FIREPOWER CAPITAL

Will Canadian M&A Activity Peak in 2020/21?

FirePower Capital urges closing deals now, while economy still has tailwinds

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M&A is thriving in North America. It's a seller's market, but how long will that last?

While 2019 got off to a slower start than the record-breaking 2018, we anticipate an active M&A environment through the coming year, based on the factors in this introduction, as well as buyer and seller behaviours in our recent transactions, and the traction we are experiencing on our live mandates.

There is an abundance of cash to be deployed by strategic buyers and private equity firms alike; the U.S. economy still has legs; and interest rates remain low and may go lower.

Competition for high-quality targets is intense, which means **sellers are commanding high prices.** It is a seller's market.

Global economic uncertainty is prevailing, however, and we seek to close deals quickly while conditions remain favorable. We are closely monitoring bellwethers, including the yield curve, corporate earnings, wage pressure, trade disputes and slowdowns outside of North America.

From a seller's perspective, the window to exit is closing. Those that choose to delay **should be ready to wait a few years, through a possible slow down or outright recession, while hoping that company performance holds up during that period.** Considering a typical mid-market sale process takes 9-12 months to close, prudent sellers will prioritize M&A initiatives in 2020.

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M&A activity is often a self-fulfilling prophecy.

If enough people believe M&A activity is about to reach a peak, they often make it so. From the trenches, that is a sentiment that can be seen in the numbers.

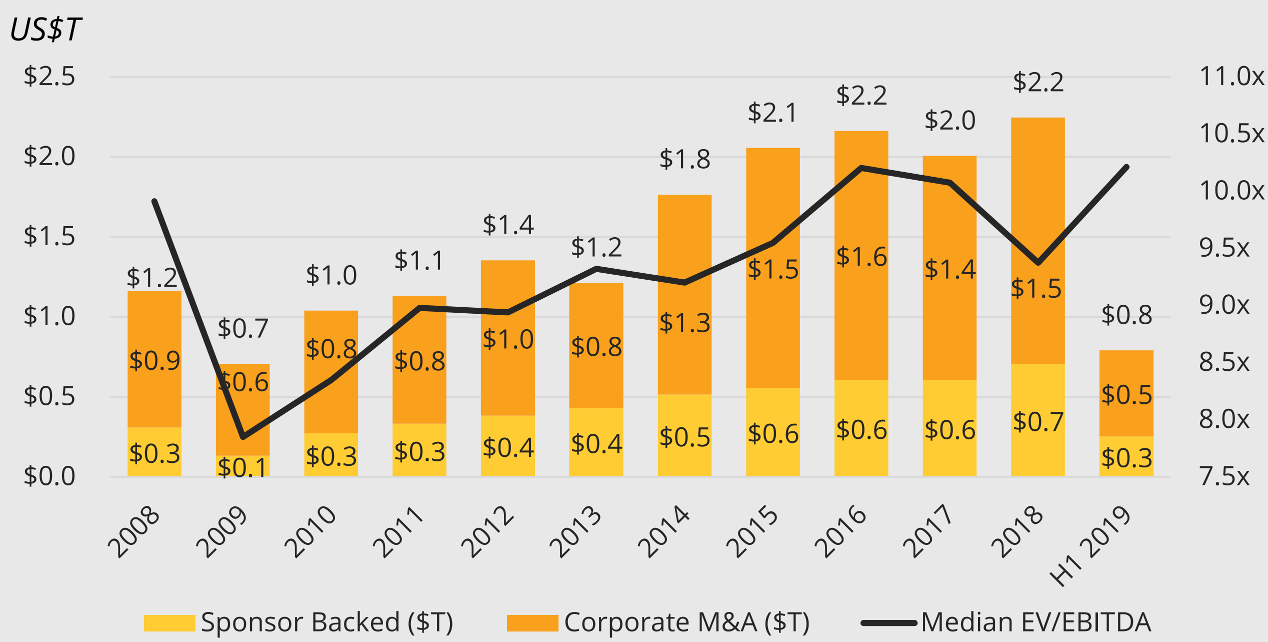
North American aggregate deal value reached a 10-year high in 2018 at $2.2 trillion, which saw increased activity from both strategic and financial buyers. On the other hand, the first half of 2019 has shown some signs of softening with $0.8 trillion worth of deals completed, an 18% decrease from the same period last year.

Bouncing back from two consecutive years of decline, median EV/EBITDA multiples averaged 10.2x in H1 2019, surpassing the 10.0x mark for the third time since 2008.

While there is little doubt that this is still a sellers' market, business owners contemplating a divestiture should be cautious with regards to timing. Buyers and sellers alike do not expect seller-favorable dynamics to last.

85% of US buyers and sellers are expecting the M&A market to shift negatively within the next 3 years.

North American M&A Activity and Multiples



Source: Pitchbook

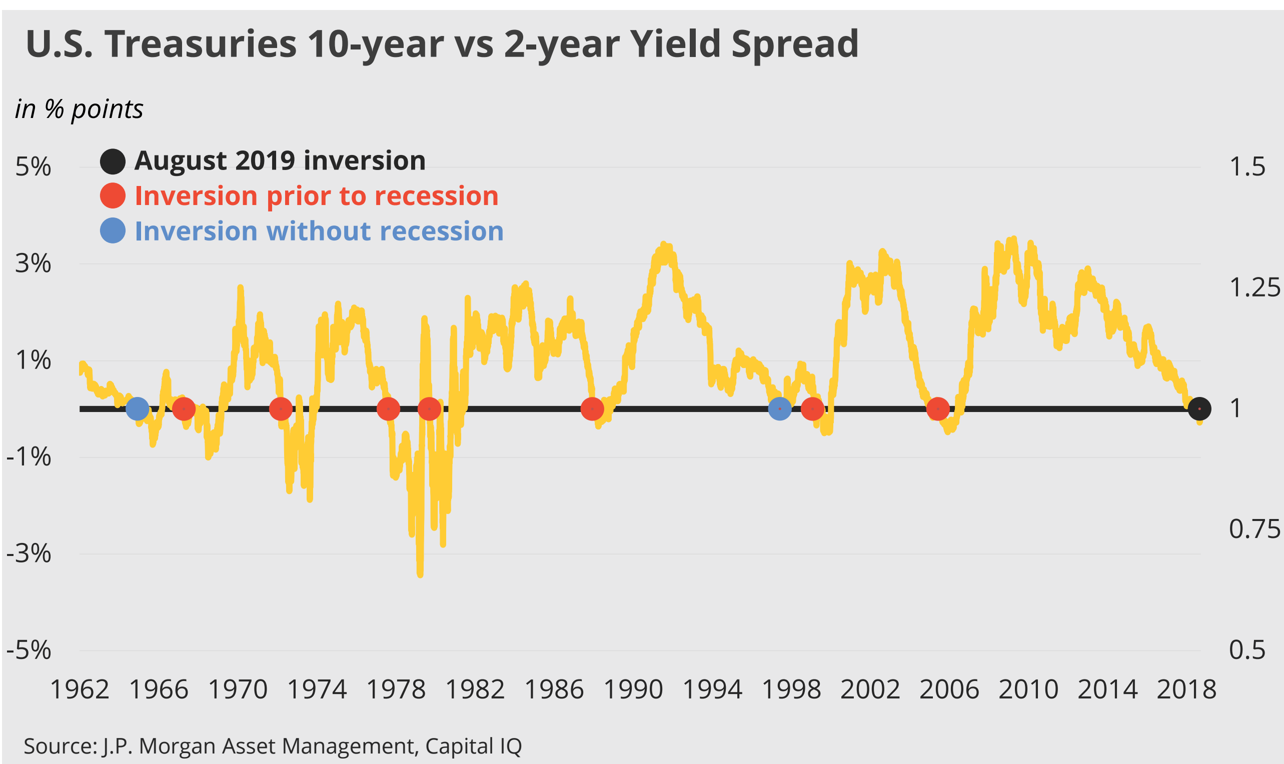
We keep an eye on the yield curve – its inversion has preceded every recession since 1962

However, the predictive nature of an inversion of the yield curve has never been tested in the context of a decade's worth of quantitative easing, which by definition should dampen its signaling ability of an economic peak.

Supporting further short-term momentum is that the US is entering the last year of its President's term. According to research from the Hoover Institution on War, Revolution and Peace at Stanford University, since World War I, the last year of a 4-year presidential term has consistently yielded the strongest economic growth. Election promises and legislative action ahead of an election do move the dial.

It is particularly salient here, in that President Trump can reasonably be expected to deliver an abundance of such actions to woo voters.

On average, the yield curve has inverted 17 months ahead of the equity market peak and 22 months ahead of the economic peak.



If selling is on the radar in the next 3-5 years, we urge sellers to accelerate those plans

We often hear from owner-operators that they do not want to sell in the short-term because they want to achieve specific milestones (for example, revenue and/or margin targets, acquisitions), partly because they believe the business would command a higher valuation, and partly because they sense their legacy would be more significant.

If the M&A environment defies odds and continues in its current state for 3+ years, then meeting such milestones should have a positive effect on a company's valuation. But if it doesn't, what are the possible outcomes?

The "soft landing" scenario is a recession-free one, wherein sky-high valuations start pushing some buyers out of auctions (they tire of losing), while attracting more and more sellers to explore their strategic options. This is classic supply and demand—multiples would be expected to soften.

A "hard landing" scenario is the "soft landing" but accelerated by a broad recessionary period and/or 'black swan'-type events (e.g. Argentina collapsing).

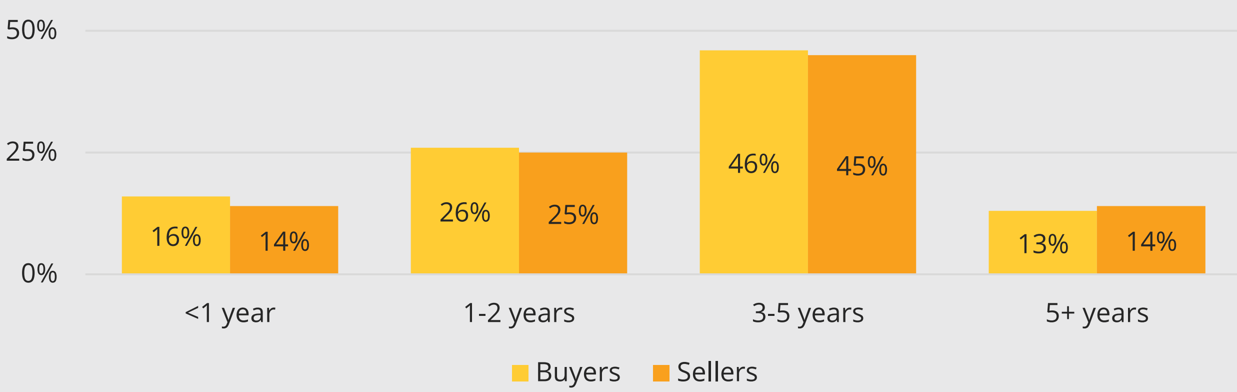
Both scenarios point to a closing window of opportunity, with the unknown being the speed at which that window is closing. In 3 to 7 years, we do not anticipate the favourable M&A conditions of today.

Many sellers may wish to hang on for the ride, and some should. It is challenging, however, to preserve the performance of a business through a recession; those that do stick it out may face declining EBITDA and declining multiples, which would negatively impact their future proceeds from a sale.

Considering it takes 9-12 months to complete a transaction in the mid-market, we are urging our clients to revisit their timelines and act sooner than later.

Citizen's Mid-Market M&A Outlook Survey

Question: "When will the M&A market change?" (fielded in Nov and Dec 2018, to C-suite executives at US companies with annual revenues between $50 million and $3 billion)



Source: Citizens Bank

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We invest in and advise Canada's entrepreneurs by financing their growth directly and helping them complete mission-critical transactions. Our objective is to become the first resource entrepreneurs think of when faced with the most challenging of strategic issues.

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