Zachary Scott has published this newsletter since 1997 to bring you a thoughtful analysis of issues affecting middle-market businesses.

ZacharyScott

PERSPECTIVES ON THE CAPITAL MARKETS WINTER 2022

INSIGHT

Exclusivity—The Double-Edged Sword

With a more liquid market, exclusivity may now be a disadvantage to the seller.

by David Goldstone

Exclusivity has been a critical component of business transactions in the modern era. Businesspeople have weighed the trade-off between playing competitors off each other and closing in on a binding agreement. Market conditions at the turn of the millennium have made exclusivity a habitual tool for middle market deal professionals. However, upon reflection over our recent experiences, it may be time to dust off the tool and examine when and where exclusivity should be used.

SLICING BOTH WAYS

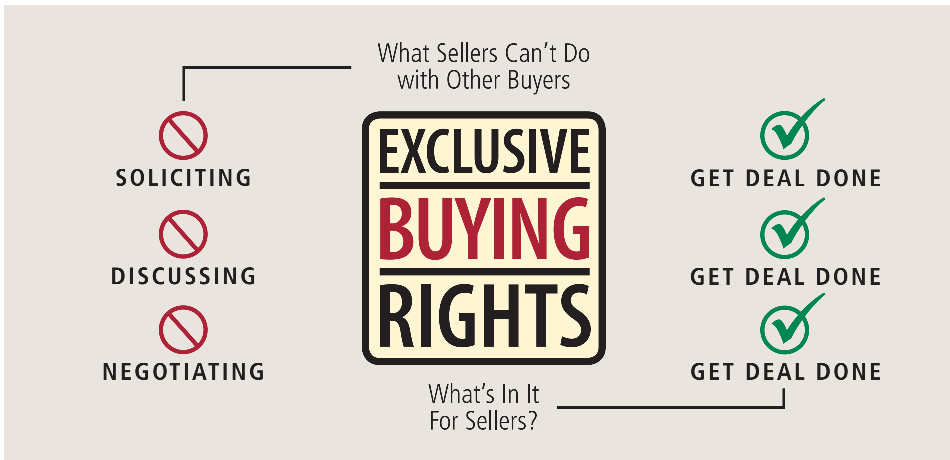
As part of their freedom of commerce, business owners have the right to discuss a transaction with multiple counterparties at the same time. Signing an exclusivity agreement limits a seller's right to solicit, discuss, or negotiate an agreement with any other party. This prevents the seller from maximizing value – ideally, buyers would compete for as long as possible. Even worse, after being granted exclusivity, the buyer has all the power in negotiations as the seller is not allowed to negotiate with anyone else, even as a means of keeping the buyer honest.

However, exclusivity brings one major benefit to the seller. Granting exclusivity (typically) increases the probability of getting a deal done. Buyers, after all, need to spend considerable time and money conducting diligence in order to confirm their investment rationale and document a deal. Buyer expenditures during this period can total one to two percent of the deal size. These buyers are concerned they will make a considerable investment investigating a business only for a third party to "swoop" the deal.

Consequently, buyers have said, "I promise I will give you a big bag of money, but you have to negotiate exclusively with me." For the past several decades, middle market sellers have decided that this trade-off was worthwhile. Increasing the probability of getting one party to spend money on completing a deal was more important than the possible negative impacts.

CREATURES OF HABIT

Repeated experience making that trade off caused middle market deal professionals to deem exclusivity an essential transaction tool. By and large, this was a sound decision. As we show in the chart on the next page, in the early 2000s, there were fewer likely buyers, as represented by the number of private equity firms, for any middle-market business. Bankers were able to keep track of these buyers. They (hopefully) knew which buyer was good for their word and which to avoid. Buyers with a reputation for promising lofty valuations and then re-trading down were avoided.



After being granted exclusivity, the buyer has all the power in negotiations as the seller is not allowed to negotiate with anyone else, even as a means of keeping the buyer honest.

The scarcity of buyers also resulted in wide valuation ranges. With only a handful of investors competing in each process, radically different views on value emerged. One buyer might value a business at four times cash flow, whereas another might calculate obtaining spectacular returns at seven times. Identifying the highest-valuing bidder was relatively easy.

Furthermore, the buyers' opportunity costs of a deal were higher. Because there were fewer buyers than businesses seeking transactions, buyers had the upper hand—they could be picky about which targets to engage. Additionally, diligence was time-intensive for investors. Buyers had to fly out and investigate a business, review physical materials in physical data rooms, and crunch numbers themselves. Every deal a buyer investigated meant they passed on many more for lack of bandwidth.

Finally, deals were done at lower valuations in the earlier years of middle market M&A. Return profiles based on low acquisition multiples gave buyers a substantial cushion in case negative findings were uncovered. A financial buyer computing a 35% return could afford to be less concerned if, for example, IT systems needed more maintenance investment than the seller represented. Because buyers tried to studiously avoid earning a reputation for re-trading, investors were generally good for their word. In total, in the days when the middle market was wildly inefficient, giving up exclusivity made sense because buyers had low

(continued p.2)

incentives to re-trade and there were enormous barriers to getting a deal done.

THEN THINGS CHANGED

The last decade has seen the development of very different market conditions. The number of buyers has doubled, and the amount of capital has expanded far more (see chart at right), as represented by the size of the private equity market. To take advantage of the greater number of alternatives, sellers and their representatives have been running broader auctions. Bankers now know less about the individual buyers they are contacting. In some cases, bankers often contact buyers with less reliable reputations because they are unsure who might bid the highest value.

PRIVATE EQUITY MARKET POWER: NUMBER OF FIRMS AND AVAILABLE CAPITAL

Sources: Uncalled capital from Bain's "The Private Equity Market in 2020," Figure 11; Number of firms to 2014 from PitchBook's "Number of active PE firms up 143% since 2000: A global breakdown;" Number of firms in 2020 from Rowe and Kliger, "Private equity in United States: market and regulatory overview"

Consequently, valuation spreads have tightened. Recent auction-sales have become large enough that multiple buyers submit bids indicating similar views on value. Those buyers now have three times as much dry powder as in the previous decade, so they must compete to put capital to work. The market is now more liquid at the ultimate transaction price.

This new M&A market liquidity, along with data-sharing improvements, has driven buyers' opportunity costs of a deal lower. Transaction volume has not increased commensurate with the firm count or available capital, which means buyers cannot remain as picky about the businesses they buy. Investors are casting a wider net and investigating more opportunities at the same time, which is now possible thanks to virtual data rooms and legions of transaction consultants. Today, buyers can investigate more deals with less time cost to themselves.

In effect, the pendulum has swung the other way. Buyers now compete so fiercely that deal valuations are at the edge of acceptable return profiles. This puts extreme pressure on buyers to guarantee adequate returns by conducting exhaustive diligence processes. A buyer looking at a 15 or 20% return might break their return profile when uncovering the aforementioned need for additional IT investment. This prompts a re-trade.

EXCLUSIVITY COSTS ARE GOING UP

The characteristics of the past decade's market imply that the cost to a seller of exclusivity has gone up and the benefits have fallen. First, a seller likely now has more options near the highest price, any of which might have a different view on the value of diligence findings. The party granted exclusivity in a process today might not have been the highest-value bidder for the business. Second, incentives have changed since buyers appear to suffer no harm from retrading. Bankers are either overlooking buyers' reputations or are not aware of them. Some buyers have even made overpromising and then retrading to nab a below-market deal their core investment strategy. Third, with so much capital chasing so few businesses, from the macro perspective, the probability of getting a deal done is enhanced less with exclusivity. Perversely, because buyers re-trade exclusive deals more frequently, the probability of getting a deal done at the promised price has fallen. In summary, the market has changed, and by acknowledging the new market dynamics, dealmakers can create a new framework about when to use exclusivity.

Sellers and their bankers have tools to navigate these new market conditions, and a future Insight article will help create a framework for readers to gauge when and how to employ those tools in a sale process. **ZS**

Sell-side QOEs: A Return to Utility

Assessing financial readiness and telling the economic story.

by Mark Working

> "It is possible to have too much of a good thing"
> - Aesop

Most modern-day sellers of middle-market businesses have conducted a sell-side quality of earnings study ("QOE"). It wasn't always so. What started out as a good idea in certain situations has proliferated and commoditized, and in doing so has marginalized its intended benefit. Now, it is viewed as just an automatic expense, a necessary procedural step in the sale process. We think it's worthwhile for the architects of the transaction process – investment bankers and investors – to revisit the original purpose of conducting a QOE and craft QOE studies to better serve specific purposes in a transaction.

This is certainly not a criticism of the transaction advisory services teams that execute these studies. A lot of talent has been accumulated in these departments of accounting firms, and they have adapted to produce what the market demands of them. They are forensic specialists and have developed skills and procedures that are very valuable. Demand for QOEs has grown dramatically and providers can't be criticized for responding to the demand. In the absence of direction from investment bankers and clients, the industry of QOE providers has created its own defined product, developing procedures to conduct analyses in repeatable processes, generating increasingly voluminous reports. Many QOEs now exceed 100 pages with very impressive graphs and tables in granular detail. Our observation is that they are beginning to look like they are coming off the assembly line in that they are less targeted and customized to address specific issues.

> **It is the investment banker's job to articulate the value proposition and identify which specific forensic analyses would support the thesis and present a defensible understanding to buyers.**

We were one of the first to propose using accounting firms to conduct a QOE study on behalf of the seller ("Case for a Seller Conducted QOE Study", Spr 2013) and have used them in many transactions since then. Our

(continued p.3)

rationale was threefold:

- In a broad sales process, the existence of an independent review of the financial statements that supports the investment banker's articulation of the value proposition (which is not always clearly reflected in the GAAP prepared financial statements) allows buyers to rely on a more detailed analysis for their initial indications of interest, making them more meaningful;
- With detailed independent analyses having been completed, the due diligence period between initial proposals and commitments can be reduced; and
- If structured properly, an independently prepared QOE can blunt the effort by the buyer's financial expert to justify a re-trade after exclusivity is in place.

A guiding principle of our thinking was that to make the QOE additive to the specific situation, it has to be customized. It is the investment banker's job to articulate the value proposition and identify which specific forensic analyses would support the thesis and present a defensible understanding to buyers. This can be hard and takes time and detailed analysis in advance.

As QOE studies have grown in popularity and the industry has accepted them as a normal part of a transaction, their use case has generalized. In 2018, we commented on this scope creep ("Effectively Using a QOE Study", Win 2018), pointing out how each study needs to be scoped to validate key pieces of financial information to answer specific questions, and how this approach appears to be falling out of favor. Most investment banks now suggest one as a matter of course, without any specifics as to its purpose.

It's hard to argue that this approach is in the best interests of the client. As an example of one area that is totally perplexing is the recommendation of a QOE when the seller's company has not previously had its financials reviewed or audited by an independent firm. The key question in a buyer's mind in this scenario is likely to be whether there is integrity in the underlying data—a QOE doesn't address that problem because its purpose and the procedures used are designed to interpret the (already verified) data in a manner and form a buyer is used to seeing, but doesn't question the underlying integrity of the data themselves. Conducting a detailed QOE in this situation ignores the more fundamental issue.

It is in both the seller's and buyer's interest to understand the base level economics of the business in its condition as it is transferred. Often, a forensic expert can be helpful in bringing light to the situation, and they should be engaged to do so.

One issue that QOEs have taken on is the justification of "add-backs", "COVID adjustments", and "recasts." In many cases, the analyses have taken on the perspective of "if it had been different, the result would have been different." Far from validating an economic reality that is masked by accounting procedures, the job has been to just make EBITDA larger. Last summer, we published an article ("EBITDA Adjustments – A Market Update", Sum 2021) where we made the case that by taking on too much of the "what if" type of adjustments, sell-side QOEs were leading to more scrutiny, not less, and creating doubt as to the entirety of the presented results.

A buyer of a business is buying an economic proposition that implies a future cash flow stream under the buyer's stewardship. Sometimes the GAAP-prepared financial statements do not clearly present that proposition. It is in both the seller's and buyer's interest to understand the base level economics of the business in its condition as it is transferred. Often, a forensic expert can be helpful in bringing light to the situation, and should be engaged to do so. The transaction services departments of accounting firms are a great source of talent to do that work. It would be a good idea for sellers and their advisors to begin thinking more as buyers to anticipate those areas of concern that are likely to arise and direct the analyses to address these issues. The best value will be obtained by working up front to design the customized analyses needed for every specific situation, thereby bringing the idea of a QOE back to its origin and making them additive to the objective of shining a light on the real economic proposition. **ZS**

The Disadvantage of Constraining the Universe of Buyers in a Sale Process

Restricting the buyer universe during a transaction puts constraints on an optimal outcome.

by Ben Adams

It is common to hear from business owners and managers that they wish to exclude certain buyers from a sale process. Reasons include a bad cultural fit between the companies (often as a result of a long period of intense competition), perceived limited financial capability because of size perception, and fear of misuse of confidential information. While these may be valid assessments, restricting the buyer universe during initial outreach restricts receipt of important information that can be used to optimize decision making. If mitigating measures can be put in place to protect the business from damage as a result of engaging with a party, a seller will benefit from the information obtained and may find new information that will cause a reassessment of initial impressions.

IMPACT OF CONSTRAINED MARKET INFORMATION ON DECISION MAKING

Constraints on the composition of the buyer universe can put holes in the market information about buyer interest in the seller's business. The following chart provides a hypothetical example of the most logical buyers for a certain business. Each column represents a different buyer and the price they have indicated they would pay for the business. In this example, there are five parties that would be willing to pay a "premium", meaning an amount in excess of the value to the existing owner. The grayed bars indicate buyers who have been suggested to be excluded from consideration. Without the information from the excluded parties, the seller has less visibility into the optimal result. In this case, excluding buyers leads the seller to believe their best alternative to no action (BATNA) is $15MM lower – but including all buyers would have lowered that difference to $5MM. That difference could lead a seller to conduct a different negotiating strategy to assure closing a deal with the buyer offering the highest price.

Allowing all supposed "bad fit" buyers to submit offers gives the seller an important advantage of being able to review all alternatives prior to deciding on which deal is best.

(continued p.4)

REASSESSING PRECONCEIVED PERCEPTIONS

Before a seller can become comfortable with discussions with these parties, it is important to address how to control the process to reduce the possibility of negative outcomes.

Concerns about buyer-seller fit stem from deeper worries about the buyer after closing a deal. Often this concern comes from a long-term developed perception of the other party as a competitor. Owners often have an impression of their toughest competitors as having evil intentions. Will the new owner keep current personnel? Will they close operations? Will they run it differently than it is now? These concerns are valid and important to consider. But two viewpoints should be considered.

First, there is a difference between obtaining pricing information and closing a deal. A seller is never obligated to consummate a transaction with a buyer until a purchase agreement has been signed. Allowing all supposed "bad fit" buyers to submit offers gives the seller an important advantage of being able to review all alternatives prior to deciding on which deal is best.

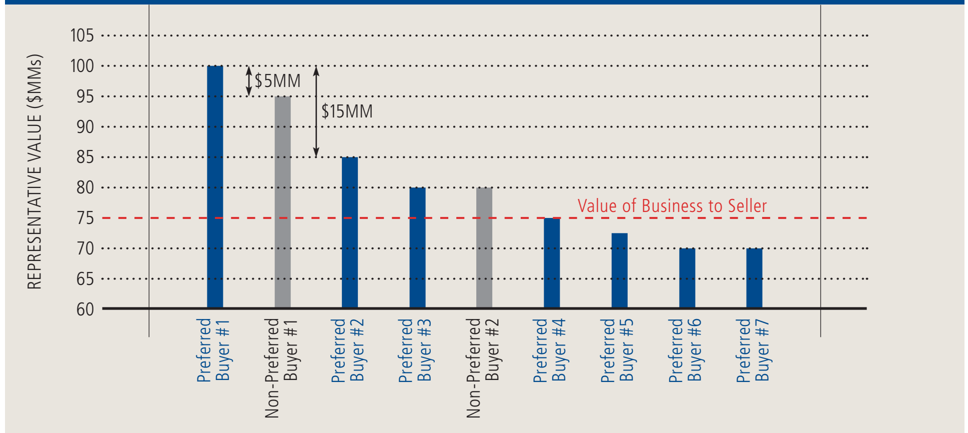
It is important to understand the long-term implications of a sale. Just like water always finds its level, companies will eventually be sold to the owner that values them the highest.

Second, it is important to understand the long-term implications of a sale. Just like water always finds its level, companies will eventually be sold to the owner that values them the highest. Excluding a buyer because of how it will run the business is likely just delaying the inevitable – if the rejected buyer can realize the highest value in the company (usually because of operating synergies), the buyer you choose will eventually discover this and negotiate a transaction at the higher price, capturing the value for themselves.

Clients typically have a strong understanding of the markets they participate in and know the relative sizes of their competitors and make decisions based on that information. We find that, in some cases, business owners overestimate their understanding of the size and nature of their competitors. While buyers without access to adequate financial resources to complete a transaction should be excluded from a sale process, that should only be done following an investigation of its owner. A small company owned by a private equity firm or a larger company may be a perfectly suited buyer.

Especially with direct competitors, information that is shared during a transaction can be extremely confidential. Even the fact that the seller is considering a transaction can be potentially harmful if it is known in the marketplace. While it is impossible to fully mitigate the risk of confidential information leakage, a hands-on investment bank and an experienced legal team can minimize the risk with the use of strong non-disclosure agreements. In a previous Insight article ("Navigating Highly Confidential Transactions", Sum 2020), we discussed techniques and procedures to mitigate unwanted disclosure risks.

HYPOTHETICAL ARRAY OF INTERESTED BUYERS IN A BUSINESS



A decade ago, our client, the owner of a business with a proprietary market position that was earned as a result of its technology, was approached by a company that wanted to enter that market. Discussions had progressed to the point that a price had been proposed. On the surface, it appeared reasonable. We suggested that several other parties be contacted as we thought they would benefit even more from the use of the technology. One buyer was a very large acquisitive public company. The owner was adamant not to approach that company as he had a very negative impression of it. We were successful in allowing that company to make a proposal and we and our client were pleasantly surprised to find a premium of 75%. The difference was significant enough to lead to a number of discussions. Eventually, the sale was consummated with the higher bidder, and our client completely changed his view of the company and its people, ending up working prior to retirement as an executive in the buyer's organization for five years following the transaction.

At the beginning of every engagement, it is important to talk with financial and legal advisors about concerns that would lead to excluding buyers from the process. The seller always has the final say but the outreach process can be modified to mitigate concerns. It is always in the seller's best interest to know all options so that the most knowledgeable decisions can be made. By maintaining the optionality that comes from approaching all possible parties, the seller can keep the process as competitive as possible and weigh the downside of individual concerns relative to the benefits of a higher valuation. **ZS**

At the beginning of every engagement, it is important to talk with financial and legal advisors about concerns that would lead to excluding buyers from the process.

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 by offering sell-side M&A and acquisition and investment advice. For more information on Zachary Scott, go to **ZacharyScott.com.**

Ben Adams
206.838.5526
badams@zacharyscott.com

Frank Buhler
206.224.7383
fbuhler@zacharyscott.com

David Goldstone
206.838.5521
dgoldstone@zacharyscott.com

William Hanneman
206.224.7381
bhanneman@zacharyscott.com

Ray Rezab
206.224.7386
rrezab@zacharyscott.com

David Working
206.224.7850
dworking@zacharyscott.com

Mark Working
206.224.7382
mworking@zacharyscott.com

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