Middle Market Transaction Update
Second Half 2020

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Introduction

As described in the following pages and charts, U.S. M&A activity slowly rebounded in the third quarter of 2020 from the pandemic-shocked levels seen in the second quarter and reached pre-pandemic levels of activity in the fourth quarter. In the second half of 2020, reported TEV/EBITDA multiples on private equity transactions across all tranches of enterprise value remained fairly consistent with observed multiples in the first half of the year. Multiples in the middle two tranches did increase during the fourth quarter, which is likely a result of increased buyer demand towards the end of the year. Overall, multiples for both strategic and private equity deals were down slightly from levels observed in 2019, and overall activity in 2020 was still considerably below levels observed in 2019 given the economic impact of the pandemic on both acquirers and target companies. Levels of activity observed in the second half of 2020 suggest that buyer and seller appetite for transactions is beginning to return.

**U.S. Deal Value & Volume**
Q3-2018 to Q4-2020

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Deal Value ($B)</th>
<th>Transaction Volume (000s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q3 2018</td>
<td>$53.4</td>
<td>0.82</td>
</tr>
<tr>
<td>Q4 2018</td>
<td>$54.7</td>
<td>0.88</td>
</tr>
<tr>
<td>Q1 2019</td>
<td>$46.5</td>
<td>0.77</td>
</tr>
<tr>
<td>Q2 2019</td>
<td>$46.3</td>
<td>0.79</td>
</tr>
<tr>
<td>Q3 2019</td>
<td>$55.0</td>
<td>0.93</td>
</tr>
<tr>
<td>Q4 2019</td>
<td>$57.1</td>
<td>0.94</td>
</tr>
<tr>
<td>Q1 2020</td>
<td>$51.8</td>
<td>0.84</td>
</tr>
<tr>
<td>Q2 2020</td>
<td></td>
<td>$22.3</td>
</tr>
<tr>
<td>Q3 2020</td>
<td></td>
<td>0.38</td>
</tr>
<tr>
<td>Q4 2020</td>
<td></td>
<td>0.61</td>
</tr>
</tbody>
</table>

Source: Capital IQ

**TEV/EBITDA Multiples**
Financial Buyers | Q3-2018 to Q4-2020

Source: GF Data®
Debt Multiples

Debt multiples among private equity buyers trended upwards in the fourth quarter of 2020, nearing pre-pandemic levels in terms of both total debt and senior debt to EBITDA. Still, deals that reported debt utilization in 2020 dropped to 81% in the fourth quarter of 2020, down from a range of 85% to 90% in 2019 and the first half of 2020. The increase in the senior debt multiples in the fourth quarter can be viewed as a sign that commercial banks are beginning to finance deals again exclusively with senior debt, a trend that came to light in 2019 and was overturned in the early uncertain stages of the pandemic.

Source: GF Data®

Source: Capital IQ (strategic) and GF Data (financial)
Strategic multiples exclude outliers (defined as EBITDA multiple > 15x)
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Summary

The flurry of activity in the second half of the year, particularly the fourth quarter, can be attributed to several factors. First, several COVID-19 vaccines received emergency-use approval in the U.S. in the fourth quarter, which investors and other market participants viewed as a light at the end of the tunnel as it pertains to the economic and societal effects of the pandemic. This positive development eased economic uncertainty in the U.S., and middle markets were the beneficiaries of pent-up demand from acquirers and sellers looking to commence transactions. Political uncertainty in the U.S. was also resolved in the fourth quarter of 2020 with the election of President Biden. Investors reacted favorably to a relatively smooth election process, and this positive sentiment trickled into the middle market, as buyers and sellers could now look to 2021 and beyond with clearer prospects in terms of upcoming fiscal and monetary policy and legislation. Also aiding the increase in transaction activity in the fourth quarter was the fact that many business models were validated as being structurally sound during the tumultuous second and third quarters of the year. Potential sellers that continued to demonstrate favorable revenue and profitability trends in the second and third quarters were rewarded in the fourth quarter by a return in demand by potential buyers. This trend, and those previously discussed, bears itself out in the upticks in deal value and volume seen in the chart on page 3.

In November of 2020, Joe Biden was elected President of the United States. The tax plan Mr. Biden proposed during his campaign has consequences for both potential buyers and potential sellers in the middle market. Mr. Biden has proposed increases to corporate and individual capital gains tax rates from their current levels and an elimination of the step-up in basis for estates, which currently allows for the minimization of future capital gains through adjusting the tax basis to the fair market value at the date of death. Both of these proposals will affect would-be sellers in the middle market. Further, a proposed reversal of the Tax Cut and Jobs Act of 2017 would eliminate companies' ability to immediately expense capital expenditures, potentially affecting would-be buyers in asset deals. According to a survey of U.S. executives conducted by EY, 79% of respondents expected an increase in M&A activity in the U.S. in response to the proposed tax code changes. This anticipated increase in transaction activity will certainly impact the middle market, as buyers and sellers look to beat the clock and take advantage of transacting in a lower tax environment. If passed, the increased capital gains tax rate in particular will heavily incentivize would-be sellers to accelerate transactions to a close before the changes take effect. At the writing of this update, the Biden administration is targeting late 2021 as a time frame to send a bill for passage to Congress. Any proposed tax legislation would certainly be met by fierce opposition from Republicans, but with Democrats in control of both chambers of Congress, passage is nearly guaranteed. We anticipate an increase in transactional activity in the middle market in anticipation of these changes, but the timing of this increase will likely depend on the passage of the bill and the schedule of when any proposed changes take effect. Sellers looking to preemptively take advantage of the current lower tax environment would be advised to begin investigating transaction opportunities sooner rather than later in order to avoid any potential adverse tax outcomes resulting from a delayed transaction.

In conclusion, we expect transaction activity in the middle market to continue to build on its strong end to 2020, as the factors noted that led to the rebound in activity will continue to proliferate into 2021 and business earnings continue to "normalize" following the shock of the pandemic. With the consequences of the proposed Biden tax plan in mind, transactional activity in 2021 and 2022 in terms of deal value and volume should continue to increase, as buyers and sellers look to take advantage of the current tax environment before it is altered.
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Mercer Capital leverages its historical valuation and investment banking experience to help clients navigate a critical transaction, providing timely, accurate and reliable results. We have significant experience advising boards of directors, management, trustees, and other fiduciaries of middle-market public and private companies in a wide range of industries. Our independent advice withstands scrutiny from shareholders, bondholders, the SEC, IRS, and other interested parties to a transaction, and we are well-versed in the new industry standards.

The professionals of Mercer Capital guide you through the uncharted waters of selling your business, acquiring another business or division, mergers, valuations, fairness opinions, and other transaction advisory needs. Rely on the experience, independence, and transaction know-how of Mercer Capital.

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- Fairness and Solvency Opinions
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- Maximize Net Proceeds
- Negotiate the Best Possible Terms
- Speed Up the Deal Process
- Ensure Transaction Closure
- Help Ensure Confidentiality
- Minimize Burden on the Ownership

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