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— EXECUTIVE ROUNDTABLE —

M&A due diligence goes deeper, draws out deals as cost of capital increases

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West Michigan M&A professionals describe a market where deals today get closer scrutiny, particularly as lenders ask more questions as the economy slows with higher interest rates.

While deals are still getting done, the due diligence process has been going deeper, extending the time it takes to close transactions, according to a recent M&A executive roundtable discussion hosted by *MiBiz*.

"The whole process does seem like it's taking a little bit longer because everybody's a little more cautious" given the economy and higher interest rates, said Monica King, CEO of **Gun Lake Investments**, the Grand Rapids-based non-gaming investment arm of the Match-E-Be-Nash-She-Wish Band of Pottawatomi, or Gun Lake Tribe.

Jason Kuipers, executive vice president at Ada-based **Century Technology Group**, a family office that invests in tech companies, sees a market that has a "little bit of tentativeness" where "the drive up in due diligence is really becoming much more challenging than it used to be, or much more stretched out than it used to be."

The higher level of due diligence for proposed deals was just one of the observations participants offered during the roundtable, which was sponsored by Grand Rapids-based **Varnum LLP**. They also said they expect to see more distressed deals, particularly involving highly leveraged companies.

The drive for more due diligence has "been a trend that's been unfolding for some time," as the Federal Reserve for more than a year rapidly raised interest rates to fight high inflation, said Matt Miller, managing director of **BlueWater Partners LLC**, a Grand Rapids-based investment banking firm.

"Part of that is what's happening in the economy with rates," Miller said. "It's just turning over every stone."

In their latest U.S. economic outlook issued Feb. 17, University of Michigan economists said they expect the Federal Reserve Open Market Committee will increase interest rates twice more this year. The economists do not expect rate cuts to begin until early 2024.

Set against that rate environment and outlooks for a mild U.S. recession later in the year, buyers today are "a little more cautious — strategic buyers a little more so than financial buyers," Miller said.

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Byrd


King


Kuipers


Miller


Roth


Streekstra

MiBiz M&A Executive Roundtable

Participants in the MiBiz M&A Executive Roundtable, which was sponsored by Varnum LLP, included:

- Jason Byrd, managing partner at Concurrence Capital Holdings LLC
- Monica King, CEO of Gun Lake Investments
- Jason Kuipers, executive vice president at Century Tech Group
- Matt Miller, managing director of BlueWater Partners LLC
- Pete Roth, senior corporate and M&A partner at Varnum LLP
- Mark Streekstra, a partner and managing director at Charter Capital Partners

Charter Capital Partners' Mark Streekstra, left, and Jason Byrd of Concurrence Capital Holdings, right. MIBIZ PHOTOS: JOE BOOMGAARD

"I think it really comes down to the target company and the quality of the company, and the industry and how well they're managed," said Miller, who added that there remains "piles of dry powder" in private equity that investors need to deploy that should support deal flow.

"It seems to really create a floor in terms of activity," Miller said.

Private equity dry powder, or the amount that investment firms have on hand to invest, totaled $787.5 billion in the U.S. at the end of 2022, a 10.8-percent decline from a year earlier, according to a recent report from Pitchbook. 2022 was the second straight year dry powder declined in the U.S., although the year-end level was well above most years going back a decade.

Investment by U.S. private equity firms declined in 2022 from the prior year to 8,897 deals that were collectively valued at $1.0 trillion, according to Pitchbook. That compares to 9,120 transactions for $1.25 trillion in 2021.

Even with the reduced deal volume last year, 2022 was the second-best year in the last decade for private equity investing, according to a recent Pitchbook report.

Peter Roth, a senior corporate and M&A partner at Varnum, describes a market where there's "still a lot of money chasing deals" and "still a lot of deals, but they're harder and, I think, more challenging (with) more headwinds."

"I think it's a choppy market. … We're seeing a lot of deal flow, but deals are harder to get done," Roth said. "A lot of deals have started then stopped and gone on a hold, and then restarted. So, (there's a) lot of disjointed efforts in the market. People are focusing on diligence more, and lenders are pushing diligence more. Deals that a year ago were getting done in ways that made lawyers nervous because nobody even cared about diligence now maybe have swung too far the other way. People are digging up everything."

The present market dynamics have made buyers and sellers "a little more selective and more focused on quality," Miller said. Valuations that have been running high the last few years have begun to ease as well, he said.

"It seems like we're in this period of adjustment in terms of valuations. They are starting to come down. There's always a gap, but expectations are probably still catching up with that," Miller said. "We think that will be a bit of a headwind (for deal volume) this year as people adjust to that."

However, high-quality deals are proving to be the exceptions to the general market dynamics, said Mark Streekstra, a partner and managing director at **Charter Capital Partners**, a Grand Rapids-based investment banking firm.

Well-run companies that are strongly performing should remain in high demand if their owners decide to sell, said Streekstra, a sentiment other roundtable participants echoed.

"The really high-quality deals, we don't see as much of the effect," Streekstra said. "The valuations are still holding very strong, the diligence is moving quickly, people aren't focused on the little miss that they had last month. They see the larger picture. But with less-quality companies with question marks, that's where we're seeing things get drawn out. Diligence providers are really digging in on points that maybe they wouldn't otherwise, and it just makes things more difficult to get done."

Top: Varnum's Peter Roth, left, and Monica King of Gun Lake Investments, right. Bottom: Jason Kuipers of Century Technology Group, left, and Mark Streekstra of Charter Capital Partners, right. MIBIZ PHOTOS: JOE BOOMGAARD

As 2023 progresses, Streekstra expects to see more quality deals come to market "as some of the economic uncertainty potentially starts to even out a little bit" and the M&A market starts to "see a bit of an influx."

Valuations have not come down necessarily for high-quality deals, although those companies may get interest from few buyers, Roth said. That may result is more due diligence occurring on a proposed transaction, particularly by lenders financing the deal, he said.

"The bankers might find there's one party making that premium offer instead of five," Roth said. "So, they can say, 'I'm going to take 60 days and I'm going to really do the diligence,' as opposed to a year or two ago, the banker would say, 'Look, we have five people that are right around this number, you'd better close in 15 days.' That's prevented you from doing the deep dive or if you find a little problem, digging to see if it's a bigger problem."

A year ago, Roth also noticed transactions where parties passed on representations and warranties insurance "because they wanted to get the deal done," he said. "Now, they're not doing that anymore."

Even with the higher due diligence and reluctance among some buyers, Jason Byrd, managing partner at **Concurrence Capital Holdings LLC**, a Grand Rapids-based investment firm, expects to "see a lot of opportunities" in 2023. Concurrence Capital's deal flow has picked up "a bit."

Higher interest rates raised the cost of capital and pressured valuations, "but what is not changing, and that's why I do believe that 2023 will be a pretty solid year, is that just the average age of just the business owner is getting older," Byrd said.

As business owners hit retirement age and perhaps lack a next generation to take over the company, they'll decide to sell, he said.

"People aren't getting younger," Byrd said.

Some owners today also are driven to come to market after they navigated the company through the pandemic and now face a potential economic downturn. Given the economic uncertainty, they do not want to go through any economic downturn.

"It feels like there's a push for those who have waited a little bit too long to get out because of fear of what maybe's still yet to come," King said.

Added Streekstra: "What we've heard from a couple clients is, 'We just went through COVID, you're leading a company and battled your way back. Do you really want to face another really hard time with the business just for a little bit more value?'

"It's so individualized based on what the goal of each seller is, but if you're in the area of retirement and you think you're staring a recession in the face, that's not an easy time to be a business owner. That could be enough to convince you to find the right partner, get some help through it. Maybe you do have to stay involved with a little equity, but at least you have another seat at the table to help you navigate it."

Some sellers are taking the opposite approach and waiting for a clearer economic picture, rather than run a deal.

Byrd described how some sellers are "just pausing at this point."

"The fourth quarter was a really tough quarter," Byrd said. "A lot of the people we try to stay in contact with, a lot of the deals they anticipated were going to be coming to market at the end of last year, very early now, they just totally hit the pause button and they're just waiting to see."