Opus Connect

INDEPENDENT SPONSOR REPORT

A Window Into Middle Market M&A After COVID-19

2020

TABLE OF CONTENTS

INTRODUCTION

Independent sponsors and capital providers within Opus Connect's extensive middle market M&A network are a valuable source of insight into the current state of their deal flow during the first eight months of 2020. Our findings in this report seek to illuminate the ways in which independent sponsors have both adapted to change and where they continue to pick up and go forward after a pause during the global economic slowdown. The inherent variability in the independent sponsor model led to a diversity of responses within participants' deal flow and access to capital.

This report provides a collective knowledge base for how a cross-section of independent sponsors are responding to changes in their deal structures. Opus Connect's goal is to act as a resource and deal community for current and potential members, conducting this research with the goal of providing a window into the current state of the middle market. A tool for future success, the information gathered aims to promote awareness of current practices as well as the speed and growth potential for deals going forward. Business development strategies are continually changing and growing alongside an industry that is now seeing greater utilization of digital resources and new technologies as some – but not all – parts of the deal process transition to virtual interactions and events. As the global scenario changes, business processes adapt alongside it.

Thank you to our esteemed survey respondents in this market for sharing their timely experiences and discussing the impact of COVID-19 with us as we all cope with the curveballs of 2020 and the unexpected issues that arise from shifting the ways in which we do business during a global pandemic.

ABOUT THE AUTHOR

LOU SOKOLOVSKIY,
CEO & Founder at Opus Connect

Lou is a serial entrepreneur with extensive private equity transaction experience. He is the founder of multiple entrepreneurial ventures in the technology arena, and has unique expertise in operations management, strategic partnerships and new business development. He is a former consultant who has advised many companies in the healthcare management, finance, and technology industries on improving operations and corporate strategy. Lou is the founder of the M&A professional networking organization, Opus Connect, and is an active member in numerous nonprofit organizations [including FIDF, AIPAC and JNF]. He is a member of the Milken Institute Young Leaders Circle and is Wexner Heritage Fellow.

OPUS CONNECT OVERVIEW

Opus Connect (www.opusconnect.com) is a lower middle and middle market M&A focused professional organization with members in fields of private equity, banking, finance, and other transactional professions. Our mission is to enable our members to create, expand, and maintain long-term relationships within the finance community. We produce a powerful platform to facilitate new relationships, introduce transaction opportunities among high caliber individuals, and exchange industry insights in an enjoyable, yet highly focused atmosphere.

METHODOLOGY

This survey, conducted via one-on-one interviews by Opus Connect CEO Lou Sokolovskiy in August and September 2020, showcases the views of 29 independent sponsors. These views encompass industry outlook, the state of ongoing deals and deals closed during the COVID-19 pandemic, business development strategy, the status of capital markets, changes in investment thesis, and more.

DEMOGRAPHIC

Our survey respondents are at firms that have been in existence for anywhere from two to twenty years, showcasing a wide range of experience in the industry. All major U.S. regions are represented by our respondent population.

RESEARCH QUESTIONS & RESPONSES

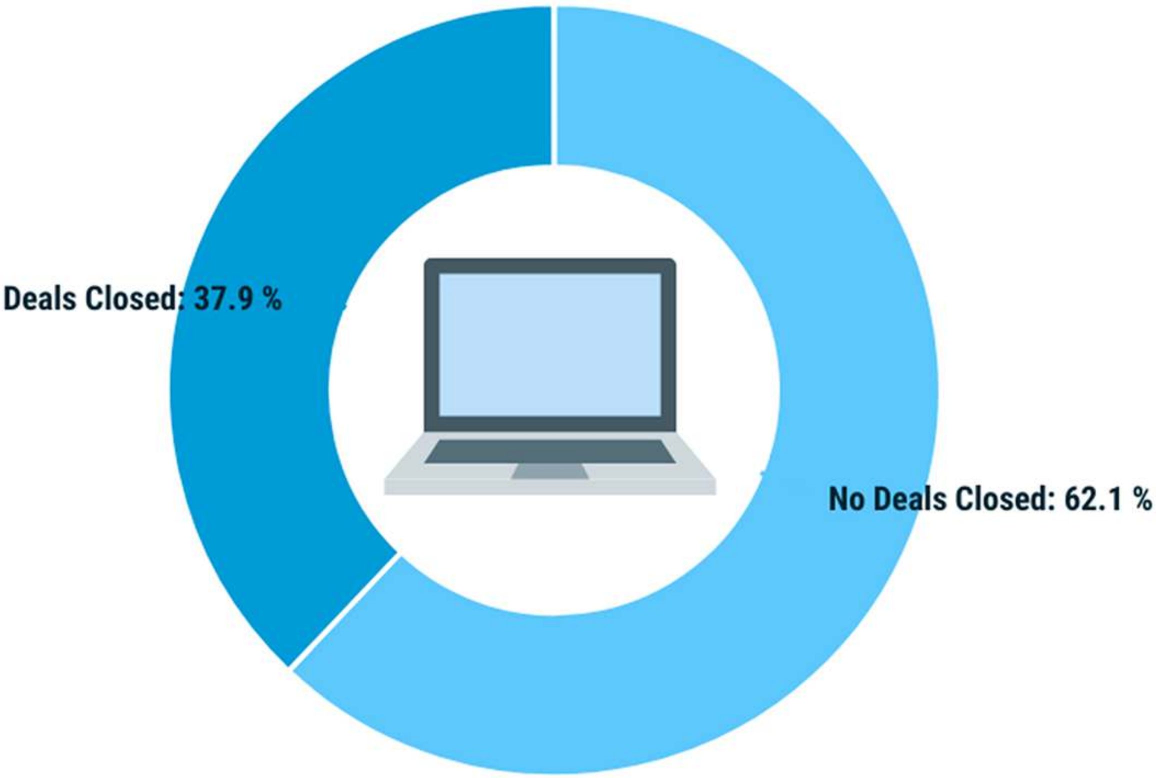
The goal of this first section is to provide a quick snapshot of whether independent sponsors have been able to close deals during COVID-19, and whether those deals were already in the pipeline prior to pandemic and subsequent lockdown in which travel was next to impossible. We also take a look at whether firms have been able to meet with management teams to secure potential deals in August/September 2020, as some parts of the world resume a more normal schedule. Air travel is essential for global economic growth, where limiting traveling means limiting deal flow.

A. DEALS

Question 1.1: Have you closed any deals since COVID-19? If yes, did you start working on those deals prior to COVID-19?

The responses to this reflected the general uncertainty of the 2020 market, but also demonstrated that deals are still occurring. Out of the 29 respondents, 18 stated that they had not closed any deals since COVID-19, with 11 stating that they had, but the vast majority (all but 1) of those that had stated that the deals had been in their pipeline prior to the pandemic and resultant lockdown and slowed economic growth.

COVID-19 Deal Flow, Independent Sponsors



Opus Connect

A.1.2. Have you closed any deals without meeting the management team?

All 29 respondents were in agreement on this issue – none had closed deals without meeting the equity management teams prior to closing. There is truly no substitute for in-person discussion and gaining insight into a business via face-to-face interactions.

A.2: Have you started working on any new deals since COVID-19?

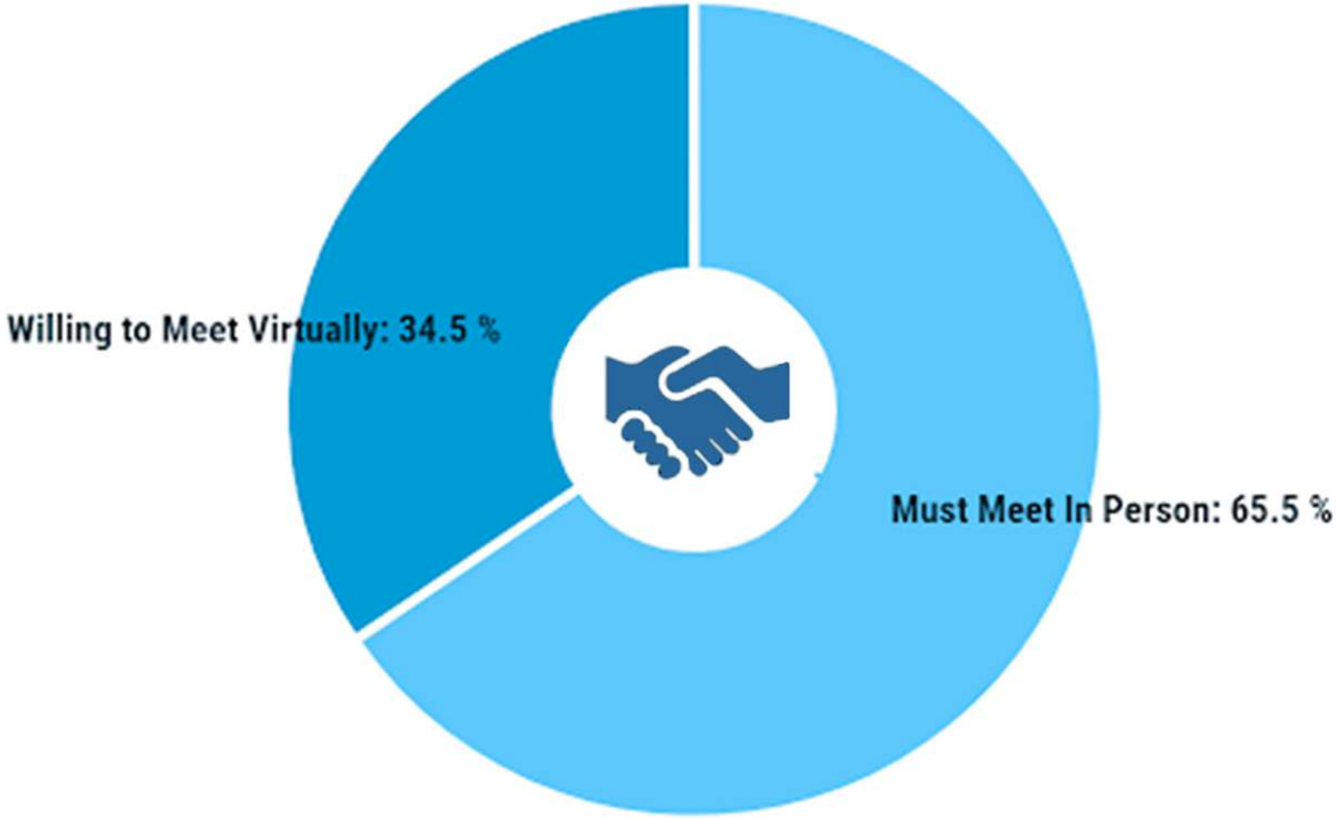
Great news for the middle market M&A industry – business is picking up again after the halt in early 2020. All but 2 independent sponsors surveyed are presently working on new deals that have arisen after the onset of COVID-19.

A.3: Have you restarted business-related air travel?

Independent sponsors were split on this question, with 8 responding that they had NOT resumed travel, and 13 stating that they had resumed limited, necessary business travel.

A.4: Will you consider closing a deal without meeting the management team in person?

The majority of respondents – 19 out of the 29 surveyed – would not consider closing a deal without an in-person meeting with management. Only four respondents indicated that they would be open to the idea, and five noted that it would depend on the industry and the individual deal. Paul Cohn noted that it would "depend on the kind of business operations" and Christopher Lee stated that if he did close a deal, "some prior interaction" was needed.



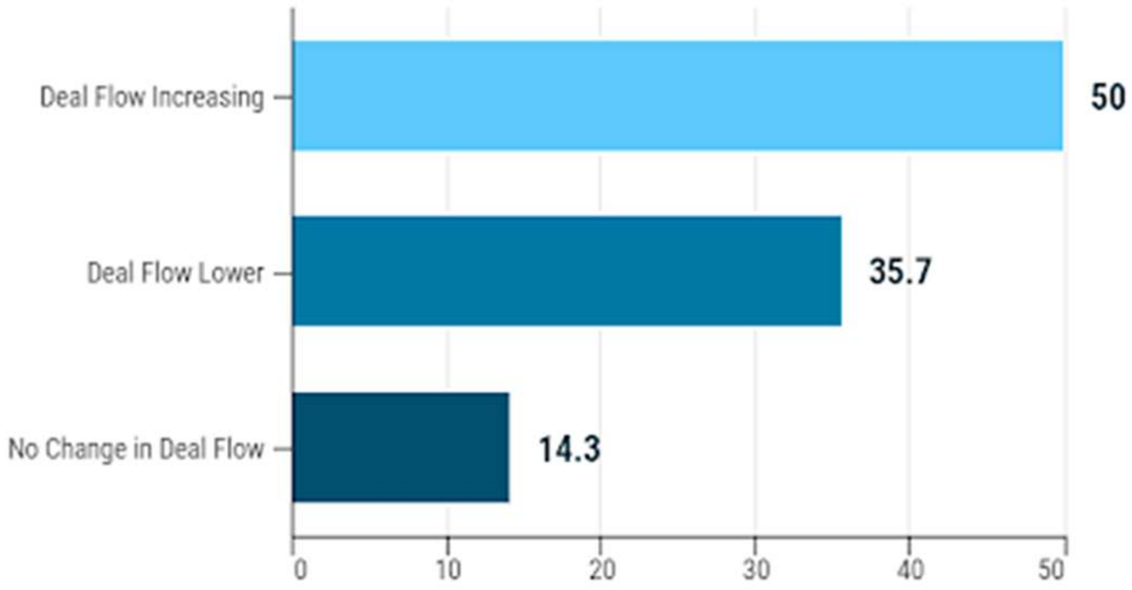
B. DEAL SOURCING

B.1. How would you rate the quantity of your deal flow?

This is a very industry-specific question, and responses will inherently vary by the industry in which the respondent is working. Quantity of deals during 2020 seemed to vary throughout the middle market, with respondents to this query split. 10 respondents out of 29 said that the deal quantity was lower, with Paul Cohn noting that “at the beginning of COVID-19, the deal flow slowed down, but now it is picking up as things have normalized in the market.” James Samuelsen provided insight into the pace of deal flow, stating that it is “fairly robust in the last 60 days. The deal flow turned off from April through May, but in mid-June to mid-August, it is back to pre-COVID-19 levels.”

14 out of 29 respondents similarly rated deal flow as improving, stating that deal flow was actually increased for them in 2020. Four respondents had not seen much change, with deals having a “constant flow on a proprietary level,” as Christopher Lee noted.

Deal Flow Quantity

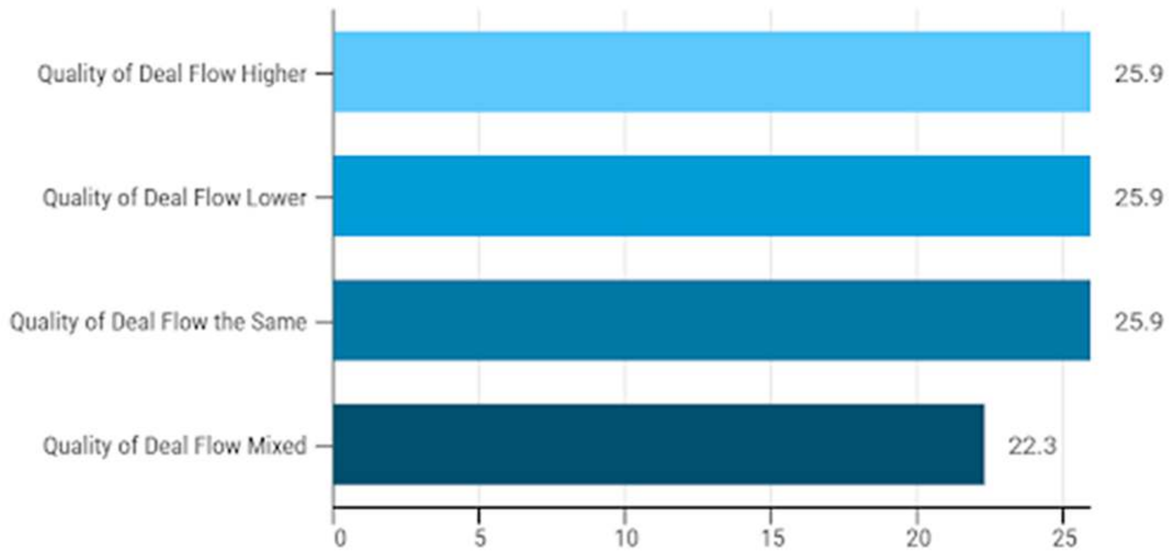


B.1.1. How would you rate the quality of your deal flow?

As with the previous question, the responses to this second part will also vary by industry, and the data supports the diversity of our respondents. Out of the 27 responses provided for this question, the results were evenly split among higher (7), lower (7), and the same (7), with 6 participants stating that quality was mixed. Vik Jindal noted that quality was "sector-specific" alongside Martin Wentzel, who also agreed that quality "depends on the industry." Drew Adams stated that there was "a wider spectrum of quality deals" than expected.

Elliot Rohde's assessment was that deal flow was "a little bit down – the new deals that are coming typically have some levels of distress," which is unsurprising given the volatile state of the global markets. Paul Cohn had an important addendum, stating that it is "more valuable for companies and investors to get liquidity today than pre-COVID-19." These statements provide an overall encouraging picture of deal flow in 2020, despite the global uncertainty caused by the pandemic.

Deal Flow Quality

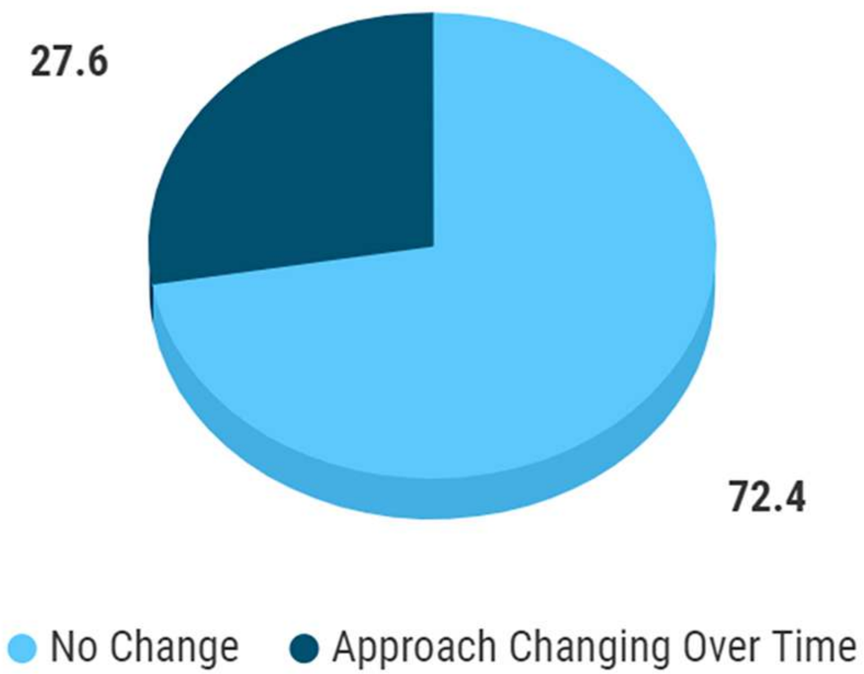


B.2. Have you changed your investment thesis? If yes, how?

While the pandemic has changed a great deal, this industry is not showing signs of shifting much, let alone drastically, which is a positive trend going forward. 21 respondents have not changed their investment thesis, with just a few noting that they had changed as a result of the COVID-19 pandemic. John Battinelli provided some insight, stating that there was a “stronger focus on finding companies that are insulated from the COVID-19 impact” and Samantha Ory telling Opus Connect that “work is more segmented” with greater emphasis on “upfront due diligence.”

Some independent sponsors are using this time to focus on relationship maintenance and others are shifting slightly but not much, as Andy Waltman notes that “we altered our approach and perspectives in certain industries - but not much changes overall.” Paul Cohn’s response was more detailed, stating “Yes - we were always going to target independent sponsors and mezzanine firms, but we are doubling down our focus on that area” because that is “where liquidities are more urgent than the traditional fund market.”

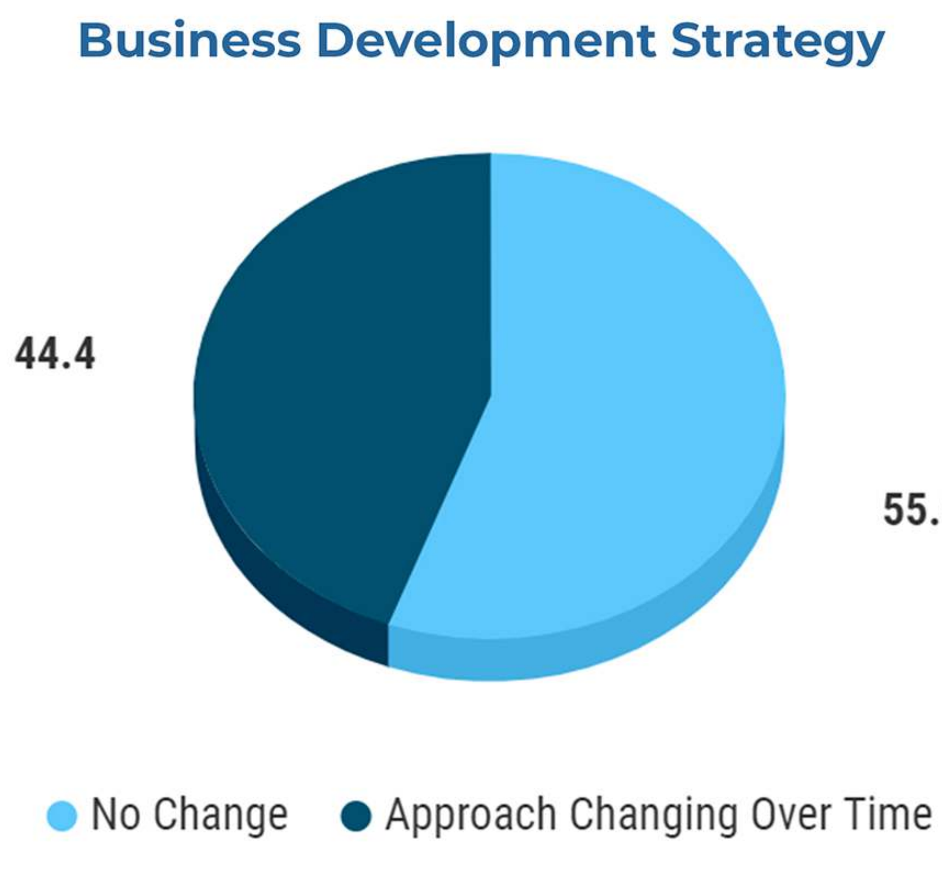
Change of Investment Thesis



B.3. Have you changed your business development strategy? If yes, how?

Respondents are split on business development, with 15 stating that their business development strategy had not changed, whereas 12 middle market professionals had changed their focus. Of those 12, all attributed these changes to a greater focus on virtual meetings, digital events and marketing efforts, and a focus on "doubling down with the existing network" (Christopher Lee).

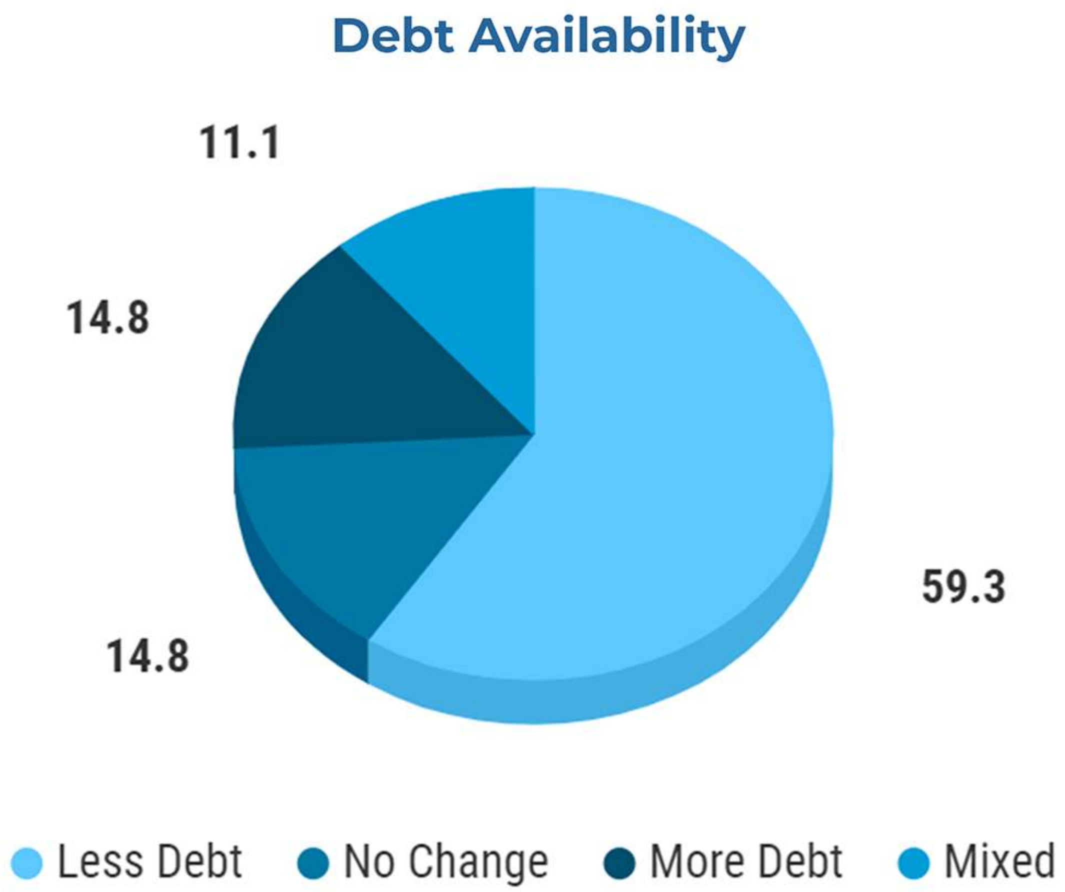
Andy Waltman noted that his firm has "now started working with buy-side brokers" as their business development strategy shifts in the wake of COVID-19. Ben Mimmack noted that his firm was changing, and is "more proactive in terms of reaching out, but not as a result of COVID-19," demonstrating that businesses are still able to focus on taking initiative in the space, being proactive instead of reactive, rather than simply responding to crises. Brian Guerin's statement also supports this, stating that his business development strategy is "more digital in terms of reaching out to people; more proactive."



C. CAPITAL MARKETS

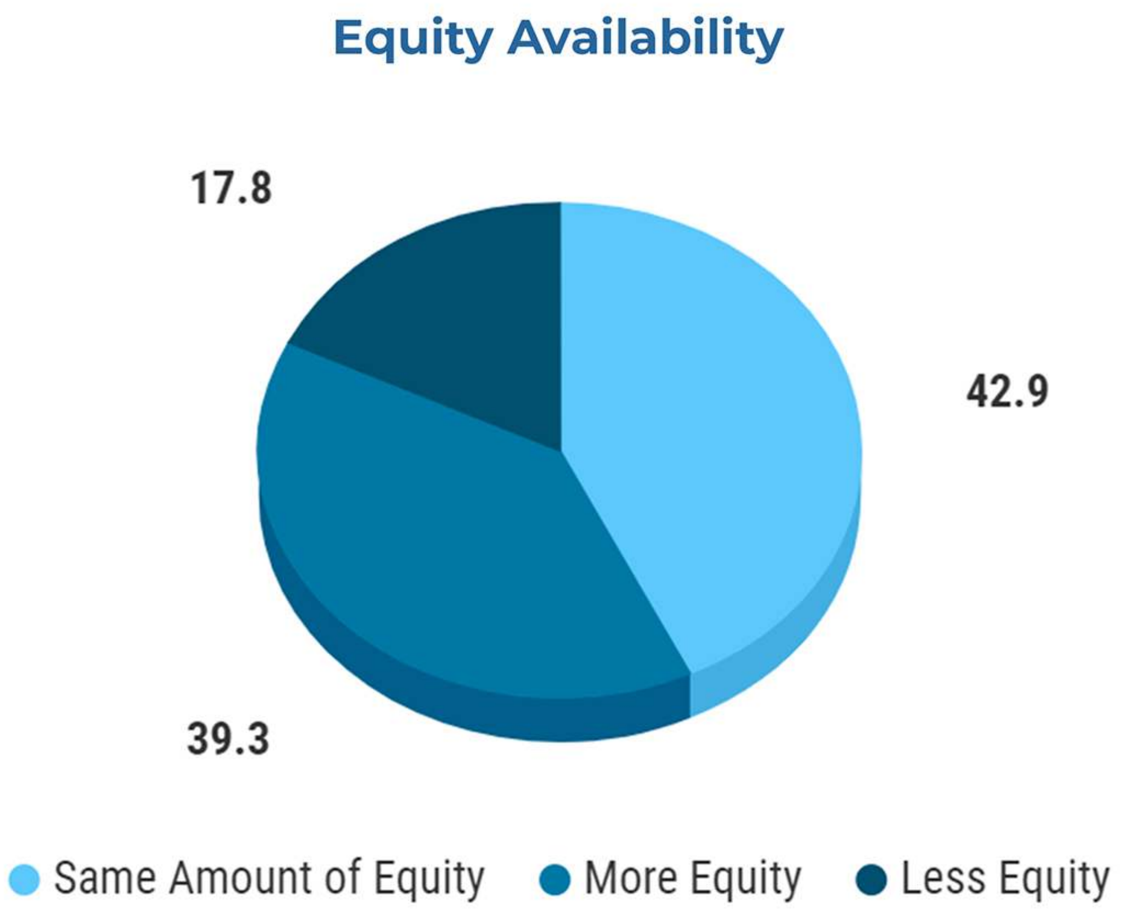
C.1. Debt availability

While there was a diversity of replies to this query, the majority of respondents (16) noted that there is less debt availability in the market. Four individuals did not see a change, four stated that there was more debt availability, and three replies were that the overall availability was mixed. James Samuelsen noted the following: “Debt tends to be about 200 points higher across the spectrum. Some of the bank lenders were hesitant to engage. For some non-bank lenders, pricing is still higher. In general, a tighter debt market and more expensive debt market is present.”



C.2. Equity availability

The availability of equity in the market was seen as decidedly mixed, with 12 respondents rating it as the same as pre-COVID-19 levels, 11 seeing more availability in 2020, and 5 seeing equity as trending more conservatively and being less available. Andrew Cohan termed equity availability as "plentiful" and Martin Wentzel noticed that "there is an appetite for distressed and for more challenging transactions" in the market. Bruce Lipian described the situation as follows: "equity is still bountiful, but the number of opportunities that equity investors will be comfortable investing in is lower."



C.3. What are the primary sources of equity (family offices, funds, wealthy individuals, LPs, etc.)?

This question perhaps saw the largest range of answers, as respondents receive equity from a wide variety of sources and the diversity of industries represented by the respondents plays a role in that wide range. Six survey respondents cited family offices as a primary source of equity. High net-worth individuals were also cited, with funds, LPs, and other sources also seeing representation. Tony Brindisi notes that sources “differed dramatically by individual group depending on how hard they were hit on their current portfolio with COVID-19.” This dramatic difference appears to be supported by the variety of answers we received for this query.

C.4. Have you seen any change in independent sponsors’ economics?

The consensus among the respondents was that there has been no change to independent sponsor economics.

D. DEAL STRUCTURES

D.1. How have you changed your deal structures?

This question netted a robust diversity of responses from survey participants. James Samuelsen states that "the size of the deals and ideal sponsors for those deals" has shifted, and Silvio Pupo-Casco cites the main difference as being one of flexibility, especially with management. Tony Brindisi noted that "there has been a re-emergence of earn out structures and seller financing as creative ways to move deal processes forward in the face of uncertainty," while Martin Wentzel discussed how his firm will "offer a more sequenced payout for the seller that has higher degree of acceptance." Essentially, there is less debt available, thus requiring that deals be over-equitized. More earnouts and seller notes now represent a significantly larger portion of existing deals.

Chris Sheeren states that "if it is a company that has been impacted, there will be COVID-19-adjusted EBITDA" (more on EBITDA in our last question); Drew Bagot asserts that the market is "leaning more toward subordinated debts and has less reliance on senior debt."

D.2. How do you estimate EBITDA considering the COVID-19 environment?

The survey participants provided a wide range of answers for this question, since there are many factors that can impact estimating EBITDA and it also varies based on industry. Instead of summarizing the answers, it is perhaps more insightful to read what the respondents had to say in their own words, as follows.

Silvio Pupo-Casco: "Some EBITDA is being disrupted because companies received PPP loans, while others saw an increase in EBITDA because of the extra money from PPP loans. We usually take that out as extraordinary income and try to evaluate on a standalone basis."

Kevin Fechtmeyer: "Most people are dragging it out. They are going to want to see the performance through that period of time in certain categories. So, most people are waiting for those proforma adjustments to burn off before making taking a new deal."

Andy Waltman: "If a company can show that they can get back in two to three months after their loss in March-May, then we'd likely give them the most credit for that."

Chris Sheeren: "It is case by case, depending on how the companies show they can get back up."

Jon Gordon: "Add-backs need to be scrutinized exactly. The value that is based on the portion that is an add back might be paid in a contingency or some other thing because I'm not sure how comfortable I am with the way they come up with the add-backs."

Martin Wentzel: "We have taken into account a business plan that includes a COVID-19 recovery and we have taken an average of the next three years – so basically a very low EBITDA in 2020, a recovering one in 2021 and then an almost back to normal in 2022."

Brien Davis: "Scenario analysis – attempt to normalize the earnings from the COVID-19 period with the realization that we need to be comfortable with what the next 12 months could look like in different scenarios."

Tony Brindisi: "We take a look at pre-COVID-19 earnings, backlog, and forward-looking projections more so than trying to dive in and come up with something normalized through COVID-19 months."

Vik Jindal: "Look for economics that are generally good today and the probability that we're going to lose money is very low, and the option value to the upside is tremendous."

RESULTS ANALYSIS

Like the majority of global financial markets, the fallout from COVID-19 has hit the middle market M&A industry in the form of slowed deal flow, an almost total shutdown of business travel, and less deals overall in 2020. Independent sponsors have not conducted any major deals in a totally virtual environment, preferring to wait until management teams can safely meet in person. The market is bifurcated and showing a strong flight towards quality deals. Deals are happening with greater regularity in the late third quarter of 2020, quantity is gradually improving, and some industries that were hit less hard by COVID-19 are not seeing too much change, year over year.

Business development strategies have not changed a great deal. Many of these strategies are the same and are just using new tools – largely digital and virtual ones that have seen a significant increase since the pandemic. It initially appears that it is a lot more challenging to build new relationships, but independent sponsors are trying to maintain relationships and deal flow, and harvest from existing relationships.

Backing up the above results from this survey, investment strategies have not changed unless their respective industries have been either hit hard or have seen a boost from the pandemic (such as the manufacturing and healthcare sectors).

Debt and equity availability, as well as deal structure, has fluctuated for some industries but remains steady in others, which presents opportunities for savvy investors looking to expand their deal pipelines as we head into the last quarter of 2020. Overall, there is more equity needed, and some are implementing more creative structures (seller notes, earnouts, and other creative tools) to close the gap between seller and buyer expectations. Deal professionals should note that in order to continue seeing and closing quality deals, more proactive business development efforts are required.

The independent sponsor landscape has shrunk considerably during COVID-19, and many smaller independent sponsors have been forced to exit the market and shut down. There is no question that the pandemic has put many out of business, and the independent sponsor niche has been adversely affected. However, for the remaining players, there are still deals to be done, even if the process and pipeline looks different.

In closing, opportunities exist as deal flow has somewhat returned to pre-pandemic levels. Nevertheless, many sectors are seeing a slow return to average business year over year as we head toward the final quarter of 2020. By leveraging and growing one's network, and utilizing the virtual and digital tools now being used with greater frequency post-COVID-19, active independent sponsors are poised to get back on track as the world adjusts and bounces back after the trials faced on a global scale.

INDEX OF CONTRIBUTORS

Andrew Cohan, Managing Member at Halmos Capital Partners
Andy Waltman, Director at Baymak Partners
Ben Mimmack, Director of Investor Relations at Baymark Partners
Bill Wilkins, Managing Partner at MSI Capital Partners
Brian Guerin, Partner at Calvert Street Capital Partners
Brien Davis, Partner at Altacrest Capital
Bruce Lipian, Managing Director at StoneCreek Capital
Chris Sheeren, Partner at Longhouse Partners, LLC
Christopher Lee, Managing Partner at RTC Partners
Dan Tamkin, Founder/ Managing Director at Resurgent Capital Partners
Drew Adams, President at StoneCreek Capital
Drew Bagot, Managing Partner at Serata Capital Partners
Elliot Rohde, Managing Partner at Newpark Capital
Farrah Holder, Director at IMB Partners
James Crawford, Managing Director at TRIAD Capital Management, LLC
James Samuelsen, Vice President at Bluejay Advisors, LLC
John Battinelli, Vice President at Rock Mountain Capital, L.P.
Jon Gordon, Managing Partner at Palladian Capital Partners, LLC
Kelvin Pennington, Managing Director at IMB Partners
Kevin Fechtmeyer, Managing Partner at Cave Creek Capital Management, LLC
Lori Lombardo, Principal at Entrepreneur Partners, L.P.
Martin Wentzel, Managing Director at American Industrial Acquisition Corp (AIAC)
Paul Cohn, Managing Partner at Tail End Capital Partners
Samantha Ory, General Partner at Ouroboros Group
Silvio Pupo-Casco, Managing Director at Logos Capital
Tim Laczkowski, Partner at Altacrest Capital
Timothy Cripe, Principal at Westbourne Capital Partners
Tony Brindisi, Managing Partner at RTC Partners
Vik Jindal, Managing Partner at Perpetual Holdings, LLC