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

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PERSPECTIVES ON THE CAPITAL MARKETS SUMMER 2020

INSIGHT

When Is It Time to Get Back In the Pool?

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

by Jay Schembs

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

THE MARKET CLOSED BUT THE DOOR MAY BE RE-OPENING

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

While equity capital remains robust, investors and lenders will evaluate all new opportunities through a new lens that generally will tend towards downside protection. This means sellers should expect far more structure than in recent years.

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

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

Buyers remain flush with equity capital. While strategic buyers are more idiosyncratic and unpredictable, private equity firms are chomping at the bit to invest their committed capital, which generally must be invested within a specific time period.

Requirements of a Well-Functioning M & A Market

WILLING BUYERS & SELLERS

AVAILABLE CAPITAL

ACCESS TO SUFFICIENT INFORMATION

NECESSARY INGREDIENTS FOR A FUNCTIONING M&A MARKET

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

Buyers remain flush with equity capital. While strategic buyers are more idiosyncratic and unpredictable, private equity firms are chomping at the bit to invest their committed capital, which generally must be invested within a specific time period. The bigger question mark for buyers (again, primarily for private

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equity) is how accommodating will debt markets be for leveraged transactions? Our market outreach indicates lenders are, at a minimum, unwilling to lend at leverage levels common just a few months ago. This lower leverage generally impacts valuations, all other factors being the same.

But, they might not all be the same. Sellers are acutely sensitive to the performance of their own businesses in determining when to go to market, and many are adjusting or delaying their market entry as a result of expectations. A meaningfully lower supply of available acquisition opportunities creates a mismatch between the amount of capital seeking a home and the number of sellers willing or able to consider liquidity. Some buyers have told us they do not expect lower multiples because of heightened competition for fewer strong businesses. That being said, they do anticipate more structure in their proposals, and, in some cases, biting the bullet with higher equity commitments with an assumption they will recapitalize later when the debt markets accommodate.

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

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

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

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

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CONCLUSION

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

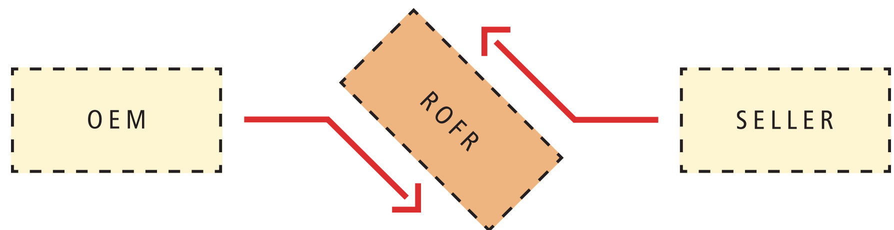
That being said, buyers are eager to make investments, and businesses are beginning to enter the market. For deals to get done, both buyers and sellers need to meet on acceptable terms and find ways to address the people-side of due diligence in a "working remote" business environment. Over the next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

Getting Past the Right of First Refusal to Complete a Sale Transaction

The ROFR can potentially complicate the problem of selling a business.

by Frank Buhler

Original equipment manufacturers ("OEMs") and franchisors sometimes employ a business model for distribution that embodies separately owned franchises or dealerships under the umbrella of the OEM's or franchisor's brand. To assure alignment of all parties around the preservation and optimization of the OEM's brand, the OEM or franchisor grants the right to operate a franchise or dealership under a set of conditions, one of which may be to approve the next owner of the dealership or franchise. A technique used by many OEMs is to require the dealership or franchisee to enter into an agreement referred to as a right of first refusal ("ROFR") that allows it the right to match any offer made by a third party to purchase the ownership interests in the business. The ROFR may additionally contain rules for selling the business, notices, and time frames for action. This presents a potentially complicated problem for the seller and his adviser that requires some tactical thinking prior to initiating a sale process.



With a ROFR, Incentives May Not Be Aligned Between the OEM/Franchisor and the Seller

COMPETITION IS REQUIRED

With any ownership sale transaction, the objective is to close a deal wherein the seller receives a market rate valuation and terms. In order to achieve this goal, competition is required, which is best accomplished by bringing simultaneously all logical and financially qualified buyers to the "table". At this point, the interests of the seller and the OEM or franchisor may diverge. The party that is the most enthusiastic and values the business highest may not be the buyer most preferred by the

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franchisor or OEM. ROFRs get in the way of achieving the seller's goals because a deal could be ready to close with all the parties having invested substantial money and time, but with the ultimate decision of whether the deal can close left to another party. The existence of a ROFR and the implied risk of not being able to close may impair the ultimate value to the seller and the number of interested parties.

REVIEW THE FRANCHISE AGREEMENT

The first step in designing a sale process is to thoroughly review the franchise agreement and understand the transfer terms. We suggest the seller's team consult with an experienced franchise attorney to understand all regulatory requirements and any industry or regional nuances. Not all franchise agreements are the same. Laws protecting the rights of franchisees also vary from state to state. We have found that, despite being designed by large OEMs with substantial resources, some agreements are ambiguous. Depending on the state, this could be for the benefit of the OEM or the dealer. The nature of the relationship and the clarity of the franchise agreement ultimately leads to a decision of whether to ask permission in advance or, at a later date, forgiveness. Each of these courses imply different tactics. For example, if the sole remedy for the OEM is a ROFR on the specific terms of the offer, moving forward without permission might be the best course, whereas if the OEM has other rights than a ROFR (e.g., right to approve the buyer or right to transfer the franchise to an acceptable buyer), gaining alignment with the OEM in advance might be necessary. There is a lot of space in the middle.

In the case of the decision to involve the OEM in the process, we recommend several steps in gaining support prior to entering the market. Our overriding advice however would be to establish a concise paper trail that leaves no ambiguity between the seller and the OEM or franchisor. Running a successful competitive process only to learn at the end, after giving up other alternatives, that there was a misunderstanding with the OEM or franchisor on the terms of transfer could be very disappointing.

- Learn the concerns and criteria the OEM has for the next owners (business plan, capitalization, type of organization, ability to support the business long term, buyer longevity, private equity)
- Receive approval (in writing) of an acceptable list of next owners prior to entering the market, such that the ROFR process becomes moot
- Receive an express OEM waiver of the ROFR (in writing) if a transaction with a pre-approved party is consummated

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If the decision and facts suggest that a process can be initiated without pre-approval by the OEM, then make it easy for the buyers and reduce the cost of investigation by having all their work completed for them, such as having all diligence materials completed and available during the process. In order to induce prospective buyers to spend time and resources on the transaction, consider providing a breakup fee to the party that enters into a definitive agreement for the purchase of the company.

Depending on the specific description of the ROFR, it may be possible to structure the breakup fee such that the OEM may have to assume that obligation if the ROFR is exercised, thereby protecting the displaced party for out-of-pocket expenses and opportunity costs, while not reducing the proceeds to the seller. The break-up fee should be expressed as a specific dollar amount plus out of pocket expenses, with the breakup fee size being a function of the size of the transaction. In a typical $100 million enterprise value transaction, it would not be unreasonable for a break-up fee to be in the range of one to two percent of the enterprise value.

To make this course most effective, all material conditions to close should be satisfied such that the ROFR is the only obstacle in closing the transaction with no additional outs in the transaction for the OEM, should it exercise its ROFR rights.

WELL-THOUGHT OUT STRATEGY

The ownership transition process is often times complicated by third party consents which may be partially out of the direct control of the selling and buying parties. This is especially complicated in an OEM or franchisor / franchisee relationship where the interest of the OEM may not be consistent with the interest of the seller. Prior to a sale, the seller and the OEM have a common interest in maximizing the market potential of the business resulting in success for each party, but when the seller decides to exit the business, the incentives are not aligned. As a result, a well-thought out strategy and competitive process will provide the seller a better outcome. **ZS**

Navigating Highly Confidential Transactions

Strategies for handling sensitive situations and information.

by Brian Bergsagel

Confidentiality is among a business owner's top concerns when considering a transaction. In particular, potential information leaks can have adverse consequential impacts on employee, customer, and supplier relationships. While every transaction demands a high degree of confidentiality, some situations are more sensitive than others and require additional levels of security and protection.

Traditional nondisclosure agreements (NDAs) are meant to protect a company and its owners in the event of a confidentiality breach. Although appearing ominous to the signer, the challenges relating to proving a breach, determining actual damages, obtaining a judgment, and collecting represents a long, arduous, and potentially expensive route, thereby dampening their protectiveness. The reality is that NDAs are rarely litigated, and are not always taken as seriously as one would expect. What steps then can business owners and their advisers take to facilitate a successful transaction while preserving confidentiality?

In each phase of a transaction, there are strategies that can be implemented to maintain confidentiality while providing investors with sufficient information to come to a reasonable conclusion. These strategies, summarized (see table on following page), can be utilized in combination with each other or in concert with one another.

INITIAL OUTREACH PHASE:

Undesired disclosure of the simple fact that a business is for sale is most likely to occur during the initial marketing phase of a transaction. Even with NDAs in place, it can be difficult to prevent word from spreading beyond the intended audience. When confidentiality is a heightened concern, it is best to limit the group of potential investors to only those with the highest likelihood of closing a transaction at an acceptable price. Once this group is determined, the parties can be contacted with detailed, investor-specific NDAs and confidential discussions can begin.

If there are competitive concerns with contacting certain strategic acquirers, it may be best to first gauge the interest of financial investors to assure that there are alternatives prior to disclosures to competitors. At a minimum, competition from financial investors helps to

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push competitors to participate in the seller's process, and according to the seller's rules, in terms of timing of information disclosure.

MARKETING & PRELIMINARY DILIGENCE PHASE:

When buyers begin to receive information about the company, confidentiality concerns generally shift away from the fact that an owner is contemplating a transaction to leaks about company-specific operating and financial information. Information memoranda with redacted information can prevent unnecessary disclosure up front, at least until it can be confirmed that an investor has a genuine interest in the opportunity and isn't simply on a "fishing expedition."

Investors will typically utilize third-party advisers such as accountants, environmental firms, and market research consultants to assist with evaluating the opportunity. Rather than including these advisers under the generic NDA signed by the investor, individual NDAs can be negotiated directly with these service providers or each such party can be required to sign a joinder to the base agreement. When there is extremely sensitive information that the seller doesn't want shared in detail with a buyer, these advisers can be used as intermediary investigators such that they can have access not allowed their client and they can give summary conclusions absent the underlying information. These NDAs and procedures can be administratively burdensome but provide an extra layer of protection, particularly in situations with significant competitive concerns.

The purpose of withholding this information is to ensure that there is an acceptable deal for both parties, including price, structure, representations and warranties, and indemnifications before disclosing the most sensitive or potentially damaging information.

CONFIRMATORY DILIGENCE & DOCUMENTATION PHASE:

Once exclusivity is granted and an investor moves on to confirmatory due diligence, a buyer will attempt to uncover every minute detail of the business, regarding its history, operations, customer base, financial performance, and more. Even during this phase, certain information can be withheld until a definitive agreement is signed. In such a case, a purchase agreement is signed that includes specific conditions that must be met in order to close the transaction. Examples of these conditions include conversations with customers, discussions with key employees, or review of key contracts. The purpose of withholding this information is to ensure that there is an acceptable deal for both parties, including price, structure, representations and warranties, and indemnifications before disclosing the most sensitive or potentially damaging information.

Strategy	Description
Detailed, Buyer-Specific NDAs	▪ In-depth NDAs including specific parties who can review the information ▪ Re-affirms the importance of confidentiality while limiting the individuals who receive the information
Staged Marketing Processes	▪ In-person meetings and fireside chats with the most likely buyers ▪ Allows you to discern interest before disclosing detailed information ▪ Preserves ability to go to a broader market if initial interest is limited
Redacted Information	▪ Information memoranda and financial supplements with key information redacted, including margins, customer identities, and more ▪ Allows investors to understand overall size and ownership dynamics without over-disclosing prior to a signed Letter of Intent
Restricted Diligence	▪ Negotiate NDAs with investors' advisers (accountants, consultants, investment bankers) in which the adviser receives detailed information, but is only permitted to share summary findings with the investor
Post-Signing Due Diligence	▪ Restrict access to certain information (e.g. customer data or conversations, employee information) until a definitive agreement is signed ▪ Ensures there is agreement on a deal that works for both sides before disclosing highly sensitive information
Break-up Fees	▪ Fee that investor must pay if the investor elects not to close the transaction after signing a Letter of Intent or definitive agreement ▪ Difficult to negotiate but provides protection against "fishing expeditions"

In the most competitive situations, a break-up fee may be possible. A break-up fee can be included in a letter of intent or definitive agreement, and provides that in the event an investor elects not to consummate the transaction, the investor owes a fee to the company to compensate for lost time, expended resources, and disclosure of confidential information. In middle-market transactions, these break-up fees are rare but sometimes justifiable.

CONCLUSION:

Concerns about confidentiality should not preempt business owners from considering a sale or other transaction involving their businesses. Situations involving heightened confidentiality concerns may hinder an ability to run a broad auction process, but careful deployment of the strategies discussed above can still allow a business owner to explore options and obtain a successful outcome.

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When considering a transaction, it is important to work with an adviser who appreciates the importance of confidentiality, and who can customize a process that finds the delicate balance between minimizing leaks and maximizing optionality and value. **ZS**

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.**

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