BMO Middle Market M&A update

Navigating a Sale Process in the Current Market Environment

In today's market environment, successfully navigating a sale process requires a strategic and thoughtful approach with a keen understanding of the true differentiators and value drivers that buyers are looking for. Achieving a premium valuation, speed, and certainty of closing are often three of the most important factors for our clients during their sale processes; almost all of which are difficult to achieve together but there are several ways to stand out to potential buyers and ensure a smooth sale process.

Valuations in today's market have tended to be more binary than in the past, driven by buyers' perceptions of stability and sustainability in the face of a rapidly changing business environment. These perceptions are (i) narrowing the buyer funnel faster as investors are looking for reasons to pass, (ii) increasing the post-LOI (Letter of Intent) diligence period as buyers dig deeper than they ever have before, and (iii) supporting strong valuations for companies that check the right boxes. To achieve a premium multiple, Tier 1 assets have several common themes and display the following attributes:

1. **Consistent, Predictable Revenue Streams with High Visibility**: Buyers are attracted to companies with predictable and reliable revenue streams; both equity and debt investors value stability and predictability. Showcasing recurring, or reoccurring, sales give potential investors high confidence in any forward-looking projections.

2. **Strong Margins that are Sustainable and Underwriteable**: Companies with robust and sustainable margins demonstrate financial health and the ability to generate profits consistently. Strong margins are the hallmark of a competitive moat, and achieving certain industry-specific threshold margins can have step-function impact on valuations.

3. **Well-Articulated Growth Stories**: Both organic and inorganic growth stories are crucial. Buyers want to see a clear path to future growth, whether through expanding existing operations or acquiring complementary businesses. Specific rationale for why a particular acquisition is accretive or strategic to the overall plan is a must.

4. **Specialized Product or Service that is Irreplicable**: Unique offerings that cannot be easily replicated by competitors provide a competitive edge and justify a premium valuation.

5. **Diversification of Customers and End Markets**: A diverse customer base and presence in multiple markets reduce dependency on any single source of revenue, mitigating risk. The more steps and decision makers involved at the customer increases the complexity and customer "stickiness", which can further help reduce risk.

Mitigating Common Challenges

While the attributes above are not absolute requirements, high-quality assets typically exhibit some or all of those qualities, which could lead to a premium that is multiple turns on EBITDA depending on the industry, company size, and other company-specific factors. Even if a company does not meet all the criteria for a "Tier 1" asset, there are ways to mitigate common challenges and still attract significant buyer attention:

1. **Project-Based or Lumpy Revenue**: Highlighting the tenure of customers with consistent purchasing patterns and showcasing a strong backlog with high conversion rates can mitigate concerns about irregular revenue streams. Having strong contracts that limit customer switching and lock-in revenue for a period of time can provide revenue defensibility and get buyers more comfortable.

2. **Recent Earnings or Margin Ramp**: Strong margins are the hallmark of a defensible business, but a sharp increase in recent years can leave buyers questioning the stability and sustainability of that ramp. Ensuring that the margin improvement story is well articulated and supported by specific examples where efficiencies were realized, or redundancies were eliminated, is key to buyers underwriting the go-forward projections. A few common areas that buyers validate are (i) any changes in headcount and whether any eliminated positions will need to be backfilled, (ii) sustainability of any price increases and whether those increases are contractual / how they were received by customers, and (iii) longevity of any procurement cost savings and whether suppliers are able to systematically take price back over a period of time.

3. **Growth Story Solely Organic (or Inorganic)**: Having a growth story that is solely organic can be a positive for buyers. Showcasing the Company's recent success in greenfielding a new market or successfully introducing a new product is very powerful, and even more powerful when the success is formulaic and repeatable. The same is true of growth through acquisitions – showcasing the success in identifying targets at an attractive multiple, and successfully integrating systems is a large value driver. The key is that buyers need to see a proven track record and a potentially multiple-year history to underwrite a growth story.

4. **Operating in a Saturated Market**: Having a highly unique product or service, while helpful in establishing barriers to entry, is not a requirement to achieving a premium valuation. Showcasing the Company's ability to win on customer service or another aspect can be equally as powerful. Demonstrating a track record of taking market share or increasing customer wallet share in a crowded market can enable buyers to get comfortable operating in a highly competitive landscape.

5. **Customer Concentration**: Having a single large customer (typically greater than 15% of revenue) is often viewed by buyers as risky. Effectively positioning large customers can be done through a number of ways, and is specific to every company, but common mitigants can be, (i) showcasing the breadth and quantity of SKUs purchased, or number of services provided, which creates a very sticky relationship, (ii) highlighting the number of decision makers involved at the customer which increases complexity and makes switching difficult to do, (iii) demonstrating a strong contractual arrangement that gives multi-year confidence that the customer will remain.

We often work with clients to address these mitigants well ahead of a process, taking the time to thoroughly understand all facets of the business. Our senior bankers work hand-in-hand with management to craft a compelling story that highlights the positives and proactively addresses buyer concerns.

New Value Drivers

Given the rapidly changing market environment, in the last six months, several new value drivers have emerged that can significantly enhance a company's attractiveness to buyers:

1. **Limited Tariff Exposure**: Tariff exposure is an ever-changing target in the current environment. Some buyers have commented that they are disregarding tariffs in their investments and continuing with business as normal – citing their long hold periods and the temporary nature of tariffs. For other buyers, it is a categorical pass regardless of the company. One thing that should be evaluated though, is the indirect exposure to tariffs through the supply chain. There has been a recent uptick in the level of diligence of suppliers, contracts, and price escalations.
2. **Onshoring Benefits**: The current administration has been strong in its support of onshoring and bringing jobs back into the United States. Despite the currently low unemployment rate, there are pockets of opportunity and significant value drivers for some businesses. Steel Fabricators, whose position was silent in the 2016 tariffs, could potentially be the beneficiary of onshoring as any foreign steel fabrication could have a tariff on the value-added portion, which could drive significant domestic fab volumes over the next few years.
3. **Savvy Management Teams**: The current market environment, more so than at any point in recent history, has demanded a savvy and well-rounded management team. We have seen a marked increase in the level and depth of diligence on not only the company, but the management team as well – taking the time to understand specific strengths and weaknesses, and to ensure a solid alignment of personalities. Investors are relying more heavily on the input from their CEOs, CFOs and COOs than ever, and placing a significant premium on management's willingness to roll equity or invest in the sale (although generally not an explicit requirement).

Other Financial Considerations During an M&A Process

It's important to note that audited financials are not a must-have when selling your business. Buyers can often get comfortable using reviewed financial statements or clean internal statements. However, a Quality of Earnings (QoE) report by a reputable provider is increasingly expected. A well-done QoE can streamline the sale process and professionalize the business. It is crucial to involve your sell-side advisor early in the QoE process to ensure that any EBITDA adjustments are market-accepted.

Even if a company has audited financials, a well-done QoE by a respected provider can add tremendous value as it often goes orders of magnitude deeper in the granular analysis of the business. Audits, while helpful, only ensure that a company's financial statements are free from material misstatements and comply with regulations. A QoE, on the other hand, often includes retroactive adjustments that strip away one-time, non-recurring, or unusual items in order to reflect the true economic performance of the company. A good QoE can provide multiples more in transaction value than their cost.

Deal Killers and How to Navigate Them

Even with positive momentum and multiple premium value drivers in place, deal killers can still stop any good process in its tracks. Recently, there have been three potential deal killers that have gained traction among buyers during an M&A process, but taking proactive measures can help navigate around them:

1. **Environmental Diligence**: Increased scrutiny on environmental aspects, including "forever chemical" (PCE or PFAS) exposures, can extend diligence timelines or be a categorical reason for buyers to pass on an opportunity. Conducting a phase 1 assessment during the pre-market prep phase can identify potential exposures and allow you ample time to proactively address the issue. In some industries, there is no way around exposure to PCE or PFAS, which is OK – so long as you're able to demonstrate proper handling procedures and compliance with any environmental laws. It can also be helpful to conduct a thorough contract / property lease review before launching an M&A process to understand where, and with which parties, any potential liabilities sit. If anything is uncovered during the pre-market prep phase that cannot otherwise be solved, the insurance market has created numerous products over the past 5-10 years that can help protect against any potential liabilities.

2. **Workforce Verification**: A fully vetted and documented workforce is more critical now than ever before as buyers have significantly increased their diligence efforts on all aspects of human capital, with specific emphasis on validating workforce eligibility. To mitigate risk of fines or penalties, and to minimize any potential roadblocks during an M&A process, employers can conduct an internal I-9 self-audit with assistance from immigration counsel to identify and correct any errors. The number of I-9 audits conducted by the U.S. Immigration & Customs Enforcement is expected to continue increasing under the current administration. Ensuring thorough documentation and compliance with employee verification processes can reduce liability. Proper I-9 records and enrollment in E-Verify are essential.

3. **Supply Chain Exposure to High-Risk Countries**: The innumerable tariff headlines through the first half of the year have only increased the uncertainty of what will eventually play out for those importing or exporting goods. While most buyers can generally understand and unwrite some level of exposure to high-risk countries, too much exposure can be a non-starter for most buyers. Buyers and their capital sources need to be reasonably sure that the company's cost structure won't flip upside down immediately after completing a transaction. Companies with sole source suppliers and / or from high-risk countries can mitigate concerns by demonstrating a redundant supply chain from alternate locations. Having the ability to quickly pivot suppliers, or at least having a plan in place in the event you need to pivot, can give buyers comfort and reduce overall risk for the transaction.

Let's connect

Whether you're expanding through acquisition or ready to transition ownership of the business, our middle-market M&A experts are ready to help you take your company to the next phase.

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