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North American M&A Report

Q3 2020

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Introduction

Stephen-George Davis
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M&A deal activity rebounded in the third quarter of 2020 as corporates and financial sponsors alike looked to the middle market to complete deals. Some M&A is being pursued as firms jostle to take advantage of opportunities presented by the COVID-19 crisis, whereas other firms are engaging in M&A activity as a defensive measure to simply stay afloat.

Dealmaking activity was scarce in the energy sector as low oil prices stemming from the pandemic continue to propel the sector's decline. In contrast, healthcare saw considerable activity stemming from defensive M&A on the part of health services operators, who have been hurt by a pullback in elective procedures.

The November elections are on the minds of most dealmakers, as the election not only factors into policy changes, but more recently into whether or when the government will issue another stimulus package in order to boost the economy. These potential policy changes often set the stage for forthcoming M&A or a lack-thereof depending on the conditions these changes produce.

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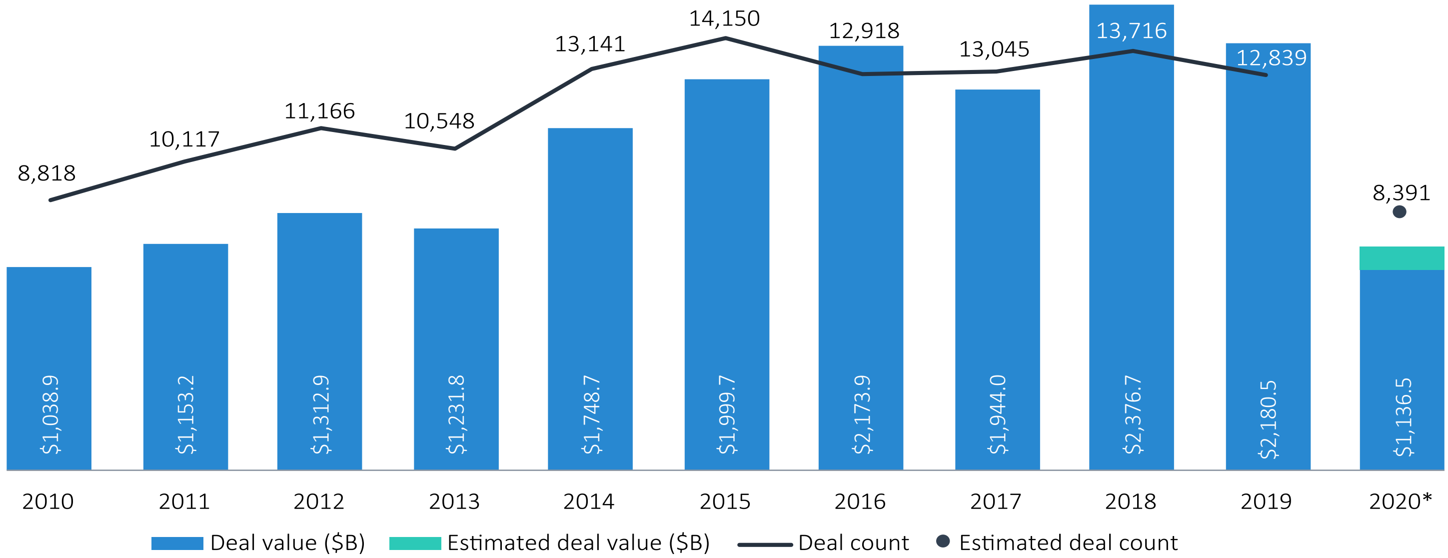
Overview

M&A activity



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

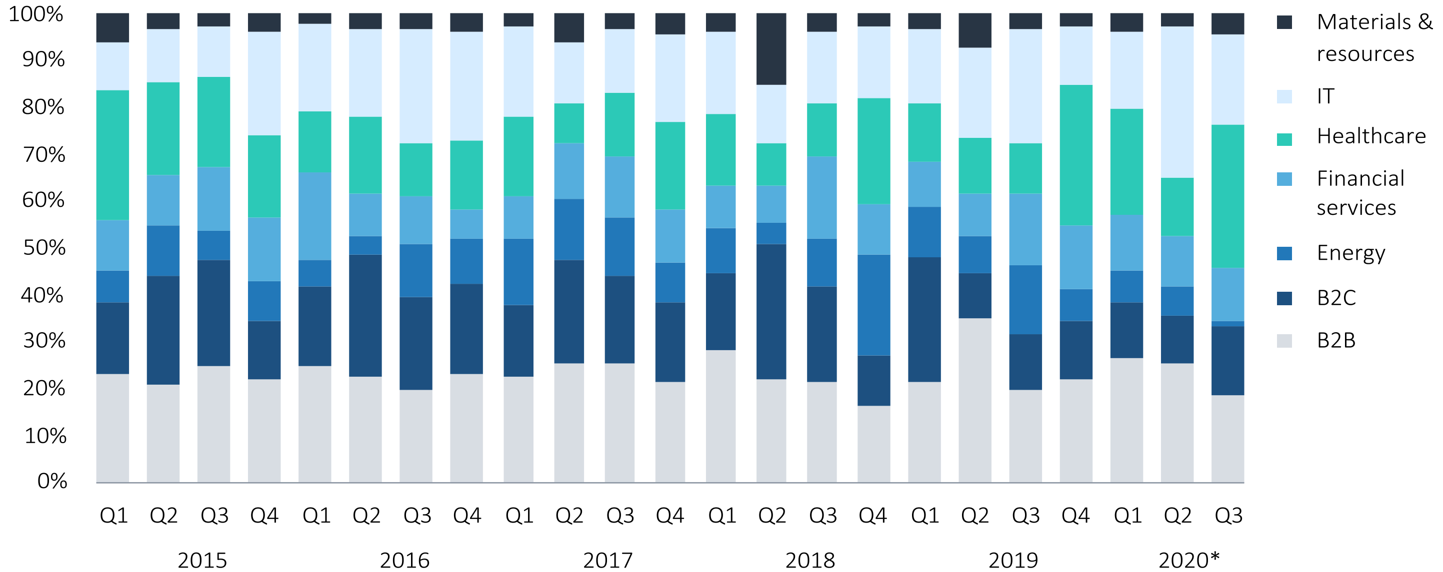
It appears Q2 may have been the trough of 2020 M&A activity as dealmaking recovered in the third quarter of the year. Deal activity in Q3 surged to 2,714 deals for a total deal value of $361.1 billion, notching QoQ gains of 23.5% and 7.0%, respectively. This denotes the first gains in deal value and count since Q4 of 2019, which came before the onset of the coronavirus pandemic. We see companies using the pandemic to pursue M&A for both offensive and defensive reasons. Firms are pursuing offensive M&A deals to take advantage of struggling businesses, while some companies are pursuing defensive M&A in order to survive.

While Q3 marked a return to M&A activity, we are not out of the pandemic woods yet. There is still no vaccine readily available, nor a plan for reopening the economy. Businesses are very much in limbo, and there have been over 220,000 deaths from the virus in the US alone. To add to the turmoil, Congress was unable to pass a fourth relief act, and state and local tax revenues have dropped precipitously. For instance, in New York, state tax collections were down 17% in June YoY. This all points to a potential further decline in the economy if a vaccine is not available soon enough to ensure the economy reopens in 2021.

Despite pandemic woes still in play, the third quarter of the year was marked by a strong performance from the public markets. The S&P 500 was up 8.5% in Q3, registering the best third quarter gains since 2010, which also translated to the S&P's best back-to-back quarter since 2009. PE firms and corporates alike were busy inking deals, with many of the latter hoping to take advantage of the booming markets before the November US elections trigger a potential return to volatility.

While corporate acquirers and financial sponsors both executed transactions, they often targeted different sectors. For instance, our data shows private equity sponsors increased their proportion of healthcare and tech deals, whereas corporates increased their proportion of deals in the B2C space. In 2020, PE firms have also increased their investments in financial services companies, and the proportion of financial services M&A transactions (31.7%) completed by financial sponsors is the highest since at least 2016. One notable deal in this space was the $420.0 million buyout of insurance firm Benefytt Technologies by HPS Investment Partners and Madison Dearborn Partners. The consortium took Benefytt private, paying a 59% premium to Benefytt's 30-day stock price average.

M&A activity ($) by sector

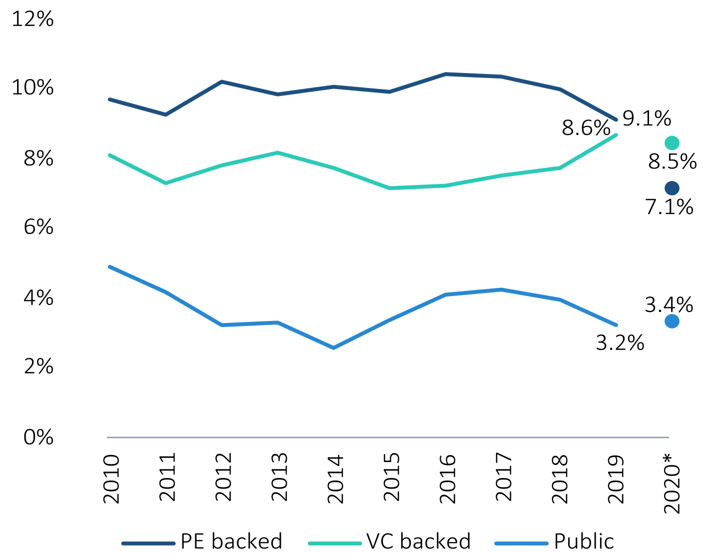


Source: PitchBook | **Geography:** North America
*As of September 30, 2020

While the premium was substantial, Benefytt's stock price was almost twice as high as it was two years ago—begging the following questions: Would the company have been better off staying private, and did shareholders receive a bad deal?

In terms of sector-specific M&A activity, healthcare had a stellar Q3. The sector currently has 13.1% of total deal count in 2020, the highest percentage we have recorded. One of the reasons for the large jump may be the pandemic. The financial pressures—stemming from a reduction in elective procedures—faced by many independent healthcare operators has led some to turn to acquisition to survive. One example of a deal in this vein was the $350.0 million purchase of St. Francis Medical Center by Prime Healthcare Services. St. Francis Medical Center was divested by Verity Health Systems as part of its bankruptcy proceedings. The California-based healthcare service provider had been struggling for years due to fierce competition in the California markets from operators with greater economies of scale and more negotiating power with insurance companies. Going forward, we expect to see more operators at the deal table looking to merge in order to survive.

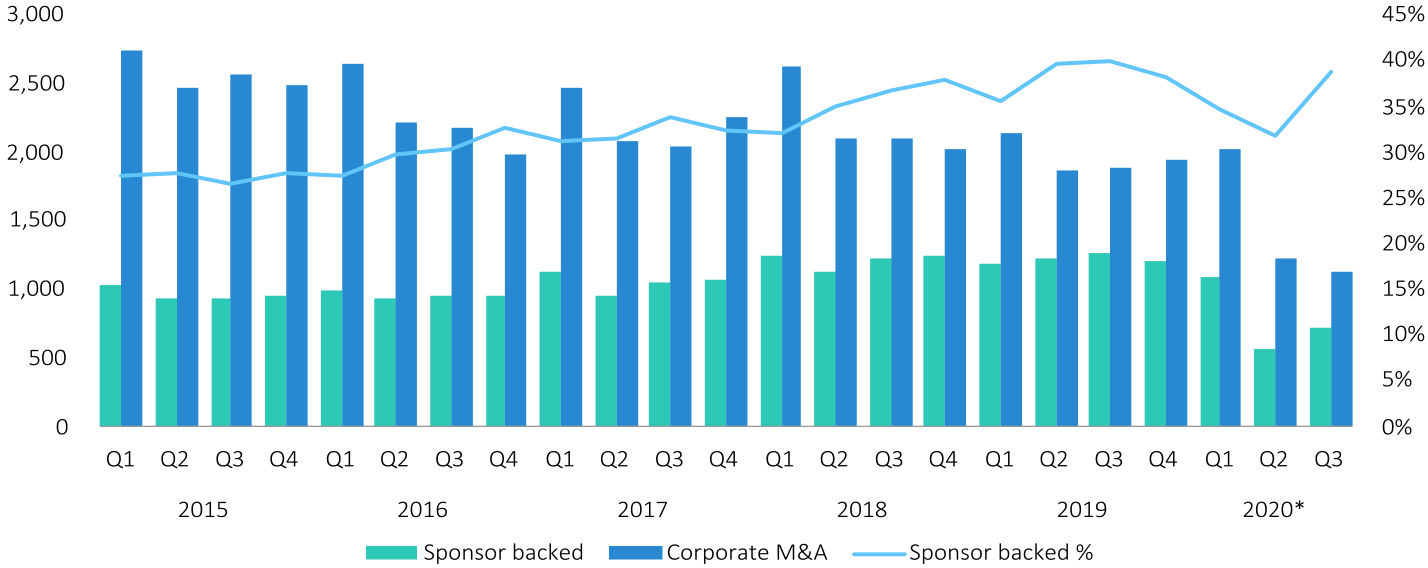
Deal count by target company backing status



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

1: "Rig Count Overview & Summary Count," Baker Hughes, October 2, 2020.

Sponsor backed deals as a % of deals



Source: PitchBook | **Geography:** North America
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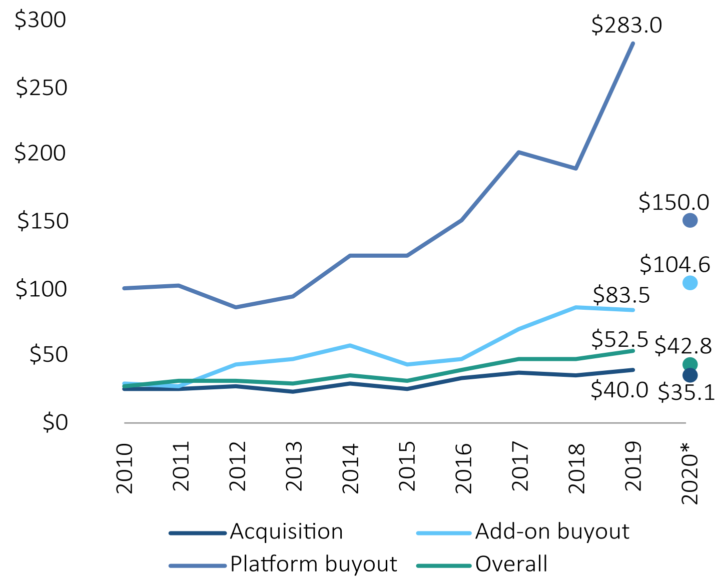
At the same time, the energy sector continued its COVID-19-led decline and posted a mere 1.5% of total Q3 deal value—the sector's lowest contribution on record. This fall-off can largely be credited to the continued decline of energy prices. Many American and Canadian oil companies have reacted quickly to the drop in oil prices by decreasing their output, numbers of oil rigs, and capital expenditures. According to Baker Hughes,[1] at the end of Q3, the US oil rig count was more than 500 rigs down from the same period last year, a decline of more than 65%. Without a clear end to COVID-19—from both a global and North American perspective—rebound in the sector seems far-off. Further dampening that possibility is the recent news of ExxonMobil's (NYSE: XON) decision to lay off more than 11% of its European workers, citing "the impact of COVID-19" as the specific reason for seeking a trimmer, more efficient workforce.[2] However, there is some light for the sector as Marathon Petroleum (NYSE: MPC) announced it was selling its chain of Speedway gas stations to 7 Eleven for $21.0 billion, and Chevron (NYSE: CVX) announced it was acquiring Noble Energy for $5.0 billion; M&A activity in the energy sector should receive a bump from these transactions when they close.

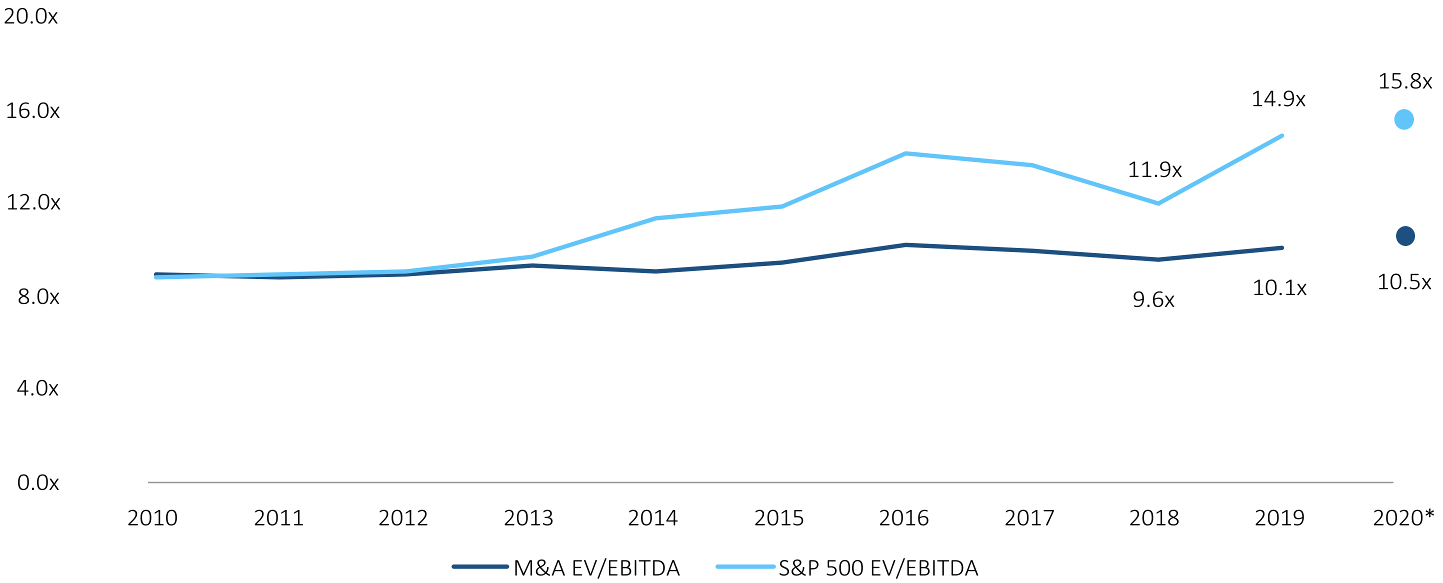
Median deal size ($M) by transaction type



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

2: "ExxonMobil Plans Reduction to European Staffing Levels" ExxonMobil, October 5, 2020.

North American M&A vs S&P 500 EV/EBITDA multiples



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

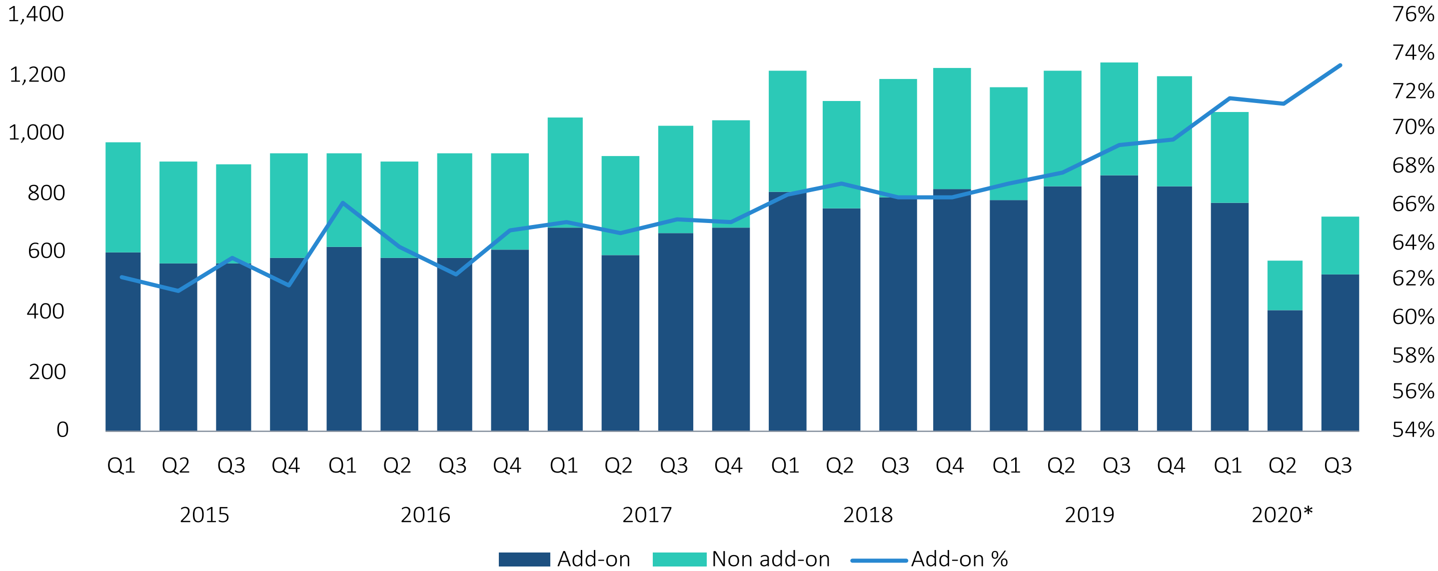
With hundreds of billions flowing into PE in recent years, it comes as no surprise that PE-backed M&A activity has had a net change of more than 32% this decade and now accounts for 35.1% of NA M&A activity. In 2020, median PE deal size has come down across the board, except in the cases of add-on deals. Add-on deals are often smaller than platform buyouts, and they allow PE firms to grow their portfolio companies via inorganic growth. These smaller companies are less likely to be institutionally backed, unlike platform companies, and are more likely to be struggling from COVID-19-related effects, making them especially attractive to PE firms. Thus, it is no surprise that add-on deals made up 73.4% of PE buyouts in Q3 2020, the highest number on record.

Pivoting to metrics, the North American EV/EBITDA multiple ticked up to 10.5X from 10.1X in 2020, as the rebound in M&A activity showed up in the data. This was especially true for software deals, where the recurring revenues of many B2B SaaS companies have become hot commodities—especially for GPs who have come to view these types of firms as resilient in downturns. The multiples for these sought-after software firms have remained elevated through 2020. One notable example of the frothiness was the take private of Boston-based software company Logmein. The firm was acquired in a $4.3 billion buyout by tech investor Francisco Partners and Evergreen Coast Capital—the PE affiliate of activist hedge fund Elliot Management Corporation. The purchase price represents a 25% premium to the firm's closing share price on September 18, emphasizing how PE firms are still willing to pay top dollar for specific software companies even at the height of a pandemic.[3]

Despite large deals (more than $1 billion) taking up most of the limelight, dealmaking in the quarter was largely driven by smaller transactions. Thus far in 2020, deals under $100 million accounted for 68.7% of all M&A—the highest level since 2016. Furthermore, deals in the $1.0 billion to $5.0 billion range made up only 1.2% of all deal count, which is the lowest percentage for this bucket since 2013. As was the case with add-ons, the pandemic has led deal seekers to scour the lower middle market (LMM) for returns that may have been overlooked by other acquirers, who have been priced out of the middle market. Corporate acquirers are often not interested in a small company they cannot readily incorporate, and financial sponsors may have funds that primarily target larger assets. Furthermore, we have seen the divergence in the public markets between the S&P 500 and the Russell 2000, where the former has gained during COVID-19, and the latter has seen declines. GPs and other investors have used the hardships these smaller

3: This deal was announced in 2019, although we believe the attractiveness of software firms still stands through the pandemic.

PE deal activity (#) by type



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

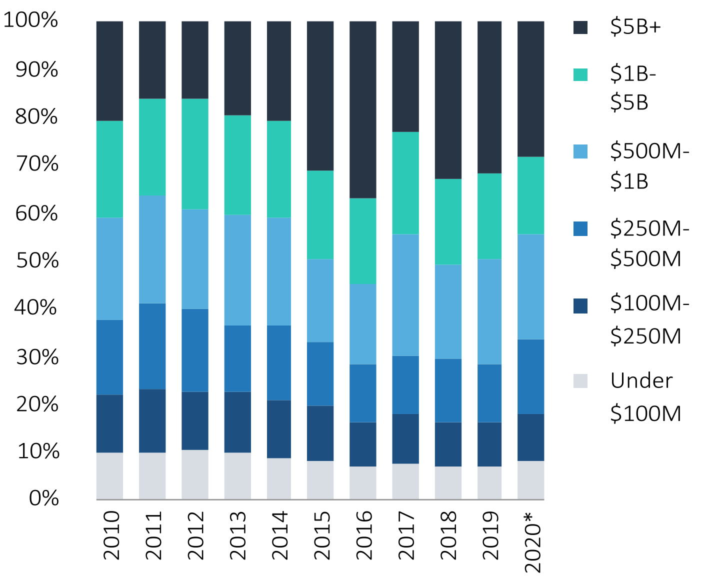
firms are facing to find undervalued-yet-attractive assets in the LMM. We expect this trend to reverse when the economy eventually rebounds and GPs have greater confidence in the economic outlook.

In terms of a recovery, the outlook is still very much inconclusive. Not only is there no end in sight for the pandemic without a viable vaccine, but there are also questions arising from a market outlook perspective. At the time of writing, Federal Reserve Chairman Jerome Powell had strongly asserted that the US needs substantial fiscal stimulus if it hopes to avoid an economic crisis. These remarks were given during a morning session of the National Association for Business Economics' annual meeting, and that same afternoon President Trump—still fresh from the hospital after his COVID-19 treatment—tweeted that he would halt stimulus talks until after the November elections, throwing the public markets into turmoil. Furthermore, while it is often thought that a Republican White House is a boon for the economy, sentiment appears to be changing for the time being. Goldman Sachs' chief economist released a note stating that a Blue Wave—in which the Democratic party takes control of both the White House and Congress—would be beneficial for the markets. The note concedes that while this scenario would likely lead to an increase in corporate taxes, it would be outweighed by federal stimuli that would likely be part of a larger spending agenda. As it stands, Democratic challenger Joe Biden is currently favored to win. The above factors call attention to the muddied outlook for the economy when faced with the uncertain impacts of COVID-19 and the US elections.

Despite the persistence of the pandemic and the turmoil it has caused, the rebound in M&A activity in Q3 is a positive sign. Currently, all eyes are focused on the November election and the potential ramifications stemming from the outcome. We will continue to follow these events closely to better weigh the potential implications of a victory for either party.

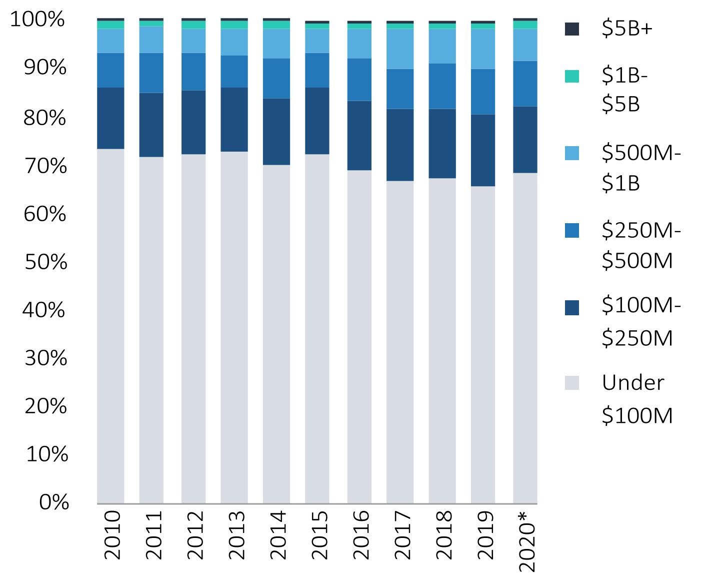
Deals by size and sector

M&A ($) by size



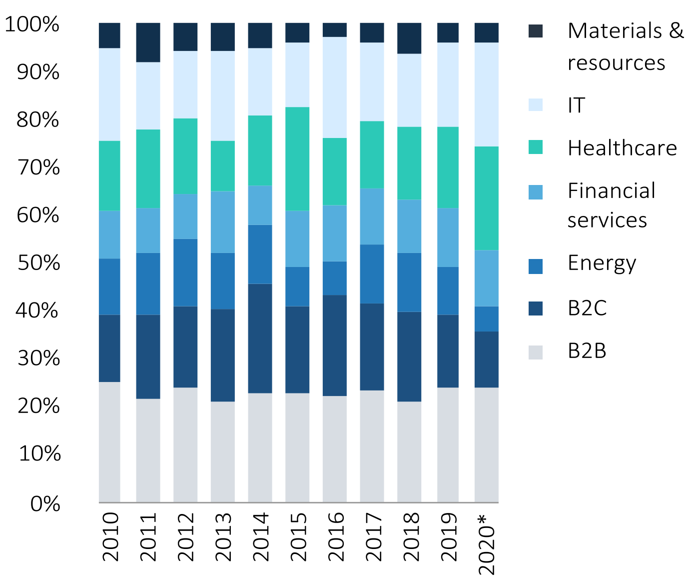
Source: PitchBook | **Geography:** North America
*As of September 30, 2020

M&A (#) by size



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

M&A ($) by sector



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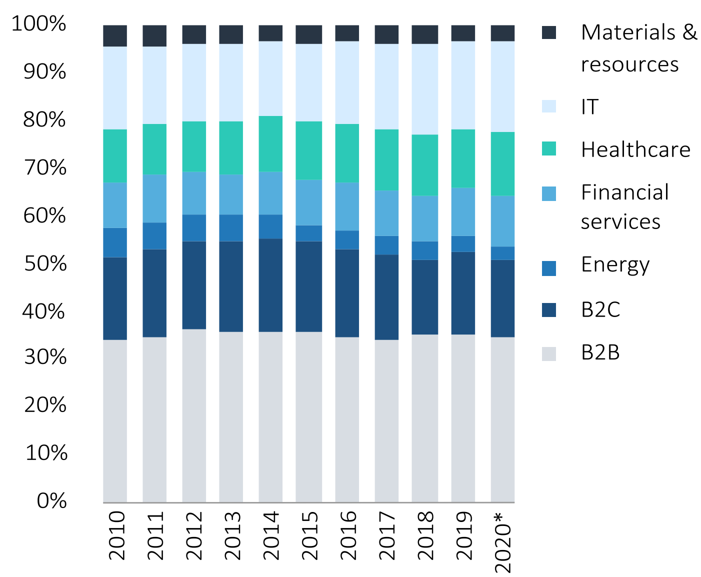
M&A (#) by sector



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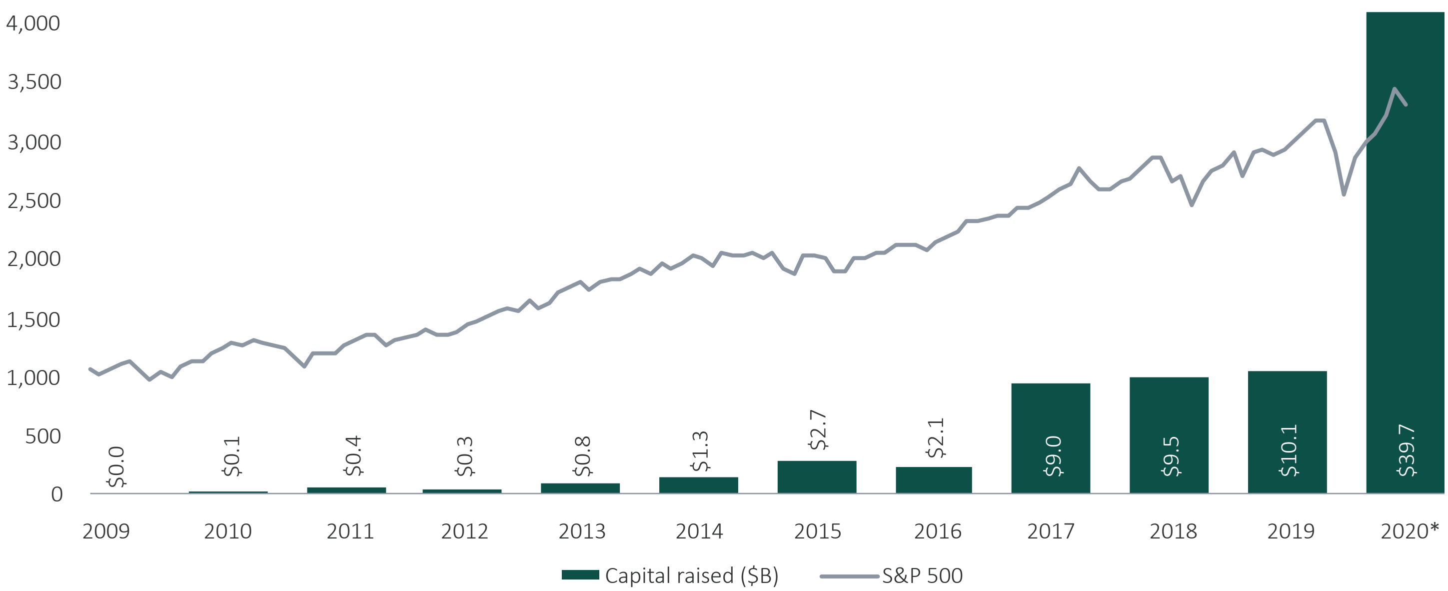
Spotlight: The 2020 SPAC frenzy

SPAC proceeds and public market performance



Source: PitchBook | **Geography**: US
*As of September 30, 2020

Note: This spotlight was abridged from an analyst note on SPACs. For a more detailed analysis of the subject, which also covers institutional investors, SPAC targets, and sector spotlights, please read our report on the 2020 SPAC frenzy.

Introduction

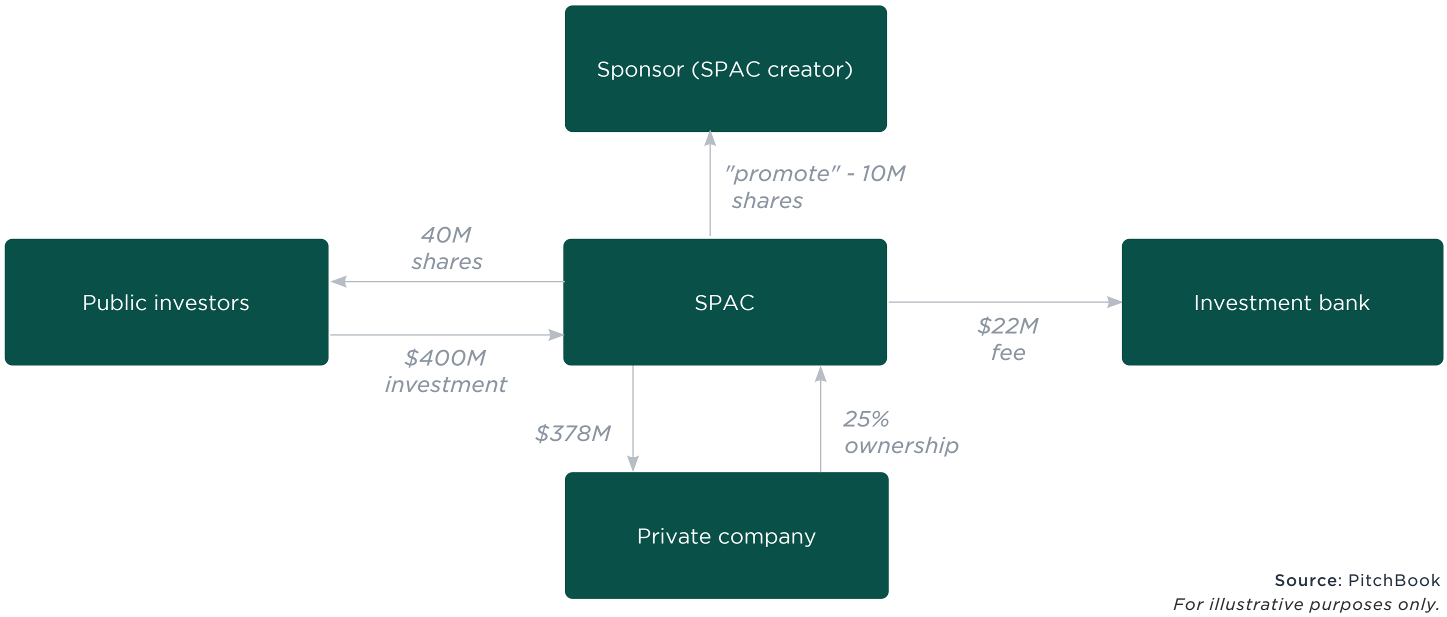
If there is one corner of the financial markets that has benefited from the pandemic, it is special purpose acquisition companies (SPACs). This atypical pathway to the public markets was once a niche strategy for small investment firms. These early embracers saw SPACs as a way to extract fees from adding structure to a reverse merger. The strategy has now become the hottest financial topic of 2020 after a massive uptick in the volume of these blank-check vehicles and as the stature of the investment professionals involved legitimized the space. The surge in IPO activity from SPACs has been covered by research providers ad nauseam, with PitchBook producing a few reports on the topic as well.

Despite extensive coverage by the industry, many misconceptions are still widely reported, and details that add nuance to the debate are commonly omitted from discussion. This analyst note aims to highlight some of these missing pieces for people in the investment community who are looking to change the way private companies become public companies and might be considering SPACs as an option.

Why SPACs? And why now?

This time last year, direct listings were the newest and shiniest toy for VCs when they were evaluating potential public market exits for their portfolio companies. Then came the pandemic, which plagued markets with economic uncertainty, especially public markets. The sustained volatility and the distinct price declines earlier in 2020 made IPOs and direct listings impractical options for the majority of private companies, which is where SPACs have found an opportunity. Unlike SPACs, direct listings do not allow private companies to raise any new capital during their transition to the public markets, which presents a problem for many startups given the elongated economic ambiguity driven by the pandemic. This is poised to change given NYSE's recent approval of adding primary shares into the opening auction, which would level the playing field of each public market pathway. Furthermore, direct listings and IPOs involve selling shares via an auction process, which can be messy in a volatile market.

Hypothetical SPAC funding



Source: PitchBook
For illustrative purposes only.

Since a SPAC is essentially just a large box of money, the listing of a SPAC necessitates a much lower level of diligence than a similarly sized IPO of an operating entity because there are no financial statements to scrutinize. For a sponsor, one could say, raising a SPAC is more akin to raising a closed-end fund, allowing for a shorter and more comfortable timeline during the fundraise. The simplified process of raising a SPAC IPO has allowed these listings to go forward since SPACs usually trade near the NAV, and the reverse merger represents the true test for SPACs when a new operating company actually becomes public and investors then evaluate and trade shares accordingly.

Sponsors

We start with the creators of the SPAC: the sponsors. For these players, incentives tend to be clear, since the sponsor acquires a special class of shares that equates to 20% of the shares in the SPAC for a nominal cash consideration, known as the "promote." These sponsors also reap other benefits in leading the SPAC, such as the option to organize a PIPE deal concurrently with the acquisition and the chance to offer some input on the strategy of the acquired business, frequently through a position on the board. This strategic decision-making aspect is why former operators and executives often lead SPACs, using their expertise to identify attractive targets and help guide them to success. Sponsors do receive a lot of economic interest in the business for essentially finding the deal; that said, there are signs, such as the reduction or elimination of the promote or warrant allocations, that the SPAC structure is becoming less of a fee grab on subpar deals and instead more of a company-friendly vehicle with potential to create value. A shift in the makeup of SPAC sponsors toward institutional and reputable market participants has also begun to further legitimize the future of SPACs.

Since traditional IPOs of operating companies have been relatively scarce, SPACs have seen a huge boost in demand so far in 2020. Typical IPO investors have rushed to participate in these deferred listings in the hopes of backing the next great growth story. The high demand has allowed many SPACs to upsize the amount raised in their IPOs; both serial SPAC sponsors and new entrants alike have taken it as an opportunity to raise capital while the strategy remains in good favor. From the sponsor's point of view, raising a SPAC is just another fundraise with a slightly different LP base.

Sponsors are also potentially assuming that the market dynamics driven by the pandemic will create a host of targets at attractive valuations, suggesting the explosion may have stemmed from opportunism rather than deeper analysis around particular investment theses. This frenzy in new SPAC listings could hinder performance for these vehicles as competition heightens, which could inflate some valuations. It will be a couple of years before we can tell whether or not this was a truly sound strategy for the sponsors, but for now it seems better to accumulate assets while the iron's hot.