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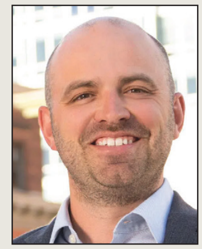

Streekstra

Roth

— ROUNDTABLE —

INFLATION, INTEREST RATES, GLOBAL CONFLICT COMPLICATE M&A OUTLOOK

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After an active dealmaking year in 2021 that was fueled by private equity, the M&A outlook for 2022 is slightly more clouded as inflation grows to 40-year highs, the Federal Reserve begins bumping up interest rates and Russia's invasion of Ukraine disrupts financial markets.

Still, business executives and M&A experts forecast a busy year as private equity continues to play a dominating role in dealmaking, and as business owners continue weighing their future after two years of pandemic disruptions.

During a recent MiBiz executive roundtable discussion sponsored by Grand Rapids-based law firm Varnum LLP, investment bankers, advisers and buyers shared an optimistic outlook for dealmaking despite the ongoing swirl of market disruptions that also include labor shortages and supply chain challenges.

Participating in the roundtable were:

- Dana Jacks, president of Century Technology Group Inc., an Ada-based family office that provides tech companies with growth capital, administrative resources and consulting;
- Raj Kothari, managing director of Southfield-based investment banking firm Cascade Partners LLC;
- Deidra Mitchell, president and CEO of Grand Rapids-based Waséyabek Development Co., the non-gaming investment arm of the Nottawaseppi Huron Band of Potawatomi;
- Pete Roth, senior corporate and M&A partner at Varnum; and
- Mark Streekstra, managing director of Grand Rapids-based investment banking firm Charter Capital Partners.

Here are some highlights from the discussion.

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Do you still see a strong pipeline for quality deals, or are you beginning to see exits driven by market or other factors?

JACKS: We're actually seeing a lot more deal flow than we have in the past. The last year was pretty chunky, and I think there were some unrealistic expectations set in the marketplace. But looking forward, I think with some of the government subsidies changing right now and going away, there's a level of reality that's starting to hit. Mostly in that $10 million to $30 million range is where we're seeing the most spike in the deals coming into play. It's been much better than it's been the last two years, I will say that.

MITCHELL: I would agree. I think the market is very active. I also think everyone got through the pandemic and now it looks like the subsidies are going away and the picture's changing a little bit and now we have these looming questions of inflation and all of that. There are a lot of people who maybe were on the fence about selling that are thinking this might be a good time to wrap it up and move along.

ROTH: Q1 was actually a little softer, from what I saw. Last year was just a record year — 2020 was a record year then 2021 we saw almost double the deals we saw the year before. Q4, particularly, being tax driven, among other reasons. I think some of the Q1 2022 deals got pulled ahead into Q4 of last year. There's a strong pipeline out there. I would just say the first quarter was a little softer and I think there's some uncertainty among some buyers (over) interest rates, inflation, world uncertainty, subsidies ending, all of those things. I still think there's a lot of people looking to sell, but buyers are treading just a touch more carefully than maybe they did last year. I think it's going to be a good year, but I think deal flow will be down.

STREEKSTRA: Honestly, I think the market was taking a collective breath from what happened in Q4 of 2021. There was so much activity, deals got pulled up, and I think everyone just needed a few weeks to reset. Since then, things have been very strong from what we're seeing. Even with the uncertainty, there's still so much capital out there and there's so many strategic buyers that have prioritized M&A as a large piece of their growth strategy that the competition for deals is still strong enough. Overall, I'm expecting a really strong year. Whether it lives up to 2021 remains to be seen, but I think it will be another strong year.

How significant are interest rate increases, inflation and the conflict in Ukraine as they start to snowball?

STREEKSTRA: Interest rates, in particular, we're keeping a close eye on just given the reliance that the private equity buyer group has on debt when they're doing deals. As interest rates rise, depending on how much they rise, that can affect returns. I see that as one of the larger risks to valuations that really have been going up for eight to 10 years now. There's always been this thought that they've got to come down sometime, but what's going to drive it? I think this could certainly be a factor.

ROTH: On interest rates, I think that could help strategic acquirers. I put Deidra and Dana in that category. Private equity relies so heavily on leverage, for better or for worse. I think it might chill a little bit of their valuations.

JACKS: You're spot on with that. We always say we're waiting for the rainy day. Well, we feel the rainy day is going to be coming soon.

How deeply during the due diligence phase are you examining supply chain issues, and what lessons have you learned during the pandemic?

ROTH: I think people are diligencing it. In one instance, there was a repricing on a deal based on concerns with that supply chain and whether it would be able to hit projections. It's something I didn't see people have on the diligence checklist two years ago. That's something where people have seen issues and now it's on everyone's checklist.

MITCHELL: It's certainly a topic of discussion with the board. We might have a little more history in how supply chains are impacted by global conflict. We might be able to define that a little better than global pandemic. Maybe that's a positive, I don't know.

JACKS: I see that as an opportunity, though. If you can solve some of those supply chain issues, that's where a lot of opportunity lies. In the industries we're in right now, we've really gotten out of the hardware componentry, but one of our previous platform companies was very heavy into the hardware, and whenever there were global issues going on, we saw that as opportunities to jump on. You can solve some of those issues ahead of time.

When do you see a course correction on company valuations and multiples after disruptions during the pandemic?

ROTH: I think the biggest impact of the pandemic on valuations was for buyers to try to figure out what are the real numbers you were applying the numbers to. Did you have a COVID bump? Did you have depressed value because of COVID or because the business was flawed? That was something I saw a lot of buyers struggle with. As for where multiples are going, I've been predicting they would go down for three years.

STREEKSTRA: If any of us could predict that, we'd probably be on a beach right now somewhere. I think interest rates are a big thing to keep an eye out for depending on how much they end up going up. The other factor to look out for is the private equity exit cycle. So many different private equity groups have entered the market the past five years. They've been very active in buying. Ultimately, their five- to seven-year hold period is going to be coming up. If you start to see returns in the private equity space going down a little bit, I think you're going to see people pulling back on valuations knowing they can't exit at the levels they thought or hoped they could. That may still be a little ways out, but I can see that over the course of the next couple years coming into play.

Are you seeing banks' appetites to finance deals change at all?

KOTHARI: It's incredibly competitive for them, especially commercial lenders, which are bumping up against the non-traditional lenders. They're deploying a lot of cash. They're not making any money if they're hanging on to the cash, so they've got to get it out the door. They're still dealing with a regulatory box, but they are aggressively trying to figure out how to deploy cash. The non-traditional lenders are making the traditional lenders open their eyes a little bit and try to be a little more aggressive, but they're still boxed in by the regulatory constraints.

What are you seeing causing distressed deals, and who are they looking at for buyers in some cases?

KOTHARI: I think we're seeing people be more opportunistic on distress. While the numbers are increasing, they're increasing off of a really small base. Everybody's always looking for a bargain. For some, it can be great.

ROTH: But distress also has risk. A lot of times, those companies are distressed for a reason. So if you're a buyer of a distressed (company), you have to go into it a little 'eyes wide open,' and that's again why strategic (buyers) may be better than private equity here because a strategic knows what to look for, they can diligence it. It's an opportunity, but there's also risk there.

Are you still seeing people speed up the diligence process just to get deals done as has been the case in recent years?

ROTH: People want to differentiate themselves. If you can say you'll do it quickly, that's a differentiator to a seller. Interestingly, I've seen an uptick in post-closing indemnity claims lately, as well on the legal side where maybe they didn't do all the diligence they should have then they find a problem and they're looking for somebody to sue. A lot of times, we're seeing a seller get a clean walk because the only recourse is the insurance policy. Given the glut of deals, given that 'diligence light' we've seen, my litigators think they're going to be busy this year, put it that way. We're seeing an uptick in post-closing litigation.

JACKS: From our perspective, we're slowing down on diligence. There's just too many variables going on right now. We are looking at one deal right now where the seller's motivation really doesn't match the financials at all. It's giving us pause and making us really dig in.

KOTHARI: Part of it is: This is the normal ebb and flow. Insurance is changing people's approach to it as well. That's changing some attitudes about areas of diligence. Cybersecurity and I.T. was embedded in other diligence — now it's its own diligence track with its own consultants and its own gray hair that goes with it.

MITCHELL: The tribes have always been really conservative when it comes to diligence, so I never got the light diligence part.

STREEKSTRA: I've had buyers where (light diligence) is a bit of a red flag, with buyers saying: 'Why are you moving so quickly? Is there something that you know that I don't know?' If they had a record year and want to close quickly, some view that as a red flag. MiBiz

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