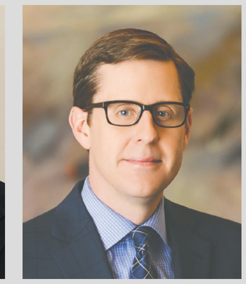
MiBiz roundtable: M&A experts forecast strong deal flow in post-pandemic rebound

Jeff Helminksi, managing partner, Auxo Investment Partners

Rajesh Kothari, managing director, Cascade Partners LLC

Deidra Mitchell, president and CEO, Waséyabek Development Co.

John Pollock, managing director, LV2 Equity Partner LLC



Peter Roth, M&A partner, Varnum LLP

PHOTOS: JOHN POLLOCK. SETH THOMPSON-GREENFROGPHOTO

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Mergers and acquisitions should remain strong through 2021 — driven by several factors affecting deal flow — although finding a good deal may come with a high price for buyers.

Participants in a recent *MiBiz* M&A roundtable discussion say they expect valuations to stay high for the foreseeable future — perhaps unreasonably so at times — as buyers compete for good deals in a robust market.

A massive capital overhang, low interest rates, and greater competition among buyers in the market drove up high valuations in 2020. Buyers ranged from strategic corporate acquirers seeking to drive growth or add to platform companies, to private equity investors and family offices. Lower deal flow after the U.S. economy fell into recession in the COVID-19 pandemic also contributed to increasing valuations that are expected to remain elevated even as activity picks up.

"You throw those all in the mix and you don't have an aggressive amount of deal flow, you're going to have high valuations and you're going to have high valuations for a while," said Rajesh Kothari, managing director of Southfield-based investment banking firm **Cascade Partners LLC**.

High valuations

Years ago companies regularly traded at multiples of three or four times earnings before interest, taxes, depreciation and amortization (EBITDA), Kothari said. Today a multiple of six or seven times "is probably the bottom end of the range, it seems like," Kothari said.

High valuations have affected a couple of **Waséyabek Development Co.**'s deals in midstream, said Deidra Mitchell, president and CEO at the non-gaming investment arm of the **Nottawaseppi Huron Band of the Potawatomi**.

Mitchell described how "uninformed" sellers heard about the multiple that somebody else got for their business, "and all of a sudden your deal just kind of starts to fall apart."

Taking advantage of high valuations ranked second among the top reasons to sell in an annual M&A activity survey from Citizens Financial Group Inc. Among the respondents, 38 percent said they expect valuations for middle-market companies to increase in 2021, while 13 percent expected a decrease.

Peter Roth, an M&A partner at Grand Rapids-based law firm **Varnum LLP**, which sponsored the roundtable, has seen some "disciplined" buyers walk away from deals because of high valuations.

"They're going to put their number in the ground and they have some room, but they're very careful not to get dragged higher than what they're comfortable with," Roth said. "So, I have seen a number of times in the last bit of buyers walking away and saying, 'Our number's our number and if somebody wants to pay silly money, have at it.'"

Strong activity

In its annual survey, Citizens Financial Group found "upbeat expectations" for both valuations and deal flow in 2021 in what was termed a "decidedly optimistic" M&A outlook. Survey data "suggests that a rush of middle-market M&A is likely in 2021," according to Citizens.

M&A activity in the first quarter has been strong, said roundtable panelists who believe 2021 could become a record year for deal flow.

"Part of that is you had pretty much almost six months of the year get trashed last year, so there's a level of pent-up demand that's driving it. We've never started out a year as strong as we're starting out 2021," Kothari said. "When I talk to my friends in the industry around the country, everybody is saying pretty much the same thing. There's just a tremendous amount of activity and interest in the marketplace."

As he scouts for deals in a strong market, **LV2 Equity Partners LLC** Managing Director John Pollock remains cognizant of sellers who — because of the nature of their business — experienced a temporary boost during the pandemic, driving up their valuation.

"You have to contend with those factors and make sound business decisions on what you're willing to pay for a business. But what we struggle more with are ones where companies are trying to get paid a premium for what in our estimation is clearly a pandemic 'bump' of sorts," Pollock said. "Outside of that, it's the ebb and flow of valuation based on supply and demand and all of the other factors that are in play."

Federal policy

Pollock doesn't see that confluence of factors and "weird bubble" changing until "a change of substance" in presently low interest rates, "and that's not happening anytime soon."

A rise in inflation could lead the Federal Reserve to begin raising interest rates, although recent economic outlooks do not expect that to occur this year.

"Overall and core inflation will pick up on a year-ago basis over the next few months because of comparisons with 2020" when "prices outright declined in the late winter and early spring of last year as the pandemic rocked the U.S. economy," PNC Bank economists wrote in a recent economic briefing. "But the acceleration in year-ago inflation will be transitory, and both overall and core CPI inflation will slow on a year-ago basis in the second half of 2021. Inflation will then pick up somewhat in 2022 as stimulus supports a strong economic rebound, giving businesses more pricing power."

In an updated U.S. outlook this month, economists at **Comerica Inc.** forecasted the consumer price index to rise from 2020's 1.9 percent to 2.6 percent for 2021, then ease to 2.2 percent for 2022. Comerica economists expect that the Federal Reserve's "highly accommodative" monetary policy "will likely be maintained through this year and possibly much longer."

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Pandemic rebound, tax concerns

The COVID-19 pandemic that hammered the economy and many businesses last spring could drive deal flow in 2021, according to the roundtable panel. Owners who struggled through the economic fallout of the pandemic and state-ordered closures may choose to sell now or accelerate their plans to exit the business.

That's similar to what occurred in the aftermath of the financial crisis in the fall of 2008 that pushed the U.S. economy in recession.

"The attention to there being real risk and catastrophe possibly happening is driving some of the deal flow," Roth said. "Those folks were kind of close to the exit, then they saw a catastrophe happen and risks became a little more real."

Roth noted that "after a brief lull" when COVID-19 hit a year ago, the M&A market remained robust through the latter half of 2020 when "we found ourselves super busy."

Grand Rapids M&A firm **BlueWater Partners LLC**'s first quarter update this month cited data from global financial data provider Refinitiv that U.S. mid-market deals accelerated in the final three months of 2020, growing 23 percent from a year earlier. Mid-market deal flow increased 5.7 percent sequentially from the third quarter to the fourth with purchase multiples seven times EBITDA, according to BlueWater Partners.

Jeff Helminksi, managing partner at **Auxo Investment Partners** in Grand Rapids, believes there's a "bunch of people" who planned to sell their business within the next two to four years, "and they just weathered this storm and said, 'Well, I don't know if I want to go through that again, I'm pulling the parachute now.'"

Potentially higher federal tax rates under President Biden also could drive more sellers to the market in the months ahead, Kothari said.

The prospect of higher taxes, particularly an increase in the capital gains tax, on top of the pandemic and "extraordinarily high" valuations "are just kind of making people say, 'Gosh, I should go' and explore it today, more so than ever,'" Kothari said.

Move to Zoom

As the COVID-19 pandemic took hold last spring and states imposed travel and stay-at-home restrictions, M&A professionals resorted to Zoom or other video-conferencing platforms to keep deals moving. Roundtable panelists expect it to be a long-term feature of the deal process.

"This is going to carry forward to some degree. The cost and simplicity of doing this is going to create an opportunity to get buyers and sellers together earlier and differently. There will be continued interest and opportunity to use technology to do that in the pre-deal process and, for sure, in the post-deal process," Kothari said. "Everyone flying in to do all of that stuff is going to cut back dramatically."

However, dealmakers should avoid falling into a "trap" where they rely too much on video meetings, Helminski said.

"People can come across very differently in this setting when you don't know each other than it would in-person. There's a trap you can fall into saying, 'Hey, I've met them on Zoom and therefore I've got a really good sense of who they are,'" Helminski said. "Sometimes that's accurate and sometimes that's not."

Roundtable panelists also expect diversity, equity and inclusion to become a larger issue in the M&A profession.

Auxo Investment Partners has sought greater diversity on its team while telling recruiters that the firm wants a more diverse candidate pool, Helminski said.

A company's reputation for diversity, equity and inclusion is an issue that Waséyabek Development will look at when buying, Mitchell said.

"That's definitely something I think you have to consider in this day and age and what that looks like and having a mitigation plan or improvement plan of some kind," she said. MiBiz