A ROUNDTABLE DISCUSSION

M&A TRENDS

DEAL OUTLOOK 4Q 2020 AND BEYOND

Since 2020 began, COVID-19 has claimed numerous M&A deals. While others have moved forward—with delays or price adjustments—still others have proceeded as planned. As the fourth quarter approaches, the continuing pandemic and upcoming presidential election are adding further uncertainty to the deal process. Amidst this challenging environment, four Chicago-based M&A advisers shared their insights with Crain's Content Studio.

How is your organization involved with M&A, and what types of clients do you typically represent?

Michael L. Vaccarella: Wipfli is a top 20 accounting firm that provides solutions to closely held businesses in the middle market. Our transaction advisory services group not only works to get those clients ready for M&A, but works with buyers like private equity, family offices and entrepreneurs who are acquiring those closely held businesses. We're focused on manufacturing and distribution, healthcare, technology, and construction services companies with EBITDA from $1 million to $20 million. Our firm also has an affiliated investment bank, Wipfli Corporate Finance Advisors, that represents clients in their sales processes.

John Iwanski: Riveron is a business advisory firm that delivers solutions throughout the transaction lifecycle. We partner with private equity firms, corporations and lenders to deliver integrated solutions and services for our clients. By blending financial, tax, IT and operational disciplines, our transaction approach creates a roadmap for identifying opportunities, assessing the environment and implementing effective strategies throughout the deal process to ensure our clients realize the greatest return on their investments.

Steven A. Migala: Lavelle Law has a robust M&A and commercial lending practice and acts as counsel to buyers, sellers or lenders in a wide range of transactions. Our clients and transactions are middle market in terms of size, and span across a variety of industries.

Yong-Jae Kim: Mesirow Financial's Investment Banking Group is a middle-market-focused advisory firm with over 30 investment banking professionals in Chicago, New York and London. We advise families, owner/entrepreneurs, private equity firms and public companies on a range of strategic advisory mandates including M&A, financing and restructuring.

What concerns are you hearing from clients regarding the impact of the COVID pandemic on the deal environment?

Kim: Some of the current impacts have been prolonged processes, increased scope of due diligence and uncertainty in the financing markets.

Vaccarella: The most talked about is deal flow—is there even going to be a market for the business? Restricted travel and meetings have caused a bit of havoc. Unknowns regarding the banking environment have caused certain deals in process to scramble and restructure terms and levels of debt versus equity. The concern currently seems to be "what's next?" as businesses and acquirers try to figure out what just happened, what's happening now and what else 2020 can throw at us. Last but not least is timing the market. Clients are wondering should they get back in, and if so, when should they launch the sell-side process.

Migala: COVID-19 has caused much uncertainty in the market. Valuations done months ago are now suspect, creating price uncertainty. Both deal activity and exit activity decreased, as private equity firms marked down their portfolio companies and chose to hold investments rather than sell. Both buyers and sellers are being more selective in terms of acquisitions and divestments because of this price uncertainty and murky economic outlook, which could lead to attractive opportunities for investors. Many M&A deals depend on debt financing, and COVID-19 is making lending more challenging relative to commercial loan availability and being able to obtain advantageous terms.

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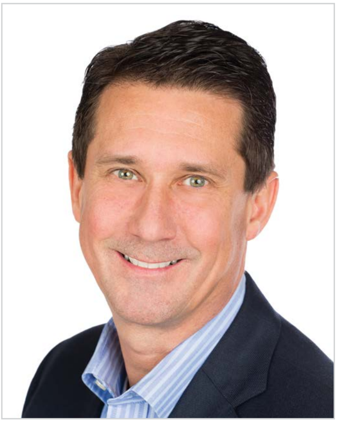
—MICHAEL L. VACCARELLA, WIPFLI

Iwanski: Our clients, like everyone else looking to make sense of today's tumultuous environment, are curious to understand what the "new normal" looks like as we emerge from the most immediate challenges presented by the pandemic. When the crisis first began, many of our clients were concerned about liquidity and wanted to draw as much cash as they could. Now, with the initial shocks subsiding, they're focused on making decisions that align with the acquisition strategy previously in place. Many are finding that the inability to conduct in-person meetings has complicated the deal process, especially when it comes to forging new relationships.

What sectors or industries have remained active?

Iwanski: Across all sectors, deals that were close to the finish line have continued, albeit at a slower pace, while most prospective transactions within "nonessential" industries have been stalled. There have been pockets of activity at companies that are not only recession-resistant but also happen to be performing relatively well despite the pandemic. Additionally, corporate carve-outs have seen a rise in activity as companies seek to monetize non-core assets and strengthen their balance sheets in the short term.

Vaccarella: For us, Midwest manufacturers have proven to be essential. Construction services related to infrastructure, telecom and utilities have remained strong. We're still seeing technology shining its light in all sectors. I'm a firm believer in the value in the lower and middle market. So, while industries have ups and downs,



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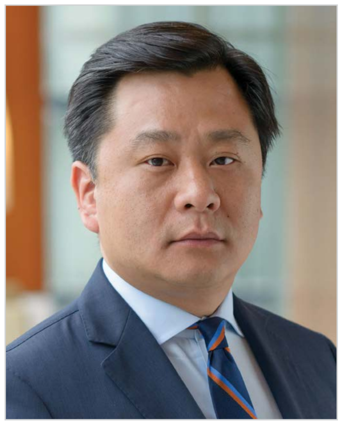

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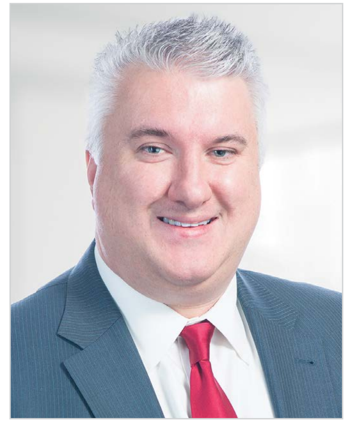

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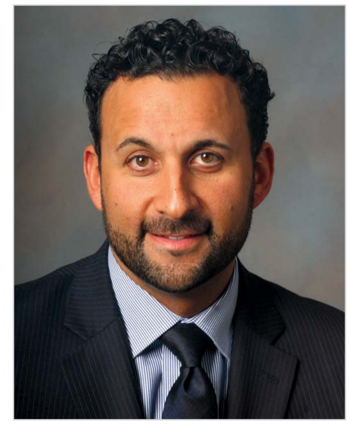

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smaller and mid-sized entities performing through this pandemic are going to draw attention from more than the usual players.

> "IN THE NEAR TERM, WE BELIEVE THAT SMALLER DEALS THAT ARE TRUE STRATEGIC TUCK-IN ACQUISITIONS . . . WILL BE IN FAVOR AMONG BOARDS AND MANAGEMENT TEAMS."
> —YONG-JAE KIM, MESIROW FINANCIAL

Kim: We continue to see transaction activity across all our covered industry sectors. Certain segments that were disproportionately impacted by the shelter-in-place orders are seeing lower levels of activity compared to the rest of the economy—for example, lodging, restaurants and hospitability. However, there continues to be significant pent-up demand in the form of private capital that's looking for a home. There's a scarcity of actionable, high-quality deals in the market and investors are aggressively seeking ways to deploy capital.

Migala: Industries with companies that have remained open because they're deemed essential, and more generally those whose earnings are relatively stable, remain active. Some health care areas and information technology are two industries that come to mind.

What impact have you seen on deal size?

Iwanski: According to FactSet data, the week of April 17 was the first time since 2004 without the announcement of a deal valued at more than $1 billion. There's been a 75 percent decrease in year-over-year deals for transactions of this size. Fortunately, activity has since picked up. Nine of the 14 deals valued at more than $1 billion that have occurred during the pandemic were announced in June. Middle-market activity also began slowing down at the end of the first quarter and was down 16.5 percent from first quarter 2019. Activity is expected to rebound more quickly in this space, however, given the size and agility of many companies that operate within the middle market.

Kim: Corporate buyers for the most part are cautiously evaluating M&A opportunities considering the macroeconomic environment. In the near term, we believe that smaller deals that are true strategic tuck-in acquisitions—smaller companies that provide strategic resources such as complementary products and technology, new end markets and geographic reach to the acquiring firm—will be in favor among boards and management teams.

Migala: Deal values are being suppressed due to price uncertainty. There's also been an increase in parties wanting to exit previously agreed-upon deals. Some invoke a material adverse effect clause, or MAE, to support its termination right—basically claiming that a change of circumstance significantly reduced the value of a company.

Do you see buying opportunities in the current environment?

Migala: Yes. Due to more price uncertainty, there's a higher risk that sellers could get the price wrong, leading to smart buyers making a quick profit by flipping the target in an early exit. Further, uncertainty surrounding the overall economy has created additional pressure on sellers to accept lower purchase prices. Also, larger corporations and private equity investors continue to look at add-ons and strategic acquisitions for themselves and their portfolio companies, especially if they can get them at an attractive price in this climate.

Iwanski: Companies are more focused on their core products and/or service offerings, and are accelerating their transition to online commerce. As these dynamics change, new opportunities will undoubtedly emerge. Further, the current environment has resulted in fewer traditional auctions. Sellers are focused on fewer buyers with a higher likelihood of successful close, which has created less buyer competition in certain situations.

Kim: Pre-pandemic, many business owners were assuming long-term continued growth in the economy along with financing availability. Now faced with an uncertain macroeconomic environment and tightening of credit markets, we're talking to more business owners who are considering an investment or a full exit. If we're facing a tougher economy in the coming years, more business owners are interested in having a partner that can provide both long-term financing to ensure liquidity as well as a source of capital to act on potential acquisitions while their underfinanced competitors suffer.

Vaccarella: The market has flipped to give an advantage to the buyer who's flush with cash, and I anticipate that buying opportunities will continue to grow. Middle-market owners will look to transition. We've long waited for the tsunami of boomer wealth transfer and it hasn't even been a lapping wave. Now there's some distress, panic and unwillingness to take the risks of whatever calamity shows up tomorrow. There will be winners and losers. Not everyone will get a trophy. Those who've been preparing, consulting with trusted advisors and carrying a little luck will seize the opportunity.

How has the global pandemic impacted due diligence procedures?

Kim: Prolonged processes, increased scope of due diligence and uncertainty in the financing markets present more risk to getting a deal completed.

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Migala: While virtual data rooms were already prevalent, due diligence meetings and site visits have moved to virtual platforms, which has made information sharing even more collaborative and efficient. I'm hearing that some deal teams are even using drones and videos to complete site visits and due diligence.

Iwanski: Nonverbal communication is a huge part of how we interact with one another; finding ways to conduct diligence and read body language will continue to be a challenge for third-party diligence providers. We're also seeing considerable impact on operational diligence, given the huge blow to companies' supply chains and other aspects of their operations. As companies assess the operational viability of a potential target, vendors and third-party customers are at risk of losing business, which has created a ripple effect.

Vaccarella: We've definitely increased our scope of diligence procedures and scrutiny of the target's forecast, backlog and pipeline because that's what matter most now—the future. Net working capital forecasting and target setting have become more important than ever. The traditional trailing 12-month analysis and other formulaic models have given way to more creative and artful approaches to be fair to both buyers and sellers.

How do you view M&A outlook for the remainder of 2020?

Vaccarella: We've seen an uptick in interest and activity in July and are hopeful that it continues through the remainder of the year. We originally thought that the frenzy of the pandemic would be tampered down by then, but two weeks to flatten the curve became much more than any of us could have expected. We're cautiously optimistic through the election, then bullish due to middle-market companies restructuring, recapitalizing and divesting before the tax increases on the horizon. The baby boomer wealth transfer is finally set to happen, something we've been anticipating for eight years.

Migala: I've seen estimates ranging from two to 12 months before we resume full deal capacity in the middle market. That's a big gap, but it seems reasonable given the fluidity of our situation, and I think it largely depends on how well states manage their containment efforts and how soon a vaccine can be found. Until then, I would expect volume to remain flat or to experience a slight increase.

Iwanski: The next six to 12 months will be a volatile period for global M&A. While there's expected to be an uptick in activity in the fourth quarter, the nature of the transactions will vary. Corporate carve-outs will remain active, distressed M&A will accelerate as sellers are faced with the economic realities of the current market conditions and value investors capitalize on the opportunities. Add-on activity will continue; smaller deals will likely be the first to return to pre-pandemic levels.

"NONVERBAL COMMUNICATION IS A HUGE PART OF HOW WE INTERACT WITH ONE ANOTHER; FINDING WAYS TO CONDUCT DILIGENCE AND READ BODY LANGUAGE WILL CONTINUE TO BE A CHALLENGE …"

—JOHN IWANSKI, RIVERON

Kim: We expect overall M&A volume will likely be down meaningfully compared to 2019. However, we do expect a pickup in activity later this year as the backlog of M&A transactions going into the pandemic begins to launch after Labor Day.

When do you expect to see an uptick in distressed M&A?

Migala: With the economy slowing down and a sharp reduction in both supply and demand, distressed M&A deals are expected to rise. Buyers with resources and an appetite for risk will have a strong negotiating position. When a seller or target is experiencing financial distress, transaction speed and closing certainty are highly sought, but that may come at the cost of a lower selling price. In addition, while buyers may desire to pick and choose the assets they want to acquire in this riskier COVID-19 climate, if speed is key, then distressed M&A deals are more likely to take the form of equity sales, as these are often less complex to close in terms of acquiring needed third-party consents and other compliance matters.

Iwanski: As consumer behavior continues to affect global supply and demand, many companies will find that their business models are no longer sustainable and they're unable to weather the storm. The June 30 debt deadline resulted in a large amount of delinquent loans, and banks are now starting to increase their reserves for troubled debt. With each passing quarter, there will be new waves of distressed companies. This will likely continue until a COVID-19 vaccine is in market and consumers feel comfortable returning to business as usual.

Kim: We've seen certain situations where companies have been directly impacted by the shelter-in-place orders earlier in the year and are facing liquidity challenges. While many companies have been able to extend operations with support from PPP loans, we expect to see more situations where companies are seeking liquidity to fund operations in fourth quarter 2020 and first quarter 2021.

What impact do you expect the presidential election to have on M&A?

Kim: The primary impact will be our assumption that a change in the current administration will result in an increase in taxes. Taxes are one of many considerations that business owners should think through when considering a potential sale of their business.

Iwanski: People are beginning to monitor each candidate's tax plans. Joe Biden expects to increase capital gains taxes while President Trump has yet to announce his formal plan. Stimulus plans resulting from the shutdown and resulting economic impact add another layer of complexity to the election discussion.

Migala: Conventional wisdom, at least before COVID-19, was that parties will want to close transactions earlier this year to avoid uncertainty surrounding a potential change of administration and related policies, and that deal flow would slow down heading into the election. I think what remains true, when factoring in COVID-19, is that deal flow will remain flat or slightly increase before the election.

Vaccarella: We have a recipe for crazy times ahead. Knee-jerk reactions based on bad information, incomplete data or bias influence will cause companies to leap before they look. Discipline will make the difference for organizations and their ownership.

How will deals likely be financed going forward?

Migala: Commercial financing is likely to continue to be challenging in the face of the price uncertainty and murky economic outlook brought on by COVID-19. I would expect lenders to strengthen the financial and other covenants in their loan documents. As a result, we're likely to see an increase in seller financing, including sellers being asked to take equity positions in the buyer as part of the consideration paid by the buyer.

Kim: For many of the strategic buyers we work with, their balance sheets have remained healthy and we would expect corporate acquirers to use cash on hand and existing credit lines to fund acquisitions. Financial buyers are still able to secure debt financing; however, the

ABOUT THE PANELISTS

JOHN IWANSKI is the executive managing director of transaction advisory services at Riveron, a business advisory firm that provides accounting, finance and operations services to clients across the U.S. and abroad. With over 25 years of business experience, he has advised clients on hundreds of buy-side and sell-side transactions in a wide range of industries. Prior to joining Riveron, he was a partner in Grant Thornton's transaction advisory services group, and before that was a CFO to a privately funded private equity group, where he was involved in financial strategy, relationship maintenance, transaction structure and due diligence.

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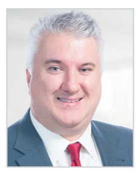
YONG-JAE KIM is a managing director in the investment banking group of Mesirow Financial, an employee-owned financial services company based in Chicago. He has 18 years of M&A and financing advisory experience across diverse industry sectors, and has completed more than 40 transactions representing over $7 billion in value on behalf of private equity firms, owner/entrepreneurs, family-owned businesses and public companies. Prior to joining Mesirow in 2016, he was a director in the global industries group at Robert W. Baird & Co., focusing on the industrial technology sector.

Mesirow Financial



STEVEN A. MIGALA is an experienced business attorney and a shareholder of Lavelle Law, a law firm of over 30 attorneys representing more than a dozen practice groups serving the Chicagoland area. He counsels business organizations in all stages of their life cycle, from start-up issues, contract negotiation and documentation, assets and equity sales/purchases, and mergers and joint ventures. He also represents banks and borrowers in commercial lending and workout matters. He serves on Elgin's Planning and Zoning Commission and is a former chair of the Chicago Bar Association's Corporation and Business Law Committee.

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MICHAEL L. VACCARELLA is a partner and leader of the private equity and transaction advisory services area at Wipfli, one of the top 20 accounting and business consulting firms in the U.S. With more than two decades of public accounting experience, he has focused his career on serving the closely held middle market—first as an auditor, then pioneering a due diligence and transaction advisory practice at another Chicago CPA firm before joining Wipfli in 2016. His focus on quality of earnings, deal value, deal personalities and the deal process contributed to his promotion to partner in 2019.

WIPFLI

cost of that financing has increased and the underwriting process is much more stringent. Given that the amount of debt financing available to borrowers is less than pre-pandemic, most financial buyers will have to contribute more equity to fund acquisitions.

Iwanski: In addition to traditional valuation bridges—earnouts, seller financing, insurance and escrows—buyers are pursuing alternative structures to mitigate risk and uncertainty. There's been an increase in nontraditional minority deals, which includes mezzanine, convertible debt and majority recapitulations. Due to the tight credit market, we're seeing less stretching for value by lenders. For smaller deals, the Small Business Association has created more incentive for buyers by offering to pay the first six months of debt payments.

What advice are you offering clients considering a transaction in the near term?

Vaccarella: COVID-19 has exposed federal, state and local deficiencies that need to be corrected with reductions in spending and higher taxes. We're preparing our clients to transition their businesses sooner rather than later to avoid the heavy burden at the corporate as well as personal level. We're also suggesting brainstorming and preparing for the unknowns, and have gone from modeling "what if" scenarios to all kinds of "where's the financing?" scenarios. Our third piece of advice is that cash matters. In buy-side transaction structuring we suggest holding on to it with proper holdbacks, negotiating to keep it until performance is achieved with proper earnouts, and strategizing for higher net working capital targets. On the sell side, we're suggesting that clients increase their cash conversion cycles, stash their cash, get to the market now and negotiate from a position of power.

Kim: A thorough analysis of financial performance before, during and after the shelter-in-place orders will be a key diligence exercise in any M&A transaction for years to come. In addition, we're counseling clients to revise their 2020 and 2021 projections based on what they're seeing in their respective markets. We expect that buyers will be raising the bar for the level of due diligence in new transactions for the foreseeable future. We're working closely with clients to ensure that they're prepared and have organized the necessary information needed for a successful process well in advance of engaging with potential buyers.

Migala: Be selective. For buyers, there's no substitute for conducting adequate due diligence. Who has the advantage largely depends on how well the target company is currently performing. If it's performing well, sellers can demand more closing certainty and deal protection; if it's not performing well, buyers can take advantage of price reductions, seller financing, more warranty and indemnification protection, and more termination rights under an MAE clause or otherwise.

Iwanski: Don't waver from your existing acquisition strategy despite the current climate—stay true to what's worked for you in the past. It's too soon to know what will happen as the dust begins to settle. History has taught us that we can expect to return to some semblance of normal once the uncertainty decreases and the economy starts to stabilize. While we can't expect a quick rebound and we're still unsure what exactly the new normal will look like, we know that there will undoubtedly be deal opportunity there for those who take it.

"... WE'RE LIKELY TO SEE AN INCREASE IN SELLER FINANCING, INCLUDING SELLERS BEING ASKED TO TAKE EQUITY POSITIONS IN THE BUYER AS PART OF THE CONSIDERATION PAID BY THE BUYER."

—STEVEN A. MIGALA, LAVELLE LAW