Current M&A Trends and Considerations in Acquiring Financially Distressed Companies

July 20, 2020

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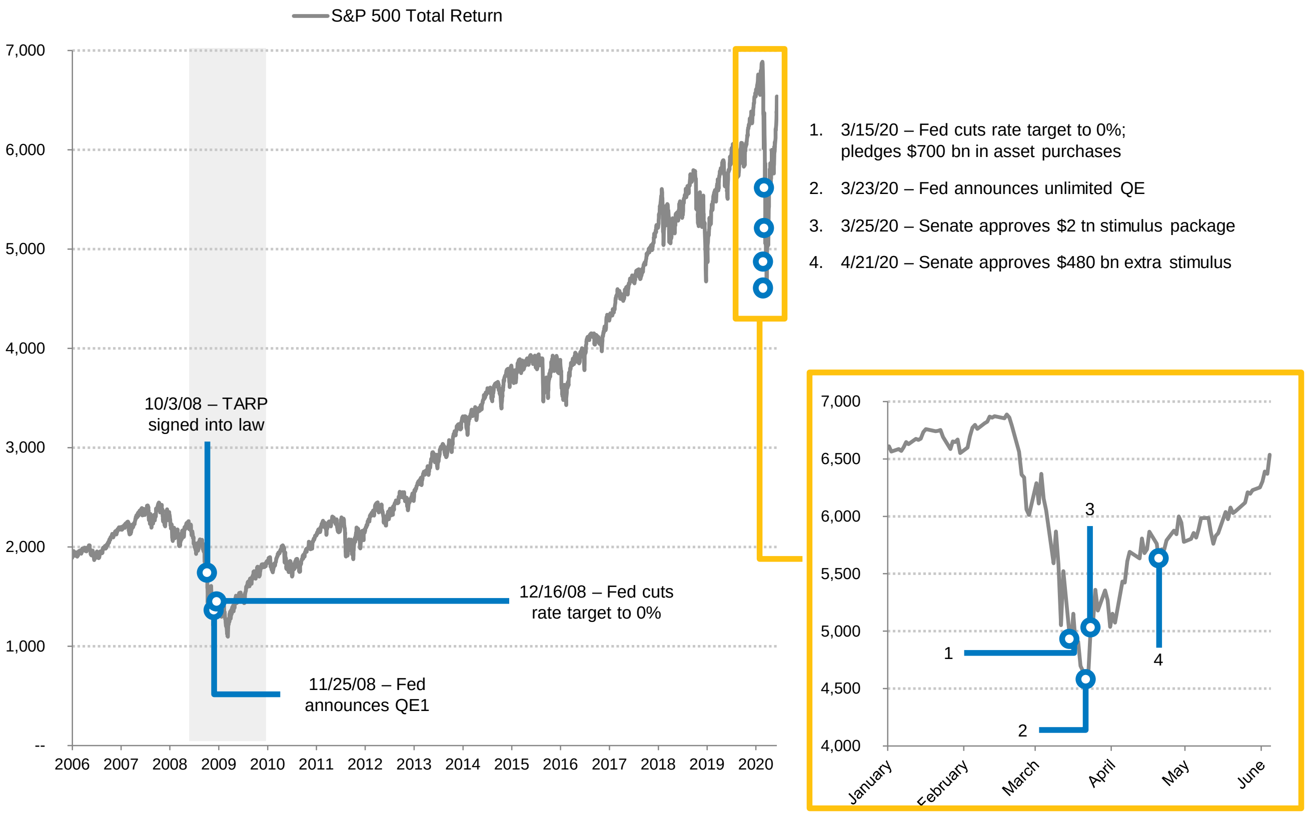
Today's Presenters

- John Chalus, Director
- Ben Marks, Director – Middle Market M&A

- Craig Arends, Managing Principal of Industry
- Brady Paschke, Senior

BMO Capital Markets

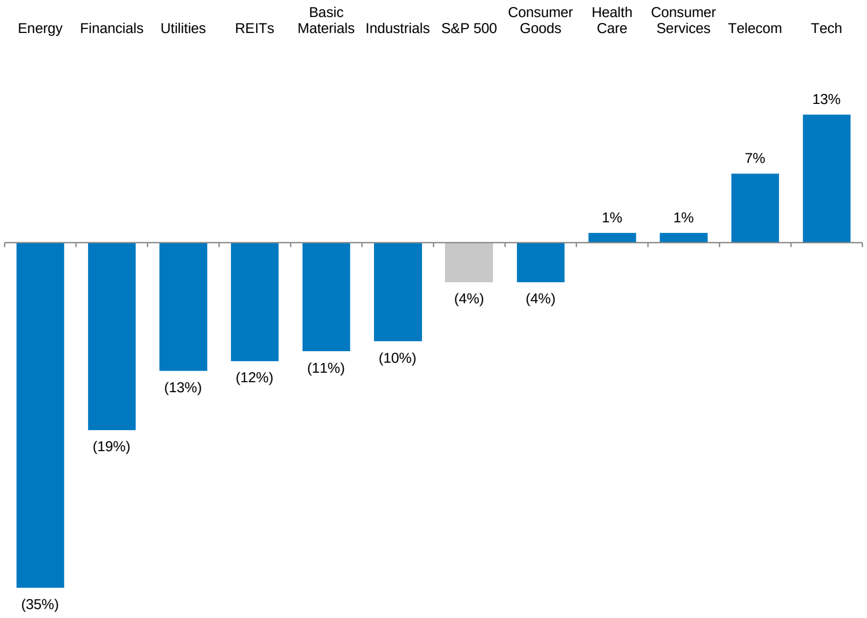
Public Equities Markets . . . Shock, Awe and Plenty of Stimulus/"Relief"…



1. 3/15/20 – Fed cuts rate target to 0%; pledges $700 bn in asset purchases
2. 3/23/20 – Fed announces unlimited QE
3. 3/25/20 – Senate approves $2 tn stimulus package
4. 4/21/20 – Senate approves $480 bn extra stimulus

… Widely Varying Impacts by Sector… All or Nothing…

YTD STOCK PERFORMANCE BY SECTOR

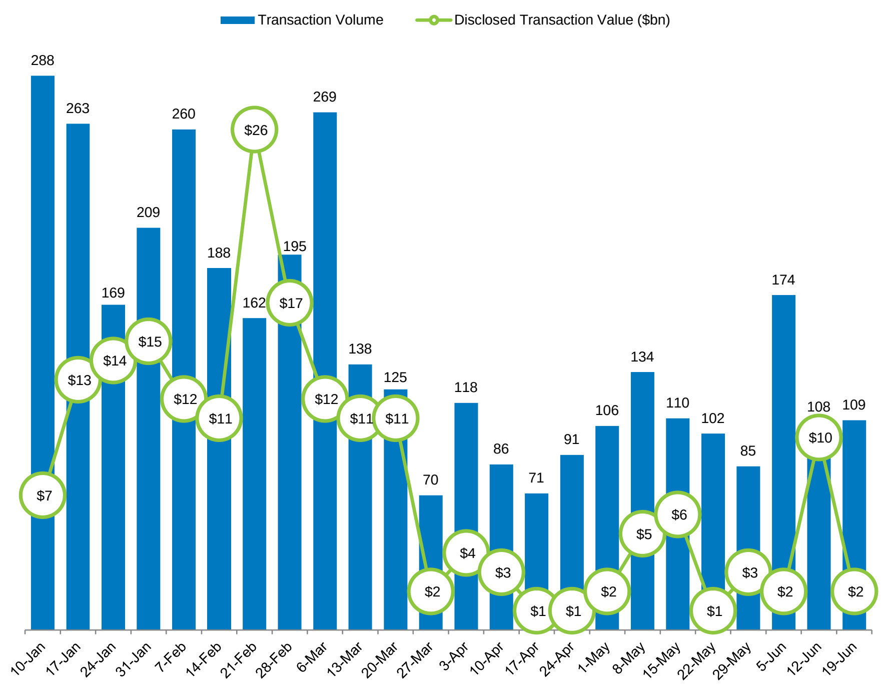


- S&P 500% down less than ~5% since beginning of
  - Seeing increased volatility in public markets – resurgence of COVID-19 fears / upcoming corporate earnings announcements
- Pain from crisis is not being felt evenly across sectors
  - Oil has been the more severely affected – down 40% YTD / followed by financials / industrials
  - Certain sectors up YTD

Source: FactSet
Note: Data as of 19-Jun-2020.

… Acute Near-Term Impact on M&A Markets …

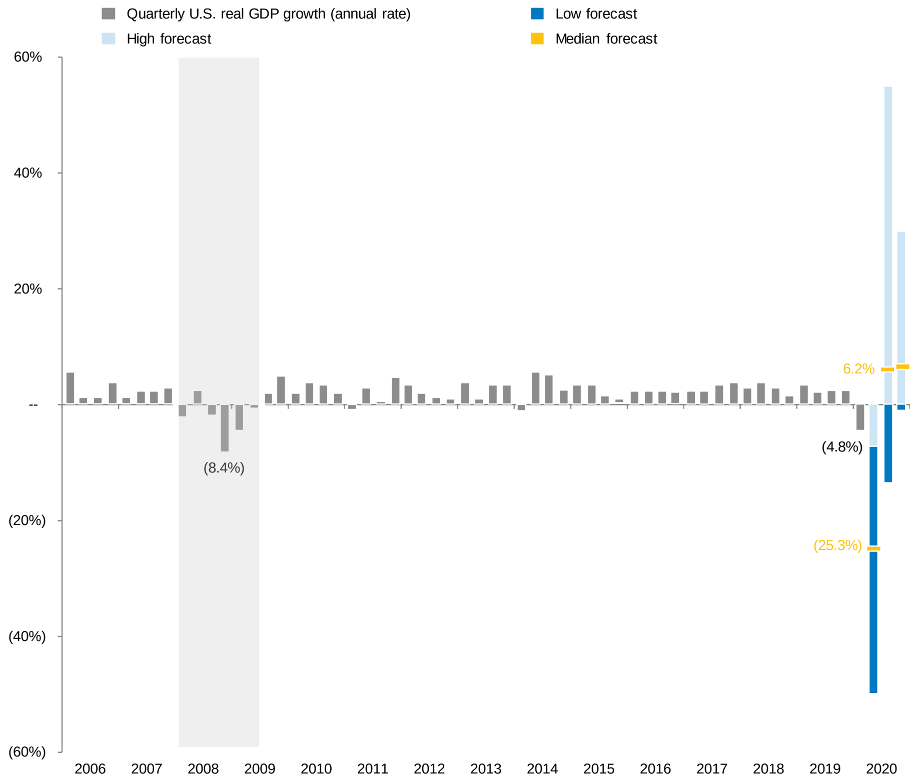
WEEKLY ANNOUNCED M&A TRANSACTIONS[1,2]



- Already seeing substantial impact on M&A environment… a few highlights…
- Week of April 20th had the lowest weekly quantity of transactions announced in over 10 years and was ~65% lower than the 10-year weekly average
- Week of April 13th was the first week since 2004 without a $1bn+ transaction announced

Source: FactSet
1. As of 19-Jun-2020.
2. Includes all complete and pending announced M&A transactions with U.S. targets.

… Let’s Be Honest… No One Knows Where We’re Going…

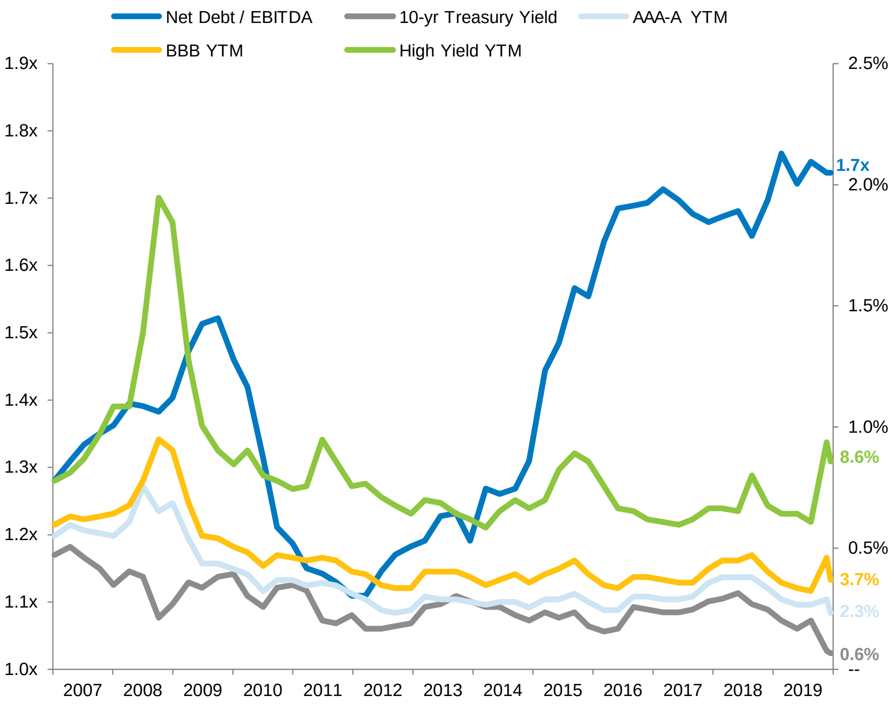


- Q1 GDP contracted by (4.8%)
  - Substantial portion attributable to the healthcare sector (i.e., no “non-essential” care)
- Range of estimated GDP growth rates for 2020 is enormous, representing the extreme uncertainty the economy is currently facing…
- Since we’re all interested in letters…
  - BMO’s economists are predicting a “V” shaped recovery – with 40% GDP contraction in Q2’20, followed by 43% and 5% growth in Q3’20 / Q4’20, respectively

1. Wall Street Journal Economic Forecasting Survey

… Most Corporates Remain Internally-Focused / on the Sidelines …

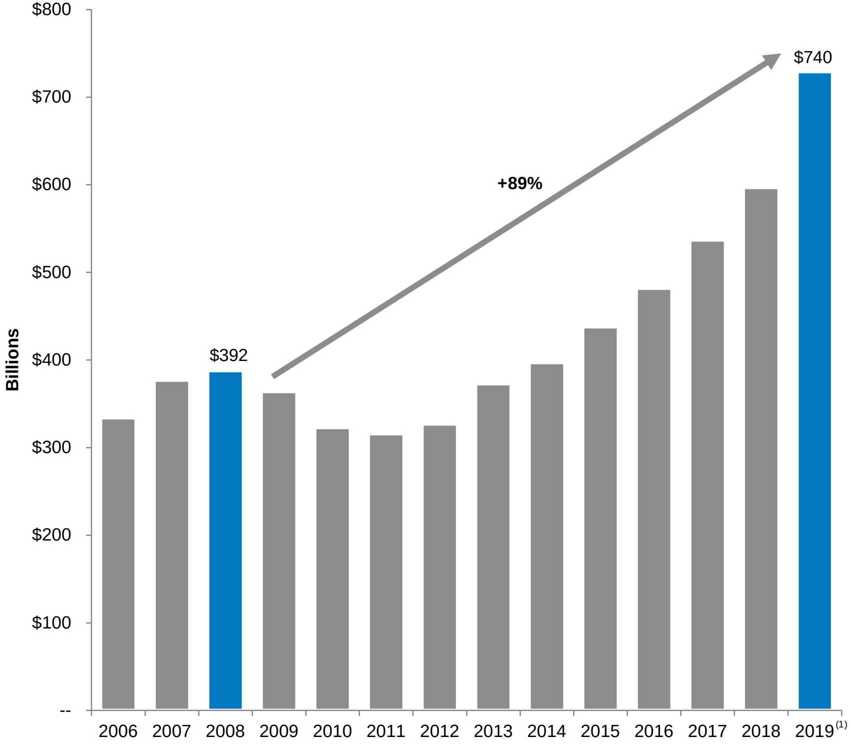
WEEKLY ANNOUNCED M&A TRANSACTIONS[1,2]



- Corporate debt levels are 30%-40% higher on average now vs. 08/09
- Liquidity is at a huge premium for most corporates – resulting strain is going to prohibit M&A (especially large transactions), in severely affected industries (outside of stock-for-stock transactions possibly)

Source: BMO Estimates, FactSet
1. As of 19-Jun-2020.
2. Includes all complete and pending announced M&A transactions with U.S. targets.

… Private Equity Beginning to Refocus on Investments with "Dry Powder"…



- Private equity "dry powder" remains at or near all-time highs
- Expect that private equity will be relatively more involved in M&A transactions than corporates over the next 12-24 months
  - Huge premiums will be ascribed to "recession-resistant" + "pandemic-resistant"/"essential" businesses (and the opposite for businesses with the opposite characteristics
- In some instances, funds may recap struggling portfolio companies / amend investment parameters to include structured / minority equity transactions

Source: Pitchbook
1. As of Q2 2019.

What Are Overarching Implications on the M&A Process?

Key Takeaways	• Transaction volume is likely to continue to trend downward; however, we expect there to be an abundance of supply when the outlook improves, as sale processes that were put on hold due to Coronavirus and numerous other companies rush to be in the market ▪ Potential for increased activity with sellers that have near-term liquidity concerns ▪ Distressed M&A may increase as time passes and more companies are impacted by the demand headwinds, supply chain disruptions, and efficiency / productivity decreases ▪ Buyers still want to deploy capital – view this as investing in companies that fundamentally still work, but just might have liquidity problems in the short-term ▪ Carve-out / asset sales may increase as companies seek different ways to obtain liquidity
Financing / Funding	• Decreased / delayed access to financing sources • Companies may be more hesitant to deploy balance sheet cash for M&A given the uncertainty of their future cash needs and the need to "weather the storm" • Contrarian funds are investing resources seeking opportunities to invest in and / or buy undervalued businesses in the current market, while many other sponsors are focusing their efforts on portfolio company performance and liquidity
Consideration	• Stock consideration will carry additional risk for both sellers and buyers in this volatile market environment ▪ Buyers risk "overpaying" due to depressed valuations / trading levels ▪ Sellers take on additional risk driven by uncertainty of the long-term financial impacts on the Buyer's stock • Cash likely carries the least risk; however, may not be as readily available • Public to public stock deals may increase given both companies will likely be impacted similarly by market swings

Debt Financing Markets Remain Cautious and Conservative

- Liquidity conditions are steadily improving in the private capital markets as a greater number of participants are actively processing new transactions
- Most lenders have moved on from the portfolio review stage / making amendments to legacy portfolio assets to actively competing for new business
- While a number of non-bank lenders have been sidelined from placing bids due to wide-ranging meltdowns in their portfolios, traditional banks remain well capitalized and open for business
- Almost every deal brought to market for the next few months will be "storied" in some way or another, and investors have already begun to discuss the concept of "Normalized EBITDA"
- LIBOR floors are back for almost all lenders. Over the course of the last two years, LIBOR floors were routinely found in non-bank and institutional senior loans, second lien, subordinated, and unitranche financing

CASH FLOW SENIOR DEBT / EBITDA

	< $5MM EBITDA	> $10MM EBITDA	> $20MM EBITDA
June 2020	**1.50x - 2.00x**	**2.50x - 3.00x**	**2.75x - 3.50x**
June 2019	**1.75x - 2.50x**	**2.50x - 3.50x**	**3.00x - 4.50x**

Senior Leverage Multiples Remain on the Conservative Side

TOTAL DEBT / EBITDA

	< $5MM EBITDA	> $10MM EBITDA	> $20MM EBITDA
June 2020	**2.50x - 3.25x**	**3.50x - 4.50x**	**4.00x - 5.00x**
June 2019	**3.00x - 4.00x**	**4.00x - 5.00x**	**4.50x - 5.50x**

Lenders More Willing to Stretch on Accretive Uses of Capital and Over-equitized Deals

SENIOR CASH FLOW PRICING

	Bank	Non-Bank < $7.5MM EBITDA	Non-Bank > $15MM EBITDA
June 2020	**L+ 3.75% - 4.50%**	**L+ 7.00% - 8.50%**	**L+ 6.50% - 8.00%**
June 2019	**L+ 2.50% - 4.50%**	**L+ 5.00% - 6.50%**	**L+ 4.00% - 6.00%**

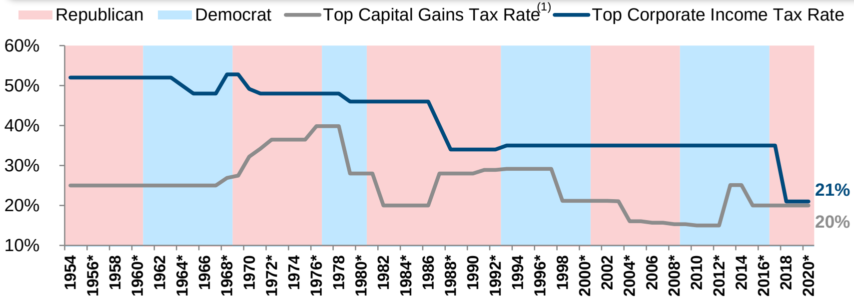
Loan Pricing Up Year-Over-Year to Compensate for Outsized Risk

While the Market Is Not Yet Back to Pre-COVID Competitive Pricing and Leverage Multiples, Liquidity Conditions Continue to Improve

Source: SPP Capital Partners

Tax Rate Trends and Potential Considerations

Long Term Capital Gains and Corporate Income Tax Rates Over Time and by Presidential Party



Average Top Rates (1989-2020)			
Administration	**Years**	**Corporate**	**Capital Gains**
Republican	16	32.1%	21.0%
Democrat	16	35.0%	22.5%
All	**32**	**33.6%**	**21.8%**
(R) - (D)	***0***	***(2.9%)***	***(1.5%)***

- Both capital gains and corporate tax rates have fallen over the last several decades
  - After stagnating at 35% for years, the Tax Cuts and Jobs Act of 2017 (TCJA) reduced the corporate income tax rate to 21% as part of a broad overhaul of the tax code
- Since 1989, capital gains taxes have been slightly lower under Republican administrations compared to Democratic administrations (see table above)
  - Under the Obama administration from 2013-2014, the top long term capital gains tax rate was set at 25.1%, or 5.1% higher than where it currently stands
  - The top capital gains tax rate was lowered considerably to 21.2% (1.2% higher than today) for the last three years of the Clinton administration (1998-2000), but averaged 26.2% (6.2% higher than today) over the duration of Clinton's presidency (1993-2000)
- Since 1954, 10 out of 12 administrations have implemented changes in capital gains tax rates with 60.0% of Democratic administrations raising rates while 57.1% of Republican administrations held rates flat or lowered them

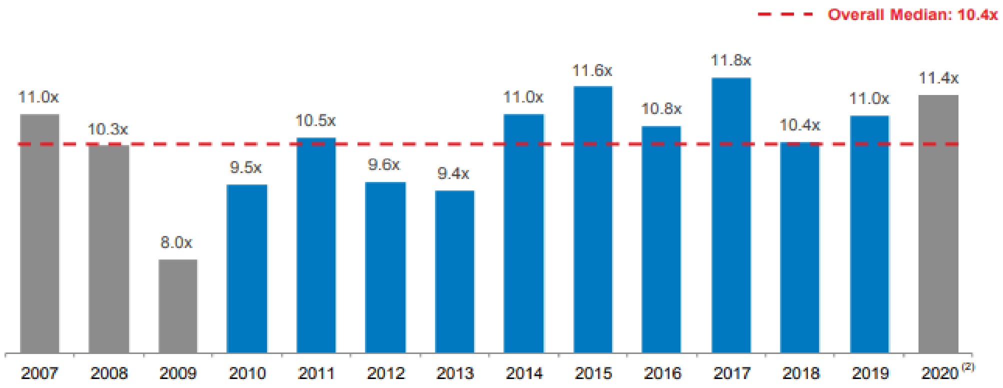
2020 Election and Potential Tax Policy Changes

- **Joe Biden** has put forth a tax plan that proposes taxing long term capital gains at the same rate as ordinary income for tax payers earning more than $1 million annually, as well as repealing step-up in basis
  - Biden's plan calls for ***increasing the top personal income tax bracket to 39.6%*** (2.6% more than the current 37%)
  - The ***top effective capital gains rate reaches 43.4%*** after considering the additional 3.8% Net Investment Income Tax (NIIT) introduced by the Affordable Care Act, ***an increase of 19.6%*** from the current top rate inclusive of NIIT
- **President Trump** has yet to release formal details for a revamped tax plan, but there is discussion of a "Tax Cuts 2.0" plan to build off of the TCJA
  - National Economic Council Director Larry Kudlow is quoted as saying, "We'd love to have a ***10 percent middle class tax cut***, and we would love to strengthen and ***make permanent some other tax cuts***."

Source: Tax Policy Center, U.S. Treasury Office of Tax Analysis, PwC, Internal Revenue Service, The Tax Foundation, Politico
** Denotes Election Year*
1. The impact of the Net Investment Income Tax (NIIT) is not contemplated in the figures.

Distressed M&A and COVID-19

MEDIAN EV / EBITDA TRANSACTION MULTIPLES



(2) Through 7/10/20

- Historically there has been low conversion of buy-side engagements to closed transactions
- Conservative strategic buyers have been turned off by high (and increasing) multiples - may find value in distressed M&A
- COVID-19 and the related economic effects are creating financial hardship for Companies
    - Every industry has been affected, but some more than others. Industries most affected include Hospitality, Transportation, Energy, Hospitals, Retail, Real Estate among others
- Financial distress is mounting and should result in increased activity in the distressed M&A market
- Enterprising buyers with financial resources and an understanding of distressed M&A may capitalize on this environment

Distressed Asset Valuation

- Distressed assets are notoriously difficult to value
  - In court vs out of court
  - What are the assets worth to the buyer vs what the buyer must pay to win the auction
  - Liquidation value
- Traditional valuation techniques are not relevant (i.e. EBITDA multiples)
- Acquiring company must bring something new to the assets to make them valuable – giving strategic buyers an advantage
  - Operating expertise
  - Supplier contracts
  - Access to distribution
  - Capacity utilization
  - Consolidation into a smaller footprint

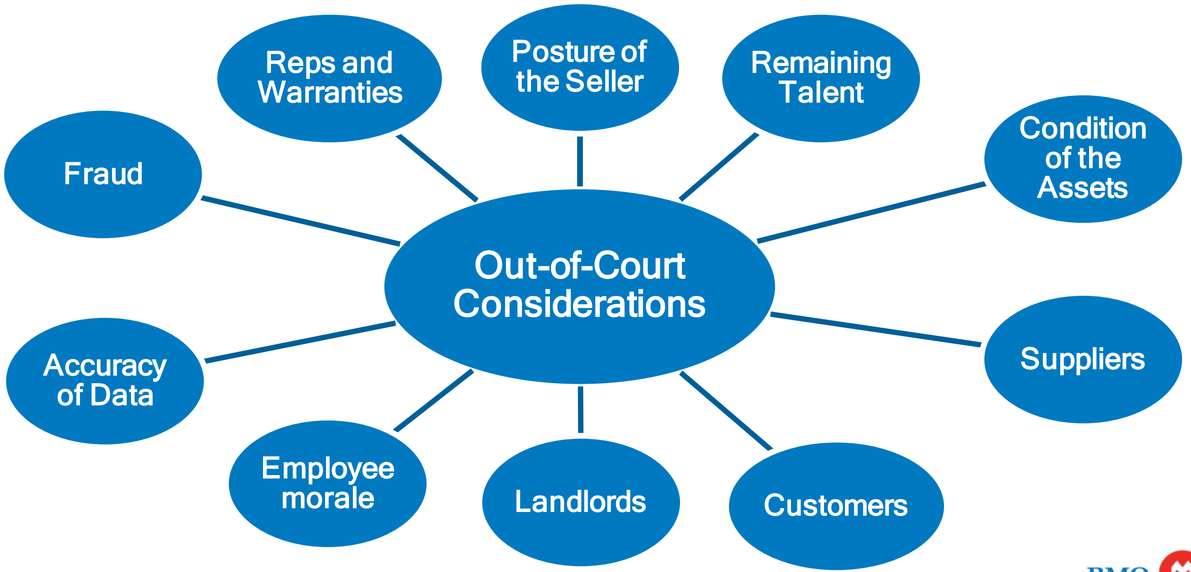
BMO

Financial Buyers and Distressed Assets

- Financial buyers often do not possess the same strategic advantages, however, they are very competitive for distressed assets due to:
  - Ample and ready capital
  - An excellent understanding of the process
  - Rapid and thorough diligence – speed to close
  - Extensive experience acquiring distressed assets - credibility

Distressed M&A Process - Out-of-Court

- Sale forced by projected losses or inadequate liquidity
- Often the business is still solvent
- Many “Good Company - Bad Balance Sheet” situations
- Process is very similar to traditional sale process



Distressed M&A Process - In-Court

Pre-Packaged Chapter 11 - 363 Sale

- Stalking Horse bidder, APA and Bidding Procedures are finalized prior to filing
- Typically, proceedings are quick and a sale is effectuated in a matter of months or even weeks
- Bankruptcy is used to ensure the assets are purchased unencumbered and free of any liens or attached liabilities
  - No successor liability
  - Assumption or rejection of executory contracts and leases
- Process is costly, time consuming and could result in an unexpected buyer interest and a competitive auction
  - Assets are sold “as-is”

Regular Way Chapter 11 - 363 Sale

- Traditional auction process
- Stalking horse bidder is identified, APA negotiated and Bidding Procedures developed
  - Advantages
    - Set the floor for value
    - Control the process through bidding procedures and form APA
    - Break-up fee of 2%-3% of transaction value
  - Disadvantages
    - Incur diligence cost (other bidders may ride coattails)
    - Do not receive traditional reps and warranties
    - Must pay in all-cash at closing
    - Sale documents are made public
    - May be out-bid

Successfully Bidding for Distressed Assets

- Successful bidders share the following attributes:
  - Well-developed view on value
  - Keen understanding of the process (in-court or out-of-court)
  - Legal gets involved early
  - Clear path to financing (or cash) – and an understanding of what can be done
    - Bring lenders and other capital providers in early
  - Thorough game plan for diligence – often involving third party providers
  - Ability to move very quickly

What Makes a "Good" Distressed Purchase?

- Evaluate the real underlying performance of the asset or business to be purchased
- Make sure you have up-to-date information
- Look for the upside

Navigate Complexity With the Right Insights

- Analysis of historical results must be comparable to the go-forward business plan
- Perform due diligence quickly to preserve the value of the company and win transaction processes
- Plan interactions with management carefully and focus on key issues

Questions for Distressed Investing Due Diligence

- How did the business get here?
- What can I change?
- What needs to go right to make this profitable—and what could go wrong?

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