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Third quarter finishes on high note; Lower middle market LBOs rally in Sept

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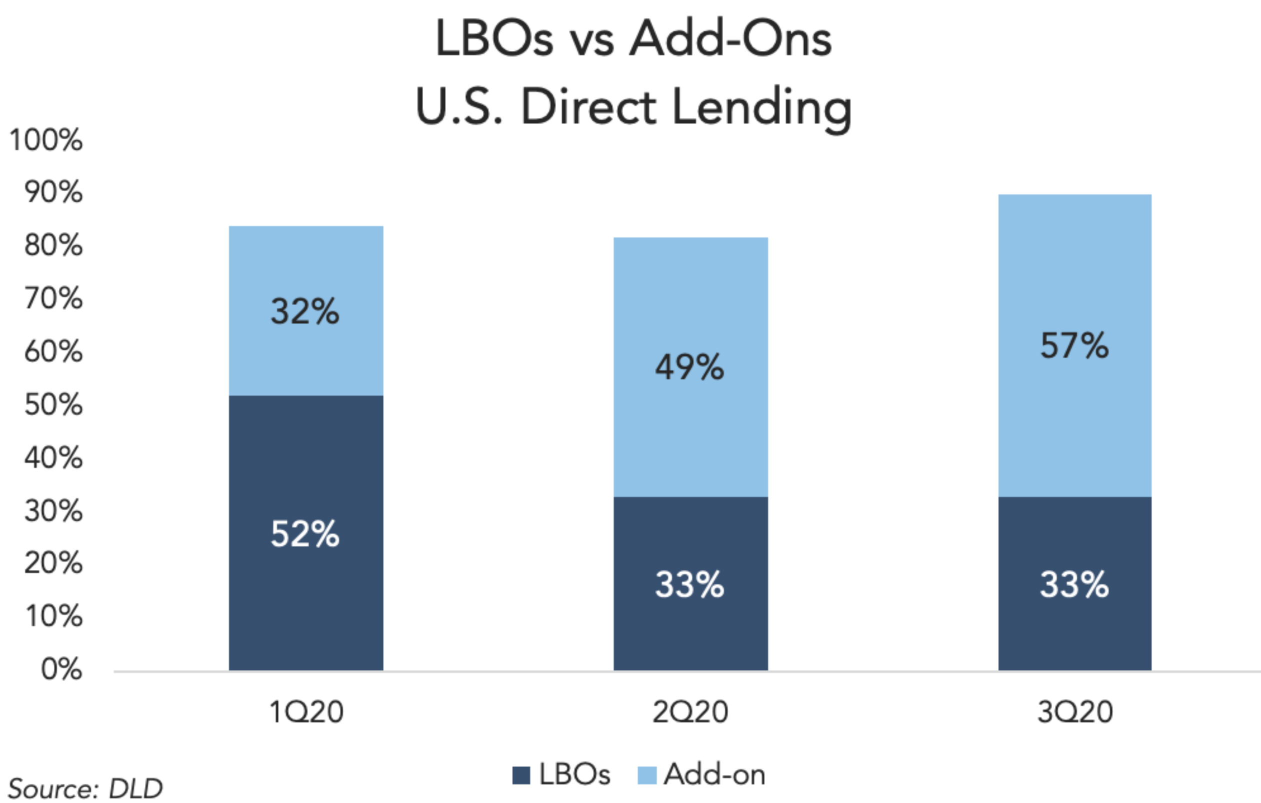

Chart

The second quarter’s heavy caution all but disappeared by last month in a swift reversal of deal flow. Uncertainty is onmnipresent, but investors have capital to deploy, financing has stabilized and after idling for six months, it’s risk on toward year end.

(See chart above)

Lower middle-market buyout financing surged in September after two moderate months of activity. For the quarter, LBO lending wrapped at 33%, in line with 2Q, but the wave in September lifted the monthly share to 41% from 23% in August. September was the biggest month for buyouts since the 45% reported in April, when deals that were booked pre-Covid were running their course.

Add-on acquisitions continue to run the table, accounting for 57% of third quarter business, up for a third consecutive quarter. Deal flow hasn't fully recovered to pre-Covid volume, but we tracked 177 transactions in 3Q, up 34% over 2Q. September's LBO surge is expected to carry through to the November election, if not year end.

Several drivers are behind the rebound in volume: 1) Businesses that were unimpacted by Covid are commanding sky high purchase price multiples (In one deal, the sponsor paid 20x for a healthcare business, according to sources); 2) Companies are leaner and recovering; 3) The potential for tax changes under a Biden administration make now an attractive time to move; 4) After idling for several months, investors need to deploy capital; and 5) Financing terms have nearly returned to their pre-Covid levels.

On that last point, lenders are describing the swiftness of the market recovery as 'breathtaking', 'mind-blowing', 'nonsensical', and 'nuts.' In the syndicated market, arrangers are resetting LIBOR floors to zero, dual DDTLs are being installed and dividend deals are parading through the streets.

At the same time, rates for bankruptcy and unemployment remain high, and significant unknowns remain unsolved. Fitch Ratings is painting a dark picture for three-year default rates, with leveraged loans outpacing HY, and topping levels from the Great Recession.