2019 Trends:
Top considerations for today’s M&A deals

Long-time UMB lending chief, Tom Terry, explains how to find the right fit and maximize ROI in today’s volatile M&A climate.

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Tell us about the M&A landscape today. What are the trends you’re seeing as a lender?

The biggest trend we’re seeing is strong and widespread interest in buying companies as an investment, and a huge amount of money is waiting to be utilized for that purpose. Family offices and individuals with significant wealth are nervous about the stock market. Low interest rates mean they’re not buying bonds, so they’re choosing to invest in companies instead. Because of the proliferation of high-net-worth individuals interested in buying, we’re also seeing increased private equity (PE) activity involving funds supported by multiple investors.

Related to that, purchase prices are at historic highs, with earnings before interest, tax, depreciation and amortization (EBITDA) multiples reaching over 10. High multiples mean two things—first, that it’s a sellers’ market. Second, purchase price inflation has led to increasingly large “air balls,” or differences between purchase price and asset valuation, which determines the amount of debt a buyer is willing to take on to buy a company.

**WHAT IS AN M&A AIR BALL?**
The difference between the purchase price and the asset valuation.

**Example:**
$8 million purchase price, $5 million collateral assets, = $3 MILLION AIR BALL
Larger air balls add complexity to the financing process, as the lender must decide whether they’re willing to lend enough to bridge the gap. If the sum unsecured by collateral is too large, a bank may not approve that loan if the air ball hasn’t been accounted for elsewhere in the deal. For example, if a buyer purchases a company for $8 million and that company owns $5 million in collateral assets, there is a $3 million air ball in that transaction. The purchase price gives the appearance of $3 million in additional net worth, but, in reality, the additional value isn’t there. From an accounting perspective, the buyer over paid by $3 million. Helping clients understand and account for this valuation gap has been a common theme in recent deals, given the high multiples we’re seeing.

**OTHER THAN THE FACT THAT THE MARKET IS HOT RIGHT NOW, WHAT ARE THE REASONS A COMPANY WOULD WANT TO ACQUIRE OR BE ACQUIRED BY ANOTHER COMPANY?**

Beyond the fact that there’s a lot of money circulating right now, there are several reasons a company may decide they want to be acquired. They may be out of funds, lack a succession plan to replace aging leadership, or they may simply have hit a growth ceiling and don’t have enough capital to break through to the next level on their own. When a company hits the end of its business line, the owner has three options: family succession, creating an employee stock ownership plan (ESOP) for an employee buyout, or engaging an external buyout. On the other side, there tend to be two types of buyers. Strategic buyers are typically in the same business or industry as the company they want to acquire and are interested in buying that company as a means of eliminating a competitor or expanding into new markets. Investment buyers, on the other hand, are motivated by return potential. They believe in the company and feel that, by buying it, they will provide the strategy, technology, or capital it needs to grow. Whereas strategic buyers tend to be other companies, investment buyers are usually PE firms.

**COMPANIES MAY BE OPEN TO ACQUISITION IF:**

- They need cash flow support
- Growth has plateaued
- They need a formalized succession plan for leadership
- They need financial backing to advance business, whether through technology, expansion or other expenses
LET'S TALK ABOUT A BANK'S ROLE IN M&A TRANSACTIONS. HOW DOES THE PROCESS TYPICALLY BEGIN?

For individual buyers, the M&A process starts with a conversation with their lender. Ideally, business strategy should be part of regular communication, so the banker can help evaluate opportunities as they arise. When the bank sees their financials on a monthly or quarterly basis, they are well positioned to assess whether a potential deal is worth exploring.

When the buyer is a PE firm, the process can be slightly different. PE firms usually maintain relationships with lending banks and reach out to their contacts when they’re interested in a deal. As those relationships mature, both parties benefit from a mutual understanding of the types of deal structures that work for the lending bank. UMB has made an effort to build relationships with in-market PE firms over the years, and we find the result to be a win-win; as a lender, we are connected with well-vetted borrowers, and the PE firms we work with are able to secure the funding they need.

Because PE firms operate on a shorter ROI timeline, the deal may be structured differently to support their specific investment objectives. Lenders need to understand that the buyer will be making decisions based on the goal of growing the company quickly; they’ll be asking for more working capital and more term debt than an individual buyer likely would. While there have been cases in which investors have asked for more than we can give, we typically find the firms we work with have a good understanding of what’s possible from a lending perspective.

HOW DOES THE BANK SUPPORT A CLIENT ONCE THEY’RE INTERESTED IN ACQUIRING ANOTHER COMPANY?

As a lending partner, we want to ensure our client is prepared for anything that might arise during or after the deal. Because there are so many different factors to consider in any M&A deal, the financing structure isn’t always the same, and all kinds of scenarios are possible. Generally, we try to start the process by educating the client on what they may expect during the transaction based on our experience.

Preparing a client for a deal involves a few different exercises, all designed to mitigate risk and ensure the deal goes through as planned.
First, we want to make sure that the buyer has assembled the right team to guide them through the process. The “big three” team members in any M&A deal are your banker, attorney and accountant. Because specialized input is required to determine the structure of the deal, we advise our clients to involve the necessary players early and to maintain clear communication between parties.

Next, we do our due diligence by challenging the buyer to test whether they’ve analyzed their strategy and considered benefits, costs, expectations and potential pitfalls. One of the most important functions we perform for buyers is solidifying their understanding of why they’re purchasing a particular company and how their strategy will ultimately benefit their business.

Are they planning to cut costs, or just grow market share? Are they buying new products or expertise they don’t have today? Do they know the customer base? Have they seen the company’s accounts receivable? Growth alone may not be a good reason to acquire a company, and it’s our job as both lender and advisor to evaluate whether the reasoning behind the decision is sound.

Another important way we support our clients is by helping them stress test the deal to account for potential pitfalls and to mitigate risk associated with the deal. We start with today’s environmental factors and forecast what may happen under various conditions. For instance, what happens if sales drop 25 percent, or we lose our biggest customer to a competitor? How much would a 20 percent decline in gross profit margin shock debt service coverage? How much cushion is there before debt service becomes negative? We want to make sure buyers have thought about these scenarios and are ready to answer questions like these. If they can’t, it’s a sign to the lender that they are underprepared.

Finally, we help facilitate the deal by determining the method of financing best fit to that transaction. We add value by consulting on financing options and by doing it early, so we can address all potential issues before the contract has been signed. As we’ve already discussed, one of these issues might be the air ball between purchase price and asset valuation. One way to bridge the gap is to have the seller carry a note back, which alleviates the risk of unsecured financing. If the seller won’t carry anything back, the buyer may not pay the full asking price. That carry-back note is a big negotiating tool, and one that we want our clients to understand as the deal takes shape.
WHAT ARE SOME COMMON MISTAKES YOU SEE IN M&A TRANSACTIONS?

The biggest issues arise from moving too quickly. Sometimes a deal requires a quick turnaround, but it’s very important to not get ahead of yourself. Signing the contract before securing financing, discussing financing with the other party before talking to your lender, or failing to assemble a team of key players early enough in the process can all cause problems that, when they don’t cause the deal to fall apart entirely, can make the transaction more complicated.

On a similar note, buyers sometimes make the mistake of showing their hand too quickly. Ideally, you want to avoid indicating that you’re a motivated buyer. If the seller knows the buyer is desperate and willing to overpay, that gives them an advantage they can leverage in the deal agreement.

Other common mistakes typically arise from a lack of due diligence. From a financial perspective, failing to stress test the deal to account for unforeseen losses or performance decline is a big problem and can lead to deal collapse or unexpected issues after closing. From a personnel standpoint, it’s equally as important to think about the impact of the merger on company culture, employee retention, and client relationships. Failing to consider the potential people-driven risks involved in a deal can leave buyers with client attrition or unexpected holes in leadership teams. It’s crucial to build relationships with clients and employees and address cultural concerns proactively.

Many factors contribute to a successful M&A deal. Our job as a lender goes beyond financing the transaction; before we ever determine a financing structure, our focus is in on serving as an advisor and ensuring our client has considered all of the logistics, implications, and potential costs of the deal prior to entering into a contract.

Common M&A mistakes:
- Moving too quickly
- Showing your hand
- Not assembling the right team
- Not stress testing
- Forgetting the human element

Failing to consider the potential people-driven risks involved in a deal can leave buyers with client attrition or unexpected holes in leadership teams.