TRANSACTION ADVISORY NEWS

TAS Year in Review 2016 and Deal Trends

GBQ's Transaction Advisory Services group (TAS) had another busy year in 2016 and signs are pointing to a strong 2017.

It's hard to believe but when we tallied 2016 results, GBQ's TAS Group had participated in **111 transactions** including:

- **Assurance and Tax Due Diligence and Structuring (22)**
- **Capital Markets (12-6 completed in conjunction with Footprint Capital)**
- **ESOP Feasibility and ESOP formations (17)**
- **Purchase Price Allocations, Pre-transaction valuations, and Fairness Opinions (60)**

While middle market deals nationwide were down about 15% in 2016, volume for our TAS group was substantially higher and 2017 is expected to be robust as well.

The following is a sampling of some of the trends we are seeing in the TAS world.

In the Due Diligence area, we are seeing more standardization of Due Diligence and Quality of Earnings reports and more Sell Side Diligence.

While previously used only on larger deals, most buyers are having outside diligence performed on even smaller deals (under $10 million in size). The practice of having a Quality of Earnings report completed by sellers prior to completing a deal is also becoming more and more common. For a seller, itoffers up a sort of "Good Housekeeping Stamp of Approval" to potential buyers. We see this especially where the readers of the Confidential Memorandum are going to have a number of questions about accounting treatments or EBITDA normalization adjustments. Many private equity firms are now doing sell-side diligence whenever they sell a company.

In general, we see less stringent diligence performed by strategic buyers than we do by PE type firms. This probably speaks to their higher level of familiarity with the respective industry. We are also seeing very standardized diligence checklists and processes by companies that are doing multiple acquisitions of similar companies in the same industry. They are also incorporating Integration plans into their diligence process.

TAS Year in Review 2016 and Deal Trends (continued)

On the Tax structuring side, we are seeing more complexity and sophistication.
It is common, for a seller to want to defer tax on equity they reinvest upon a sale to private equity. Most of the deals where we have served as the sell-side advisor have been in the $5 to $20 million range, and most of those owners who have sold to a PE buyer have rolled equity in this manner. The tax deferral on the rolled equity can amount to hundreds of thousands or millions of dollars of savings and it is not obvious or always easy to accomplish. It takes a fairly sophisticated tax group to get this piece right.

State and local taxes continue to rear their head in deals. Both buyers and sellers underestimate how sales tax, use tax, unclaimed funds, property tax and other indirect type tax issues can sneak up and add additional complexity and potential liabilities to deals. We have had at least one deal (in the last year) almost blow up because of potential exposure in this area.

On the structure side, we are seeing more and more stock deals as opposed to asset deals. Traditionally, small deals were almost always done as asset deals.
This is being done primarily for the purpose of making the deal simpler and getting to a close faster, especially where a number of contracts would need to be transferred with an asset deal. In these deals; however, many buyers are preferring to make 338(h)(10) or 336(e) elections, which allow for a stock purchase from a legal perspective to be deemed an asset purchase for tax purposes only. Attorneys for buyers seem to be getting more and more comfortable with the risks associated with a stock deal and covering their risks with adjustments to reps and warranties provisions and required escrows. Having a strong M&A attorney really pays off when it comes to these issues.

We are seeing more and more ESOP deals.
While ESOPs still make up only a small percentage of all companies sold, we are seeing more and more companies looking at ESOPs and at least doing a feasibility study of ESOP as a possible solution. We will soon be running a series of workshops on this subject. Click here to read all on ESOPs.

Fairness Opinions.
We are also seeing more requests for fairness opinions, especially where you have minority shareholders involved or others that have a vested interest in the sale but not directly involved in the decision to sell. We performed one of these last year on a plus $100 million deal based on the strong recommendation from the seller's attorney.

Possible Trump administration effect on M&A markets.
We hear some version of this question being bounced around a lot these days. Typically, what is good for the stock market will also be good for the M&A market. Thus far, stock markets have responded positively to the new administration so this appears to be a good sign for the M&A market. The caveat is when and what changes will actually be made vs. those being proposed and discussed. This does add uncertainty, which markets typically do not like. When there is uncertainty, buyers and sellers have a tendency to step back, at least momentarily. For example, many sellers will want to wait to see if planned tax reductions occur before consummating a deal. The market is quiet at the moment for this very reason. The effects of other possible changes will also create winners and losers, all of which have an impact on deals.

TAS Year in Review 2016 and Deal Trends (continued)

Why so many deals?
Click here to read "Why Are So Many Businesses Selling?" For further insight on what is going on today in the M&A market.

Many factors are driving the pace of activity but top reasons include:

Baby Boomers looking for liquidity before the next downturn.
I just heard a presentation a couple weeks ago by Jeff Mortimer, BNY Mellon's director of investment strategy at the AMAA Winter conference. Jeff leads a team that sets capital expectations for his firm and he predicted late '18 or early '19 as his best guess of the likely timing for our next recession. While the stock market has been driven to new highs recently, the current bull market has been a long one. While no one can predict the next downturn, as time goes on, the chance of our next recession increases. There are a number of aging business owners who want to do something prior to the next recession.

Huge cash reserves (what we call "dry powder") at both large strategics and Private Equity firms is driving both activity and prices. Private equity groups alone have over $500 billion to deploy.
Higher prices entice some owners who may not have thought about selling yet. In a recent survey performed by AMAA on deals completed by their members, the average multiple was 5.81 for the first half of 2016 vs. 4.93 for the first half of 2015. These are typically deals in the lower middle market. On deals closed over $50 million, the average multiple was 8.8 in this survey. In another recently released survey by GF Data, the 2016 average multiple for deals valued in the $10 to $250 million range was an all-time high of 6.9. This is from data submitted by 200 PE contributors who submit proprietary deal data.

The low yield environment also drives up prices.
As everyone knows, interest rates have been historically low now for some time. This has driven up the price of stocks because investors in stocks are willing to accept lower returns than normal as these returns are still favorable as compared to fixed income. The same logic applies to private companies and this is why the prices for these companies are higher in this environment. Frankly, we have been a little surprised at some of the multiples where value characteristics are strong.

At the same time, more companies are looking to acquire to meet strategic objectives.
Organic growth has been hard to come by for many companies in many industries making acquisitions the only way many companies can achieve their growth objectives. In addition, companies are making acquisitions to add strong people, expand geographically and add to their intellectual property. It simply turbo charges strategic plans.

This article was written by

Wade Kozich, CPA, CMAA, CEPA
Director of Transaction Advisory Services
wkozich@gbq.com