted LPs will be unable to get comfortable with them during this time.

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