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IN$IGHT
PERSPECTIVES ON THE CAPITAL MARKETS

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When Is It Time to Get Back In the Pool?

Understand the current business climate and be prepared to act quickly.

by Jay Schembs

COVID-19 caused middle-market M&A activity - particularly new deal flow - to grind to a virtual halt beginning in March. Middle-market private equity firms used to seeing 10-20 deals per week reported volumes down more than 90% on a year-over-year basis. While the market appears to be slowly reopening, ongoing uncertainty means owners and their advisers need to understand the realities of the current environment and be prepared to move quickly when opportunity presents itself.

THE MARKET CLOSED BUT THE DOOR MAY BE RE-OPENING

The second quarter of 2020 will go down as one of the weakest quarters ever for M&A activity. Our conversations with clients, deal professionals, national private equity firms, and family offices underscore two realities. First, sellers backed away from the market, recognizing that their businesses need to stabilize before either engaging or restarting processes. The more difficult task now becomes assessing and articulating the path forward.

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The difficulty of this assessment ties in with the second new reality. While equity capital remains robust, investors and lenders will evaluate all new opportunities through a new lens that generally will tend towards downside protection. This means sellers should expect far more structure than in recent years. Headline valuation multiples may not meaningfully decline, but a portion of that multiple may come in the form of preferred returns, seller notes, and earnouts. As always, the more certainty a business can provide in terms of future performance – either through contractual relationships, diversified customer bases, or robust growth – the less buyers will demand protection against uncertainty.

Requirements of a Well-Functioning M & A Market

WILLING BUYERS & SELLERS

AVAILABLE CAPITAL

ACCESS TO SUFFICIENT INFORMATION

A byproduct of the current environment is that deal professionals are getting used to virtual work. We heard an interesting anecdote from an East Coast private equity firm whose office lease was expiring. They had planned to move to a new space, but shelved that idea for the time being, instead letting the lease expire and working remotely. They plan to use this time to better gauge how much space they truly need. This might work well for internal work, but deals will undoubtedly still require face-to-face engagement to meet management teams, conduct site visits, and perform other critical on-site diligence. The fact remains that most deals cannot get across the finish line until face-to-face meetings can occur with more ease.

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NECESSARY INGREDIENTS FOR A FUNCTIONING M&A MARKET

A well-functioning M&A market requires willing buyers and sellers, available capital, and exchange of information necessary to make informed decisions.

Buyers remain flush with equity capital. While strategic buyers are more idiosyncratic and unpredictable, private equity firms are chomping at the bit to invest their committed capital, which generally must be invested within a specific time period. The bigger question mark for buyers (again, primarily for private equity) is how accommodating will debt markets be for leveraged transactions? Our market outreach indicates lenders are, at a minimum, unwilling to lend at leverage levels common just a few months ago. This lower leverage generally impacts valuations, all other factors being the same.

But, they might not all be the same. Sellers are acutely sensitive to the performance of their own businesses in determining when to go to market, and many are adjusting or delaying

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their market entry as a result of expectations. A meaningfully lower supply of available acquisition opportunities creates a mismatch between the amount of capital seeking a home and the number of sellers willing or able to consider liquidity. Some buyers have told us they do not expect lower multiples because of heightened competition for fewer strong businesses. That

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being said, they do anticipate more structure in their proposals, and, in some cases, biting the bullet with higher equity commitments with an assumption they will recapitalize later when the debt markets accommodate.

For some businesses, not only has current performance deteriorated, but longer-term demand trends have dampened. In 2008 and 2009, we saw many owners anchor to perceptions of value based on historical performance and market conditions unsubstantiated by new market realities. This phenomenon may repeat itself, with gaps emerging between buyers and sellers that cannot be bridged. It might take some time before business owners and their advisers need to accept that the world is now different, and that the market generally does a good job of assessing value. Anchoring is a very real psychological bias that can lead to suboptimal outcomes for owners in businesses whose prospects continue to weaken.

The best way to combat uncertainty is with information. Now more than ever, robust financial and operational reporting capabilities will be critical. Investors are going to demand more data with more frequency as the uncertainty of economic recovery will cause many investors to rely more upon sensitivity analyses rather than longer-term forecasts.

Further, new ways to articulate a business and its unique attributes are emerging. Filmed interviews with senior managers, videos of facilities showing critical capabilities and features, and other virtual meetings are often replacing traditional in-person management presentations and tours. Buyers want to find ways to have their information gaps filled; sellers need to adjust to accommodate.

Our usual "good housekeeping" advice also remains as important as ever. Well-organized diligence information, fully-executed contracts, and current environmental or other third-party reports enable an owner to rapidly respond to unanticipated interest from prospective investors, where time can be of the essence, while also making the preparation and marketing phases of a transaction more efficient.

CONCLUSION

While market participants are optimistic that more normal times are on the horizon, assumed timelines are being consistently pushed out, along with a resignation that the horizon may not look the same when we get there.

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That being said, buyers are eager to make investments, and businesses are beginning to enter the market. For deals to get done, both buyers and sellers need to meet on acceptable terms and find ways to address the people-side of due diligence in a "working remote" business environment. Over the next year, we will find out how successful these efforts were. **ZS**

ZacharyScott

1200 Fifth Avenue, Suite 1500
Seattle, Washington 98101
ZacharyScott.com

ABOUT ZACHARY SCOTT

Since 1991, Zachary Scott has assisted owners of privately-held businesses in the greater Pacific Northwest to plan and execute major business or ownership transitions through three service lines: sell-side M&A, acquisition and investment advice, and direct investing. For more information on Zachary Scott, go to **ZacharyScott.com.**

Brian Bergsagel
206.838.5527
bbergsagel@zacharyscott.com

Frank Buhler
206.224.7383
fbuhler@zacharyscott.com

Mike Dannenberg
206.838.5531
mdannenberg@zacharyscott.com

William Hanneman
206.224.7381
bhanneman@zacharyscott.com

Ray Rezab
206.224.7386
rrezab@zacharyscott.com

Jay Schembs
206.838.5524
jschembs@zacharyscott.com

David Working
206.224.7850
dworking@zacharyscott.com

Mark Working
206.224.7382
mworking@zacharyscott.com