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 2021

INSIGHT

The Effect of Externalities on Business Stability

"The Lord giveth and the Lord taketh away"

by Ray Rezab & David Working

We have employed many words over the years discussing the importance of owners understanding the competitive environments of their businesses in order to make educated forward-looking decisions, but this past year has illustrated as clearly as anything how an unpredictable external force, in this case COVID-19 and the world's subsequent responses, have introduced incredible instability. The purpose of this article is

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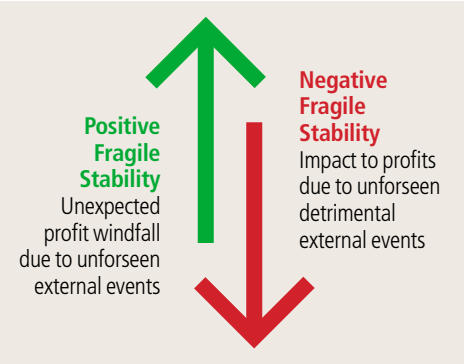
to present some examples of how businesses have been impacted—not implying that these impacts could have been foreseen or prepared for, but to illustrate the fragility of "stability." Sometimes "stuff just happens," and it's for this reason that wealth managers stress the dangers of not diversifying away from a highly concentrated personal investment portfolio, like owning a business.

POSITIVE FRAGILE STABILITY

Revenue windfall is what happened to one of our close friends in the agribusiness sector. The business buys product from farmers and creates products that are sold to consumers on grocery and club store shelves and to other food manufacturers as ingredients in other consumer products destined for the same shelves. When the COVID pandemic hit, many people stayed home, and adjusted their food consumption patterns accordingly. Instead of going to restaurants, people bought food and ingredients from grocery, club, and



direct-to-consumer channels. Supermarkets were overwhelmed with demand and reached out to their suppliers to try and buy more. Interestingly, suppliers to restaurants almost immediately lost their customer base and tried to pivot to sell to grocery and club; but, these companies had different product forms and retailers preferred to sell through SKUs they already managed, rather than onboarding new suppliers and adding SKUs. Companies such as the one owned by our friends were the beneficiaries of the concentration of demand through these three channels. Historically a very stable business with consumer-staple-style growth dynamics and cycle resiliency, the impact was a revenue increase of 40% YOY, maximizing utilization of facilities that generated outsized bottom line profits. The secondary effects of this windfall included expanded supplier relationships, improved customer relationships as a result of delivering under high pressure conditions, and a stronger balance sheet, which has led to more investment in facilities. Although a very good company at the end of 2019, in 2021 it has become a powerhouse. The growth would not have occurred without great management, an able

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workforce, a long-term positive reputation in the supplier community, and strong connections throughout the whole supply chain (e.g., trucking, cold storage). They were well-positioned for the sudden challenge, but the instability would not have occurred but for a series of events and conditions totally out of

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the company's control.

NEGATIVE FRAGILE STABILITY

There are many stories of revenue shifts that created winners and losers, but the effects of COVID also caused unexpected changes in cost structure and profitability that have had devastating effects on some companies. A good example is what has happened in the "head and gut" (H&G) sector of the Alaska seafood industry. Also referred to as the "Amendment 80" or "multi-species" sector, companies in this sector utilize catcher-processor vessels to harvest and process pacific cod, atka mackerel, ocean perch, rock sole, yellowfin sole, and flathead sole fish. The H&G companies had developed an efficient system wherein fish that were caught in Alaskan waters and primarily processed on the vessel were then shipped to China where the product was further processed and packaged for sale into markets all over the world. This has been a very profitable sector in recent years, as evidenced by the price paid in 2017 to buy one of the sector participants. A key to profitability has been the low-cost value-added processing in large efficient plants in China. But in 2019 and 2020, these H&G companies were impacted by two detrimental external events; first, a 25% tariff in September of 2019 related to political tensions with China, which immediately took a bite out of profits as the H&G companies had to absorb a portion of the tariff. Then, primarily as a result of COVID, worldwide trade declined in 2020, resulting in the largest decline in global GDP since the Great Depression in the 1930s. With declining demand for shipments, containers ended up being stored in different delivery ports around the world. The ready availability of containers and frequent container ship trips, critical to H&G companies, were disrupted by the impacts to the global supply chain. What had been a delicate and efficient system of ship and container movement across the globe, was disrupted. As economies are beginning to recover and demand for shipping has rebounded, ships and containers aren't where they are supposed to be, exacerbating supply chains, resulting in an increase in freight rates. The H&G companies, which depended on that efficient global system to ship product great distances, have been hit with outsized freight costs. What was a very profitable sector through mid-2019 now labors under the burdens of higher tariffs and freight rates, neither of which could have been anticipated or avoided by good management.

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SIMPLY A MATTER OF LUCK?

When we hear owners express with certainty how they expect the future to unfold, we can only point to these and other examples to say that there are forces beyond the control of the company and its owners and managers. Fortunes can be gained and lost simply as a matter of luck. Nobody can predict the future, and nobody knows which butterfly effect is going to have the next global impact – but even decades of stability should not be taken for granted when preparing for the next ten years. **zs**

EBITDA Adjustments: A Market Update

While valuations remain high, EBITDA adjustments climb higher.

by Brian Bergsagel

Most M&A transactions involve a discussion around adjustments to EBITDA. These adjustments to a company's reported financial statements are made to better reflect the true expected performance of the business. When used appropriately, these adjustments are a valuable tool for helping a buyer and a seller understand the real economic performance of the business and therefore avoid misunderstandings that could get in the way of a deal reflecting true fair market value. In essence, these adjustments create a transparent view of what is really happening. When used incorrectly, these adjustments create a lack of transparency, can cloud understanding and lead to a loss of credibility and a gap between a seller's valuation expectations and a buyer's willingness to pay.

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Over the past several years, we have observed a gradual increase in the number and magnitude of proposed EBITDA adjustments relative to a business' actual performance. While some of these adjustments are rational and defensible, others are not. Walking the line between defensible and aggressive adjustments is a risky game. Every seller wants to present performance in the best light, but moving too far from reality projects an image to buyers as to expectations and reasonableness in getting a deal done.

ADJUSTMENT CATEGORIES:

Broadly speaking, EBITDA adjustments can be categorized into four main buckets:

1. ***GAAP Adjustments:*** Adjustments to conform a company's financial statements to generally accepted accounting principles (GAAP)
2. ***Non-Recurring Income and Expenses:*** Adjustments to remove any income or expenses from one-time events
3. ***Ownership-Related Adjustments:*** Adjustments to remove owner-related and non-business related expenses that are unrelated to the generation of revenues and profits and, therefore, would not continue post-closing
4. ***"What-If" Adjustments:*** Adjustments to convey what performance would have looked like under different operating and market condition scenarios

As you make your way down the list, the adjustments become increasingly more hypothetical and there is less empirical evidence to prove the case. In the years leading up to 2020, we saw an increasing level of creative and aggressive adjustments within categories three and four. When these adjustments stray from true expected performance, they become counter-productive to the original purpose of EBITDA adjustments.

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THE COVID ADJUSTMENT

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Many have become familiar with the term "EBITDAC", or Earnings before Interest, Taxes, Depreciation, Amortization, and COVID. The idea behind this calculation is to understand

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what a business' performance would have looked like had COVID not occurred. This applies to both businesses that were negatively impacted by the pandemic, as well as to those that benefitted.

There are two sides to the COVID adjustment: expenses, and lost revenue. The expense side of the adjustment tends to be more defensible, and includes such costs as personal protective equipment, extra paid time off, hero pay, and more. As we discussed in our recent article, "Deal Making in a Pandemic," this portion of the COVID adjustment is generally accepted by the market. COVID revenue adjustments, on the other hand, receive much more scrutiny and are often heavily discounted or disregarded entirely. It can be difficult to accurately assess the exact missed revenue (and EBITDA) associated with the pandemic and how that missed revenue may impact the next few months and years.

DETERMINING DEFENSIBLE ADJUSTMENTS

So, how does one determine adjustments that will be accurate and accepted by the market, while also capturing full fair market value? By always coming back to the original purpose, which is to adjust reported financial performance to reflect the true expected performance in the ordinary course of business. Each adjustment must be examined under this lens.

Quality of Earnings (QOE) analyses have long been performed by buyers to validate seller-proposed adjustments and to identify adjustments that may not have been brought to light. This analysis is typically performed by third-party accounting experts who can review both the GAAP accounting and the less-concrete adjustment categories. The output of this analysis, a QOE Report, can be a crucial piece of diligence information for buyers and their financing sources.

Generally Accepted			
1. GAAP Adjustments	**2. Non-Recurring Income & Expenses**	**3. Ownership-Related Adjustments**	**4. "What -If" Adjustments**
Examples: ▪ Cash to accrual conversion ▪ Revenue recognition corrections ▪ Straight-line rent adjustment ▪ Monthly paid time off accrual	Examples: ▪ Transaction expenses ▪ One-time legal costs ▪ Income from Paycheck Protection Program loan forgiveness ▪ COVID expenses (e.g. personal protective equipment, extra paid time off)	Examples: ▪ Fair market owner compensation ▪ Excess family-related costs (auto allowances, inactive family members, etc.) ▪ Non-operating activities and assets ▪ Excess management compensation or generous benefits	Examples: ▪ Missed revenue due to COVID-19 ▪ Recent margin improvement projects yet to materialize in financial figures ▪ Planned expansion ▪ Business combination or merger economics
		Heavily Scrutinized	

The past several years have seen a rise in the use of sell-side QOEs, in which the seller commissions an accounting expert to assist in identifying and quantifying appropriate adjustments. When done well and used correctly, a sell-side QOE can improve market confidence that the adjustments are accurate. When a sell-side QOE is involved in a transaction, we tend to see fewer "creative" adjustments, and more data and analysis in support of each adjustment. The resulting adjusted EBITDA numbers in turn receive more acceptance in the market.

STAYING TRUE TO THE PURPOSE

The increased prevalence of adjustments to reported financial statements and the creativity of those presenting the adjusted performance is, in our opinion, moving away from the original purpose of these adjustments. It is not a game to see how creative one can be to produce an improved income statement. Buyers want to know the truth about how a business they are considering buying performs and will perform in the future. Sell-side QOEs are intended to give credibility to an argument that there are discrepancies in the actual statements that do not reflect the underlying economics of the business. When presentations deviate from that simple objective, trust is lost as a result of the perceived unreasonable nature of the claims and the length of the due diligence process lengthens, as buyers find the need to dig deeper to find out what is not being shared accurately. Eventually, each claimed adjustment will be evaluated within the original context of measuring real economic performance, but in the process there may be unexpected costs of time and lost opportunity. **zs**

Know Your Middle-Market Deal Team

It takes a village.

by David Working

A transaction process is a unique undertaking in the lifecycle of a business owner. It is often accomplished once, and the implied lack of experience and familiarity with the process is a meaningful source of discomfort. In such a state, most people would be expected to hold tightly to people or relationships that they trust, and we see many business owners doing exactly that. But the truth is that the highest-functioning advisory team for an operating company and the highest-functioning transaction team are not the same, and feature unique elements. Far from advocating that a business owner upset closely-held relationships, we instead advise owners to augment their close personal circle with professionals that bring value to the deal process.

We have written before [Creating Effective M&A Teams, 2018] about how to foster cooperation in a team of deal professionals. As a prequel to that discussion, we thought it worthwhile to highlight the key members of a successful middle-market M&A team and the roles they play in a transaction. As a note – many advisors (ourselves included) find it valuable to engage with business owners over a long period of time, far before the contemplation of a transaction and after the execution of the deal. We also encourage shareholders to engage other professionals throughout the process as personal advisors – most notably for wealth, tax, and estate planning purposes. But for simplicity's sake, we'll narrowly consider here the roles in the business transaction itself.

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INVESTMENT BANKER

The investment banker is the quarterback of the process, understanding and advocating for the seller across deal points and throughout the sale of the business. Bankers gather, organize, and prepare materials that explain the company to a market of buyers; handle initial contact and presentations to potential buyers; lead discussions and guide buyers' fact-finding process; and negotiate price and terms of the final deal. Bankers serve as the point of contact

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for all communications – they manage the needs and requests of other team members as a "traffic controller" on behalf of the owners. Other team members' findings and suggestions are put in context with the whole of the deal so that individual deal elements aren't considered or negotiated in a vacuum. The goal is to present key decisions to owners within a framework of supporting information and implications so they can make critical decisions without headaches. [A quick acknowledgement: of course an article about deals written by an investment banker is going to highlight our own importance. But truthfully, an orchestra needs a conductor, and someone who stays deeply involved in that role throughout the entire process is invaluable.]

LAW FIRM

The law firm plays many roles and often includes many different professionals along the process. The key M&A lawyer and their supporting staff play the critical role of translating negotiated business terms and deal language into accurate legal language, in the context of their active experience across many deals. In addition to the core deal team, other professionals will weigh in on buyers' areas of inquiry around litigation history, transaction structure, entity formation, tax implications, employment, environmental, or IT, and so on. In complicated transactions, a firm that has all of the different subject experts and the M&A team leader to coordinate their input and involvement is quite valuable. The legal team works very closely with the banker and owner in the negotiation of the deal in order to capture quickly changing negotiation elements throughout the process in a way that reflects the specific, unique aims of the seller.

It is impossible to overstate the importance of a lead deal professional whose main practice is middle-market business M&A, as that market context and experience enables the inclusion, exclusion, and language of key deal terms, and overall supports a faster, cleaner, and smoother process. Additionally, the seller's law firm needs to be able to match the buyer's legal representation in both expertise and deal team resources. Large national firms have expectations around pace and approach that, if not met by the seller, can overwhelm and cause challenges at very critical stages of the deal.

ACCOUNTING FIRM

An outside accounting firm can also play many roles in the process. Many regional accounting firms offer the capability of providing a Quality of Earnings study to support a transaction process; a "QoE" was rare not long ago, but is now very common in middle-market transactions for both buyers and sellers to commission. On the sell-side, this provides a framework and detailed support for how someone should think about the run-rate profitability of a business and highlights financial issues that can be mitigated if found in advance of a buyer's due diligence process. It can be critical for providing a consistent story through the marketing process, as well as having grounded answers for when potential buyers commission their own reports. Additionally, outside CPAs who compile, review, or audit annual financial statements can be called on to provide context or background to their findings early in the process as the investment banker works to put together a comprehensive understanding of the business.

TAXES

A special subset that can include professionals from law firms, accounting firms, or independent advisors is for taxes and the implications of a transaction structure on an owner's tax bill. More than just explaining what the tax implications will be of a certain deal structure, a tax advisor who can collaborate with the lawyer and banker on the front end to suggest structural alternatives for the transaction is valuable. This advisor may or may not be the company's current tax advisor, and most regional or larger law and accounting firms have professionals who specialize in tax planning and transaction structuring.

The better-presented and more detailed the support, the more likely a buyer will accept (and pay for) in the deal, either in pure economic terms or other associated elements of the deal structure.

CONSULTANTS

Much more deal-specific are the roles that special consultants can play in supporting the deal process. Some deals benefit by commissioning a study on a particular element of a marketplace, the competitive landscape, the behavior of a large key customer, or other elements that are particularly make-or-break from a buyer's perspective. Some consultants even step in and fill a management role throughout the transaction process (most commonly in a CFO or VP of Finance role that the company might not already have). Other consultants can provide an outside opinion about unique components of a transaction – real estate, special assets, environmental considerations, dealer/manufacturer relationships, permitting and regulatory impacts to name a few – that are critical to helping a buyer become educated about the risk (or lack thereof) of a certain deal element.

MANAGEMENT

Finally, the management of the company plays a critical role throughout the process. Questions about the business's past, present, and future – and both the quantitative support and narratives that create the body of knowledge that a buyer will consider in a transaction – have to ultimately be supplied and articulated by the management team. The CEO or business leader, the CFO or head of accounting and finance functions, the chief sales and marketing officer, and the COO or operations leader all play important, time-consuming roles in the months leading up to and continuing through a transaction. While the investment banker can be valuable in optimizing and focusing these professionals' time and energy, it is impossible to fully divorce the transaction process from the people who play key management roles.

In totality, this is quite a team, and we find it is usually deeper than a business owner first expects. Far from being frivolous, the key focus of the team's job is to provide potential buyers with a thorough, consistent, and convincing story about the present condition and future direction of a business, for which multiple skill-sets are best-suited. The better-presented and more detailed the support, the more likely a buyer will accept (and pay for) the business in the deal, either in pure economic terms or other associated elements of the deal structure. **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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