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GET FASTER:
How to Be Deal Ready in 2023

The mergers-and-acquisitions industry should expect a busier 2023 than conventional wisdom might suggest with the prospect of an economic downturn, and this means companies on both sides of the equation shouldn't just sit back on their haunches. They must be deal-ready for opportunities that could poke through and belie a landscape that seems sleepy.

"We've seen a challenging year in M&A," said Bill Myers, vice president of sales for Datasite, which provides the SaaS digital platform and technology for "data rooms" for M&A candidate companies. "This is nothing new. There are several big economic factors; interest rate increases, inflation, supply chain issues, geopolitical issues. But we see many deals that don't get announced, so the story is actually a little bit different. Some of our findings indicate that the M&A market is busier than the current news suggests."

Myers was addressing a recent *Chief Executive* roundtable, "How to be Deal Ready in 2023," where PE executives and experts in M&A exchanged observations and ideas with a group of CEOs and CFOs.

Several acknowledged that a sort of quiescence has settled over M&A after the go-go era of record activity over the past few years. "For 2023, everybody is kind of waiting," said Jerrod Stoller, president of Digital Envoy, a provider of IP-based geolocation data. It's kind of wait and see. If you've got portfolio companies" in a private-equity firm, for instance, "you're probably not eager to sell low. So, you tell [their management], 'Hey, plan to use 2023 to invest, fix [and] polish."

Mark Vale, CFO of ScentAir Technologies, a provider of ambient scent marketing solutions, agreed that "there's a lot of discussion all around these tables at the moment about how things are going to play out over the coming six to 24 months, particularly for companies that were maybe bought out just before the pandemic hit. There's a lot of consternation about value now."

But Myers noted that the number of initiated deals on the platform has "remained more buoyant year-over-year than publicly announced M&A activity has, and we see global M&A deals" in the first three quarters of 2022 were ahead of the year-earlier period.

Datasite's data rooms allow M&A candidates to store information about the company and make it accessible to potential buyers and other relevant constituencies, all compartmentalized in one place for convenient access. Datasite does more than 13,000 transactions a year and, in 2021, facilitated more than one-third of the world's top M&A deals.

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Based on data from monitoring all this activity, Myers said increases in activity late last year indicated "we may see an increase in activity starting up again in the first quarter of 2023."

Of the three largest sectors for M&A activity, health care was hit hardest in 2022, down 11% year-over-year in October, with similar declines in North America and the Europe-Middle East-Asia region, as the industry "continues to go through some necessary digestion pains after Covid-fueled engorgement."

Industrials cooled slightly in the third quarter but remained up by 13% overall for the year. Real estate boomed as PE firms rushed in to seize hard assets, and Myers said the expansion of M&A deals in the real estate sector, will continue into 2023.

Business and financial services were bright spots. Technology and media remained sluggish compared with 2021, though the sector could have been much worse given what happened in the digital-tech sector in 2022 after a bullish 2021.

So, what are some key best practices for this volatile market? In our roundtable discussion, one element stood out above all else: If being organized and agile going into any transaction is always a crucial part of effective dealmaking, in a market like this it's even more essential. Here's some of what CEOs shared in the conversation:

Agility Is More Everything.

Even in less volatile times, "time kills all deals," said Jon Haas, managing director of Clarion Capital Partners. "People who are well organized and have put together their materials in a thoughtful way have a much higher probability of transacting. And when they don't have the analysis, and they've got to go back and do it, and now all of a sudden time goes by, then maybe actually the performance might have deteriorated too. Then, all of a sudden, they're not hitting their projections.

"So, they went in thinking, 'We're going to be valued at 'X,' and now, all of a sudden, because they couldn't generate the analysis and it's taking more time to get the information, and they questions answered, [and] they're not performing during the process, that gets buyers concerned. Because a lot of times, [sellers' financial] projections are pretty aggressive. And valuations are high in this market, so anything that jeopardizes that makes it harder" for the deal to go through.

Muir said that "to the extent a company is less ready, it's more distracting, and when the management team is distracted by scrambling around, getting information, then the financial results suffer. You take your eye off the ball; you're focused on doing a deal, not on growing the company."

Due diligence on average takes about ten months once information is made available to prospective buyers, the company has found. The cost is quantifiable: It's an average of $104,000 a week, according to a recent Datasite survey of more than 600 M&A professionals. In 2022 through three quarters, 41% of deals fell apart due to last-minute red flags, Datasite information revealed.

"We also found a 50% increase in chances a deal doesn't close for every extra week of due diligence," Myers said. "It's all about having your ducks in a row."

Complexity Is Growing.

Even before potential buyers can be ready to kick the tires on an acquisition, many sellers face the challenge that "it takes a lot longer in prep time right now to get your assets ready for sale," Myers said. Investment bankers are "sending their diligence request lists over, and the information is all over the place. That becomes a real headache."

Sellers may want to use email or some sort of repository for due-diligence information, for example, and "some buyers are going to have problems filling out and using some of those technologies to try and get a deal done. Best practices we're seeing is that more and more people want to use a data room.

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"We usually have our companies do a data room when we make the investment, and we just say, 'You've got to keep your data room current,'" said Jeff Muir, co-founder and partner of Fulcrum Equity Partners. "'You never know when somebody's going to come in and make you an offer that is very attractive, and so you've got to keep it current.' It's a lot easier to keep a data room current than to build one from scratch, you know, two months before you do a deal."

Self-interviewing from the point of view of a potential buyer can be a valuable exercise for sellers.

"You can never have everything ready and buttoned up, but what I always encourage our portfolio [selling] companies to do is think of the questions you would be asking if you were buying this business—and now go get the answers," Haas said. "Try to put together a list of the top 50, 25 questions, 100 questions you're likely to get asked, and ask every person on your team to work on preparing responses. It will make you look a lot smarter and make your process go a lot quicker.

"Don't wait for the question to get asked and [then] you've got to scrounge through the organization to try to pull together the information, because you just don't look like you're that organized, you don't look like you've been thinking about these issues. And you know all the questions people are going to ask. And if you have a PE investor, they've probably already asked you the questions once. What would you say to them? If you were buying this business, what would you want to know?

"So, I literally have prepared lists of, I don't know, a hundred questions and have presented them to the management team and said, 'You should have answers to all of these, and I want you to think through this and get the data ready, and put it in the data site. Now, you're not going to anticipate everything, but boy do you look good when you can.'

Haas continued, "When somebody says, 'Have you done a decile analysis to look at blah, blah, blah' and [you] can say, 'well, actually, yes, we have'—it's like, if I'm a buyer, I'm like, 'These guys are really on top of their business.'"

To help, some companies use firms that represent the management team, including lawyers and compensation experts and bankers, and make the sales process more streamlined and productive, especially for larger transactions. They ask the buyer to pay the higher fee for the convenience and accountability the outside team provides.

"A lot of our smaller companies don't have a CFO, so they rent a CFO, somebody who's done deals, and that helps them get everything ready," Muir said. "And that's positive in our view."

Likewise, Haas said, "most companies we've bought either have a controller or a CFO in place. But I definitely think there's value in [supplementing] your finance staff. Because if there's one person who gets really bombarded during a sales process, it is the CFO. They're the ones building the model, answering a lot of the detailed questions and doing a lot of the analyses, and also trying to run the business."

Preparing for the Exit Is Bumpier.

Does the selling owner stay? Or roll part of his/her equity into the company going forward? What about the key managers? Are they eyeing the exit? Having these questions figured out well in advance of the deal—or even taking the company to market—is absolutely critical in an environment as tricky as this one.

"The investment bank wants to see how much management or the founder is prepared to roll" into the deal, Haas said. "They want to see who they are, what are your plans for the business, what role you play. And then they decide [you may want] to be more invested, or no, this isn't right for [you], and you just take your chips, and the transition, and move on."

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Myers said Datasite has found "one common thread that it never really plays out the way [buyers] expect it to play out, and it never really plays out the way [sellers] expect it to play out, either. That losing control, the emotional part of it, doesn't necessarily sink in from day one. It could sink in in year three, right?—where you sign a five-year deal [but] your pockets are already lined, so [your] motivations tend to really change."

In standard terms, Haas said, sellers want to see management teams roll forward 20% to 40% of their equity. "It's a great sign of someone's conviction, the more equity they want to hold on to," he said. "But we also tend to prefer majority deals. If we want to own something, we usually want more of it, not less of it.

"But there's a fine line. Sometimes you're like, 'Whoa, this guy is selling? What does he know? [If] he's got these hockey-stick projections, and EBITDA next year is going from 15 to 30, [and] it took him 20 years to get to [EBITDA] of 15, would he really be selling 100% of his business? So, there's some signaling that goes on there, too."

And once your employees know that you're thinking about selling the business, your best, most loyal employees "are going to start looking around," Muir said. "Does he need to start polishing his resume and looking around? You've got to have those conversations early."

Let sellers know some highlights about the company's culture and the positives that have resulted from it. "There's not a ton of quantitative information out there, [but there are] Glassdoor reviews that you can use," Haas said. "You can point to employee retention; [but] obviously, you don't want to hold on to bad employees, so there always should be some turnover in an organization. If you compare yourself to some of the peers in your industry, that's usually a good sign.

"And then describe your culture. What is it about your culture? Oftentimes it's very hard for an outsider to look in and understand, but maybe there are some case studies or values that are very important to your company that you want to highlight to people."

Myers said that when PE buyers "sit down in a room with a management team, you will learn so much about that culture, about how that's run, that it's probably the single biggest indicator. You see the interaction with the broader team. And where you see a CEO lead the entire conversation—that can be the most telling thing. You'll learn [a lot] about the company."

Sometimes the learnings for potential buyers on this score alone can be determinative.

"The one thing I'm always shocked [to see happen] is when a founder or an owner of a business who is exiting does 100% of the presentation, and the rest of the management team is basically silent," Haas said. "It's just like, 'Really?' I mean, I get it—you're in control, and you want to control the messaging. But I'm not betting on you; I'm betting on those five people over there, and they're not saying a thing, so maybe they really don't make decisions around here, and this can be a whole new role for them."