mergers & acquisitions

A detailed look at the deal-making market

Moderated by Robert Bobroff, Publisher

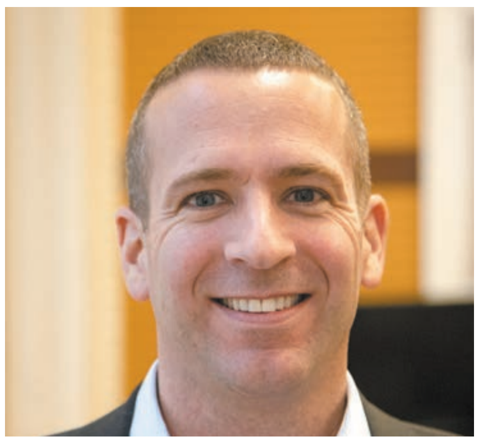
MEET THE EXPERTS

KEVIN SHORT

Kevin Short is the CEO of Clayton Capital Partners, a St. Louis-based investment banking firm specializing in mergers and acquisitions. He is also the author of "Sell Your Business for an Outrageous Price," winner of the Axiom Business Book Award's bronze medal and 10 additional awards. For over 25 years, Short has represented buyers and sellers in more than 150 purchase/sale transactions of midsize businesses with an aggregate value of more than $1 billion. In 2018, Acquisition International awarded the firm the distinction of being the Best M&A Investment Banking Firm. Additionally, Short is chairman of the Today and Tomorrow Educational Foundation, the Finance Council of the Archdiocese of St. Louis, vice chairman of the Show-Me Institute and a board member of The Children's Scholarship Fund.

MARK JOSTES

Mark Jostes is a principal and CPA at CLA (CliftonLarsonAllen) in their St. Louis office. He has 12-plus years of experience in public accounting as well as several years within private industry. Jostes brings this unique perspective to assurance, accounting and advisory services he provides to clients within the retail, manufacturing/distribution and construction industries. He also works within CLA's private equity group by providing transaction support services including buy-side and sell-side due diligence. Jostes holds a master's degree in accounting from the University of Missouri - Columbia and serves on the board of directors and chairs the finance committee for the St. Louis ARC.



MIKE ADRIAN

As leader of Lathrop Gage's M&A and securities group, Mike Adrian concentrates his practice in corporate, business and transactional matters, serving small and middle market companies in mergers and acquisitions, as well as entrepreneurs and startup companies with formation, early-stage financing and strategic issues. Adrian brings a pragmatic and creative approach to his practice, assisting his clients in drafting and negotiating complex transactional documents, including technology licensing agreements and services agreements, and providing counsel in highly regulated industries, including health care, accounting and gaming. He also routinely provides guidance regarding corporate governance issues and has substantial experience assisting with securities reporting and compliance matters. Adrian is routinely named a "Rising Star" by Missouri & Kansas Super Lawyers, and is an alumnus of Saint Louis University School of Law.

TOM LALLY

Tom Lally joined UMB in 2011 and currently serves as a team leader in the St. Louis commercial banking division. He spearheads the bank's efforts in both retaining key customer relationships as well as seeking new commercial clients. In addition, Lally leads the local treasury management group, which provides cash management and payables solutions for both for-profit and nonprofit entities. Prior to joining the commercial banking team, Lally was a member of the UMB investment banking department for six years, after spending the prior 12 years serving in Edward Jones' public and corporate finance departments. Lally's experience includes fixed-rate revenue bonds as well as general obligation structures for a variety of municipalities, not-for-profit institutions and utilities. He has served as guest lecturer in the field of public finance at Saint Louis University's School of Public Policy and served on the state of Missouri Legal Disciplinary Committee (Region XI). The Missouri Supreme Court reappointed him for two terms, and Lally completed his service in 2010. He is presently a board member of St. Louis Counseling and Kenrick-Glennon Seminary.

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What is your high-level overall outlook on trends in the area of mergers and acquisitions?

Kevin Short: We've gotten a fair amount of feedback in the last two weeks from clients around the country. Some that are struggling and worrying about being impacted by tariffs, which are having two- and three-tier down effects on their business. So they're worried about that causing a recession. In general, we believe the economy is pretty strong but there are some niche markets that seem to be struggling.

Mark Jostes: On that same line of thinking, if you're someone that's looking to go out and potentially monetize your company, that's something you have to think about. How long is that going to last, and what is the political environment going to be in the short term and long term? It's always an unknown, but right now it seems to be pretty rocky, especially related to tariffs.

Tom Lally: Our economic team at UMB doesn't see a recession happening in the next 12 to 18 months. We think it's important to look at several data points. We had the yield curve inversion a couple of months ago briefly, but if you look at other data points such as the LEI or the neutral rate versus Fed Funds rate, we're just not seeing it in the near term. We think it's important that we advise our clients to look at multiple data points, and not rely on one metric.

Mike Adrian: To Mark's point about the variableness of the market, it can turn sharply day by day, minute by minute right now depending upon the news cycle, but we encourage a longer view. Some of our clients struggled following the Great Recession, and even though nearly all survive, some eventually reached a point where they were compelled to sell under duress. Those that survived that stage are now willing and able to take a longer-term outlook and are not as focused on some of the blips and short-term instability in their markets.

Anybody else want to add on to that?

Kevin Short: The only thing I would add is it seems like most people we talked to are worried about the election. If it goes Democrat, they are worried about the impact that has on business. If it stays Republican, they are not too worried about it. I don't know how that fits into all of your 18-month outlooks.

Tom Lally: Well, with the Chinese trade agreement yet to be inked and the impeachment discussions going on today, that does create a little uncertainty. We know markets don't warm to uncertainty, but again we have always stood by multiple data points and we do not see the whole market going into any kind of tailspin in the near term. However, particular business sectors might be affected. For instance, the heath care sector could be impacted if a particular party or a presidential candidate with a broad legislative health care agenda is elected.

Individual questions. Let's start with Mike. What industries have seen a recent uptick in M&A activity?

Mike Adrian: We've continued to see increased rates of consolidation within a lot of highly regulated industries, especially in the health care sector. Doctors, dermatologists and dentists, in particular, have seen their opportunities to join larger platforms increase exponentially over recent years. That activity isn't all driven by private equity capital. Even though there is a large component of that, there has also been quite a bit of movement on the other end of the spectrum with single-physician practices and single location practice groups looking to expand and become more appealing to larger groups, including those backed by private equity. Whether through organic growth or by acquisition, these smaller groups have been active in order to better position themselves to take full advantage of this exit strategy.

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Accounting firms have also become more active in the market, using acquisitions to expand into new geographic markets, acquiring new talent and gaining access to new clients, but as anyone who has worked in this area understands, these are not typical M&A transactions. These deals have their own nuances, and they must be negotiated with an understanding of this fact. For instance, these deals generally don't see a lot of cash changing hands at closing, as the parties are focused on the assumption of outstanding liabilities, primarily those owed to retired partners, allocating dollar amounts to the incoming partners' capital accounts, addressing in-process engagements and the smooth transitioning of clients.

So, Kevin, is now a good time to sell?

Kevin Short: We get that question all the time, and up until about a year ago, I would have said it didn't matter. The outlook for the future looked pretty strong. Multiples were strong. That has not held true for this year. For the first time since the recession, we're concerned about the future. We're hoping that any kind of correction is mild, but mostly we're concerned about tariffs and the election. The election seems to be affecting the mindset of clients at the moment. So as a result, we believe we are seeing more clients that are selling than we have ever seen before. Our client load used to be 10 to 15 deals at a time, that were sellers. Today we're looking at 20 to 25 sellers at a one time.

How long has that been going on?

Kevin Short: Mostly this year. It's a 2019 phenomenon. I think people want to get out, because they missed it last time and they do not want to miss it again. They see the multiples, and the multiples are higher than we have ever seen. So, I'd say there is a fear factor pushing people to become sellers.

Are they trying to get this done before the election or potential downturn in the market or both?

Kevin Short: I would say they're trying to get it in the first six months of next year to make sure they're not impacted by the election or any recession if there is one.

Mark, why do you think there has been an uptick in the volume or importance of sell-side due diligence advisory services?

Mark Jostes: It really relates a lot to what Kevin was talking about. We have seen an uptick in the number of sellers. So when you look at the market, it may still be a good time to sell and there's a lot of private equity money out there wanting to be put to work, but we're starting to see a shift in the supply and demand as far as our business portfolio goes. We've seen a lot of sell-side due diligence. We see a lot of individuals that want to monetize. They don't want to miss this window. They want to be prepared.

I think sell-side due diligence is also a good way for owners to look at their income projections, locate current multiples and figure out what is a fair estimate of their selling price. Sell-side diligence develops more accurate expectations on their end. For example, diligence can uncover potential tax situations, legal contingencies, or other items that may be potential roadblocks to a deal.

Tom, if I'm a business owner and thinking about a possible exit, what steps should I be taking to be ready for the sale? What things should I be thinking about?

Tom Lally: We typically will share a few high-level ideas. First, we recommend that our midsized companies clean up their accounting three to five years

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before they anticipate a possible transaction. They should inspect all of the assets of the company including real estate holdings and any subsidiaries. It's important to do that. An audit would be best, but at a minimum, an auditor's review should be completed. That's the first thing we share with our clients.

Second, we recommend hiring an experienced M&A attorney. Don't view it simply as a transaction that involves structuring documents. Instead, bring them in to the strategy of your company so they can give you the best kind of advice. Make certain the legal team understands any potential macroeconomic fear that you might have, along with the key factors of what drives the success of the company. If they have sector experience, that's going to be a real benefit, but certainly bringing them into your planning and the vision of your company is something we recommend.

The final thing we like to share with clients who are thinking about selling is to put yourself in the shoes of the buyer and really ask those tough questions. We have a lot of successful clients and it's hard sometimes to see any warts with their own operation, but it's critical to ask the tough questions. Am I overly concentrated with customers and/or contracts? Am I in the throes of a commodity business that could be really impacted with some kind of economic change? Are my cash flows repeatable and dependable? Are there any environmental issues looming relating to your real estate holdings? All of these aren't easily corrected at the time of sale, so three to five years out is really the time to start planning at a minimum for how these issues could impact your sale price.

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> MARK JOSTES
> CLA

Mike Adrian: To follow up on Tom's point of the importance of bringing in other professionals, we highly recommend engaging service providers that are willing and able to work together for the benefit of the client. Even if the client has engaged three fantastic sets of resources, if the client has a financial planner who does not communicate well with the client's attorney, who, in turn, is not willing to work alongside the client's accountant, that client is not going to obtain the services it deserves. It's not about "staying in your lane"; it's about open lines of communication and providing the best service for your client. St. Louis has fantastic resources in each of these fields, and having a network of extremely qualified and personable professionals within each sector is truly valuable.

Do you find that most of your clients will start planning that far?

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> MIKE ADRIAN
> Lathrop Gage

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Tom Lally: Most do, but as we discussed, some clients might do something in a more hurried fashion if they begin to sense an economic turn. Again, I think it's important to share multiple points of data with individuals so they don't make a mistake, so they don't rush. I think a lot of individuals think we're closer to a recession because we've had such a long expansion, but again, I think we have to be careful not to make a rushed decision.

I'm assuming these tough questions that you're talking about asking the clients should come from multiple service providers, CPAs are going to ask tough questions and so too are attorneys, correct?

Mark Jostes: Everything you've said is something I would tell my clients to do as well. It's tidying up your accounting records. It's getting those audits and reviews done. I think all those things if not taken care of are potential roadblocks to transactions or could cause painful adjustments that will eventually have to be made in the due diligence process.

Kevin Short: I think most of us have family-owned or entrepreneur-owned business clients. Entrepreneurs are not known for being the most organized human beings. They're known for other strengths that have gotten their business to a certain point, but they don't normally have the patience to sit and clean up and organize everything until it's the last minute. So, when we're talking about doing it ahead of time they may say, "I don't want to worry about that. I want to go out and find a new customer." So that's part of it.

The other is, I would marry both questions. Due diligence on the sell side has become almost unbearable environment for our clients versus if you go back to pre-2007 it was radically different due diligence, much easier for the seller, particularly with private equity. Private equity did a lot of bad deals in 2007 because they hadn't done their due diligence. Now, even this late in the cycle, buyers are bringing in one, two or three different teams of due diligence experts depending on what the subject matter is. The clients, who are the same entrepreneurs who have no patience, don't do well with it. It's critically important to do it ahead of time.

Do you see that getting any easier? I mean we are this late in the cycle, and it hasn't gotten any easier.

Kevin Short: What happens is when prices rise, so does due diligence, because the buyer wants to be really sure that it is a good deal.

Mike, how important is it to have familiarity with your client's business in order to help them successfully acquire and integrate a business or execute an effective exit strategy?

Mike Adrian: Every client deserves to have a service provider who takes the time to learn about their business and develop an understanding of the opportunities they encounter and the risks they face.

My parents owned a small school supply store up in North County when I was young. Having seen the pride that they took in their business, and how much of their hearts they poured into making it work, I can certainly relate to the challenges that small and closely held business owners face. I also know firsthand how much pride they have in their work and how much they love talking about their businesses, so there are a lot of opportunities to learn about them.

These traits aren't unique to family businesses. They all love to talk about their business, to show you around the factory floors and things like that. When we are able to learn from them and really delve into the details of their operations, we are better positioned to document and negotiate their transactions.

On the sell-side, this concept is easy to demonstrate because we have to provide thorough disclosures in order to limit our client's exposure to liability. On the buy-side, we have been fortunate to work with a few clients on many similar acquisitions. Through these engagements, we learn their risk tolerance levels and negotiating style, and we are able to drive a lot of efficiencies into the process.

I'm amazed at the number of family-owned businesses here. What percentage of the clients that you work with are family-owned businesses?

Mark Jostes: I can start just by looking at our local portfolio. It's the majority of our businesses. We aren't providing services for public companies. So, a lot of our businesses come from that middle privately held market. I think in St Louis you have a phenomenon where the people who are born and raised here like it here, and so I think that you see a lot of people who grow up here and stick. It's a good community, and it's a family-oriented community. I think that also permeates into the business world.

Tom Lally: I don't have a definite percentage to give you, but I'm just thinking of the last several transactions that have gone through our local credit committee, and all of them are family-owned businesses.

Kevin Short: We're 100% privately held focused, every client is privately held. Even when the owner is only one individual, the family is involved. I'd say 100% are privately held, probably 60% to 70% have family members involved.

Mike Adrian: The vast majority of our clients are closely held. Of those, somewhere between 50% and 75% are family businesses.

Kevin, what is the benefit of selling your company with many buyers competing for it versus one?

Kevin Short: I firmly believe in auctions. If you come to me and asked me what is your business worth, I'll give you an educated guess, but I will always tell you I don't know and nobody really does. We've taken things to market that we thought we were getting a five or six multiple of EBITDA and someone bids an 11, all cash. What we did not know was what was going on their side of the ledger that they needed to fix something or take advantage of the opportunity. So we've learned that the more deals we do the more we don't know about what's truly going on inside a buyer's mind. So today our whole process is set up to find out what the buyers going to do with the business, so that we can then negotiate towards a number of what it's worth to them.

So when someone comes to you and says, "Someone wants to buy my business, will you help me?," do they come at various times in a transaction or have they already negotiated a price?

Kevin Short: Generally, there's a lot more buyers in the marketplace today being very aggressive looking for acquisitions. More than I think any of us have ever seen before. What that means is almost all of your clients are going to be approached. So, most of our collective clients say, "No, I'm not interested in selling, " until the one shows up that makes the case that gets their attention. We hope they call us at that point and say I've got one I really like. They have the funds. They have the synergies. I would trust my employees to them. They are good guys. You always worry about that. Can I hire you to negotiate the deal and close it? Getting a letter of intent is easy. They throw around a lot of LOIs. It's almost like the buyers are throwing them up against the wall to see what sticks, and you have to be real careful. Getting them closed, from LOI to closing, is very difficult because of the due diligence that we talked about.

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Tom Lally: To your point, we have so many clients with very impressive profitability margins. They know their competitors. They know the bolt-ons that they desire. They are reaching out. Business has been very good for a number of our very important clients so they are very active.

Mike Adrian: To Kevin's point, my least favorite e-mail exchange or conversation is when we receive a signed letter of intent from our selling client saying, "Does this work? Can we go forward with this?"
Kevin Short: Those are really hard to unravel.

On a much smaller scale, I used to deal with that type situation. My first career before joining the Orlando Business Journal, I was a residential real estate agent for 13 years. And I would have past clients of mine, and certainly during the boom, that I sold them their house and they would stick up a for-sale-by-owner sign out in the yard, then they'd call me and say would handle the transaction. They thought that they had done the hard part by getting a contract. To your point, not realizing that the hard part is getting that thing closed. I'm sure that buying and selling a business can get emotional but there's not a more emotional transaction than selling your personal home. Sellers are certainly very prideful. And buyers find every little problem.

Kevin Short: Well, there's a reason there aren't many M&A firms that handle individual sellers because of the emotion. With our clients, you can have a great price on the table and for one reason or the other, they don't approve it. Now if you got private equity or corporate selling you don't have these problems. They just look at the numbers.

Tom, the next one is for you. Valuations have been at high levels for quite some time now. How long do we stay in this seller's market?

Tom Lally: We see the seller's market continuing in the near term. We've touched on economic data. However, we also have to keep in mind that we're in a very low interest rate environment, so that's going to fuel a lot of it. It is going to be especially favorable to sellers of larger companies. I think you're going to see some impact on those that may have more steep and wild revenue cycles, but larger companies that are pretty stable in revenue, I see it being very favorable to them. Also, the sheer volume of private equity money in the market right now is likely going to continue, which is probably equally as important a driving force for a seller's market continuing.

Mark, what are some of the differences between traditional GAAP financials and the quality of earnings reports that companies can use in buy-side sell-side diligence?

Mark Jostes: Your traditional GAAP financials were some of the ones Tom alluded to earlier which are subject to the reviews, the compilations and audits. GAAP are the regulations that put a standard set of rules around a financial reporting ultimately providing a fair view of what your financial performance looks like given those uniform set of rules. They're there to ensure comparability. That's why public markets like them a lot as investors can discern one to the other. Quality of earnings, or QofE, contain numbers that are based on GAAP financials. However, QofE's will give you a lot of different subjective qualifications that somebody might be looking for when making an investment. You're going to have analysis of revenues and expenses. You're going to have assessments on the sustainability and the accuracy of historically reported EBDITA as well as what ideas are on the achievements of future objectives. I think all of those are important and I think buyers are going to want to see the adjustments that were made to previously reported financials. Again, I think that quality of earning differs from GAAP, in the main aspect of trying to remove those one-time non-recurring items that are nonessential to the business to give you more or less a look at the future profitability of a company without all the associated "noise".

Mike, describe some of the elements that you have found to be particularly effective when you begin the process of documenting and negotiating the terms of the transaction.

Mike Adrian: At the beginning of any deal, it is important to understand the motivation behind the transaction,

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so you have to ask certain questions. Number one, how critical is this particular sale or acquisition? Number two, what is the order of priority of the key business terms? Number three, are any of our positions non-negotiable? The responses to these and other high-level questions provide us with a better understanding of the context of the deal, which will help dictate which points to push and how far to push them.

It's also worth noting that we're trained to think dark thoughts and ask difficult questions, so as we begin documenting the transactions and clarifying the business terms, it also is incumbent upon us to identify and talk through the legal and economic risks and make sure that our client is comfortable. I like to tell clients that we need to prepare for the divorce at the time of the wedding. No one wants to do that when they are acquiring a business, as everyone is excited and would rather focus on optimizing synergies and all these other buzzwords. It's sometimes difficult to slow down and ask about the "what ifs," but it is critically important to walk through them and account for them as best as you can in the documents.

And are most clients willing to have that conversation?

Mike Adrian: At the end of the day, yes, and it's especially important to have these conversations with clients that have not been through the sale process previously. We respect that this is their business and ultimately their decisions, and our clients are willing to discuss these possible negative outcomes once they understand that we are speaking from experience and are simply walking through these possible scenarios in order to place them in a position to make the most informed possible decision.

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> TOM LALLY, UMB

Tom, what types of trends are you seeing in the lending market for deals? What types of debt structures are most common?

Tom Lally: I touched upon smaller companies. They're encountering some pricing and leverage hurdles. That's also the case for some companies that are in sectors that might be the first to enter into a recession. We think that's a little bit unfortunate, again for the reasons that the economic conditions are pretty solid. Some market participants are preparing for that scenario and demanding more in return. Overall, there are just too many seekers for too few opportunities. Part of that is that more banks are entering into this space than ever before. We're seeing a growing number of banks that were maybe once gun-shy entering the M&A space. This is because banks are facing such competition for loans that they're trying to find ways to fuel growth. Also, insurance companies are very prevalent in this market. When we see them involved, they bring a great deal of pricing and term prowess. On the deal structure front, we're seeing more straight senior deals getting done. Again, this is just more of a UMB perspective, what flows through our credit committees, but we are not seeing as many deals with third party or mezzanine debt involved. Private equity is handling those tranches more themselves, and that is possibly due to the fact that they don't want to deal with some of the requirements that come with mezzanine debt. I don't know, Kevin, if you see the same.

Kevin Short: We do. Also, they have so much cash; they could take up the mezzanine themselves. Like we said earlier, the amount of cash that is available is almost unbelievable to put into deals. They're really struggling because the PE firms don't make any money if they don't put that money to work.

Kevin, is it harder to get from start to letter of intent or letter of intent to close?

Kevin Short: It is much harder to get from letter of intent to close.

Tom, can you comment on EBITDA (earnings before interest, taxes, depreciation, and amortization) add backs? In particular, are you noticing any trends? Is this consistent with historic norms?

Tom Lally: We are seeing add backs ramp up both on the sell and buy side. As a result, that makes the lender's job more difficult to really test any management-adjusted EBDITA that comes our way. We have a philosophy at UMB that we will lend on hard EBDITA add backs, such as staffing efficiencies, if there are plants and facilities that will be streamlined, and corporate perk reductions. However, when process improvements become the storyline, we tend to shy away from that. That makes us a little bit uncomfortable. We want to make sure that anytime we're involved, our lending is based on solid projections and not inflated ideas of what's to come.

Mark, how does your firm differentiate themselves in the M&A space?

Mark Jostes: I think how we position ourselves is fairly unique. We look at the services we provide in a seamless manner. We have M&A professionals who work through the due diligence. They have track records of getting deals closed. Couple that with CPAs and what seems like an army of tax professionals. They can assess, for buyers, the tax implications of potential offer A versus offer B. There can be differences there. Then we have wealth advisory to put your capital to work should you be able to monetize your business. I think this process is very seamless, which I think our clients appreciate. Similarly to what Tom was talking about, Mike as well, it is very important to be sector focused, and keep the industry in mind. We try to align ourselves by industry. It is one of our core competencies. There are a lot of accountants out there, but do they know your industry and specialize in it like we do?

Kevin, how do private equity groups compare with strategic buyers?

Kevin Short: Two different animals for sure, becoming more and more distinctly different. Private equity will kill you with due diligence, as we mentioned. Until about three years ago, private equity would buy based on a financial formula, so they couldn't compete with a buyer who was buying based on the synergies. Now if it's a private equity buying a platform acquisition there are no synergies. If they're buying add-ons, there could potentially be synergies. As a result, three years ago, private equity was topping out at five multiples of EBITDA and strategic will go seven, eight, 10, whatever they need to get it done to get the right synergies. So we used to almost always sell to strategic. Today it is turned around and we almost always sell to private equity, because they realized three or four years ago, they weren't getting any deals done. So in PE the industry, to a person, they realized that they had to raise the top side of their offers and to protect themselves, which is why they do all the due diligence.

Tom, given the interesting political environment in the looming election year, do you see any slowdown in the M&A space?

Tom Lally: Well, we talked about this already, and we don't think so, but I think one should keep an eye on consumer confidence levels — that could be one of the first key data points to turn so it's important that we watch that. That hasn't eroded presently. Certainly, I think that the best advice, and I've said it several times, is to keep your eye on multiple data points so you make prudent decisions. A look to the LEI, yield curve, that spread between neutral rate and federal funds rate, and consumer confidence all together, so we're looking at the total picture when we're offering advice and strategy to our clients.