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North American M&A Report

Q2 2020

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Introduction

M&A activity in the quarter continued to decline as COVID-19 remained an unrelenting problem in North America, and especially the US. North American M&A activity reached $336.8 billion over 2,025 transactions in the second quarter of 2020, substantial declines from the record activity seen in recent years. The US seems to be on track for a W-shaped recovery and potential second wave of the virus, which threaten to further drag down M&A activity and inflict a heavy human toll.

Nevertheless, certain sectors are seeing pockets of stable dealmaking. Tech and healthcare continue to ink deals, as many companies in these sectors have benefited from COVID-19 side effects and have opportunistically sought out M&A transactions in times of volatility. However, in less robust areas such as oil & gas, frail companies are completing deals just to survive. Often, companies in the latter sectors were in precarious positions to begin with, and the virus only exacerbated their difficulties.

There is the possibility of increased regulation for both corporate and financial sponsors. While legislators have had PE in their crosshairs for some time, PIPE deals and other minority transactions may also come under fire as the government targets predatory behavior in the wake of COVID-19. For similar reasons, corporate acquirers have drawn the attention of antitrust bodies.

Stephen-George Davis
Analyst, PE

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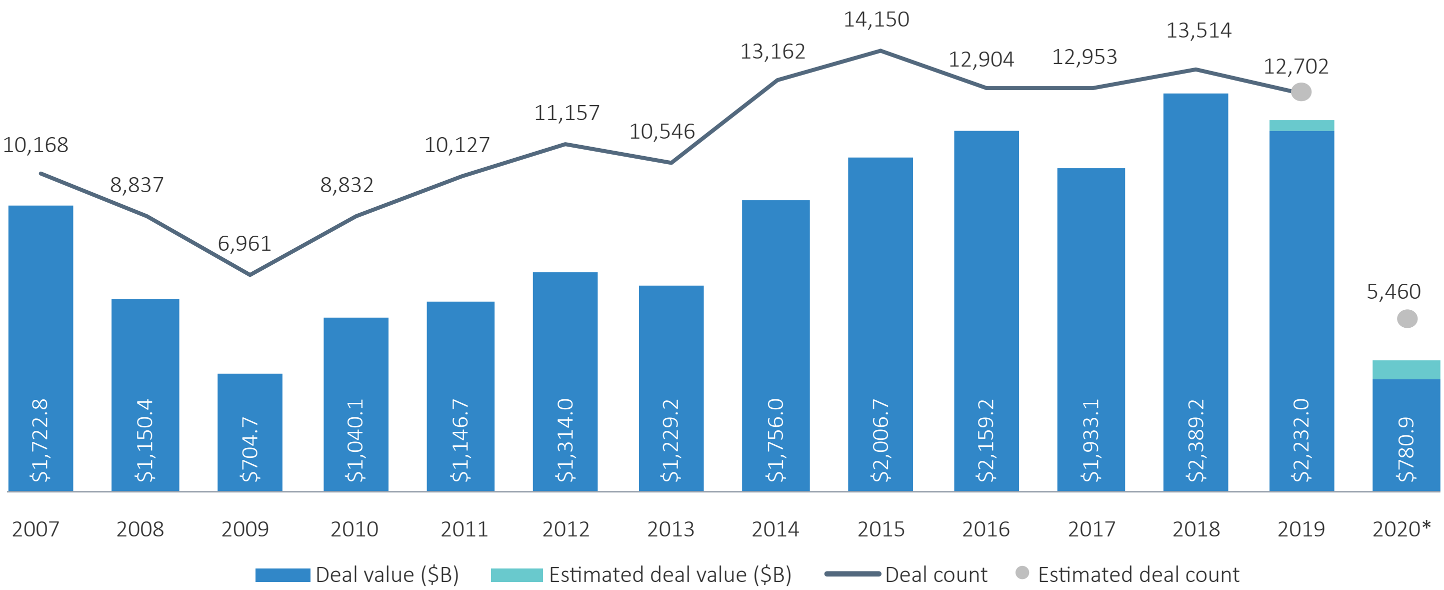
Overview

M&A activity



Source: PitchBook | **Geography:** North America
*As of June 30, 2020

In the second quarter of 2020, continued declines in North American dealmaking are merely the canary in an M&A coalmine. In Q2, 2,025 deals were closed for a value of $336.8 billion, YoY declines of 33.1% and 26.7%, respectively. However, these figures are misleading as Q2 2019 was a relatively weak quarter for North American M&A activity. The reality is much bleaker, as this quarter registered QoQ declines of 41.1% and 24.2% for deal value and count, respectively, compared to an already anemic Q1 2020.

Currently, there is no indication as to when the virus will disappear or when the country will be fully up and running, and thus M&A activity is likely to be subdued. Buyers and sellers will continue to grapple with the lack of accurate earnings forecasts, leading both parties to shy away from sitting at the deal table. In Q2, both the US and Canada confirmed their economies entered recessions during the previous quarter. While Canada has since emerged from its shortest recession on record, prospects for the US are bleaker because COVID-19 cases are still increasing in the US, meaning the economic outlook continues to sour. Furthermore, many of the states which had opened up saw dramatic increases in cases shortly afterward and shut back down. Putting this into context, the International Monetary Fund is forecasting an 8% decline in GDP for the US in 2020.[1] It seems there is no end in sight for the pandemic in the US, which has the most cases and deaths from the virus globally. In fact, at the time of writing, the US reported a then-record 60,000 cases in a single day.

Despite the impact of COVID-19, the public equity markets came roaring back in Q2, and the S&P 500 gained 20.5% in the quarter. Although public equity gains have largely been influenced by government stimulus programs buying corporate debt and lending to small businesses directly, some companies did well for COVID-19-related reasons. For instance, the biotech company Moderna (NAS: MRNA) shot up more than 19% on the day on news of "positive" phase one results for a COVID-19 vaccine that they were testing. Also, the Trump administration created the "Operation Warp Speed" program, which links government and military agencies with private pharmaceutical companies in order to quickly create a vaccine for COVID-19. In addition to Moderna, President Trump also selected four other pharmaceutical companies for inclusion in the program: the combination of Oxford University and AstraZeneca (NYSE: AZN), Johnson & Johnson (NYSE: JNJ), Merck (NYSE: MRK), and Pfizer (NYSE: PFE). In

1: "A Crisis Like No Other, An Uncertain Recovery," International Monetary Fund, June 2020.

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July, drug maker Novavax (NAS: NVAX) was also added to the roster. Many companies within the healthcare sector have undoubtably done relatively well in part due to COVID-19 issues, with the sector only 2.7% off its YTD highs, whereas the total S&P 500 is more than 6% below its 2020 peak. Furthermore, healthcare firms have been rewarded for M&A activity. According to Willis Towers Watson's (NAS: WLTW) Quarterly Deal Performance Monitor[2] acquirers in the space have outperformed their index by +3.4 percentage points. The largest healthcare acquisition in the quarter was one such example, where Gilead Sciences (NAS: GILD) acquired Forty Seven for $4.9 billion. The purchase allows Gilead to expand its immuno-oncology presence as well as add significantly to Gilead's clinical pipeline. Year to date, Gilead's stock is up over 17%, trouncing many of its peers.

We see a dichotomy in the M&A market with deals holding steady at the top and bottom of the spectrum. As with healthcare, acquisitions in the thriving tech sector have also remained steady—especially when so many Americans are working from home and technology is as critical as ever—while other sectors have seen activity diminish. Many of the public tech companies have stockpiled cash in order to capitalize on the abundant opportunities. More to the point, the tech- and biotech-heavy Nasdaq has outperformed the S&P 500 and Dow Jones Industrial Average by more than 20 percentage points since equities fell off a cliff in February. In fact, the top six deals of the quarter all came from the tech sector. One of the more notable deals to close was Accenture's (NYSE: ACN) acquisition of Broadcom's (NAS: AVGO) cyber security business Symantec—a notable deal given the security concerns arising from so many Americans working remotely due to COVID-19. This deal follows a trend similar to the one in healthcare in which companies in robust sectors are completing M&A transactions for growth.

In contrast, deals are also getting done in the most distressed sectors as a matter of survival. For example, the oil & gas industry has long been in peril, and the pandemic has exacerbated its problems. As of April, 70% of all debt in the sector was trading at distressed levels, indicating much of the sector has the potential to follow Chesapeake Energy, which suffered from weak demand for oil & gas during the COVID-19 outbreak, into bankruptcy. The largest oil & gas deal of the quarter is a good example of distress dealmaking. Haldia Petrochemicals—backed by private equity firms Rhone Group and The Chatterjee Group—purchased supplier Lummus Technology for $2.73 billion from McDermott International Ltd. The deal was done as part of Houston-based McDermott's bankruptcy restructuring process, from which it emerged with around $4.6 billion

2: "COVID-19 Drags Q2 North America M&A Deals to Lowest Level in Over a Decade," Willis Towers Watson, July 7, 2020.

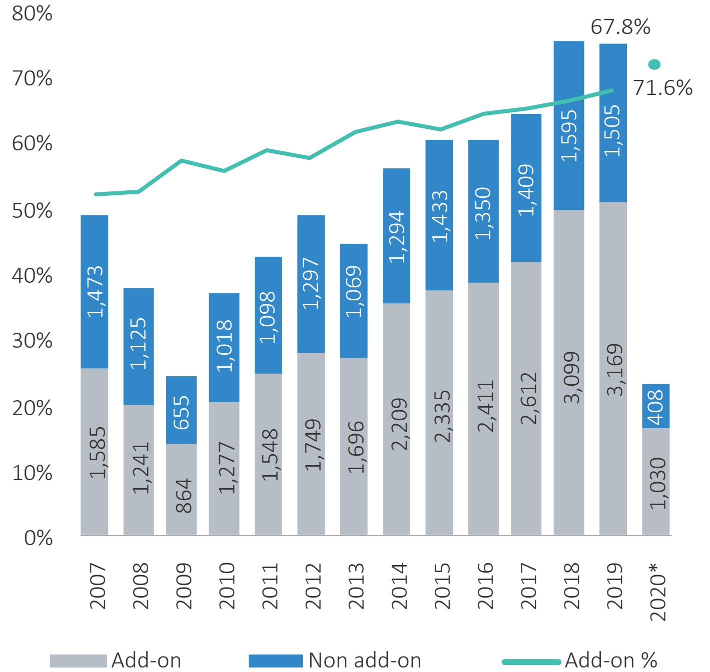
in debt eliminated from its books. The Lummus sale allowed McDermott to repay its debtor-in-possession financing in full as well as strengthen the firm's balance sheet. The Lummus sale not only was an example of a deal completed in a distressed sector, but also an example of private equity firms using the global pandemic to their advantage.

The healthcare, tech, and oil & gas sectors saw median deal sizes increase. However, the increases were tempered by decreases in all other sectors, and the overall median deal size remained in line with past quarters. M&A multiples have also kept in line with recent periods. Because it has become a challenge to accurately value assets during the COVID-19 era, acquirers have resorted to using alternative valuation methods to assess earnings. Valuation issues are especially relevant for financial sponsors, given the nature of their investments, when compared to corporate acquirers; financial sponsors are looking to resell these companies after a specified period of time whereas corporations are usually trying to entirely integrate firms they acquire. However, PE firms compete on a more even playing field when it is their platforms doing the acquisitions because they also permanently integrate the firms they acquire.

Though add-on acquisitions have been an increasingly important part of sponsor-backed M&A for the last decade, the COVID-19 pandemic has propelled their use to new heights. PE add-on deals accounted for just over 70% of all buyouts in the quarter. This is the second time add-ons composed such a large proportion of PE deal flow; the first time was in Q1 of this year. Add-ons allow a PE firm to pursue a buy-and-build strategy for a company, which can help bolster an already established portfolio company and increase earnings. This strategy will be paramount as PE firms seek to cut their losing portfolio companies and attempt to increase the exit multiple for their portfolio companies that survive the pandemic crisis. Buying non-sponsor backed companies—which tend to be smaller, family-owned, and used for add-ons—may be one of the only viable areas for PE deal sourcing. Moreover, adding a company to a platform is much less risky than a platform acquisition, something financial sponsors are taking into account as the uncertainty around COVID-19 remains palpable.

Interestingly, private equity firms' proportion of

Add-ons as proportion (#) of overall PE deals



Source: PitchBook | **Geography:** North America
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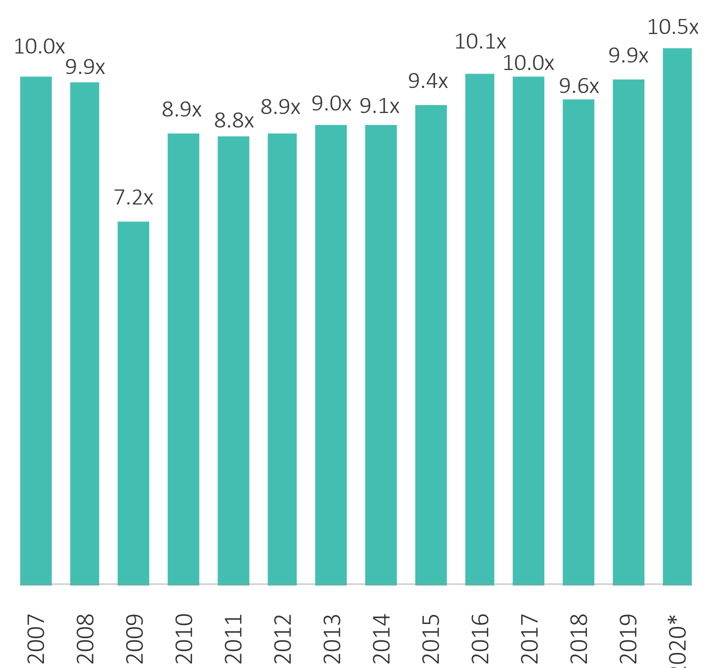
Median M&A EV/EBITDA multiple



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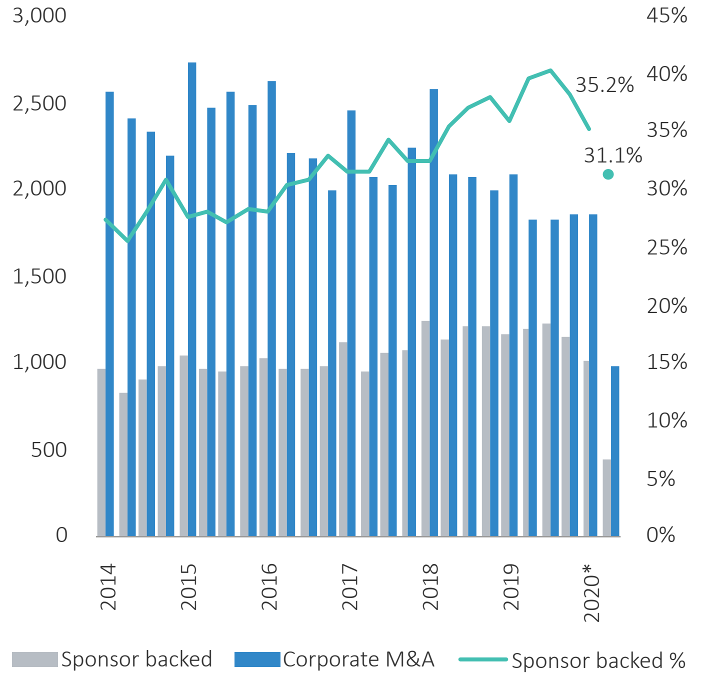
both M&A deal value and count declined in Q2 2020. This retreat can be partially attributed to PE firms' preoccupation with their portfolio companies, as well as their involvement in more PIPE deals and other minority stakes transactions, which serve as a way for them to deploy capital but don't show up in the M&A data. However, given the legislative attention M&A investments have drawn, such as the proposed Pandemic Anti-Monopoly Act,[3] and that the House Antitrust Subcommittee chairman believes most mergers should be banned during the coronavirus pandemic,[4,5] and that Federal Trade Commission (FTC) Commissioner Rohit Chopra has said, "The commission also needs to closely scrutinize any HSR [Hart-Scott-Rodino] filings by private equity firms to gain insight on their future acquisitions that may be non-reportable,"[6] there may be increased antitrust scrutiny on PIPE deals as well as other minority stake investments. For example, PIPE deals may trigger HSR filings, depending on various criteria including the size of the transaction and whether the acquisition includes voting rights, among others. Although neither the FTC nor the US Department of Justice (DOJ) have challenged a PIPE deal to date, these agencies have investigated partial acquisitions involving competitors under antitrust laws in the past.

Sponsor-backed M&A as proportion of overall M&A



Source: PitchBook | **Geography:** North America
*As of June 30, 2020

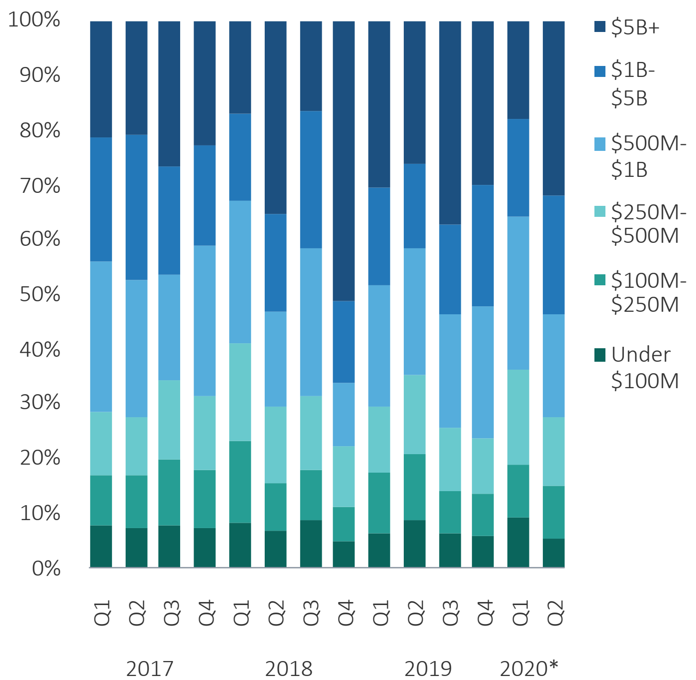
While private equity has long been under a microscope—increasingly from both sides of the aisle[7]—corporate M&A activity has also come under scrutiny from antitrust legislators as of late.[8] The CEOs of Amazon (NAS: AMZN), Apple (NAS: AAPL), Facebook (NAS: FB), and Google parent company Alphabet (NAS: GOOGL) are set to testify as part of the House Antitrust Subcommittee's review of digital markets. As the stock market has regained much of its losses from February, the companies under investigation have all posted double-digit gains, whereas only one of the smallest 50 members of the S&P 500 is in positive territory at the time of writing. Still, these hearings echo a growing sentiment that more should be done to rein in the power of well-capitalized players in the M&A market, and they are likely to have ramifications going forward. This could have a major impact on M&A in the tech sector because the top companies tend to be some of the most acquisitive.

It seems safe to say that COVID-19 has persisted longer than most anticipated and has a chokehold on M&A activity along with the rest of the economy. Looking forward, it will be prudent for acquirers and sellers alike to come up with ways to work around the logistical implications of the virus, which have hampered social interaction and thus due diligence, one of the staples of M&A activity. Firms will need to adjust, adapt, and innovate if they hope to surmount these issues and complete transactions.

3: "Pandemic Anti-Monopoly Act," Elizabeth Warren: US Senator, ND.
4: "House Antitrust Chairman Says Most Mergers Should Be Banned During the Pandemic," CNBC, Lauren Feiner, April 23, 2020.
5: "House Antitrust Chairman Proposes Merger Ban During Pandemic," Politico, Leah Nylen and Betsy Woodruff Swan, April 23, 2020.
6 https://www.ftc.gov/public-statements/2020/07/statement-commissioner-rohit-chopra-regarding-private-equity-roll-ups-har
7: "Populists Don't Know Much About Private Equity," The Wall Street Journal, M. Todd Henderson and Steven N. Kaplan, June 30, 2020.
8: "House Antitrust Chairman Says Most Mergers Should Be Banned During the Pandemic," CNBC, Lauren Feiner, April 23, 2020.

Deals by size and sector

M&A ($) by size



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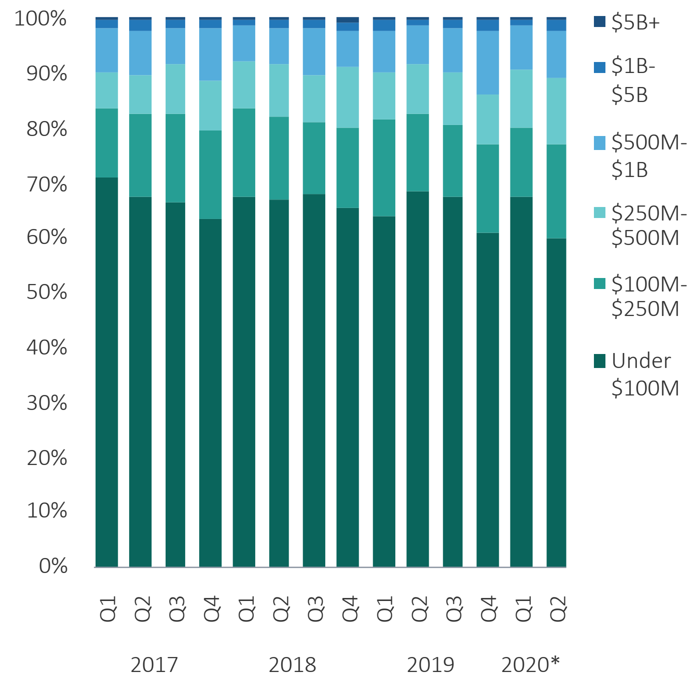
M&A (#) by size



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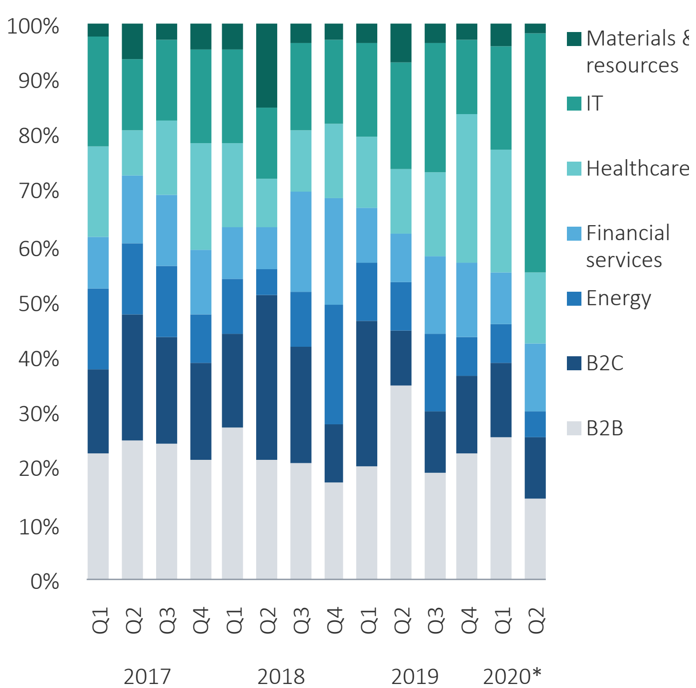
M&A ($) by sector



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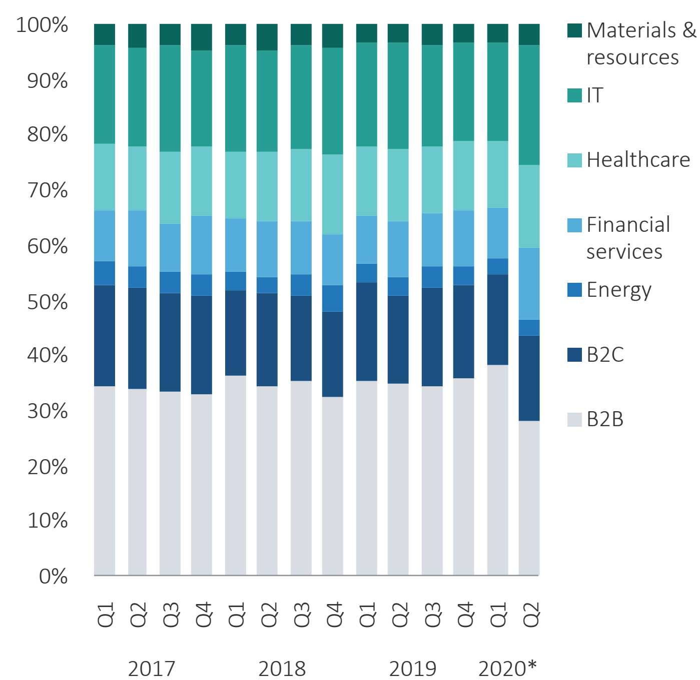
M&A (#) by sector



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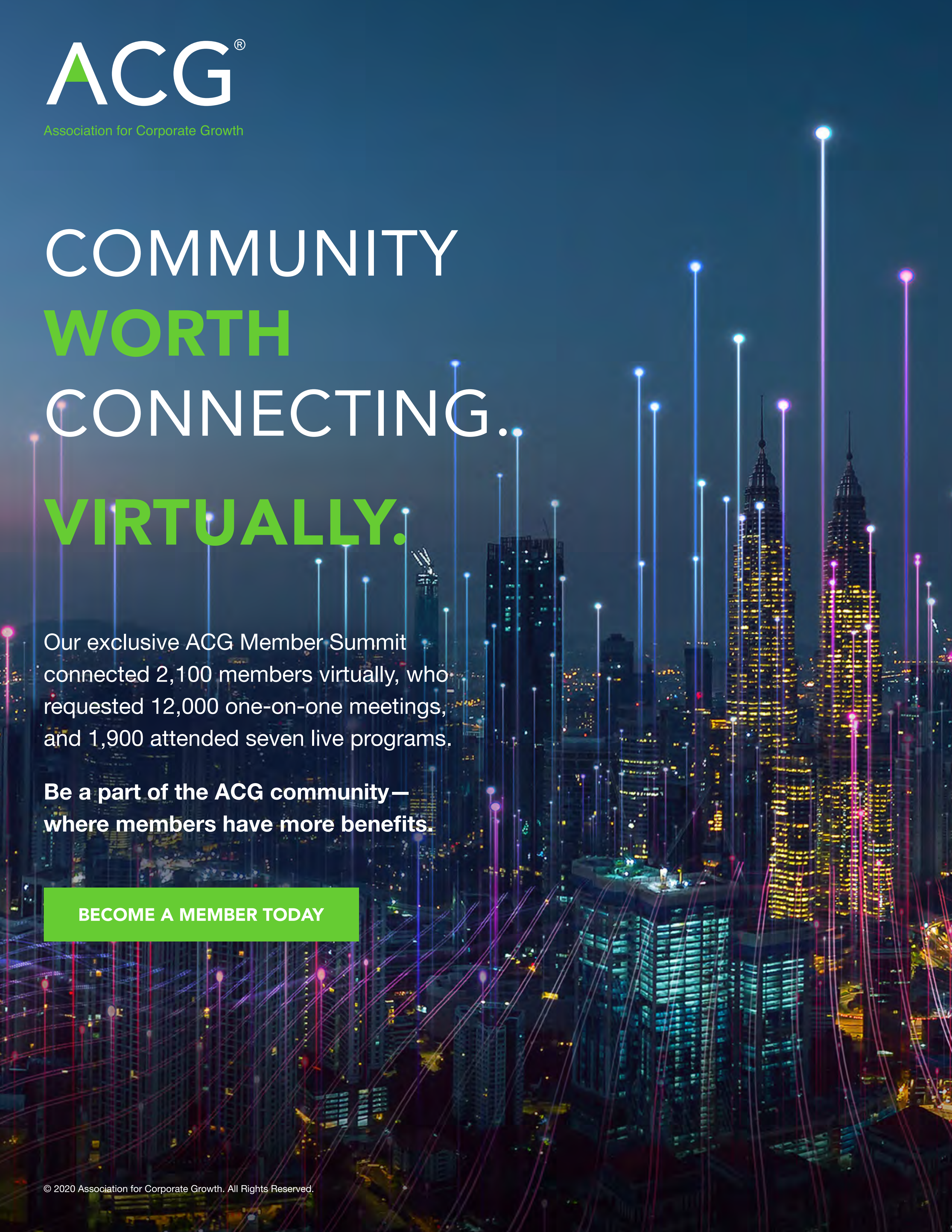
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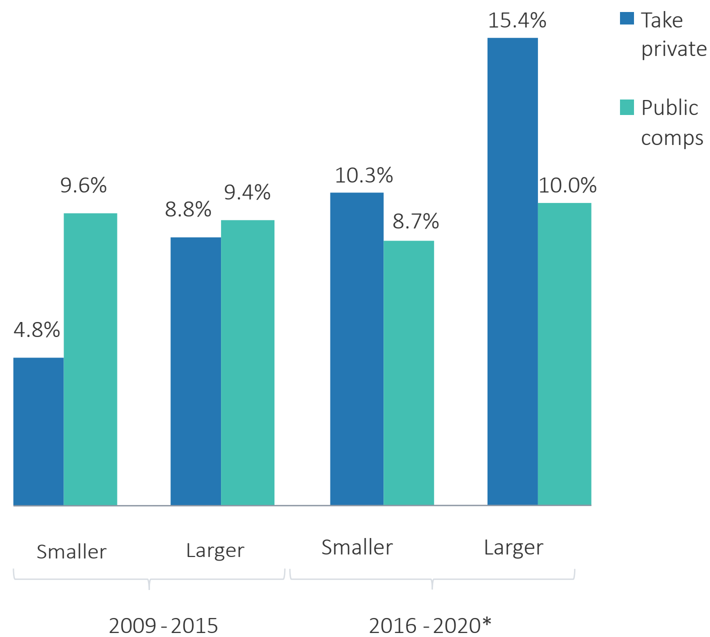
Spotlight: Buying out public tech companies

Note: This spotlight was abridged from an analyst note on tech take-privates. For a more detailed analysis of the subject, and to see the list of possible future acquisitions, please read our buying out public tech companies note.

Although the overall number of take-privates has been relatively flat in recent years, tech deals have consistently accounted for the bulk of deal count. We have seen tech deals constitute a rising share of buyout activity overall, but the sector is highly overrepresented in take-privates compared to other PE deal types. Not only have they been purchased at higher price points than their non-tech equivalents on a median basis, but they have also been orders of magnitude larger than most privately sourced buyouts. We believe this phenomenon began with Vista Equity's $1.8 billion delisting of Marketo in 2016. For tech take-privates that have closed since 2016, the median deal size stands around $1 billion, with several companies in that group closing above this mark. Three-quarters of those deals fell between $400 million and $4 billion. In this note, we focus primarily on the group of companies that have closed in that price range since the global financial crisis, splitting them into two cohorts. For the sake of clarity, we dub the companies that closed between $400 million and $1.25 billion the "smaller cohort" and companies that closed between $1.25 billion the "larger cohort." Each of these size cohorts represents distinct characteristics. We also pay close attention to these deals pre- and post-2016, when the tech take-private boom began.

Comparing these two cohorts post-2015, we see little difference when examining the median time between a tech company's IPO and its eventual take-private, counter to our expectations. For the smaller cohort, this median is 5.9 years. For the larger cohort, it stands just slightly higher at 6.4 years. The spread between these groups was quite different less than a decade ago, however. Between 2009 and 2015, the median time between IPO and take-private was 12.2 years for the smaller cohort and 9.8 years for the larger cohort. In the past few years, it appears the waiting time for a PE firm to take a tech company private has dropped off. For example, Vista Equity delisted Mindbody for $1.9 billion just four years after the company went public.

Change in revenue (3-year CAGR)



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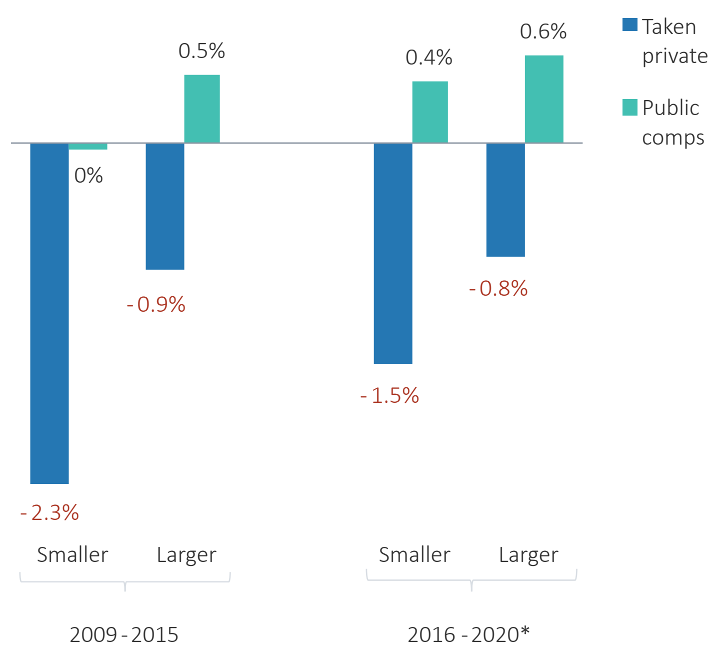
3-year change in gross margins



Source: PitchBook | **Geography:** North America
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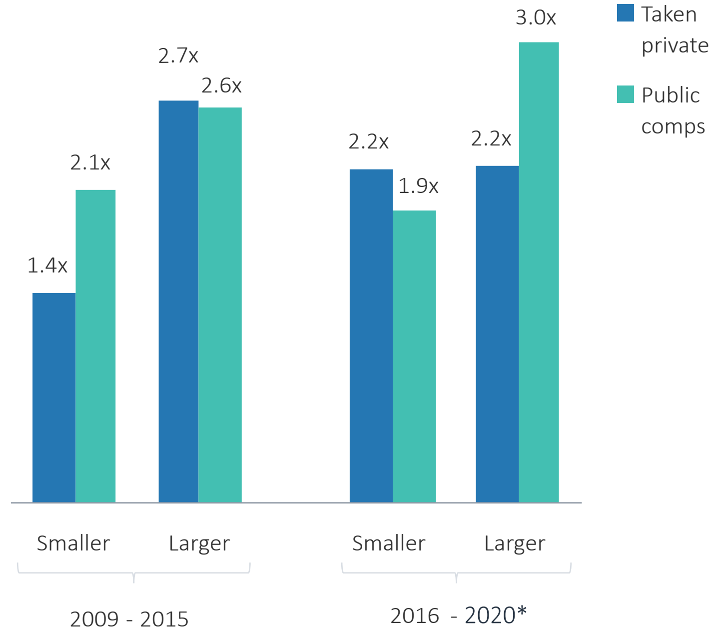
PE firms typically eye younger tech companies, even buying out still VC-backed companies, as earlier-stage companies more often have healthy growth projections. However, looking at the financials of tech companies before they were taken private reveals that GPs may have targeted them for reasons beyond their age. Between 2009 and 2015, smaller public tech companies that delisted tended to have low to negative revenue growth, which was usually well below the median for their public peers. Since 2016, however, tech take-private targets in both of the size cohorts exhibit higher revenue growth and outpace public comps. This is consistent with the evolution of the PE playbook, with tech-focused buyout firms focusing on top-line growth rather than reviving mediocre businesses.

Looking at margins, we see that GPs have consistently bought out public companies with above average gross margins, while operating margins tended to be closer to public comps. Indeed, we see a healthy number of firms targeting public tech companies with lower to negative operating margins than in years past, as they tend to indicate higher growth profiles. These financial profiles are typically seen in software companies, which have comprised a swelling proportion of tech take-privates. Turning to margin changes, tech take-privates have been seeing a mixed bag in terms of their operating margins prior to the buyout. Tech companies that were taken private almost always saw gross margins fall in the three years preceding their delisting, possibly allowing GPs to swoop in and quickly mend their financials.

Buyout multiples tell a somewhat different story. Broader buyout multiples have risen over time, along with what PE firms are paying for public tech companies, and there appears to be a convergence in the valuations of the companies these firms have targeted across cohorts at 2.2x EV/revenue since 2016. However, 2.2x EV/revenue is above public comps for the smaller cohort and below public comps for the larger cohort since 2016. This divergence between take-private and public comps could indicate that the smaller cohort was more growth-oriented than its publicly traded peers, while the larger cohort has lower growth prospects than its peers. Another unique factor appears to be that the target companies in both cohorts saw declines in EV/revenue before PE firms bought them. This illustrates that regardless of growth rate or profitability, PE firms are likely watching many companies but choose to be opportunistic in their acquisitions and buy companies after periods of price weakness.

Median EV/revenue



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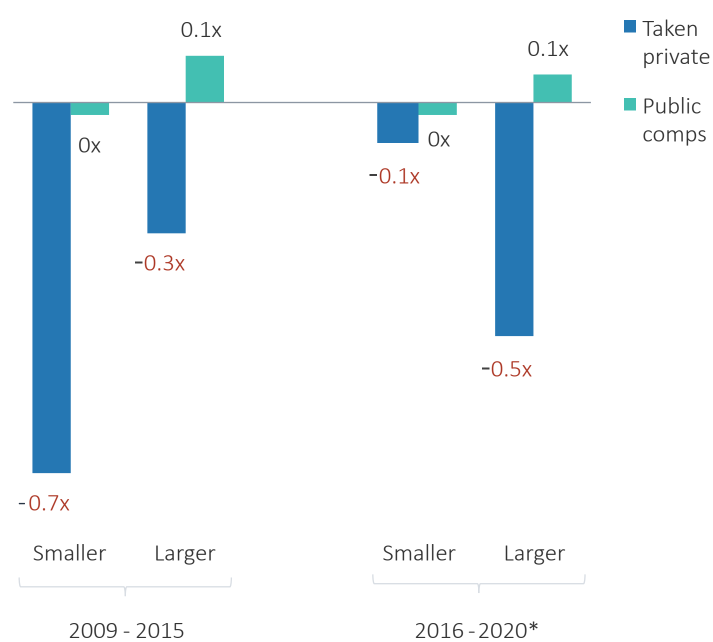
3-year change in EV/revenue



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