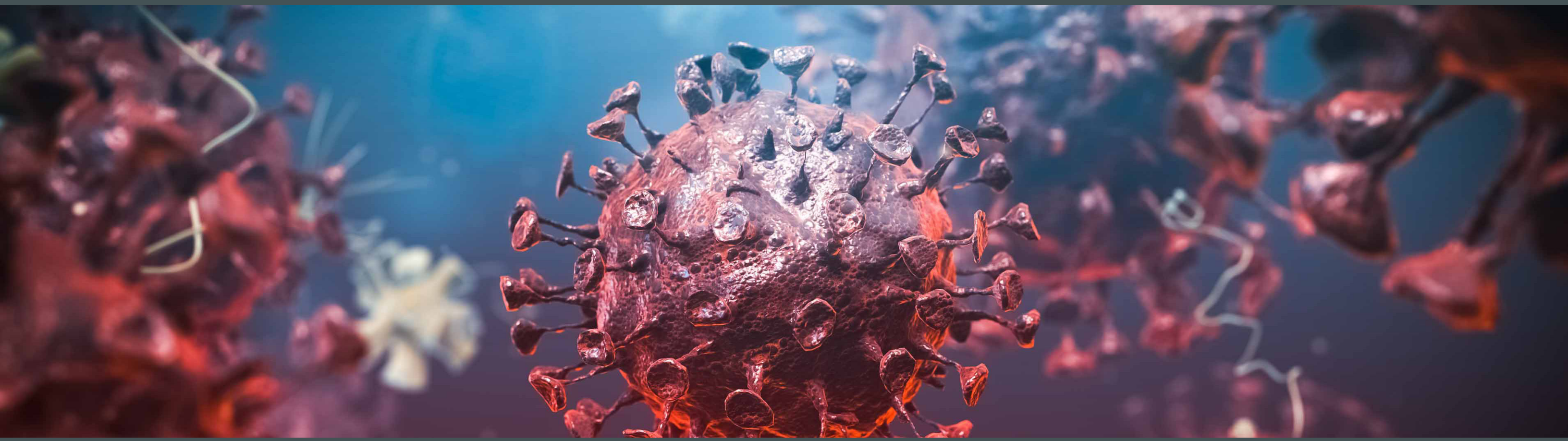
Pandemic Pandemonium and the Return of M&A



By Brandon Quartararo, Managing Director

The past four weeks have impacted humanity and the financial markets in unforeseen ways leaving many people wondering what is next. Despite the tragic consequences that COVID-19 has caused to various countries and the personal impact on our lives, Intrepid remains optimistic that we will rebound from this on a social and economic level faster than other crises for several reasons. To frame our analysis, we gathered quantitative and qualitative data surrounding the Great Recession of 2007-2009 and the Dot-Com Bust of 2000-2002. Based on relative trends and financial market indicators, we believe that the economy, capital markets and M&A levels will make a strong resurgence and do so quickly.

The underlying themes driving this opinion:

1. The speed and size of the Federal Reserve (Fed) intervention and fiscal stimulus measures
2. The rise of private equity (PE) and growth of dry powder over the last decade
3. Low interest rate environment
4. Health of the financial system and alternative lenders
5. Election year dynamics
6. Potential for a scientific remedy to the scourge

The Fed and Fiscal Shock and Awe

Up until Feb. 20, the government and financial markets had largely ignored the potential impact of COVID-19. Within days, a dramatic market sell-off forced the Fed to lower the benchmark Fed Funds rate by 50 basis points on March 3 to 1.25% and subsequently lower the rate on March 15 to a target of 0.00%-0.25%. Additionally, the Fed announced repo and bond buying programs of $1 trillion (comprised of two $500 billion programs) to stabilize the financial markets.

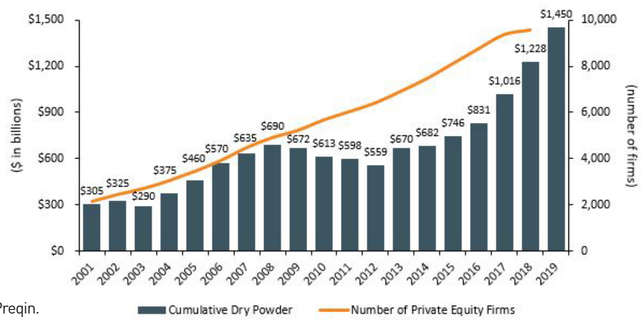
Compared to previous events, the speed and breadth of these programs enacted by Jerome Powell dwarfed the actions of his predecessors. Swift action undertaken by the Fed was further complemented by fiscal stimulus measures never before seen–the speed at which the massive CARES (Coronavirus Aid, Relief, and Economic Security) Act was drafted and passed underpins the severity of the situation and should provide a strong backstop to the overall economic engine, including stability of small- to medium-sized businesses and sentiment among middle-class consumers.

Breadth and Growth of Private Equity

The continued rise of PE has served as a primary driver of global M&A and alternative investment growth over the past decade, accelerated by investor appetite for yield and returns. Both the amount of PE dry powder and sheer number of PE participants has risen dramatically over the last decade (see chart 1). Intrepid believes these funds will become active participants in the M&A and capital markets over the next few weeks, providing a critical source of liquidity to fuel a rebound in the markets. While deal closings have slowed amid the fallout from COVID-19, largely due to cancelled in-person meetings and postponed travel, PE groups remain interested in new opportunities and continue to invest time and resources to complete diligence on active opportunities. Another interesting factor to consider is the fund vintages with the best historical returns (see chart 2) demonstrates how funds raised during previous economic slowdowns have outperformed both the peers and public markets over a five-year period.

Chart 1

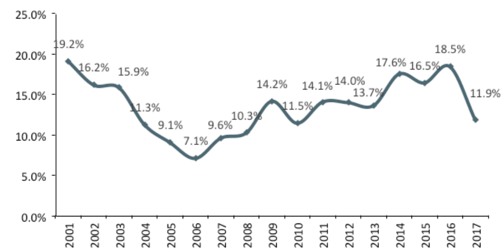
Cumulative Dry Powder and Active Private Equity Firms



Source: Preqin.

Chart 2

Private Equity Pooled IRR by Fund Vintage

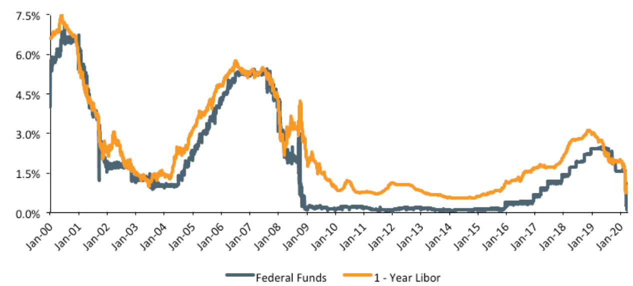


Source: PitchBook, reflects equal-weighted data.

No Interest Rate Environment

In response to the 2008 crisis, the Fed acted quickly to bring rates down to near 0% levels and maintained low rates through 2015 to support the recovery. While central banks had been moderately increasing rates since 2015, the current crisis has led these institutions to aggressively purchase outstanding treasuries and loans, bringing the Fed Funds rate and LIBOR back to 2009 levels. As rates were already at modest levels as the COVID-19 crisis emerged, the total impact from monetary policy is relatively limited, suggesting that central banks will once again exhibit a high degree of patience by allowing low rates to persist for several years until a recovery is well under way.

Chart 3



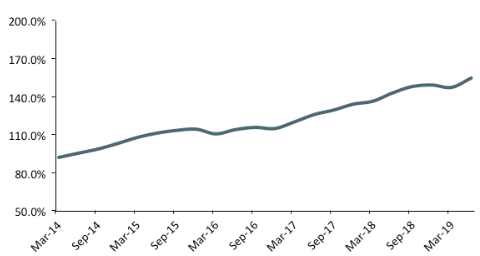
Source: Macrotrends.

Health of Financial System and Alternative Lenders

From 2014 through 2019, the U.S. experienced a substantial improvement in the conditions of its banking systems, driven by a number of factors, including: (i) a shift in loan volume from residential real estate to more stable categories, such as commercial real estate and commercial and industrial loans; (ii) an increase in share of loans from regional banking organizations; (iii) improving loan performance; (iv) higher banking reserve coverage ratios; and (v) improved institutional capitalization.

Chart 4

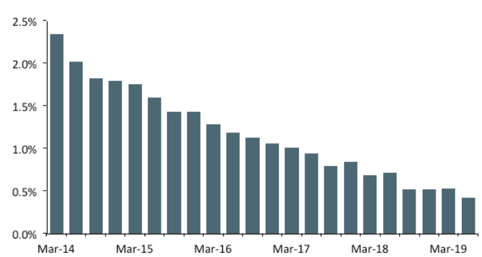
Reserve Coverage Ratio



Source: Federal Reserve Supervision and Regulation Report–November 2019.

Chart 5

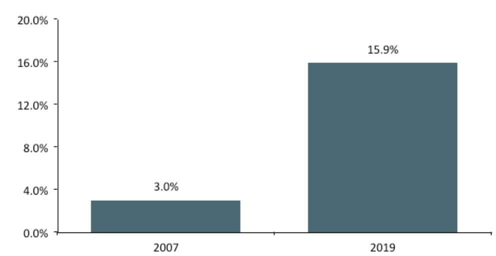
Share of Institutions Not Well-Capitalized



Source: Federal Reserve Supervision and Regulation Report–November 2019.

Chart 6

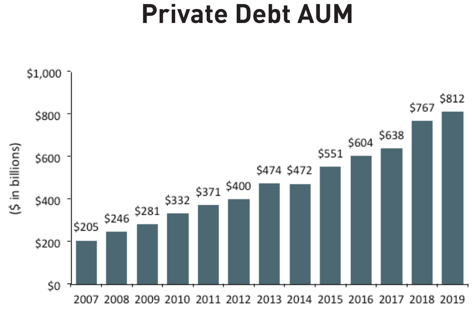
Liquid Assets as a Share of Total Assets



Source: Federal Reserve Supervision and Regulation Report–November 2019.

Additionally, the private/non-bank lending market has exploded over the past decade, providing a new source of flexible capital to growing businesses and funding for PE-backed buyouts. In the months and years following the COVID-19 crises, Intrepid expects non-bank lenders to continue to gain market share as investors seek yield in the low-rate environment and business operators identify alternative capital solutions to help navigate market dislocation.

Chart 7



Source: Preqin.

Election Year Dynamics

An interesting dynamic that dovetails with the current environment and desire to implement action is that it has come about during an election year. During the previous two economic slumps, the U.S. had a lame duck, outgoing two-term President. We believe that this event is forcing the current political administration to work quicker and be more amenable to policy suggestions across both aisles. The recent passing of the CARES Act showcases a desire to address uneasy consumers with tangible benefits and relieve small- to medium-size businesses as quickly as possible. Chart 8 shows the speed and size of the support packages the current politicians have passed fiscal stimulus legislation compared to 2008-2009.

Chart 8

Bill	Introduced	Signed	Estimated Cost	Act Summary
Economic Growth and Tax Relief Reconciliation Act	May 15, 2001	June 7, 2001	$1.35 trillion	Tax cuts
Jobs and Growth Tax Relief Reconciliation Act	February 27, 2003	May 28, 2003	$150 billion	Tax cuts
Economic Stimulus Act	January 28, 2008	February 13, 2008	$152 billion	Tax rebates for individuals and tax incentives for business investment
Emergency Economic Stabilization Act	September 27, 2008	October 3, 2008	$700 billion	Created the Troubled Asset Relief Program to purchase toxic assets from banks
American Recovery and Reinvestment Act	January 26, 2009	February 17, 2009	$831 billion	Job preservation, tax incentives, healthcare, education and infrastructure investment
Hiring Incentives to Restore Employment Act	June 12, 2009	March 18, 2010	$32 billion	Payroll tax breaks to hire unemployed workers
Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act	December 1, 2010	December 17, 2010	$858 billion	Extension of the Bush tax cuts
American Taxpayer Relief Act	July 24, 2012	January 2, 2013	$364 billion / year	Partial extension of the Bush tax cuts
Coronavirus Preparedness and Response Supplemental Appropriations Act	March 4, 2020	March 6, 2020	$8.3 billion	Coronavirus vaccine research and development
Families First Coronavirus Response Act	March 11, 2020	March 18, 2020	$104 billion	Paid sick leave and unemployment benefits for workers and families
Coronavirus Aid, Relief, and Economic Security Act	March 19, 2020	March 27, 2020	$2 trillion	Corporate and small business loans, direct payments to Americans, unemployment insurance and tax benefits

Source: Intrepid research.

Opportunity for Scientific Breakthrough

The biological nature of the COVID-19 pandemic fundamentally separates it from previous crises that were products of structural dislocations. While the economy is being impacted by social distancing initiatives underway nationally, this virus can, and will, be mitigated by breakthrough R&D efforts from the healthcare community. Over the past few days, more than 50 firms have announced vaccine development efforts (see exhibit 1 for a partial listing), the FDA has fast-tracked diagnostic testing to enable faster detection and other groups have contributed to other medical initiatives that are beginning to make a mental and physical impact. These efforts will be critical as we move beyond mitigation and back to our day-to-day routine. Once there is either a highly effective treatment or cure, any thought of a viral resurgence will be doused, and our routines can resume.

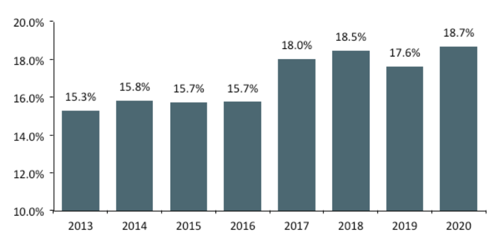
Exhibit 1

What Is Next and What Sectors Will Lead Us Out?

Once social distancing guidelines are relaxed, the recovery is likely to favor service-oriented businesses with technology-enabled and asset-light models. While traditional manufacturing and retail companies have experienced a high-degree of disruption from labor forces being kept at home, businesses that rely on technological differentiation and highly-trained, knowledge workers are more likely to have navigated the great work-from-home experiment with at least a modest degree of success. Just as the Great Recession yielded a new set of lessons to operators and investors through the 2010s, the COVID-19 crisis will likely influence deal-making decisions for years to come, with a premium being placed on businesses that leverage technology and maintain a dynamic workforce.

Chart 9

Technology and Communications Services Transactions as % of Total U.S. Transactions



Source: S&P CapIQ, reflects Information Technology and Communication Services verticals.

Final Thoughts

As we continue through this difficult time, we remain excited and optimistic that we will overcome this virus and return to normal. We believe our scientific and entrepreneurial communities will work to overcome this situation and rise to the occasion, finding a treatment and eventual remedy for COVID-19. We remain encouraged by the small and large acts of kindness that have captured the nation's hearts and minds. Finally, we look forward to working through this situation and getting back to normal… doesn't that sound good now?

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About Intrepid Investment Bankers

Intrepid provides M&A, capital raising and strategic advisory services to entrepreneurs and middle-market companies in various industry sectors. Our heritage breeds a culture that embraces teamwork, tenacity and creativity to help our clients win big. We believe that every company has an entrepreneurial passion that drives it and a story that defines it. Our team delivers results through skillful positioning and relentless execution. Based in Los Angeles, Intrepid augments its international capabilities through its active participation in Oaklins, an exclusive global alliance of M&A advisory firms.