



MID-MARKET INVESTMENT BANKING

Spring 2022

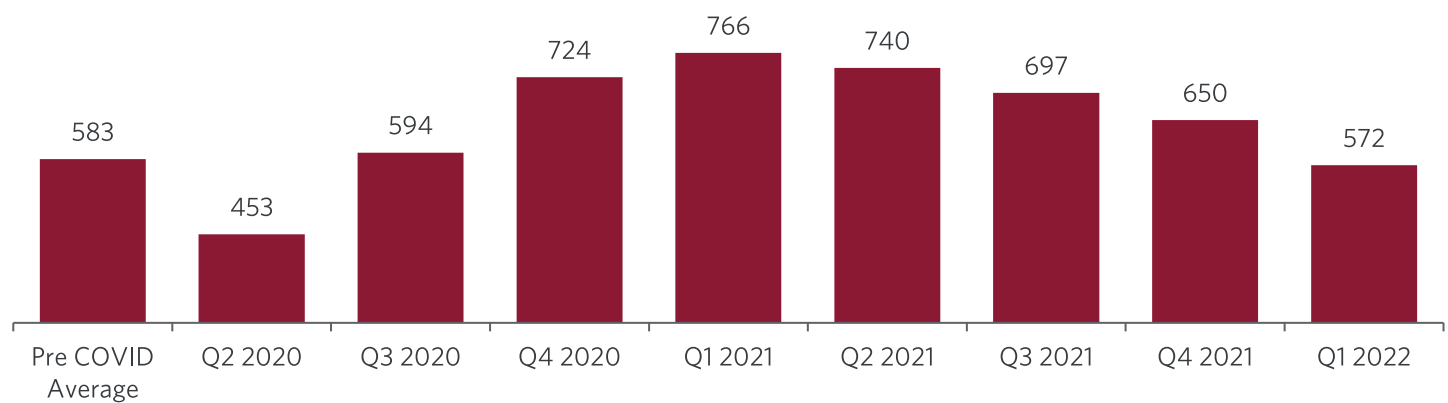


Market update

We are pleased to share our views on the M&A environment so far in 2022.

M&A activity

Canadian Quarterly M&A transaction count



Source: S&P Capital IQ.

Transaction volumes in Canada have returned to pre-COVID levels. This is consistent with our team's experience as we have worked through deals that had previously paused, in addition to a higher number than usual of new mandates with business owners whose companies had performed well and who wished to take advantage of attractive valuations.

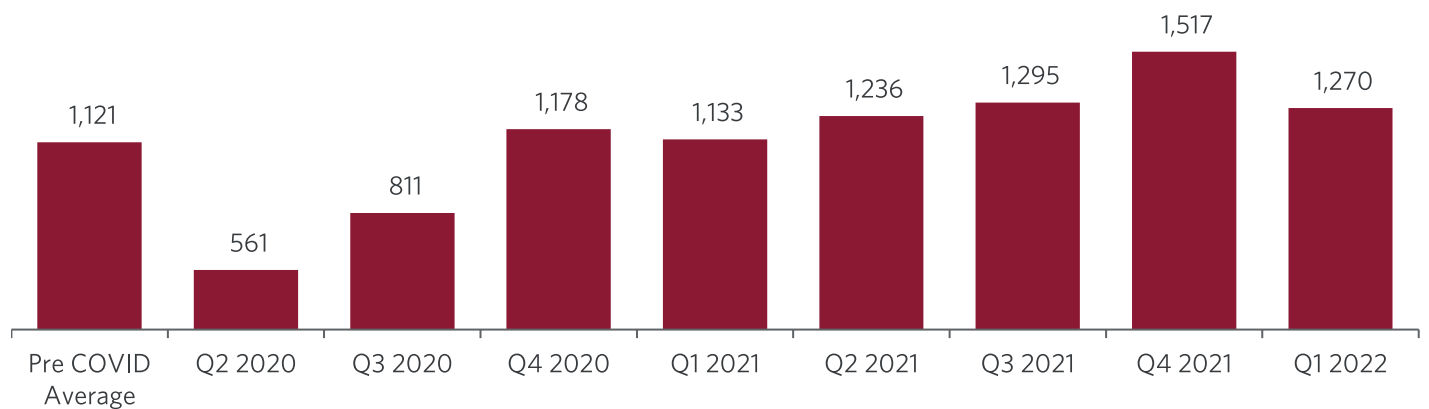
Last year, our newsletters commented on the capacity constraints in the M&A ecosystem with deals backing up. Lawyers, lenders, and due diligence teams are now saying they remain busy, but conditions have eased.

Trends in Private Equity

Private equity continues to play a key role in the M&A market. The chart below shows quarterly volumes at higher levels than pre-COVID. This should not be a surprise given the amount of capital needing to be deployed plus the growing number of PE-backed companies seeking add-on acquisitions. We see this trend in our transactions as now 1 in 3 of the buyers are a PE-backed strategic company, compared to our historical average of 1 in 6. This is a helpful trend for our M&A processes as they have invested in our client's sector and wish to grow through acquisition. Additionally, they offer our business owners the option of selling 100% or retaining a minority stake.

The spike in Q4 2021 transactions reflects anticipated changes in the US capital gains tax rules which encouraged a huge push to close deals before December 31. We would have expected Q1 2022 to be lower as deals were pulled forward, but volumes have remained strong.

North American PE-backed transaction count



Source: S&P Capital IQ.

Uncertain times have arrived

Notwithstanding the pause in M&A activity in the spring of 2020, we have been reporting a robust M&A market and seller-friendly conditions for several years. Through 2021, many companies performed well, a new normal EBITDA was being evidenced and confidence had returned. This is being replaced with uncertain market conditions.

We are often asked about the impact of rising interest rates. While they will affect valuation models, the actual effect on mid-market transactions is marginal. Of far greater importance are supply chain issues and inflation:

- Global supply chain disruptions have been well documented and, while some aspects have eased (e.g. shipping container costs have declined from their peaks), the lack of a reliable supply continues to impact many companies' ability to manufacture or distribute a product or deliver a service. The demand is there but supply is delayed.
- It seems clear that inflation is no longer a temporary issue and is now at levels not seen by many in our working lives.

The questions for us are how these headwinds will impact valuations and deal activity and how best to prepare.

Will valuations be impacted?

So far, we do not see any decline in EBITDA multiples being offered by buyers. Deal processes remain competitive with multiple offers on the table. Private company valuations did not follow the significant rise in public stock markets of the past 18 months, and so we are unlikely to see the recent public market declines repeated in the mid-market.

The question is, what EBITDA are we multiplying? Determining the sustainable EBITDA of a company is always a key metric and is becoming more challenging. Common questions buyers are asking during due diligence include:

Many businesses have seen gross margins increase.

- Customers have been price takers – will this continue?
- Input prices are increasing – can these be passed on?

Sizeable increases in salaries and benefits are now necessary to attract and retain skilled employees.

- What are the normalized wage costs going forward?

Rents for commercial and industrial buildings are increasing, particularly in larger cities:

- When do existing leases expire and what will renewal lease rates be?

As the monthly disposable incomes of Canadians decline, how will this impact the business?

Another critical aspect of any M&A transaction is agreeing on the level of working capital that a seller must deliver at close. Supply chain issues are causing many companies to abandon lean inventory models and order more raw materials, parts and supplies than needed. We are seeing buyers challenge historic levels of working capital, saying that higher levels of working capital will be needed to run the business for the foreseeable future, reducing cash received by a seller.

What does this mean for M&A activity?

Private company transactions will continue to get done. All deals have issues and the items noted above are new issues that must be overcome. The need for buyers to grow by acquisition and the personal reasons sellers decide to transact, remain the same. We expect deals structures to continue to involve earn-outs or equity roll-overs as a way to share future risks between parties.

Finally, what has not changed is that companies that are prepared for a transaction process are more likely to get a deal to the finish line and on favourable terms. Answering the above questions from buyers should be part of that planning process. Evidencing the ability to pass on price increases, stable employee turnover rates, and finding North American suppliers to replace products from China are examples that will help gain agreement on sustainable EBITDA and working capital – key ingredients for a closed transaction.

About us

CIBC Mid-Market Investment Banking is a leading M&A advisor, providing services to private companies:

- Divestitures
- Acquisitions and management buyouts
- Raising equity capital and securing debt financing

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