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CORPORATE FINANCE PRACTICE

DEAL ADVISOR DIGEST

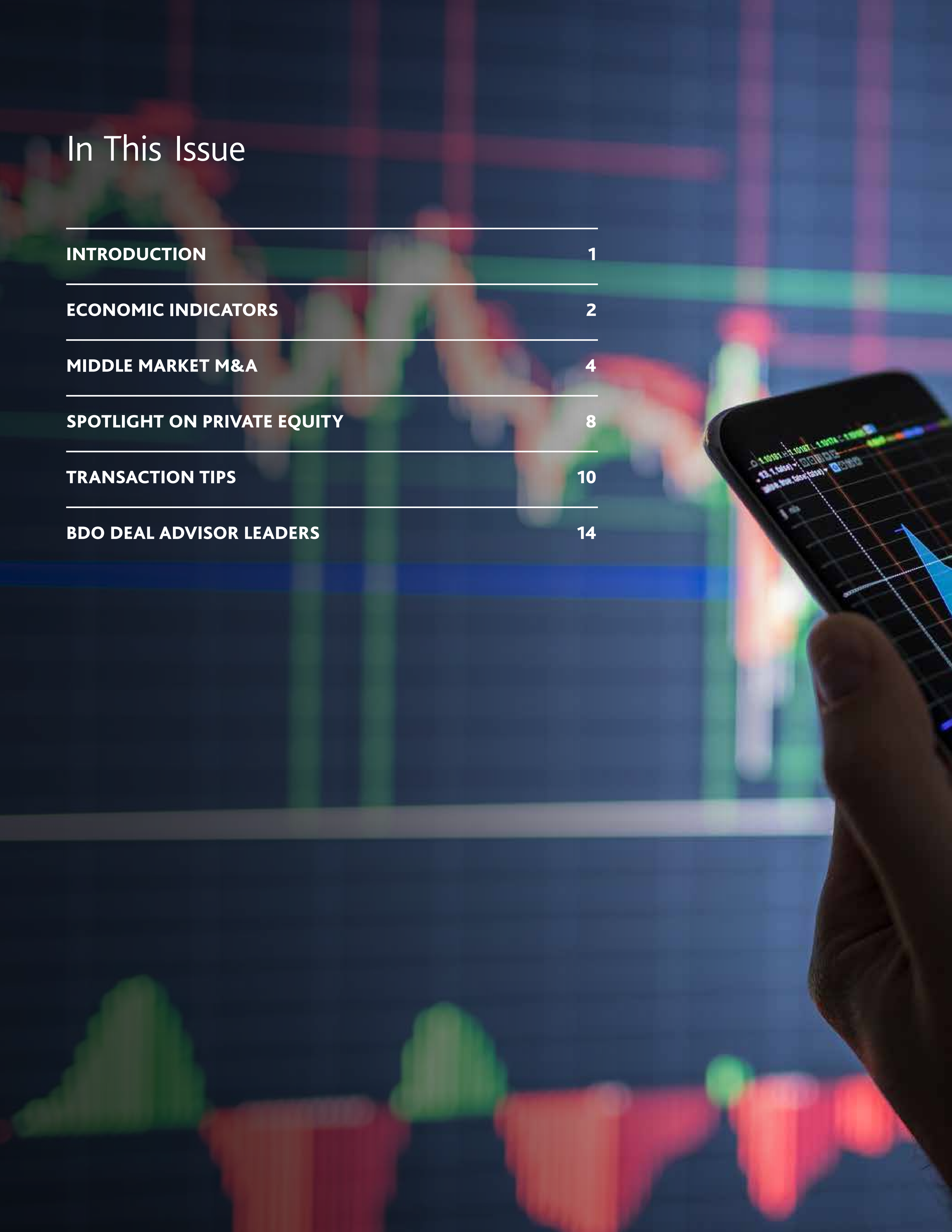
M&A Trends Report

Q3 2019 / ISSUE 3

UNLOCKING TRANSACTION VALUE THROUGH DILIGENCE

BDO

In This Issue



Introduction

The U.S. M&A market got off to a slower start in 2019 given uncertainty around the government shutdown and volatility in the public equity markets, but conditions look stable for the balance of the year as private equity firms and corporations vie for high-quality targets.

Though public and private companies will continue to face differing forces, capital is accessible and motivated sellers will ensure continued merger and acquisition activity. A growing U.S. economy, abundant cash, and low interest rates following a rate cut will also contribute to demand.

Economic Indicators

Following an uneven end to 2018, economic indicators point to a more positive outlook for public companies and consumers in the near-term based on the economy's performance in 1H 2019. Solid fundamentals offer an attractive environment for deal-making, but a tenuous global economy and a cautiously optimistic U.S. market underscore the importance of due diligence to ensure short- and long-term value in any deals.

U.S. Gross Domestic Product (GDP)

First half GDP growth beat expectations with 3.1 percent growth in Q1—significantly higher than both the initial expectation of 2.3 percent and the year-end slump in Q4 2018. Though the second estimate for Q2 GDP growth slowed to 2.0 percent, the quarter outperformed low expectations below two percent growth. An interest rate cut, strong job numbers, stock performance, and government spending buoyed the economy in the first half, overcoming the impact of the government shutdown in the beginning of the year. As the U.S. economy continues to grow despite market volatility, conditions are ripe for deal activity.

Source: **U.S. Bureau of Economic Analysis**

Institute for Supply Management (ISM) Index

Overall economic growth continued for the 122nd month at the end of Q2 and marked the 34th consecutive month of expanded activity in the manufacturing sector, though this growth is softening. The PMI registered at 51.7 percent at the end of June, the lowest reading since October 2016. The first half of 2019's performance, though evenly mixed, highlights the resilience of the manufacturing industry, which is facing pressure from continued geopolitical tensions between the U.S. and China and throughout the global economy.

Source: **ISM**

Auto Sales

New vehicle sales have slowly tapered off in the first half of 2019, as anticipated by the industry. The forecast for annual sales in 2019 stands at 16.9 million, the lowest since 2014. Smaller tax refunds, down an average of 16 percent per taxpayer compared to last year, may have played a role in the weaker performance this past half. Higher interest rates have also been cited as a factor slowing new vehicle sales, but the auto industry could see a reversal in these figures following the Fed's rate cut.

Source: **Automotive News**

Housing Starts

Privately-owned housing starts through the end of Q2 fell 1.8 percent below May 2019 but outperformed the June 2018 rate by 5.2 percent. Though consumers may be encouraged by a continued lower-cost borrowing environment, the mixed performance highlights the challenges the real estate and construction industry face with labor shortages and rising material costs, in part due to trade uncertainties. While a lower-interest policy from the Fed may drive consumer demand in 2019, material, labor and trade concerns are likely to persist.

Source: **U.S. Census Bureau, U.S. Department of Housing and Urban Development**

Corporate Profits

Recovering from December's slump, the S&P 500 soared to record heights and near record growth in 1H 2019. The S&P's 17.4% growth was the best first-half performance of the index in over two decades, with the index expected to hit 3,000 for the first time ever in Q3. June's performance, in which the benchmark rebounded from a trade-related plunge in May, was the best for the month since 1955. Following at least one rate cut in 2019, improving fundamentals present a prime opportunity for deal activity—but also an increased need for due diligence, as some companies may become overvalued or overbought as the market continues its bull run.

Source: Standard & Poor's, **Yahoo Finance**

Unemployment

Unemployment figures fell through the first half of 2019, closing at 3.7 percent through the end of June—down from 4 percent in January—to match Q3 2018's 10-year low. Employment increased in professional and business services, health care, and transportation and warehousing. Positive performance is expected to continue through 2019.

Source: **National Conference of State Legislators**

Consumer Indicators

The Consumer Price Index (CPI-U) grew slightly in 1H with a seasonally adjusted 1.6 percent rise over the past 12 months to 256.143. Consumer confidence in 1H 2019 was in line with the mixed economic conditions over the past nine months, with the Consumer Confidence Index reaching 135.1 in August. Though the trade and tariff tensions may have manifested in lower consumer confidence levels, increasing steadiness from the Fed and cautious optimism regarding market performance and wage growth is likely to drive renewed confidence.

Source: **Bureau of Labor Statistics, Nielsen/The Conference Board**

Oil Prices

The first half of 2019 was inconsistent for oil prices. While global oil prices saw the largest quarterly gains in nearly a decade during Q1—during which the global benchmark for Brent crude rose 27 percent and the price of WTI gained 32 percent—increased geopolitical pressure, softer the global economic signals and strong U.S. supply are putting downward pressure on prices. The EIA anticipates inventory build of only .3 million b/d by 2020 and for prices to remain near current levels—about $64/b—through the rest of 2019. Though further geopolitical or wider macroeconomic uncertainty may drive prices lower than expected by the EIA, prices are unlikely to fall below the $50-60/b range.

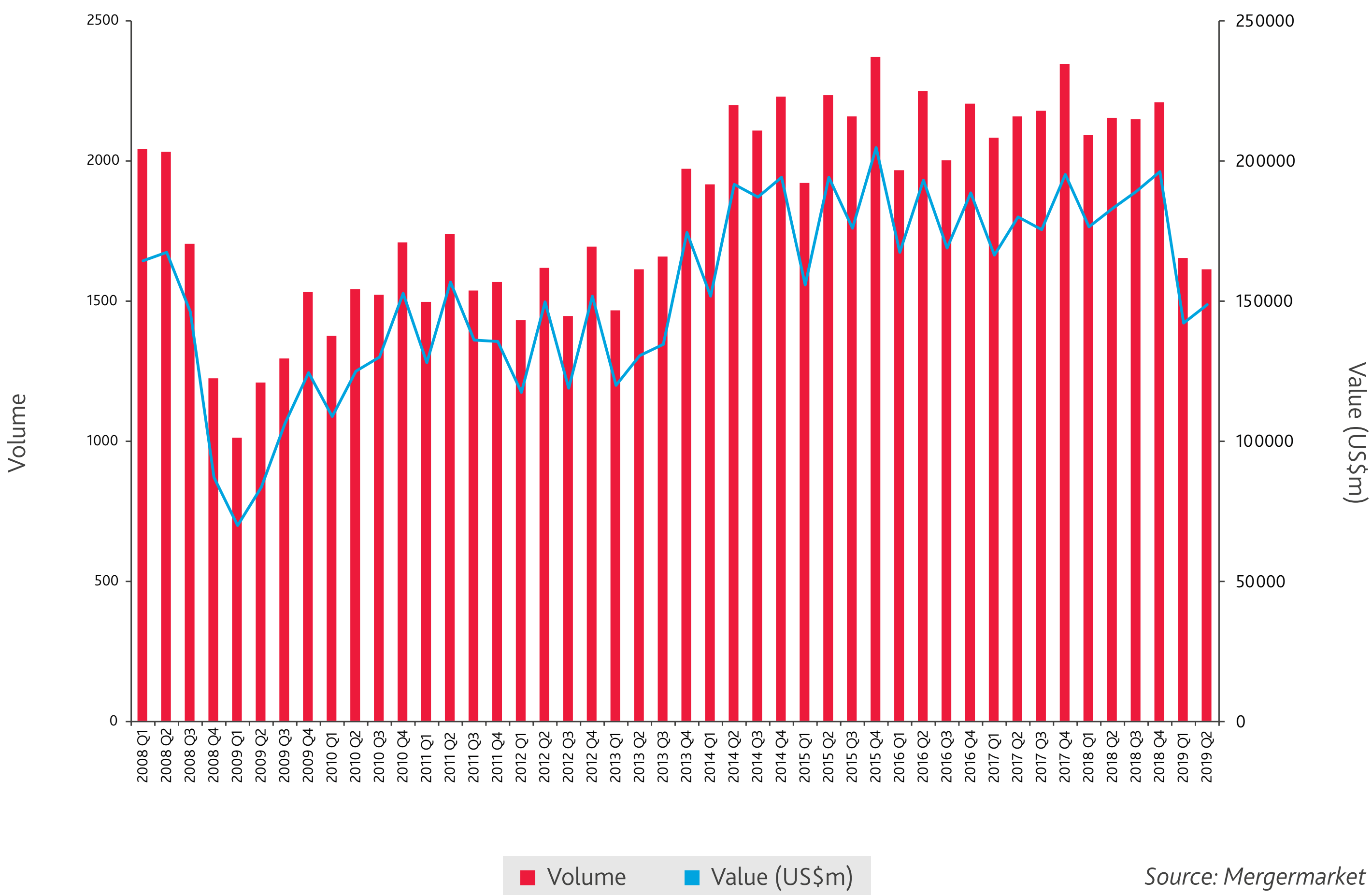
Source: **EIA**

Middle Market M&A

GLOBAL MIDDLE MARKET

Global middle market M&A activity in 1H reached $290.8 billion through 3,266 deals, according to Mergermarket. While this marked the slowest start since 2013, the North American market served as a bright spot, with an increase in deal value at the end the second quarter.

GLOBAL MID MARKET M&A



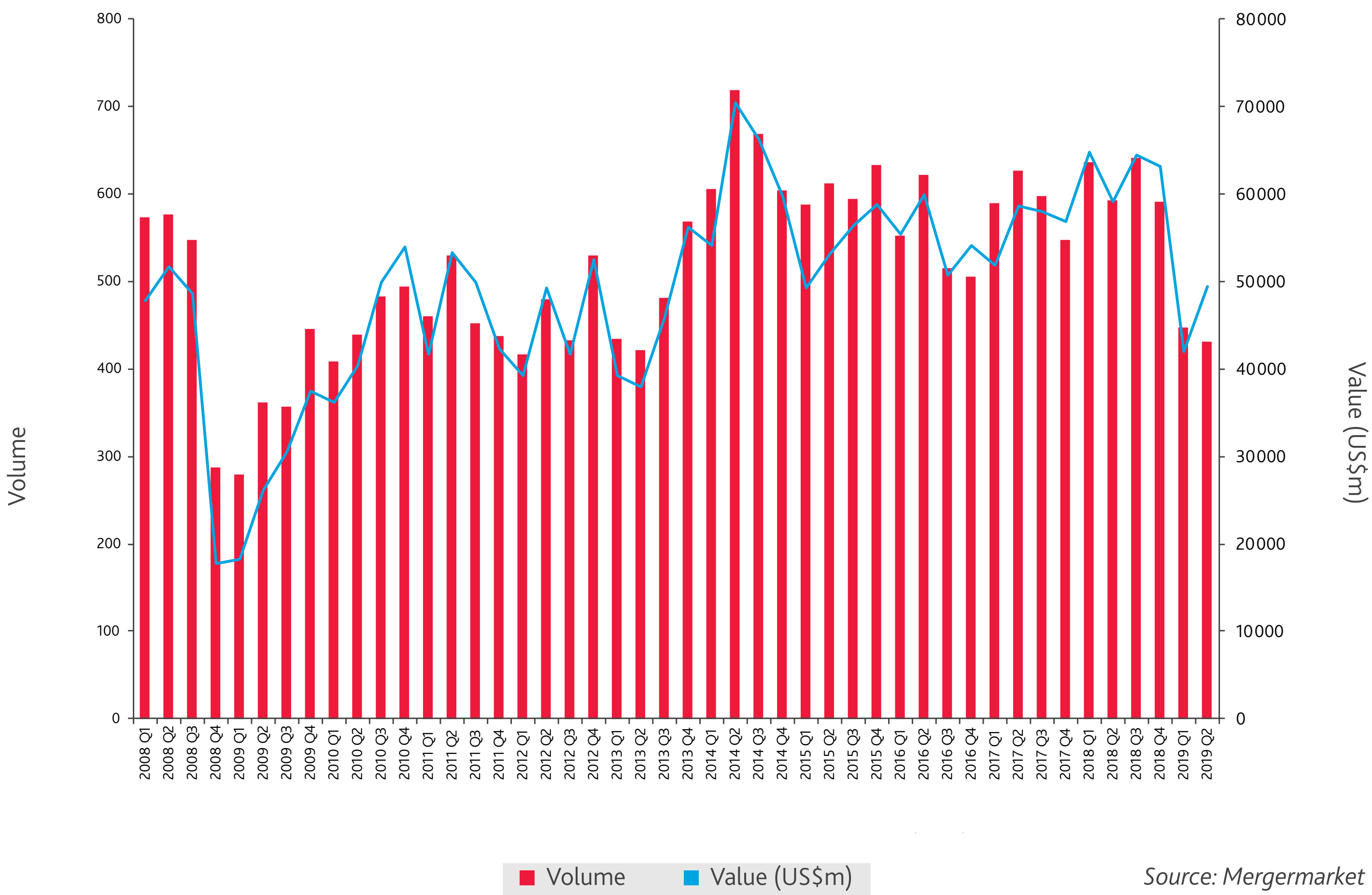
Source: Mergermarket

NORTH AMERICAN MIDDLE MARKET

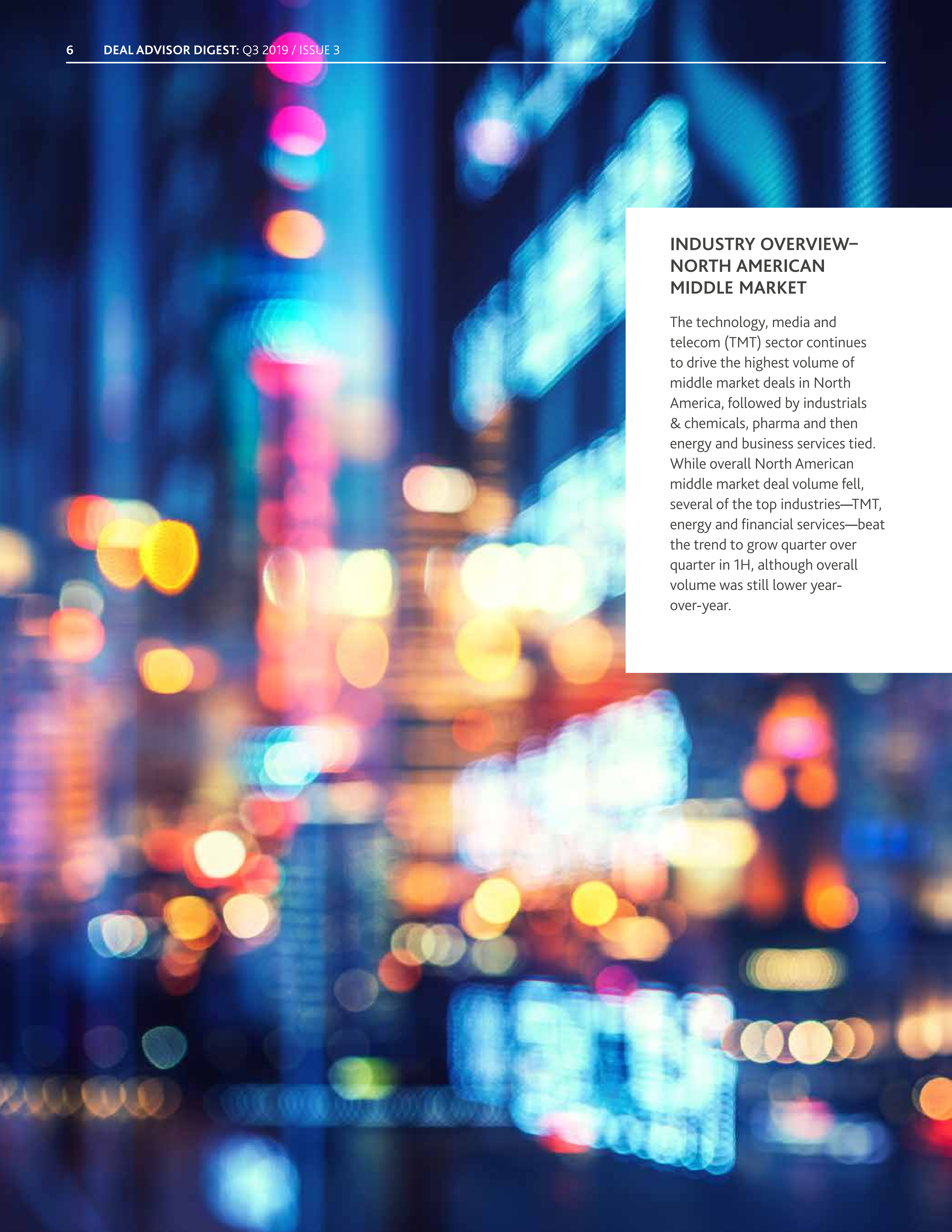
Significant market fluctuation and cooling at the end of 2018, coupled with concerns of a potential market downturn have likely contributed to some skittishness in the first half of 2019, but the picture for the North American middle market for the rest of the year remains optimistic. After a tepid start in Q1 and subsequent rebound in Q2, more solid fundamentals and significant demand within private markets should signal steady deal activity for the remainder of 2019.

Deal volume in the North American middle market held across 1H, sliding slightly from 448 to 431 deals between Q1 and Q2, while deal value rose to $49.4 billion from $42 billion in Q1.

NORTH AMERICA MID MARKET M&A



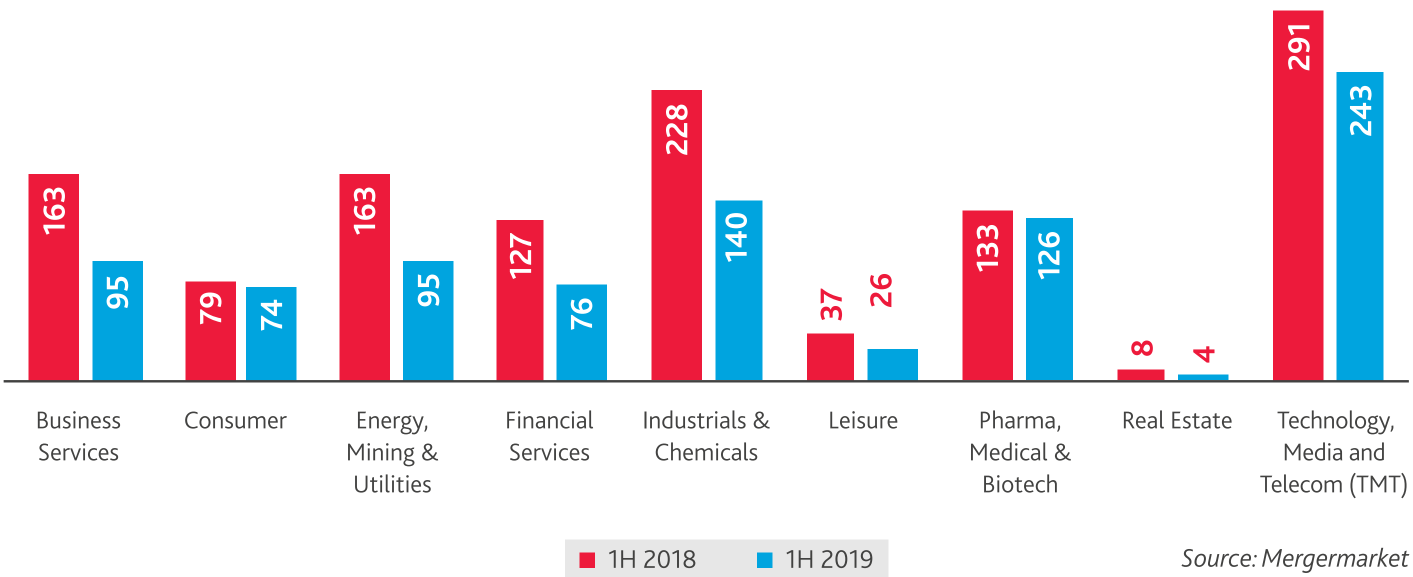
Source: Mergermarket



INDUSTRY OVERVIEW–NORTH AMERICAN MIDDLE MARKET

The technology, media and telecom (TMT) sector continues to drive the highest volume of middle market deals in North America, followed by industrials & chemicals, pharma and then energy and business services tied. While overall North American middle market deal volume fell, several of the top industries—TMT, energy and financial services—beat the trend to grow quarter over quarter in 1H, although overall volume was still lower year-over-year.

NORTH AMERICAN MID MARKET INDUSTRY DEAL VOLUME YEAR OVER YEAR



Source: Mergermarket

SPOTLIGHT ON PRIVATE EQUITY

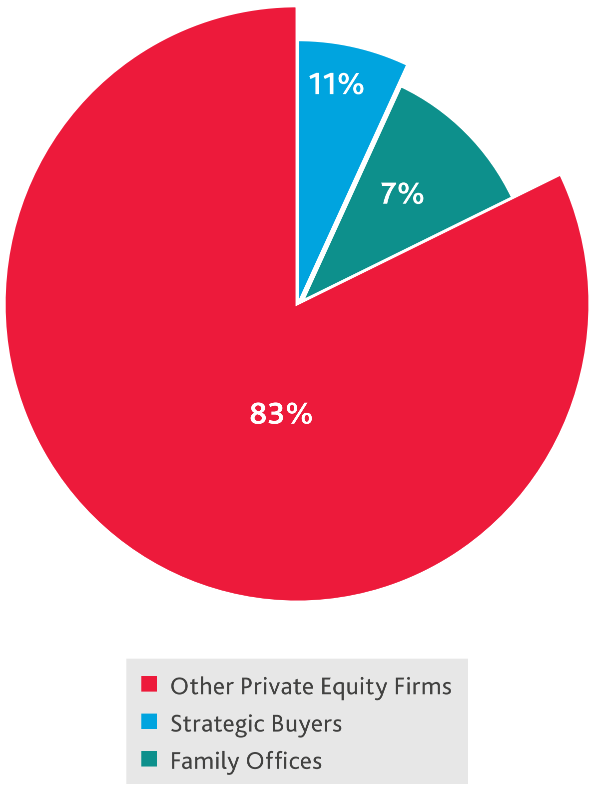
PUBLIC AND PRIVATE PERFORMANCE DIVERGENCES AS MARKETS PREPARE FOR DOWNTURN

The outlook for private equity-backed deals remains positive. While private equity deals slowed in 1H 2019 from 2018's record highs in the global and North American middle markets, 1H performance remained among the highest on record, according to Mergermarket data. Globally, 1H saw 737 deals driving $93.1 billion in value. In the North American market, there were 261 private equity buyouts, valued at $36.8 billion.

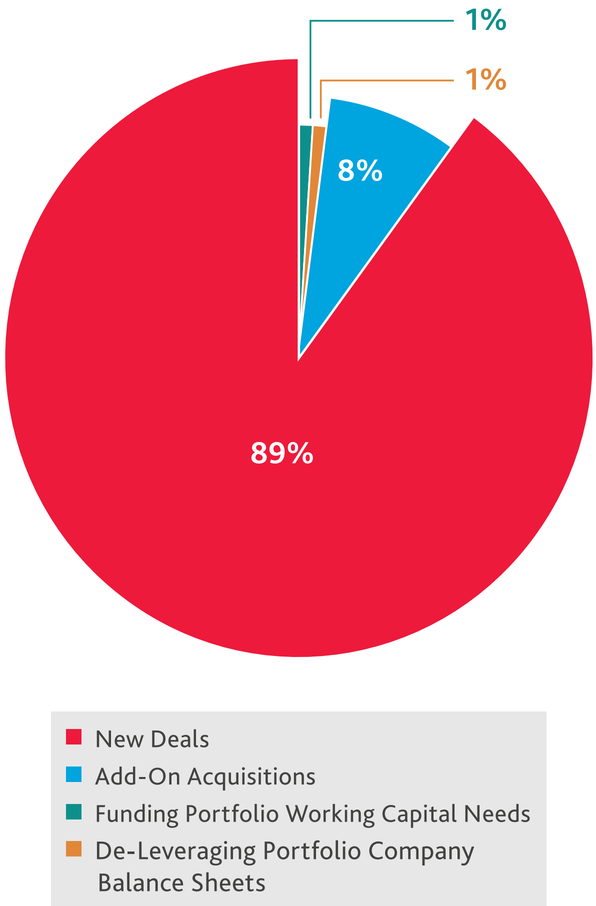
According to BDO's **Private Equity PErspective** survey, nearly 9 in 10 (89 percent) PE fund managers anticipate a prolonged downturn to hit the U.S. economy by 2020. Although they may be more protected from market volatility than their public peers, PE firms are taking steps to prepare themselves accordingly. Seventy percent said they're being more selective when evaluating highly-valued deals as a precaution.

At the same time, private equity firms, particularly those in the middle market, are facing increasing competition for new deals with the greatest ROI. Ample dry powder is available for private equity financing as PE firms chase higher growth, particularly in the technology sector. Median multiples are expected to comfortably top 12x for the remainder of the year. In the first half, our practice saw multiples well north of 20x, and we expect similar high-multiple deal-making to continue.

OVER THE NEXT 12 MONTHS, WHERE WILL THE COMPETITION FOR MIDDLE-MARKET DEALS COME FROM?



IN THE NEXT 12 MONTHS, WHAT DO YOU ANTICIPATE YOUR FIRM WILL DIRECT THE MOST CAPITAL?



Transaction Tips

"UN-FAQ": THE FIVE FREQUENTLY FORGOTTEN FACTORS IN DUE DILIGENCE

Due diligence and an operational value creation plan post-closing is critical for successful M&A transactions across the board, but particularly as companies prepare for a potential economic downturn. Many M&A deals fall apart or result in underwhelming or unrealized outcomes in the aftermath of incomplete due diligence. For dealmakers of all sizes, a thorough diligence and value creation strategy can help optimize outcomes for both buyers and sellers, no matter the market conditions.

Middle-market firms looking to participate in deal-making in H2 2019 can position themselves well with this deep dive into the variables that can affect a deal. While some financial and operational due diligence topics are table stakes ahead of any M&A transaction, these five often overlooked factors can also make or break the end game:

1. **Vision for Value AND Operations - The Dueling Prerogatives of Profit and Performance**
   No one signs a deal without a clear vision for the value added to one's organization, but the operations behind value creation are often handled reactively. To maximize ROI, it is critical for buyers to have alignment on strategy, a 100-day plan, long-term strategic planning and a value creation roadmap that focuses on profitable growth, drives margin improvement, optimizes capital management and unlocks the full value of the transaction. Some elements of the acquired organization may ultimately continue to stand alone, and effort should be made on the part of the buyer to make changes incrementally and in a targeted manner.

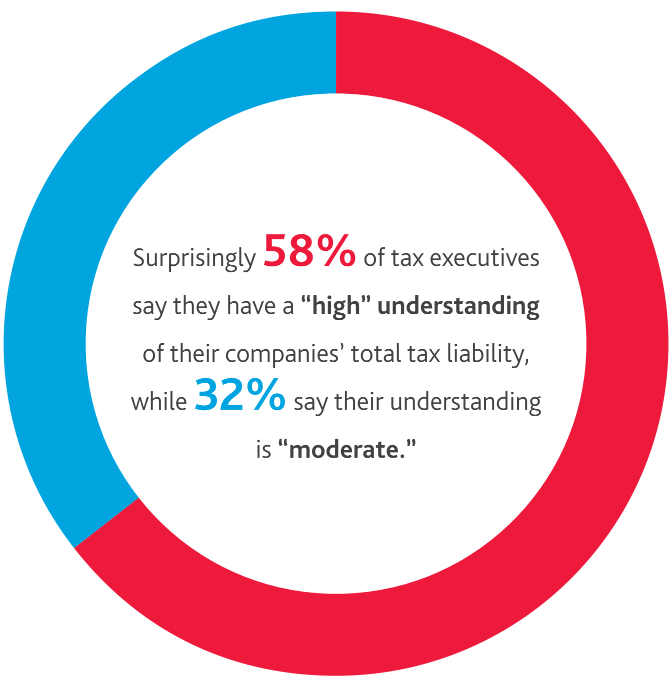
2. Total Tax Liability – Getting Ahead of Total Tax Liability

A company's total tax liability encompasses a variety of issues including the sum amount of all taxes owed, factoring in income, indirect, property, payroll, excise and other taxes, as well as credits, incentives, customs, duties and deductions at the international, federal, state and local levels (SALT). Although total tax liability is key for deal success, executives and board members alike need a better understanding of their positions.

Middle-market firms typically have more exposure to SALT liability as they may not have the resources to actively monitor and react to SALT changes. This can cause problems in the negotiation process from a seller's perspective when buyers want to renegotiate the terms of a deal in lieu of current or projected SALT liability.

Both parties can improve leverage and insight automatically in an M&A transaction by investing in an audit of total tax liability. Often, a single material tax issue can derail M&A and give license to renegotiate the terms of a deal, or in extreme cases, walk away completely.

The selling party has the upper hand when presenting their own tax risk. As a buyer, be sure to perform extensive diligence on the tax information provided by any selling entity in order to minimize current and future risk of your new combined entity.



Source: BDO Board Survey; BDO Tax Outlook Survey

3. **Digital Due Diligence (IT Platforms, integration, etc.) – Digital Integration Drives Value**

   Selling firms of all sizes use software that is often unique and difficult to integrate into a wider organization. While it might seem more resource-heavy to address upfront, buyers should consider the hidden costs of waiting to address digital integration until after a deal is signed. Any IT platforms inherited will require standardization to effectively and rationally interface with the rest of a buyer's organization. Learn ahead of time how information will flow to preempt any unseen roadblocks that could hurt the bottom line.

   An unplanned digital merger can resemble a wobbling tower of ill-suited parts, especially if digital synergy is ignored over successive acquisitions. Digital fixes are always more time-consuming and costly if enacted reactively rather than during the integration process between companies. Map out a digital risk assessment and create solutions now to defer the future costs of inaction.

4. **Cybersecurity is Financial Security**

   The addition of new software solutions and data assets from an acquired organization can cause unanticipated cybersecurity risks. Too often, organizations hastily merge without proper consideration to how data is shared and managed within the new combined entity or external vendors. This may lead to accidental or malicious disclosure of proprietary company data and litigation risk.

   A buying firm may determine to preemptively opt for a third option if the two software systems are incompatible. Companies should consider their cybersecurity weakness and overall security strategy as intrinsic to the process of M&A. Preemptive cybersecurity diligence is essential for a smooth integration process.

5. **Talent and Culture Strategy – Squaring Your Organization with Rounded Individuals**

   Buyers also often inherit the current employees and culture of an acquired company, so care should be taken to determine strategic use of acquired human capital. The employment status of new staff can be reviewed to better structure a newly acquired firm. Due diligence is useful to determine the percentage of employees that fall under 1099 or W2 status and whether different time allocations are value-optimal for your business. Make sure to check the third parties your organization contracts with for I-9 employment verification to see if these onboarding processes can be improved.

   The culture of a seller's firm is critical to a buyer's success but can't be easily quantified in a financial document. Your new firm's culture may be valuable to the social cohesion of your acquired employees and could help inform your own company culture. Request permission to perform interviews with management to better understand the cultural tone of your new firm. Be strategic and realistic about any plans to change company culture of a new firm or take steps to meet your new employees halfway. Emphasizing a culture where employees are consistently trained and rewarded for good work can help significantly reduce future turnover. Keep in mind that acquired work cultures can be just as valuable as your own company's work culture and shouldn't be immediately discarded in favor of what is familiar.

Leave no stones unturned in your due diligence investigation. Those executives who spend the time to ask these less obvious questions will fare better than their hurried counterparts. Slow and steady wins the deal and secures the value.

3 KEY DILIGENCE FACTORS FOR BUYERS AND SELLERS

Due diligence occurs on both sides of a deal, and the more consensus between parties, the smoother your process will go. Consider these three factors, refined for both the buyer and seller, to enhance your process. In M&A, some of the best opportunities arise as a result of thorough due diligence.

BUYERS:

1. **Don't overlook risks that could hinder the value of a prospect post-integration**
   The issue you don't prepare for is the one that will bottleneck and potentially hinder your organization going forward. M&A for its own sake is doomed at the outset. You need to have a near omnipotent picture of the risks you're exposing your employees and business to in order to maximize success. It's not always possible, but diligent review can help.

2. **Ensure total tax liability for the combined entity is understood**
   Seek outside help to manage the risks associated with current and future tax liabilities that may arise from your acquisition. Don't rely solely on the seller's diligence or skirt your own responsibilities as a party to the transaction. Full tax liability can only be understood on a case-by-case basis and many middle-market firms simply lack the resources and expertise to appropriately model their tax risk. Many deals end in failure because of assumed tax liability without a proper audit. Don't fall victim to lurking unknown tax risk.

3. **Know exactly what you're purchasing**
   Caveat emptor! Buyer beware! The purchase of a firm does not automatically grant the purchaser rights to a seller's intellectual property. Make sure to fully outline the scope of your purchase or you may not own the underlying value of the firm and brand you've decided to acquire. The right to core underlying technology of a firm may rest with another entity or individual, and efforts should be made during due diligence to track down all IP loose ends that may complicate a merger. The cumulative book value of a transaction is also increasingly outweighed by the intangible goodwill value of IP, brand name, customer base, customer relations or employee relations that should be considered relative to measurables on a balance sheet. Make attempts to reverse engineer the value proposition of a firm you seek to acquire and perform your own assessment.

SELLERS:

1. **Conduct a mock due diligence exercise to prepare for the M&A process**
   Sellers are in the driver's seat of M&A transactions when they have nothing to hide from potential buyers. Thorough examination of any and all risks and liabilities your company is exposed to allows for remediation of risk on a seller's own terms ahead of a transaction. Prepare as much as you can to solidify your company's valuation. Buyers have a vested interest in maximizing value for price and your sell-side preparations will pave the way for a smooth M&A process.

2. **Be open and realistic about information to prevent hurdles in integration**
   Sellers must be forthright in their presentation of company risks and liabilities. A buyer can delay and even walk away from a deal upon discovery of unseen issues from the seller. Wider reputational concerns may affect all offers going forward depending on the severity of a seller's indiscretion in hiding pertinent information. If your business has an issue that cannot be solved internally, consider hiring outside help to guide organizational restructuring or to propose a solution to an issue. Even small hidden risks can drag an M&A process out much longer as they give buyers an excuse to revisit their due diligence process. Additional time spent negotiating is unlikely to result in a better price for your company.

3. **Diligence the components of value in advance**
   By commissioning a sell-side Quality of Earnings (QoE) report, sellers can proactively confirm the key components of valuation and best position the company's financial information and trends well in advance of any buyer scrutiny. For example, a well-constructed sell-side QoE report will identify certain adjustments and non-recurring expenses that often positively impact EBITDA, a key measure in valuing a firm. Such thorough upfront diligence and positioning enables sellers and their investment bankers to argue for the best price. Use a QoE report to highlight the true cash flow of the enterprise and to mitigate the potential for buyer manipulation of your financial data and information in negotiations.

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To learn more about how we can help your company through a transaction process, reach out to our key leaders:

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