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COVID-19 M&A Flash Survey Results

Given the disruption caused by the COVID-19 pandemic, in June 2020, Dykema, and the Association for Corporate Growth—Detroit, San Antonio/Austin and Columbus Chapters—canvassed senior executives and M&A professionals to gauge the effects of the pandemic on the U.S. economy and M&A. We compared the results to Dykema's 15th Annual M&A Outlook survey that was completed in the autumn of 2019 ("the 2019 survey").

Since 2005, Dykema, with the help of our top deal community clients and friends, has developed a premier annual "State of the M&A Market" analysis cited by a range of national media including *The Wall Street Journal*, *The Deal*, *Dow Jones* and *Bloomberg*. We canvass senior executives—CEOs, CFOs and other professionals involved in M&A activities with their respective companies and firms—to gauge their insights and perspectives on the mergers and acquisitions market in the coming 12 months. The results provide a snapshot of the M&A market and the economy and how they compare to previous years.

Executive Summary

Continuing issues surrounding the impact of the COVID-19 pandemic are creating uncertainty about the strength of the U.S. economy over the next 12 months, with respondents evenly split between positive, neutral or negative outlook. However, when looking out 24 months, respondents are overwhelmingly positive about the U.S. economic outlook. This bodes well for the U.S. M&A market, as the economic health of the U.S. economy is once again cited by respondents as the number one driver of U.S. M&A deal activity. The majority of respondents believe their company or portfolio companies will be involved in an M&A transaction in the next 12 months.

Valuations are playing an increasingly important role in the COVID-19 world, with a vast majority of respondents believing there will be a decline in M&A valuations over the next 12 months and many believing that will be a key driver of M&A activity in the next year.

The most significant impact of the COVID-19 pandemic on M&A has been delay, whether that relates to negotiations, due diligence or closing. Approximately one third of respondents terminated a deal because of COVID-19, while only a small percentage of dealmakers have increased their activities during this period.

Sectors to watch for increased M&A activity in the next year include Healthcare, Technology, Food & Beverage and Retail, some because of increased growth opportunities, some because of increased distress and some because of both.

U.S. economic outlook: an uncertain 2020; but a bullish 2021

In light of the continuing uncertainties surrounding COVID-19, respondents are evenly split on whether they feel positive, negative or neutral about the U.S. economy over the next 12 months. This is similar to the results of the 2019 survey which reflected concerns about a possible recession last fall and the continuation of the longest economic recovery in U.S history.

	2016	2017	2018	2019	**2020**
Positive	28%	60%	64%	38%	**34%**
Neutral	54%	30%	27%	34%	**36%**
Negative	18%	11%	8%	28%	**30%**

With regards to the outlook for the U.S. economy over the next 24 months, the vast majority (76%) of respondents in this survey have a positive outlook over the longer term; with only 5.7% of respondents having a negative outlook. This bodes well for the U.S. economy based upon the 2019 survey, where respondents told us that consumer confidence/spending were the most relevant economic indicators in the U.S.

Economic Outlook Next 24 Months

76%
POSITIVE

5.7%
NEGATIVE

Good news for M&A

According to a recent Pitchbook report, during the first half of 2020, a total of 2,173 deals totaling $326.1 billion, were closed by U.S. private equity firms, a reduction in deal value of nearly 20% when compared to the first half of 2019.[1] The second quarter of 2020 had even a steeper decline with deal value down by more than a third from the prior year.

While the first half of 2020 was weak for U.S. M&A, respondents have a positive outlook for the next 12 months. A little more than 50% of respondents in this survey believe that the U.S. M&A market will strengthen in the 12 months ended June 2021.

There was already a great deal of uncertainty about M&A activity going into 2020, with recession fears growing and a slowing of M&A activity, so the current positive outlook is particularly encouraging. Last autumn, only 33% of respondents were optimistic about the U.S. M&A market, with the remainder having either a neutral (36%) or negative (32%) outlook for the next 12 months.

	2016	2017	2018	2019	**2020**
Positive	33%	39%	65%	33%	**51%**
Neutral	47%	41%	20%	36%	**14%**
Negative	20%	20%	15%	32%	**35%**

COVID-19 seems to have increased the appetite for future acquisitions. These results are not surprising given the positive outlook for M&A. The majority (62%) of respondents believe that their company or one of their portfolio companies will be involved in an acquisition in the next year.

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[1] *Q2 US PE Breakdown*; July 9, 2020

A COVID pause, but deals will be getting done in the future

The majority of respondents (58%) say that the COVID-19 pandemic impacted their M&A activities by delaying negotiations, followed by delaying due diligence (48%) and delaying transaction closing (37%). Approximately one-third of respondents actually terminated negotiations (35%) or reduced transaction valuation (33%) because of COVID-19. Only 12% of respondents terminated deals because of the pandemic and only 6% of those used a MAC (material adverse change) condition to do so. Most dealmakers have taken a wait and see approach, with only a very small percentage (less than 6%) initiating or increasing their deal making during this period of uncertainty.

How has the COVID-19 pandemic impacted your M&A activities?

Delayed negotiations	**58.10%**
Delayed due diligence	**47.62%**
Delayed transaction closing	**37.14%**
Terminated negotiations	**35.24%**
Reduced transaction valuation	**33.33%**
Terminated executed purchase agreement	**12.38%**
Unable to obtain transaction financing	**8.57%**
Terminated transaction using material adverse change closing condition	**5.71%**
Initiated sale process	**5.71%**
Increased deal making activity	**3.81%**
Accelerated transaction timing	**2.86%**

Pitchbook notes that as a result of the COVID-19 pandemic, U.S. private equity firms have "sought to back out of some deals and passed on others, shifting their focus away from traditional buyouts and toward add-ons, PIPE deals and other strategies." [2] Add-ons in the second quarter of 2020 made up the highest percentage of leveraged buyouts on record.

[2] *Q2 US PE Breakdown*; July 9, 2020

Changing drivers of M&A activity

2020		2019
General economic conditions	1	General economic conditions
Lower deal valuations	2	Availability of capital
Availability of capital	3	Financial markets
Financial markets	4	Favorable interest rates
Favorable interest rates	5	Changes in U.S. tax laws
Additional U.S. government stimulus	6	Deal valuations

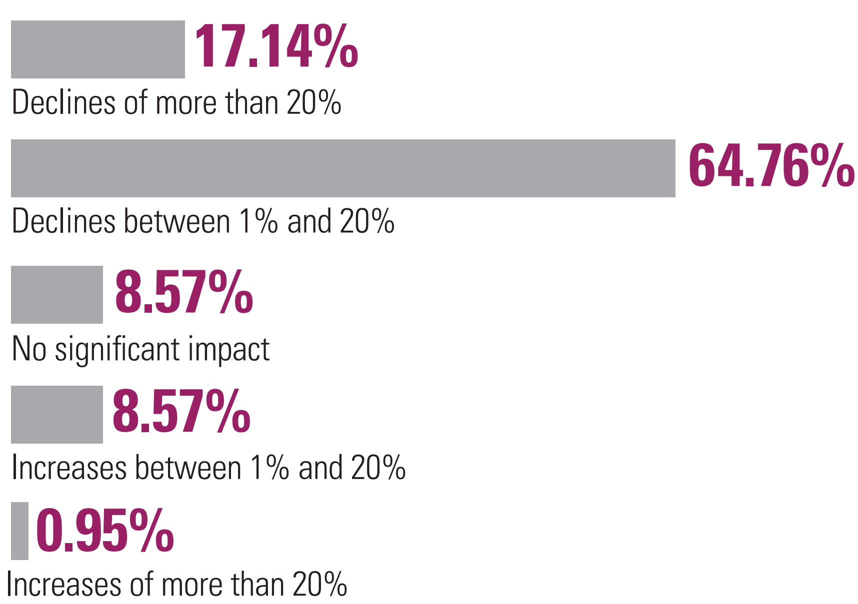
An overwhelming number of respondents (51%) identify the health of the U.S. economy as the number one driver of M&A activity in the post-lock down world. This compares to 33% in the 2019 survey. Interestingly, lower deal valuations (23%) is the second most selected driver of M&A. This compares to the 2019 survey where deal valuations ranked near the bottom at 5%. Throughout the years we have typically seen the availability of capital to be the primary driver of M&A after general U.S. economic conditions. In this survey it ranked third with 11.43%.

Deal valuation in the COVID-19 world

One can conclude that value will be an increasingly important driving factor of M&A activity in the post-lockdown world. Further, "reduced transaction valuation" was ranked as one of the primary responses (33%) to the question, "How has the COVID-19 pandemic impacted your M&A activities?"

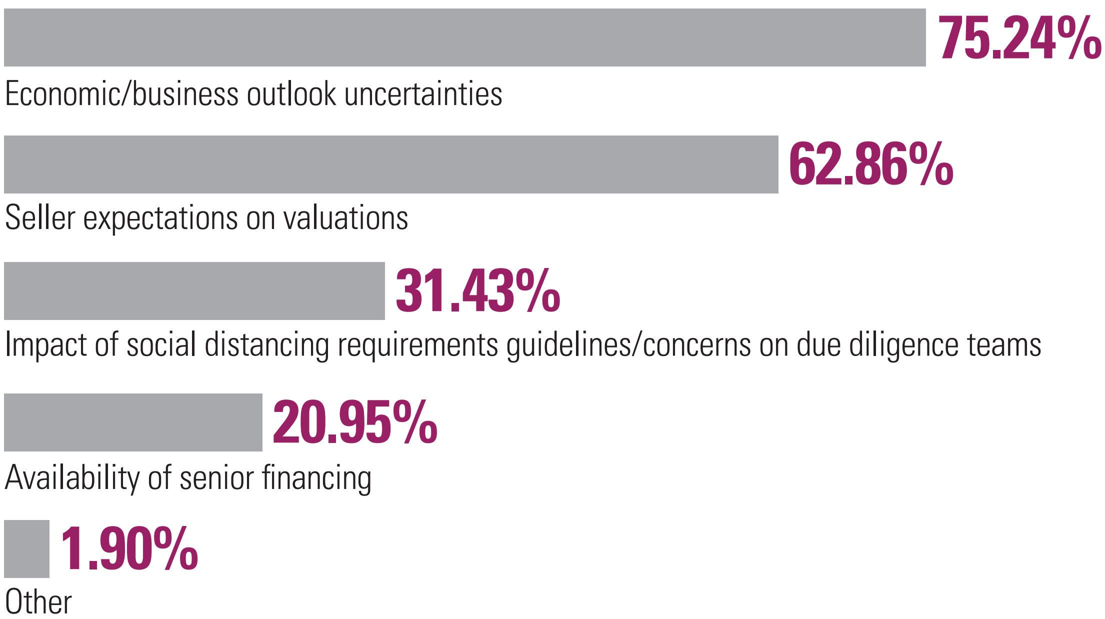
A significant majority of respondents (82%) believe there will be a decline in M&A valuations over the next 12 months. We expect that will have a positive impact on M&A activity, as the expectation of lower valuations could lead to an increase in deal volume. This compares with our findings in the 2019 survey, where only 41% of respondents expected that valuations would decline during the next year. However, seller expectations have not caught up with the expectations of buyers and the broader M&A market, as 63% of respondents believe seller expectations on valuations are a continuing impediment to completing deals.

What impact do you believe the COVID-19 pandemic will have on M&A valuations over the next 12 months?



Bumps in the road

Which of the following factor(s) are an impediment to your company or portfolio company completing an M&A transaction?



By far, respondents' most selected impediments to their company or portfolio company completing an M&A transaction are economic/business outlook uncertainties (75%). This comes as no surprise since it is clear from our other findings that as the economy goes, so goes M&A.

Interestingly, only one-third of respondents (31%) found the effects of social distancing on due diligence to be having a negative impact on completing an M&A transaction. We surmise this limited impact can be attributed to the adoption of technology in the due diligence process (e.g., virtual data rooms, video conferencing, etc.).

We are also seeing some tightening of the credit market, with 21% of respondents ranking availability of senior financing as an impediment to their deal making activities. Banks have been holding back on lending until they get more clarity. We are finding this to be the case for existing bank customers, as well new borrowers. Non-bank lenders are moving in to fill the gap.

"We have seen a significant drop in values in the market. There are sellers with a high sense of urgency to move assets. They have come to the realization that they need to act now. There is another part of the market in a sit and wait mode, waiting to see what happens—if we get a vaccine," noted Cyrus Nikou, Founder and Managing Partner of private investment firm Atar Capital.

COVID winners and losers

2019		2020
Automotive	1	Healthcare
Healthcare	2	Technology
Energy	3	Food and Beverage
Consumer Products	4	Retail
Technology	5	Industrial

In light of the significant impact of COVID-19 across our healthcare system, from increased hospitalizations to the expansion of telemedicine to accelerated vaccine/treatment research, we aren't surprised to see that Healthcare is the industry sector that comes out on top with regards to predicted M&A activity over the next 12 months. After months of lock downs, shelter-in-place orders and virtual meetings, it also is not a big surprise that respondents selected Technology, Food & Beverage and Retail as the next three sectors likely to see increased M&A activity over the next 12 months. Just under 20% of all U.S. private equity deals in the first half of 2020 have been technology deals according to Pitchbook figures.[3]

Growth opportunities make the Technology sector particularly attractive, while a combination of growth opportunities and inevitable consolidation of distressed players make the Food & Beverage and Retail industry sectors to watch. This contrasts to the 2019 survey, where the top three industries identified were Automotive, Healthcare, and Energy. The COVID -19 recession has had a negative impact on both the Automotive and Energy sectors. The level of uncertainty in the Automotive industry is likely to slow M&A in that sector while buyers and sellers wait to see where valuations land. In the Energy industry, the players are still waiting to see if the market for energy has reached a bottom yet.

This is bolstered by the results of the recent Dykema survey of automotive industry players. 84% of whom have been required to suspend or curtail operations in the U.S. due to COVID-19, and 63% of whom expect the suspension of existing orders and 55% of whom expect to negotiate further price reductions with their customers.

[3] *Q2 US PE Breakdown*; July 9, 2020

"Recession proof industries will be the most active, with healthcare at the top, food packaging, more than processing, technology and SAS platforms," explained Nikou of Atar Capital. "Some markets are forever changed—airlines, entertainment, cruise lines. Post-COVID, consumers will have continued uneasiness with the way they used to live. We will see shifts in consumer behavior over the next 5-10 years. Silicon Valley is looking for the next big thing to replace these."

To learn more about Dykema's M&A practice and our annual M&A Outlook Survey please visit www.Dykema.com or contact any one of our attorneys.

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