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CORPORATE FINANCE PRACTICE

DEAL ADVISOR DIGEST

M&A Trends Report

Q4 2019 / ISSUE 4

PAVING THE WAY FOR INTEGRATION

In This Issue

Introduction

After an inconsistent start to the year, the market for mergers and acquisitions is poised for robust activity ahead. Private equity firms have shown an increasing appetite for deals and public companies continue to target value. Following the Federal Reserve's third rate cut of 2019, low interest rates will persist, and private markets still have ample capital available. As generally positive economic indicators prevail, the outlook for deal activity remains promising going forward.

Each deal also brings a degree of risk, so it's important to examine key strategies for integration. Businesses that engaged in deals earlier in 2019 are fully immersed in the complex work of integration, and they are looking to 2020 with an eye toward realizing value. Buyers must focus on their deal rationale and plan to capture value quickly, while also carefully shaping the new organization for long-term success.

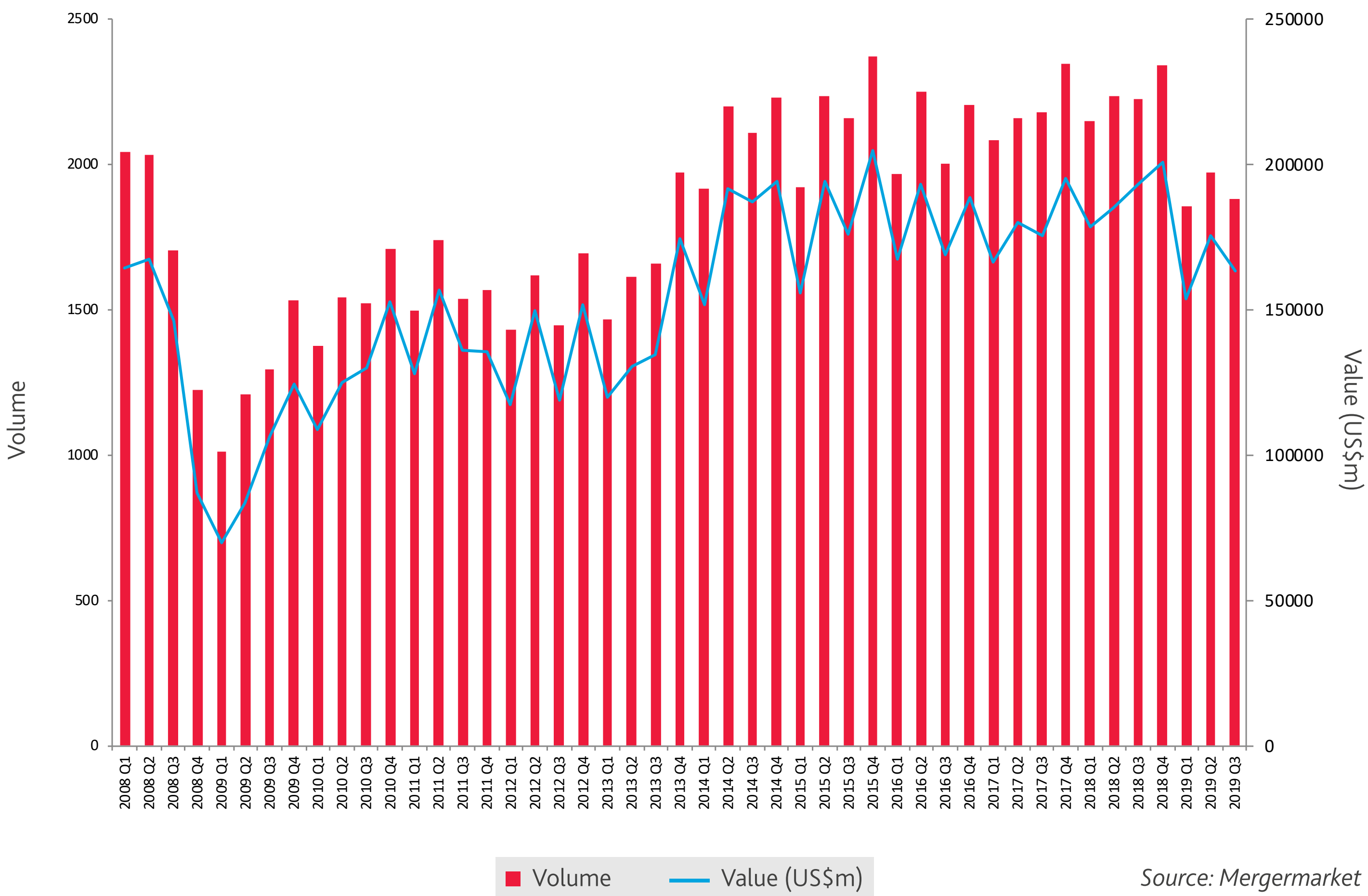
Middle Market M&A

GLOBAL MIDDLE MARKET

Globally, M&A activity in the middle market for Q3 saw 1,883 deals totaling $163 billion overall, per data from Mergermarket. In addition, activity for M&A deals of all sizes remained strong as well, with deals for U.S. targets during the first nine months of 2019 valued at more than $1.4 trillion, the highest mark for any opening period since record-keeping began in 1980, according to Refinitiv. Worldwide, all announced M&A deals totaled $2.8 trillion for the fourth-largest opening since 1980, despite a slight decline from 2018.

After Q2 brought an increase in middle market deal activity, Q3 declined slightly while still beating Q1 results. There remains cause for optimism, as Q4 produced the best quarter for deals in both 2017 and 2018, as well as in six of the last seven years. With ample capital still available and mostly positive economic indicators persisting, the dip during Q3 could signal more value ahead for buyers who might have paid higher multiples in previous quarters. So, a push to make deals before end of year can be expected.

GLOBAL MID MARKET M&A

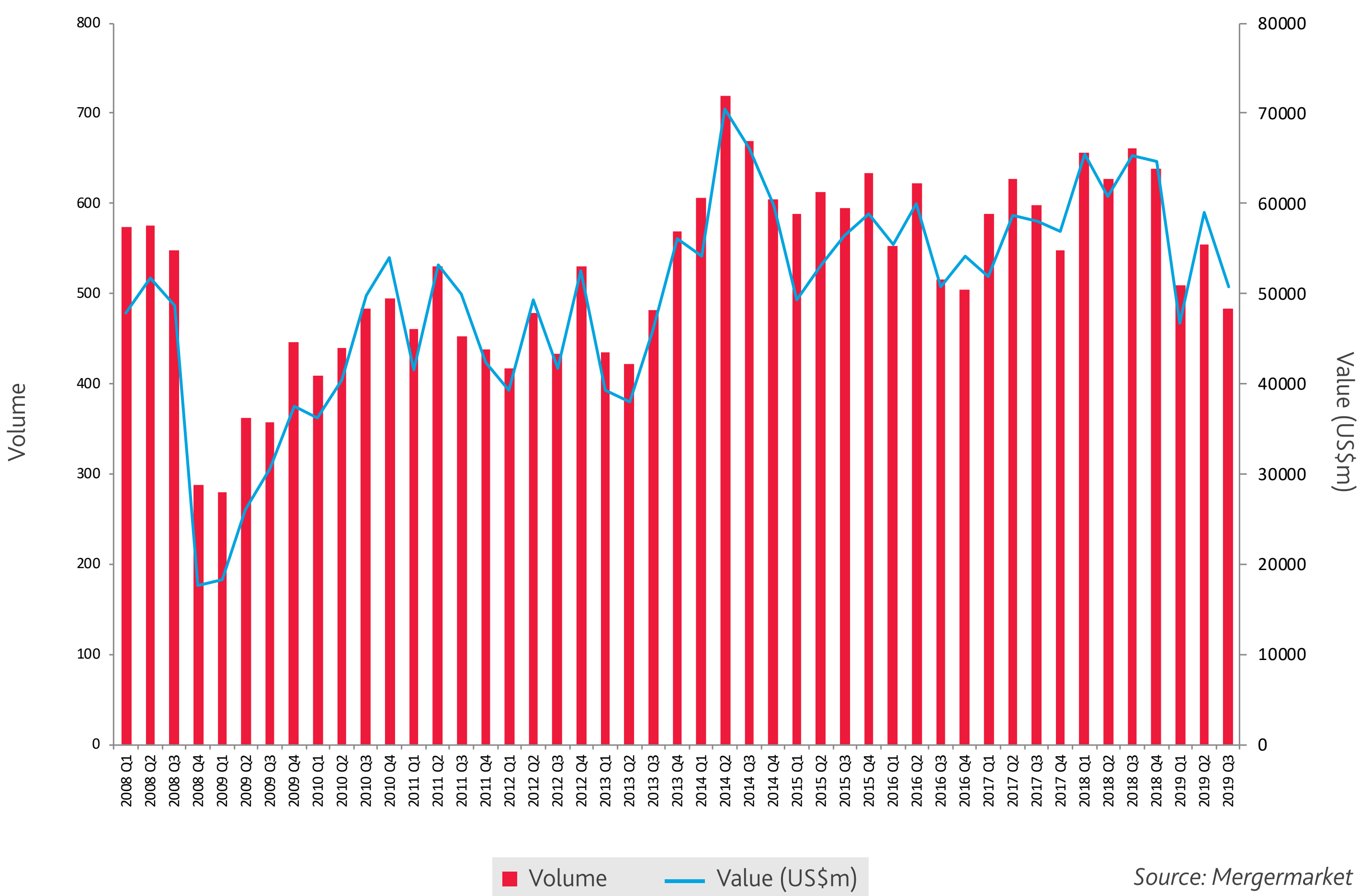


Source: Mergermarket

NORTH AMERICAN MIDDLE MARKET

In North America, middle market activity totaled $50.8 billion from 484 deals during Q3. In light of a 10-year period of record-setting economic expansion, that represented the lowest quarterly volume since 2013. However, deal value still beat Q1 2019, and average deal value hit the highest annual level of the decade. Concerns about looming economic uncertainty for 2020 could help fuel more volume, with high demand from private markets and some companies seeking to trim their growth plans, leading to favorable conditions for carve-out acquisitions. And as soaring transaction multiples begin to come back to Earth, there will likely be an increase in larger deals as well.

NORTH AMERICAN MID MARKET M&A

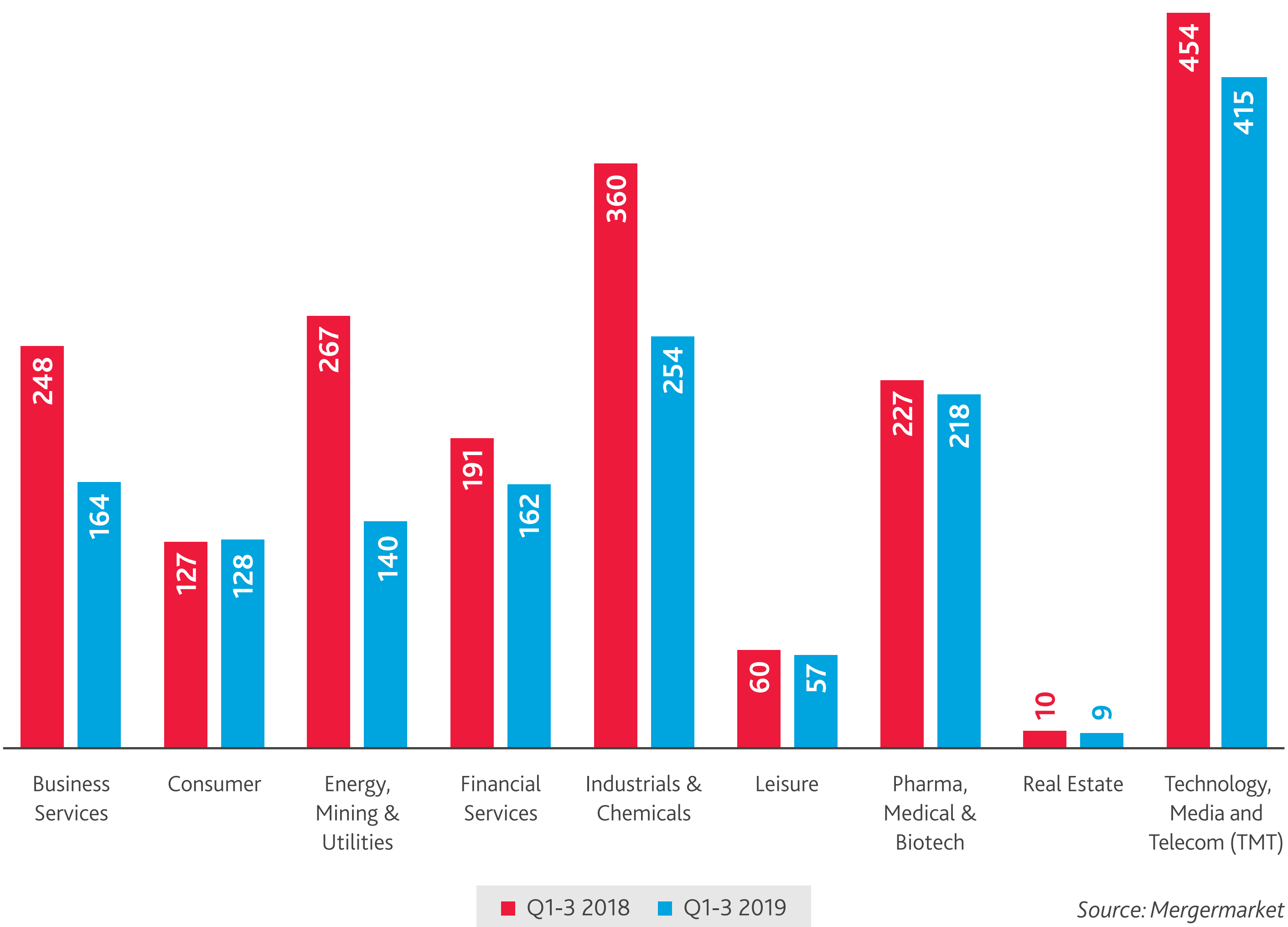


Source: Mergermarket

INDUSTRY OVERVIEW – NORTH AMERICAN MIDDLE MARKET

The financial services, leisure, and real estate sectors had increased deal volumes in Q3 compared to both Q1 and Q2, and these sectors also increased year-over-year. In fact, leisure saw more deals in Q3 2019 than during all of H1. Consumer sector activity also outpaced 2018 levels. The TMT (technology, media, and telecommunications) sector had the highest overall deal volume, although quarterly volume was the lowest for that sector since Q4 2017. Political and regulatory concerns have impacted the TMT sector, but the outlook remains bright for technology deals moving forward.

NORTH AMERICAN MID MARKET INDUSTRY DEAL VOLUME YEAR OVER YEAR



Source: Mergermarket

Economic Indicators

Key economic indicators show a positive outlook for the U.S. economy. These solid fundamentals continue despite pressures from global trade tensions and signs of an economic slowdown abroad. Record-low unemployment numbers and a 12-year high for housing starts, as well as encouraging corporate profits and better-than-expected GDP growth, signal a strong outlook for future deals.

U.S. Gross Domestic Product (GDP)

Gross domestic product grew at an annualized rate of 2.1% in Q3, per the third estimate from the U.S. Bureau of Economic Analysis (BEA). This beat the expectations of economists polled by Dow Jones for quarterly growth of 1.6% and marked a slight increase from Q2's GDP growth rate of 2%. Encouraging job numbers and a rising stock market signal conditions for continued economic growth, setting up a favorable environment for deal activity.

Source: U.S. Bureau of Economic Analysis

Institute for Supply Management (ISM) Index

Results from the Institute for Supply Management (ISM) index of manufacturing purchase managers in November came in at 48.1% (results below 50% indicate a contraction for the industry). While the index beat September's figure of 47.8%, it fell short of expectations for 49.2% and declined slightly from 48.3% in October. ISM's November figure represented the fourth consecutive month of contraction for the industry, with August 2019 ending a 35-month streak of expansion that had averaged 56.5%. September's index also reached the lowest point since June 2009. Exports have taken a hit during the ongoing trade war, in addition to a broader slowdown in the global economy, but signs of easing trade tensions could be a boon for the industry.

Source: Institute for Supply Management

Auto Sales

Among the Big Six auto companies, Ford, Nissan, Fiat Chrysler and General Motors all saw auto sales decline from Q2 to Q3, according to data released by the automakers. Honda and Toyota enjoyed a slight uptick, with the industry as a whole slumping to 4.275 million light vehicles, down from 4.392 million in Q2, although it still rose in comparison to Q1 sales. A 40-day strike at General Motors that began in mid-September likely also had a temporary negative impact on Q3 results. Additional rate cuts by the Federal Reserve should defray rising interest rates for auto loans, and auto loan and lease originations for new and used vehicles increased 1% in Q3, according to a New York Federal Reserve report.

Source: Finance and Insurance (F&I) Tools, New York Federal Reserve

Housing Starts

August delivered very encouraging figures for U.S. homebuilding, with housing starts hitting a 12-year high of 1.375 million units. Following a decline in September, housing starts rose in October and increased by 3.2% in November to a seasonally adjusted annual rate of 1.365 million units, beating expectations of economists who predicted 1.345 million units, according to a Reuters poll. This represented significant year-on-year growth of 13.6% from November 2018. Building permits also increased by 1.4% to 1.482 million units, reaching the highest point since May 2007. Overall, the housing market has been helped by lower mortgage rates related to the Fed's multiple rate cuts.

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

Corporate Profits

The S&P 500 Index eclipsed 3,000 for the first time ever during July and it shot past that mark in October, finishing the year up 29% for the biggest annual gain since 2013. In Q3 earnings, the majority of companies reported actual earnings per share (EPS) above estimates, and actual sales above estimates as the market headed into a promising holiday season, although many companies had previously lowered their Q3 estimates.

Source: Standard & Poor's, FactSet

Unemployment

The U.S. Department of Labor reported that the seasonal unemployment rate fell from 3.7% to 3.5% in September, hitting a 50-year low as the economy added 193,000 jobs for the month. Those job gains for September came in above the monthly average for the year of 173,000, and the number of jobs added outpaced the population increase of working-age individuals. An increase in part-time workers also contributed to low unemployment as the job market headed into the seasonal hiring period. After edging up to 3.6% in October, unemployment declined again in November and returned to 3.5%. Nonfarm payroll employment increased by 266,000 in November, far above economists' expectations for 187,000, per a Dow Jones poll. Jobs in motor vehicles and parts manufacturing surged, largely due to the GM strike that ended in late October.

Source: Bureau of Labor Statistics

Consumer Indicators

After no change in September, the Consumer Price Index (CPI-U) increased 0.4% in October and an additional 0.3% in November on a seasonally adjusted basis. That represented a 2.1% rise over the last 12 months without seasonal adjustment. The energy index increased 0.8% and shelter increased 0.3%, which were the major contributors to the rise in the all items index. The indices for medical care, recreation, and food also rose. The Consumer Confidence Index, also rose slightly in November heading into the busy holiday season.

Source: Bureau of Labor Statistics

Oil Prices

After seeing volatility during the first half of 2019, crude futures have hovered around $60 a barrel in recent months. In November, Brent crude averaged $63/b, with West Texas intermediate (WTI) at $57/b. Factors impacting these prices include ongoing trade tensions, regional political conflict, slack demand and an increase in U.S. inventories.

Source: Energy Information Administration

SPOTLIGHT ON PRIVATE EQUITY

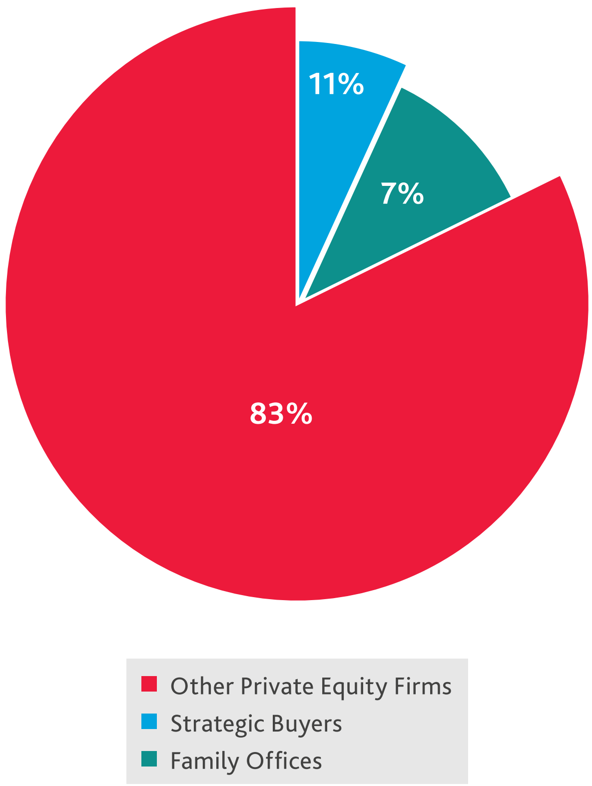
PRIVATE MARKETS SHOW HEALTHY APPETITE FOR DEALS AS PUBLIC MARKETS WAVER

Globally, private equity buyout activity for the middle market began 2019 with the highest value for any nine-month opening in the decade. PE buyouts represented a stunning 24.1% of global deal value in Q3, nearly double the percentage seen in Q4 2016. North America saw similarly strong results, as PE deal activity for the first three quarters of 2019 hit the highest volume for any opening period of the decade.

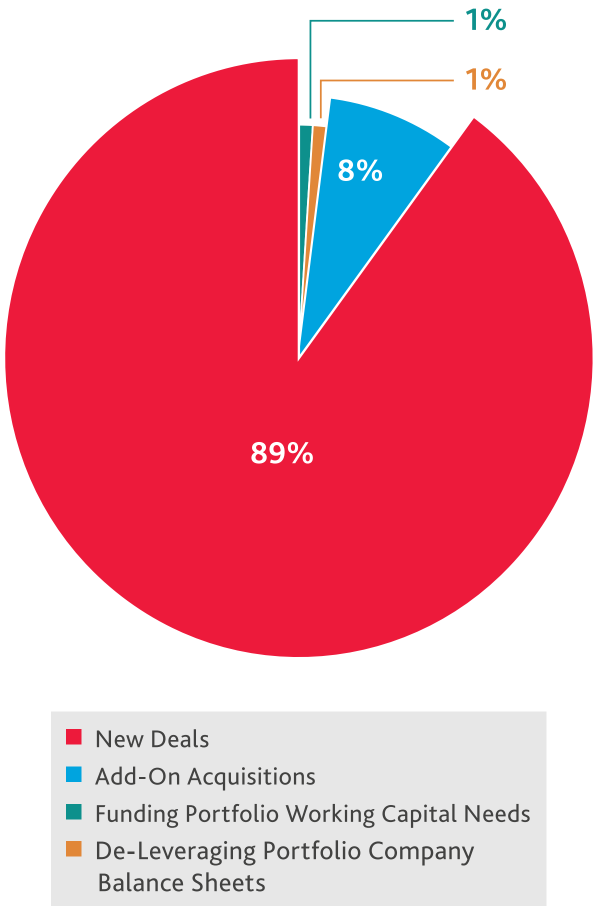
As noted in BDO's Private Equity PErspective Survey, while the vast majority of PE fund managers (89%) expect a market correction by the end of 2020, 97% of them still anticipated that their firm would direct the most capital to new deals (89%) and add-on acquisitions (8%) during 2019. That has been demonstrated by the increased proportion of PE buyouts relative to overall deal value. Firms are also targeting more deal opportunities within non-cyclical industries – including utilities, healthcare and technology – to help recession-proof their portfolios.

According to data from PitchBook, buyout funds in the U.S. had already raised more than $246 billion by November, surpassing the 2017 record. As market pressures begin to suppress high transaction multiples that have prevailed in recent years, PE buyouts will increase further, with firms seeking timely opportunities for all that dry powder. This increases the likelihood for a rise in both deal volume and value. Additionally, economic headwinds will create favorable conditions for PE buyouts of distressed companies. Although concerns over an economic downturn may increase the expected hold period for acquisitions, certain sectors are less vulnerable than others to market fluctuations. PE firms will still engage in deals with a clear investment thesis and look to implement this very quickly to take advantage of value drivers.

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



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



Source: 2019 BDO Private Equity PErspective Survey

Transaction Tips

6 KEY STRATEGIES FOR INTEGRATION

Due diligence before a deal closes forms the most important part of the integration process. This should provide detailed information about all aspects of the target, which helps the acquirer strategize in advance and identify areas of potential risk. Ideally, proper diligence should address all questions and highlight any concerns before a deal closes, thereby paving the way for a seamless integration. Of course, that is not always the case, and many unforeseen issues can arise during the integration process, especially regarding aspects that can't be quantified on a financial report.

Negative synergies or dis-synergies can be an issue for integration. An acquirer expects to leverage combined resources to increase productivity and profitability, but instead finds that the new whole is less than the sum of its parts. While negative synergies can be addressed and mitigated, they are often inherent to a deal. So, the focus should be on identifying these issues and preparing to solve them swiftly rather than avoiding them.

Lost synergies from not implementing the acquisition strategy in a timely manner present a major concern for integration. Every day of synergy lost is a substantial loss, especially with a likely economic downturn looming, so allocating capital efficiently is a high priority for buyers. While synergy issues vary from industry to industry and deal to deal, the following strategies can help bring a prompt resolution to aid successful integration.

1. Stay Focused on the Deal Rationale

Mergers can create a chaotic environment with a multitude of concerns following the close of a deal. Don't get lost in the weeds. By maintaining a focus on the deal value drivers and prioritizing the "why" of a deal, the acquirer can clearly identify the primary goals to accomplish during integration. Devising strategies guided by this can help the new organization realize greater value as quickly as possible post-close.

2. Reject Artificial Timelines

Beware of basing integration timelines on concerns that are not directly relevant to the integration process and those needs. For example, considerations related to tax filings can sometimes force unrealistic constraints upon integration timelines. These can also come from external pressures exerted by the investment bank or private equity firm involved. Timelines dictated by accounting practices or end-of-year concerns can lead to major mistakes and lost opportunities.

It's vital to distinguish what's core (activities that give the business a competitive advantage) from what's context (all other business activities). Successful integration requires sufficient time to be realized properly, but it's still important to act with a sense of urgency. Synergies have a shelf life, and these will diminish over time or be lost entirely if they are not harnessed and heightened. That's why a prudent and realistic timeline focused on the deal rationale paves the way for success and profitable growth.

3. Change Management and Transparent Communication

There are two stakeholders at risk during any integration: your employees and your clients. Competitors will target both during times of transition, hoping for upheaval that creates conditions to poach them. That reality underlines the importance of transparent communication with staff and customers alike. Considering the costs of hiring and training, as well as the costs of customer acquisition, ineffective change management can have dire consequences that affect the bottom line.

Change creates anxiety, so allaying the fears of staff must be a central objective. Employees will naturally have many questions about the future of the post-deal organization and how this affects them directly. Will there be changes in their role, location, supervisor or compensation and benefits package? Even if concrete answers to those questions have not been determined yet, the employees deserve reassurance to stave off unnecessary worries, and they should receive timelines and updates about when answers will be communicated. Similarly, you must communicate expectations to clients to avoid churn. Because many deals entail some degree of cannibalizing sales by absorbing another entity in that space, customer retention is even more important during integration.

4. Two-in-a-Box Management

Although some might view the two-in-a-box model of management as creating redundancy, this can be a very effective approach for integration management. If the integration teams can have two managers – one from both the buyer's and seller's sides – overseeing each team's work during the integration period, this ensures the perspectives and interests of both companies are represented and facilitates buy-in. It can also help enable the sharing of ideas and leading practices so the combined company can benefit from the best of both worlds when it comes to processes, policies and systems. During integration, two are indeed better than one.

5. Thorough Knowledge of Compensation and Benefits

Compensation and benefits issues can cause major disruption after a transaction if the intricate minutia has not been examined during diligence. This area presents a significant financial liability for the acquirer and can raise a litany of unexpected challenges. In many cases, when a larger company acquires a smaller company, it will also need to increase compensation for the acquired employees to match the level of their co-workers.

When conducting diligence, the acquirer will want extremely specific knowledge of all obligations, such as:

- Which executives or key staff can resign with full severance?
- Do executives have a non-compete clause for a certain period of time?
- What are the obligations around equity awards and stock options?
- Will corporate-owned life insurance be continued?
- Will there be any compliance issues or potential litigation related to tax-qualified plans?

Beyond these questions, new staff may have expectations for future compensation that were not revealed during diligence. For example, they may anticipate getting recognition for past accomplishments, and raises may have been put off before the deal as well. Gathering as much knowledge around these issues as possible will help prevent any costly surprises after the deal closes.

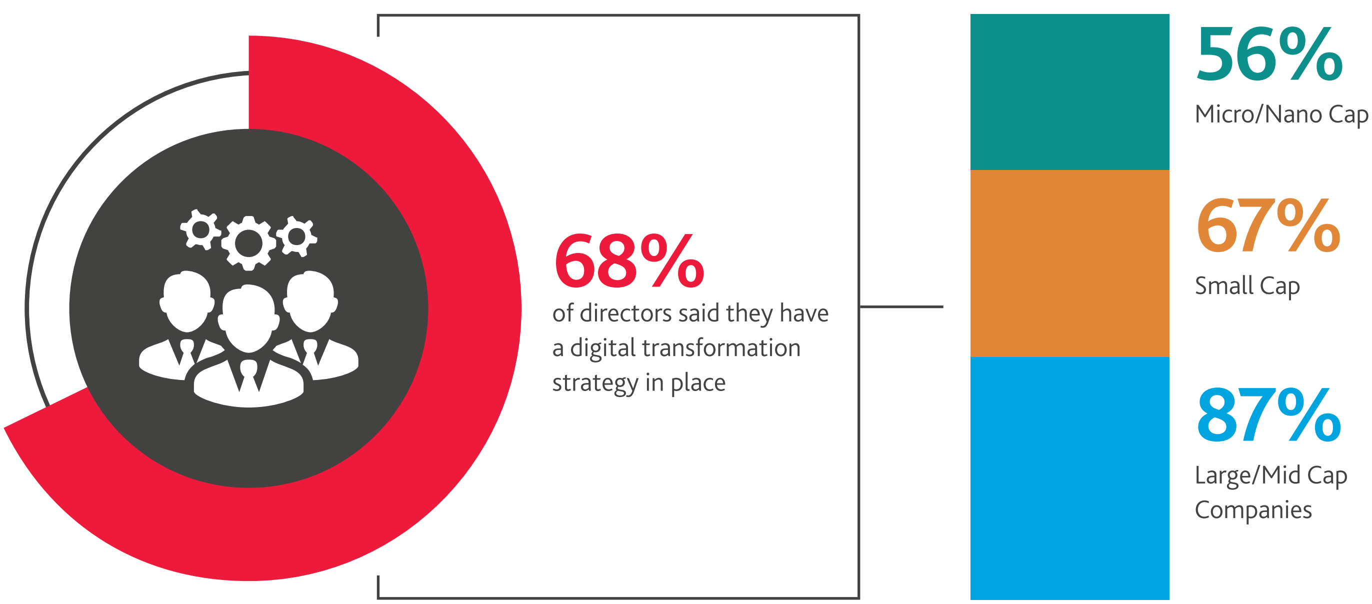
6. Multiple Options for Digital Transformation

In an economy increasingly driven by insights from data analytics, companies need a digital transformation plan to stay competitive, but many smaller companies struggle to devote enough resources to this area. That's why IT due diligence and integration must be a primary consideration during any deal, because any potential IT deficiencies or cybersecurity risks that come with the target must be addressed promptly to avoid facing more significant costs later. Ensuring data quality and continued master data management also helps ensure the acquirer can realize full value from the deal.

According to the 2019 BDO Board Survey, while 87% of directors at large/mid cap organizations said they had a digital transformation strategy in place, less than two-thirds of small and micro/nano cap companies had one. So, many smaller companies may require substantial investment in digital initiatives, but these expenditures often do not show returns in the short term. And in a low-growth economic environment, it can be challenging to devote the necessary resources to this.

To address this, an acquiring company can devise tiered options for a digital transformation plan and outline the triggers for each, which can be communicated transparently across the management team. The three levels can correspond to varying priorities for digital initiatives and stay responsive to any economic condition, whether the climate is one of growth, stagnation or contraction. This balances the need to invest in digital transformation for the future of the organization without draining capital expenditures.

DOES YOUR ORGANIZATION HAVE A DIGITAL TRANSFORMATION STRATEGY IN PLACE?



Source: 2019 BDO Board Survey

3 FACTORS IN DISPUTES

Despite the best efforts to prevent them, post-transaction disputes do occur. The devil is in the details. Whether due to misunderstandings or misrepresentations, the buyer may realize after a transaction that they were not provided with full and complete information in the financials. When this occurs, the main options left are either filing a lawsuit or a claim under representations and warranties insurance. Knowing the most likely causes of a dispute and how to address these in advance can help avoid unnecessary headaches following a transaction.

1. Comprehensive Language to Address Disputes

M&A agreements should always have comprehensive language to address disputes and help take away any subjectivity about potential adjustments that may be needed after the deal closes. While lawyers will draft the deal agreement, an accountant should review the language in the contract, as well as the underlying documents and schedules. They can identify certain issues that a lawyer might not be aware of, such as whether the complete general ledger was used and communicated for the deal, which can be of particular concern in PE transactions.

Because the contract is the product of a negotiation between the buyer and seller, lawyers often use standard language about accounting practices to help facilitate the close of the deal (e.g., "the closing balance sheet should be prepared in accordance with GAAP, consistent with past practices, policies, procedures and methodologies"). However, a lawyer may not be equipped to determine whether past practices have been completely in line with GAAP. Even in accordance with GAAP, there are estimates and judgments made about matters such as allowances for doubtful accounts and reserves for excess and obsolete inventory. These are examined pre-merger but may still result in disputes. So, the deal agreement needs to have mechanisms to address such issues with specificity.

2. Be Wary of Financials for Carve-outs

Deals involving carve-outs can be more prone to disputes, because the part of the business that was carved out did not have its own set of financials. These financials are created uniquely for the transaction and can sometimes present a scenario that seems more positive than the reality. Also, certain financial information may not be available if it hasn't been tracked historically. That is why transactions involving carve-outs require more work during diligence to identify any potential issues.

If there is an earn-out as part of the deal, that introduces even more possibility for dispute. For example, the seller may have allocated overhead costs to the parent company, but the buyer needs detailed financials about those overheads to plan for the back-end costs of integration before the deal closes. If this is not communicated with complete accuracy, it can lead to substantial unexpected costs.

3. "Most-Favored Customer" (MFC) Clauses

In certain cases, a company may have entered into an agreement that includes a "most favored customer" (MFC) clause (sometimes known as a "most favored nation" clause), which guarantees that customer will receive the lowest price the company would sell its product for to any other customer. If an agreement with such a clause gets transferred over in a sale, it effectively prevents the acquiring company from offering a lower price to other customers, unless they refund the difference under the MFC clause. Because this could amount to a substantial sum, and the M&A deal is based on a multiple of earnings, such a clause could potentially lead to a significant overpayment in the merger relative to the agreed-upon multiple. That's why all clauses in transferred customer agreements require thorough review to know of any potential obligations.

After closing a deal, identifying opportunities for value and acting swiftly to capture that value is of the utmost importance. Preparing the new organization for long-term success requires more than just rigorous due diligence to ensure a successful deal. The acquirer should strategize for integration in a holistic manner that focuses on deal value drivers. Poring over the details of the target company can also safeguard against unexpected problems and post-deal disputes. Through sound change management and a measured timeline, the acquirer can achieve successful integration and put the new business on a path to sustaining profitable growth.

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