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 SPRING 2021

IN$IGHT

SPACs: Private Equity Goes Public

Apocalypse? Or, just an evolutionary stage for private equity?

by Mark Working & Dror Bareket

Everybody is talking about them. Lots of opinions. Most are related to whether SPACs constitute a good investment. With short sellers growing, many are betting they are not. Before coming to any conclusions about SPACs, it is important to separate the chatter about investment risk and understand how this might apply to an owner's decisions when approached by a SPAC.

BACKGROUND ON SPACS

A Special Purpose Acquisition Company, or SPAC, is purely a structure for raising capital and, as such, is neither inherently good nor bad. A SPAC is a company formed for the purpose of combining with one or more businesses. The unique aspect of a SPAC is that it is created to become a public entity and recent rule changes have contributed to their popularity. The founder forms the company, capitalizing it with enough to "take it public." In the IPO, funds are raised with the net proceeds, after paying expenses, held in a trust account until released to fund a business transaction. These initial investors earn warrants, or "free" equity, which has attracted early investors. There are some constraints on these funds. The SPAC has two years to find a target and negotiate a merger before having to return the trust funds to investors and, once a combination is negotiated, the transaction must be approved by SPAC shareholders. Shareholders who do not approve are bought out, with the remaining shareholders converting their trust account interests into shares of the public company, effectively making the target a publicly traded company.

Why doesn't the private company just go public itself? Speed, cost, and confidentiality. In some transactions, the target can become public within two to three months. A traditional IPO for the same business would be approximately twice as long. Because the SPAC has no history and very simple financial statements, and the sale of shares is considered "easier", the cost of the initial public offering (IPO) is lower than for an operating company to go through the same process. Disclosure of the target is not made public until after the transaction, whereas in a traditional process, disclosure is made public when the company files its registration statement with the Securities and Exchange Commission (SEC). Therefore, if the deal does not go through, all information is protected.

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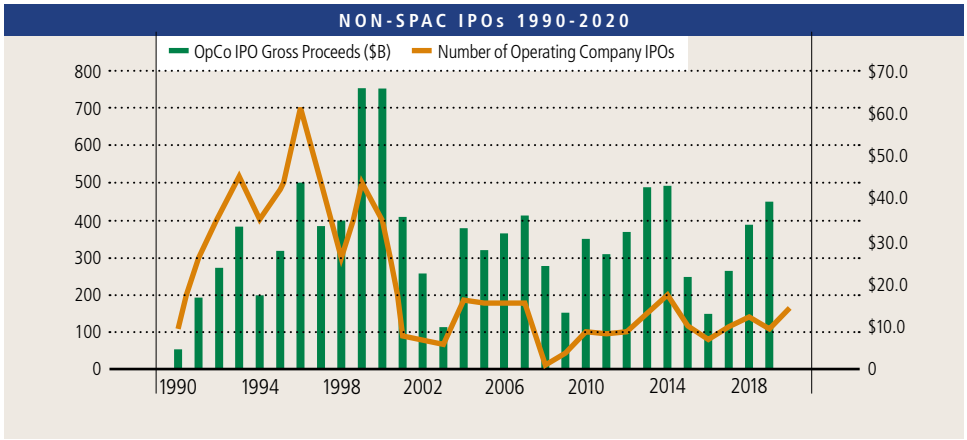
The sponsor is the key party to all of this. The sponsor creates the initial company, arranges funding for the IPO stage, finds the target, negotiates the combination, and arranges the transaction. For that, the sponsor receives warrants that are converted to equity in the public company. A "standard" promote interest is 20% of outstanding shares after the combination transaction. Most recent SPACs have been sponsored by private equity fund managers although there is no restriction on who can be a sponsor.

MARKET ACTIVITY

IPOs represent a market opportunity for a company to raise capital. When public equity markets are highly valuing company profits, companies that can access that market and have capital needs will try do so. It appears that is exactly what is happening now. Non-SPAC IPOs have been relatively stable in number for the last twenty years with the exception being after the bursting tech bubble in 2000 and the great reset in 2008, although the actual amount of dollars reached its highest point in 2020. SPACs, on the other hand, had not been a "real thing" until they started gaining popularity in 2017 and exploded in 2020, with the number of SPACs dwarfing non-SPAC IPOs, and the dollar amount of proceeds also exceeding that taken by non-SPACs. New SPACs have already equaled the 2020 number in the first quarter of 2021 and the pipeline is full.

The dynamics of going public through a SPAC have some unique attributes. First of all, the sponsors already have raised public capital and are motivated to spend it. We have commented numerous times about the pressure private equity has to invest committed capital. SPACs are private equity on steroids. When a SPAC undergoes its IPO, it cannot have a deal with a target lined up without triggering a different set of SEC requirements. Therefore, the clock is running when the IPO occurs. Two



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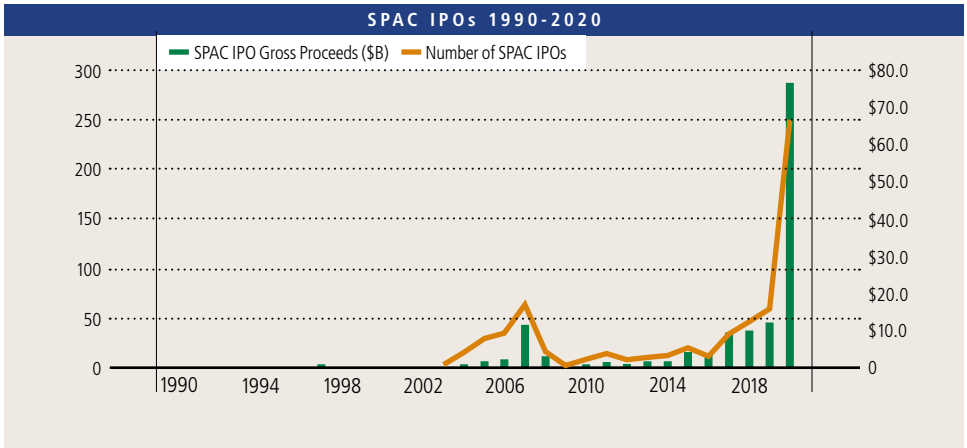
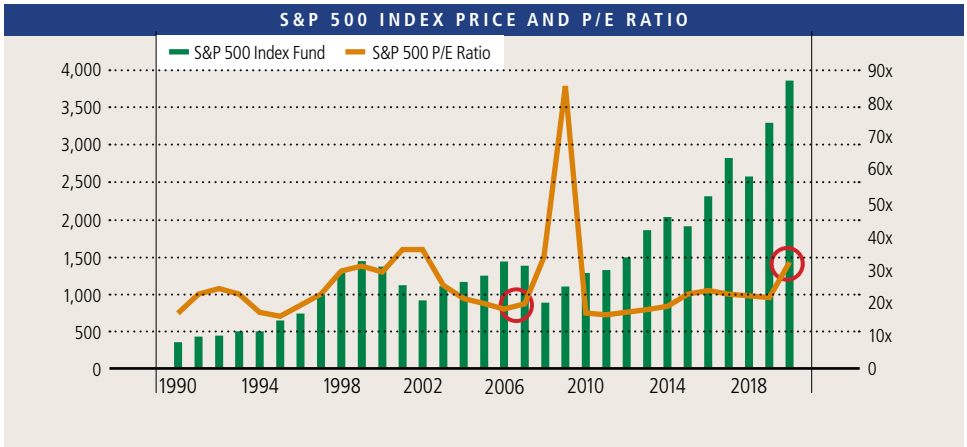
years pass, and the money is returned. It might seem like a long time, but it isn't to find, negotiate and close a deal. There are two other motivating factors for sponsors to find and complete transactions. The sponsor earns actual equity (approximately 20%) in the target once a deal occurs. This is in comparison to the private equity practice of earning 20% of the gain subject to a minimum return threshold (usually around 8%) for investors putting up the money. The additional factor is that a SPAC is measured for the sponsor strictly on the single deal and not averaging into a pool of investments as with a typical private equity fund. All the gains from this investment are earned and any losses do not drag down other investments. A cynical observer might conclude the incentives could lead to "any deal is a good deal" because 20% of something is always better than 100% of nothing.

IMPLICATIONS FOR PRIVATE COMPANIES

An IPO is a good tool to raise new capital, provide a liquid market for all shareholders, and take some chips off of the table. If the additional reporting and scrutiny from being a public company don't outweigh the benefits, the question is "how much of the company's shares need to be given up in exchange for the capital raised (either to buyout existing shareholders or fund the company's future growth)?" When there is a large diversion between how public and private equity markets value operating performance, this market deserves attention.

SPACs are simply a tool to be used to access a capital market. When used by capable and disciplined investors, there is no reason that it can't and won't lead to a good result for all parties. Rain is needed, but sometimes leads to floods. Similarly, some SPACs will be misused by inexperienced or incapable investment managers to the detriment of SPAC investors. Nevertheless, if merging with a SPAC allows a company and its owners to achieve their liquidity and capital objectives, it is still a good option to consider. An old adage of equity market observers is that "when the equity window opens, it is time to back up the truck." **zs**





Deal Making In a Pandemic

The pandemic brought positive changes to M&A transactions.

by Jay Schembs

In the wake of last year's COVID lockdowns, M&A markets became an absolute desert in the second quarter of 2020. Projects were put on hold and owners contemplating a transaction paused to focus on COVID impacts to their businesses. Surprisingly, once the dust settled and there was more clarity about how businesses would perform, 2020 ended with an extremely robust level of M&A activity.

Dynamic markets adapt, and the M&A market in 2020 was no exception. To understand what occurred, let's revisit what we said last summer: a well-functioning M&A market requires willing buyers and sellers, available capital, and exchange of information necessary to make informed decisions.

WILLING BUYERS AND SELLERS

One primary reason M&A markets are cyclical is that during periods of heightened uncertainty – often seen during recessions – a growing gap emerges between buyers and sellers. When such moves in the market occur quickly, it takes time for market participants to adjust their expectations. Last spring, no one could anticipate what the next year, or years, would look like, and as such most deals were put on hold.

Once business owners regained confidence in their ability to forecast near-term performance, the expectations gap began to narrow. Buyers, who remained eager to put capital to work, also began to get creative and flexible to grease the skids. For example, the "COVID adjustment" became common in diligence as buyers tried to understand a company's underlying earnings power.

While the concept of adjusted EBITDA is common in M&A transactions, the bar is high for accepting what is an adjustment. Buyers intensely try to quantify and verify what sellers argue are non-recurring or extraneous expenses. Over the last year, COVID adjustments became commonplace, greatly expanding the definition of adjusted EBITDA. Adjustments are often driven by costs, but COVID adjustments are often focused on revenue. For example, where orders were either delayed or cancelled because of factors believed to be attributable to the pandemic, buyers did concede some justification while sellers recognized the uncertainty of the claim. Earnouts re-emerged as a structure to bridge gaps to get deals done.

AVAILABLE CAPITAL

Part of what helped the markets quickly rebound was that most private equity groups (PEGs) did not like the alternative of staying on the sidelines and returning capital to investors. While strategic buyers are often fickle and unpredictable in their acquisition desires

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– particularly in times of uncertainty where they turn inward to focus on internal issues – PEGs oversee capital that contractually must be invested within a finite time horizon. No PEG builds its business plan assuming prolonged periods of inactivity, yet that is what every PEG faced last March. Most went on the offensive, doubling down on outreach efforts. Although initially it was much like pushing on a string, with each passing month, the imperative to put capital to work helped provide comfort on the sell-side that deals could still get done.

The availability of debt capital over the last year was much less certain. Acquisition financing became a lost cause as commercial lenders were overwhelmed assessing the impact on their credit portfolios, fulfilling requests to maximize credit lines, and serving as the conduit for clients accessing the Paycheck Protection Program.

Even once the M&A market began to thaw during the summer, considerable uncertainty remained as to what lenders would be willing to do. Lenders returned to prior form in relative short order, but it certainly took some time for both equity and debt markets to align themselves to provide sellers more certainty that deals could be financed.

INFORMATION EXCHANGE

Uncertainty over how deals would get done – particularly due diligence and negotiations, both of which are often largely conducted in person – was a major obstacle last spring. Unprecedented travel restrictions and an inability to conduct in-person meetings meant that many critical aspects of a typical transaction were effectively impossible.

This was where adaptability proved critical to restarting the markets. First, buyers became increasingly flexible on how and to what extent they would conduct their diligence. Certain efforts, such as a site visit, still required in-person verification, but due diligence predominantly became virtual. Technology has for years improved efficiencies related to diligence (only our senior partners can recall the time when a data room was a literal room). While video calls remained inferior to in-person interactions, they were an improvement over conference calls for establishing personal familiarity and rapport.

Like diligence, negotiations became almost entirely virtual. While this also has its drawbacks, particularly in cases where reading body language and making emotional decisions is important, the market made do with a lesser alternative.

HOW THE PANDEMIC IMPROVED DEAL MAKING PROCESSES

While much of this adaptation and flexibility emerged out of necessity, certain areas in the deal making process may have been improved.

Most significant is the management meeting. Historically, investment bankers would solicit initial indications of interest, and then narrow that group for in-person management meetings. These meetings generally included a dinner the night before and four or more hours the following morning. Management then would repeat this process day after day, sometimes numbering more than ten meetings.

One primary reason M&A markets are cyclical is that during periods of heightened uncertainty—often seen during recessions—a growing gap emerges between buyers and sellers.

This process presents many suboptimal outcomes. First, what is the "right" number of meetings? For processes with significant interest, picking the best 8-10 parties is difficult, even after thoroughly vetting buyers during the initial phase. Second, while a larger group of meetings maintains competition deeper into the process, it puts significant strain on the management team. Lastly, these meetings are time consuming for both sides. Taking travel out of the equation offered buyers the chance for more meetings and for sellers to interview a greater number of interested parties.

The virtual management presentation emerged as an outstanding tool to refine the market. For example, last year we had a project with 23 indications of interest. Prior to COVID, we would have agonized over selecting the right number and composition among those bids to meet management, with a reasonable probability we excluded a seriously interested party. Instead of burdening the management team with two weeks of in-person meetings, we invited 13 parties for 2-hour video meetings. This enabled buyers to get their high priority questions answered, as well as get an initial feel for the team.

We then asked parties to refine their initial bids. From there, we had a much higher degree of confidence in picking five parties for in-person meetings. Of that group of five, all submitted final bids, which significantly improved our competitive position without putting undue stress on the management team.

Another improvement in deal processes is the increased virtualization of the due diligence process. Quality of earnings projects, which typically include exhaustive Q&A and line-by-line review of general ledger accounts, are an obvious candidate for virtual workstreams in lieu of onsite visits. Eliminating often significant travel time to and from a company frees up more time for both buyer and seller participants to focus on other matters.

WHERE DO WE GO FROM HERE?

We were pleasantly surpised and encouraged by the resiliency and adaptability of market participants to ensure M&A markets remained robust as we settled into pandemic life. Without question, removing uncertainty and increasing in-person interaction will continue to improve the market function. Meanwhile, we believe COVID-related EBITDA adjustments will become increasingly difficult to support, as businesses must prove their ability to navigate future uncertainties and expect EBITDA adjustments to converge with the historical framework. Finally, we strongly believe applying virtual means to achieve certain process objectives – such as with initial management meetings and confirmatory diligence – will remain in some form, helping to improve deal making efficiencies. **zs**

Unlocking Value Through a Sale Leaseback

The sum of the parts may be greater than the value of the whole.

by Brian Bergsagel

All cash flows are not created equal. This adage is particularly relevant when considering the combined value of business cash flows and real estate cash flows. When business owners sell both an operating business and the real estate that supports that business, they may be leaving money on the table if the situation is not handled appropriately.

Over the past three decades we have encountered countless private businesses that own real property or properties within the same entity as the operating business itself or where business owners own both the real estate and the operating company. The prevalence of this strategy stems from the fact that owning their real estate provides business owners:

- An opportunity to re-invest in the business through a long-term asset;
- A sense of security, as there is no risk of eviction or lease renegotiations;

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- Additional annual income via lease rentals;
- Ability to amplify equity returns via higher leverage associated with real property; and
- Upside potential through property value appreciation.

The logic is not dissimilar from a consumer's rent versus buy analysis for their homes: If they are going to pay a monthly amount to a landlord, they would prefer to make those payments to a lender so that at least some portion of their payments accrues to themselves via increased equity.

Despite these reasons, institutional investors and large corporate buyers typically prefer not to own operating properties, given the differing risk profiles between the operating business and real estate and the resulting impact of those risk profiles on relative valuation and returns. There are, of course, institutional investors who focus on real estate investments, but these investors typically have different investment mandates, hold periods, and return targets than do acquirers of operating businesses.

In order to maximize the value of all related assets, acquirers of a business will commonly pursue a sale leaseback transaction post-closing. Prudent private business owners should be aware of this strategy and may benefit from deploying it themselves.

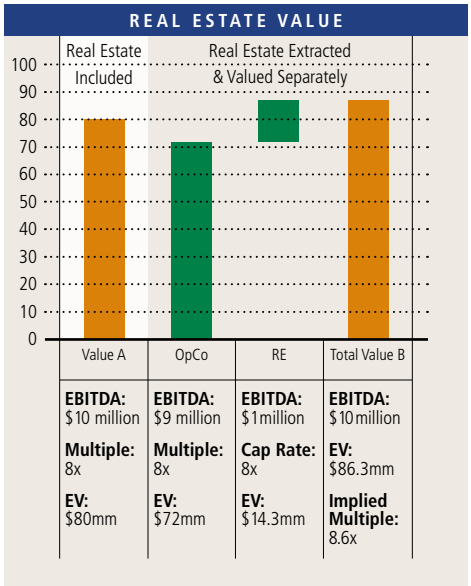
DEFINING A SALE LEASEBACK

A sale leaseback transaction involves the simultaneous sale of a property and establishment of a lease arrangement with the new owner. This process requires agreeing upon the fair market value of the property as well as the future lease rate and terms. Sale leasebacks are typically structured with long-term leases – as long as twenty years – with a few additional five-year lessee renewal options. This longer term gives stability to the tenant and eases the investor's concern that they may ever have to find a new tenant.

ARBITRAGE OPPORTUNITY

Owners of both an operating company and the related real estate are indifferent to the source of the cash flows from the two assets, and may not appreciate that these cash flows are valued differently. The differing risk profiles, or costs of capital, between an operating business and the related real estate typically create an opportunity for value arbitrage. This arbitrage opportunity exists when a capitalization (cap) rate for the property is lower than the weighted average cost of capital (WACC) of the operating business.

Cap rates can be thought of as the inverse of an EBITDA multiple: a 7% cap rate on a property implies a multiple of one divided by seven percent, or 14.3x, on the annual net operating income (NOI). In this example, so long as the operating business is valued at less than 14.3x EBITDA, there is value to be gained or lost depending on the lease rate because a dollar of lease income is valued more highly than a dollar of EBITDA at the company level.



Although "removing" the go-forward rental amount from the EBITDA of the operating business results in a lower enterprise value (EV) for the business, the value is more than made up for through the sale of the real property.

TACTICAL CONSIDERATIONS

While sale leaseback transactions are not structurally complex, the timing and sequence of events require careful coordination. Sale leaseback transactions involve three principal parties: the seller of the operating company and real estate, the buyer of the operating company, and the buyer of the real estate. At the appropriate time, each party needs to be made aware of the other parties and their financial capacity in order to fully understand the pro forma capitalization structure and credit profile of the tenant.

There is always a risk that the sale of the operating business does not go through, in which case a business owner may wish to retain ownership of the real estate. To mitigate this risk, sellers can solicit sale leaseback proposals on the property that would only be executed in the event of a sale of the operating business. At that point, the new property owner will need to know who the owner of the business will be and may need to provide landlord consent for the transaction, but the bulk of the due diligence and underwriting will already have been done. This all requires synchronization of timing between the business sale process and the sale leaseback process, but can be the optimal way to preserve optionality and avoid unwanted outcomes.

Given the extensive coordination required, this effort may benefit from a sale leaseback expert. We have worked with a number of specialists in this field over the years. A sale leaseback specialist can work alongside the other transaction advisors to tee-up the sale leaseback transaction for an eventual closing simultaneous with the closing of the business sale.

Sale leasebacks can also be a useful strategy to consider outside of a business sale. The proceeds from a sale leaseback can be used to de-leverage a business by paying down debt or can be re-invested in higher-return segments of the business.

CONCLUSION

When considering a sale, business owners should understand the different components of value that they are selling, and the strategies that will allow them to maximize the value of each of those components. At the end of the day, acquirers of an operating business with real estate are likely to enter into a sale leaseback transaction almost immediately after closing to obtain the value arbitrage for themselves. Fully evaluating the opportunity for a sale leaseback prior to completing a sale of a business can allow this value to instead accrue to a seller. **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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