Troutman Pepper Podcasts **Opportunities and Optimism: M&A Deal Trends - Discussion Around ACG Atlanta M&A South Panel**
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[JEREMY LEVY]

Hello I am Jeremy Levy and I am a partner with the law firm Troutman Pepper. I am joined today by my fellow partner in the Private Equity Practice Alec Watson out of our Charlotte office. Alec recently moderated the Opportunities and Optimism M&A Deals Trends panel at the ACG Atlanta M&A South conference in February 2022. He is joining us today to discuss some of the key points that came out of the panel. Welcome Alec.

[ALEC WATSON]

Hi Jeremy. Nice to be with you. Thanks for doing this.

[JEREMY LEVY]

Absolutely. Thank you for joining. So before we get into the panel discussion, how did it feel to be at a conference in person again?

[ALEX WATSON]

It was actually pretty energizing. I felt like everybody was sort of refreshed right to do these and they kind of seemed like old hat and you are going through the motions. And so I think everybody was you know pretty appreciative of the opportunity to be there. There was a lot of energy in the room. You know again people were fired up and glad to be in that setting. I think it was mostly, it was relatively new for everyone. I don't think there has been, I have been to one conference recently and I heard a little bit about some others, but there hasn't been that much of this, so I think everybody really did appreciate the opportunity to be able to get together again.

[JEREMY LEVY]

I know that people are happy to get back to board meetings in person and shaking hands and trying to live again in society. So it's nice. So your panel was about 2022 Emanated Deal Trends. Who was on the panel with you?

[ALEC WATSON]

We had a really good panel. It was Gary Denning from Balmoral Advisors, Linnea Geise from PDI, Cardell McKinstry from Aprio, Michael Rostfrom PNC River Arch Capital and Phil Theodor from McGriff so we had an investment banker, a strategic, a private equity sponsor an accountant and reps and warranties insurance broker and so that it really did offer a nice diverse perspective in terms of the M&A market.

[JEREMY LEVY]

Before we talk about 2022, let's step back and take a couple of minutes to review 2021. Give us your take on what kinds of trends we were seeing at the end of last year in the market.

[ALEC WATSON]

I think it pretty consistently it was an ultra-competitive market and sellers were still king. You still felt like a good asset could easily be sold. A good asset could easily be sold and even the garbage was getting pretty good traction. I think one of the key things that we get to talk about as a buyer, right, what do you do to distinguish yourself in that market. It's difficult. There is a lot of capital there. Everybody out there is hunting for the same trophy at the end of the day. It's really tough as buyer, what do you do. One thing that we heard consistently from the folks ono the panel and is really similar to the experience that we had in terms of talking to some of our clients was that buyers are really being more selective. The days of you see an NDA, a teaser you like it you saw the NDA and you really spend meaningful time on it, in a market like this, you really just can do that. Y0u can't sort of dip your toe in the water and expect to be competitive in these processes. You can got to really jump in. You have to spend meaningful resources in terms of third party costs. You got to spend a lot of time from the buyer's perspective. You can't just say let me take a look at this one and that one. It's like buyers are getting a little more selective just because they have to. And the cost of participating in the process is increasing and you know we have really seen a good bit of that. That was one thing I think resonated a lot from all sides of our panel.

[JEREMY LEVY]

And at the same time at the end of last year, it was really difficult for our private equity fund clients to find service providers, third party consultants and things like that who had the band width to help fund deals. So it was a challenge on both ends. So what kind of timelines were you seeing in the market at the end of last year?

[ALEC WATSON]

Fast and faster. I think it was certainly 30 days or less on anything competitive. Sort of start to finish. That didn't make things done actually drag out longer when issues came up. You certainly couldn't go into the process and say you get a deal done in 45 days and having a chance, right. Everything is moving quickly. There is really a significant increase we have seen in terms of the pre-day diligence on the sell side. So our standards have been standard for some time. Seeing more in terms of that pre-diligence, people having consultants come in a perform the diligence report at the outset, cyber data privacy reports, things like that where anything that a seller can do to basically check that box and convince the buyer hey you are in a good place, go forward with this quickly, take one of those variables off the table, we continue to see a lot of that. And I think that is something that we expect to see more of going forward.

[JEREMY LEVY]

That is consistent with my experience and others in our group are seeing as well. My clients didn't submit any bids at the end of last year that promised more than 10 days to sign near closing. So it was a pretty frothy market at the end and everyone was sprinting to the finish. But let's pivot to rep and warranty insurance. You had that on your panel as well. As you know, insurers were completely overloaded at the end of last year. That changed both pricing in terms that we were seeing in the market for rep and warranty insurance. What are your thoughts on what we have been seeing and will see for 2022?

[ALEC WATSON]

It was extremely difficult right as you mentioned to even get rep and warranty insurance at the end of last year. The market was so crazy that it just ended up in a situation where they could charge what they wanted to charge and you really saw the insurers basically picking and choosing. They got to pick which deals they thought were the ones thy wanted. Where they could charge the most premium. They could be most profitable. And that left a lot of folks out. Whether it was a timing issue and you mentioned vendor availability issues that were prevalent across the market but certainly let them price it the way they wanted to price it. The question is whether was it underpriced before. People talk about client histories and more claims are being made and maybe the pricing tends to trend up. It was interesting because one of the things that we have talked about and our group has talked about is sort of what happens going forward. Once we are out of Q4 of last year and things are stabilized a little bit, normal in today's times, but what does that mean from a pricing perspective and the panelist were pretty consensus in terms of the idea that prices may go down, but they are not going down meaningfully. Once the insurers have figured out we can charge this and there is still a market for it, there may be a dip but certainly not going to go back to what you would have seen 12, 18, 24 months ago. I think that is kind of is what it is and we will see how the market plays out. One thing that we have seen more of, and really seen a bit over the past couple of years, but certainly some more of it last year, was especially financial sponsors deciding to self-insure. Look if we keep paying these premiums and it's a lot of money and it certainly exacerbates as the premium gets more expensive. But we pay these premiums and we are still not making claims on the policy because you have to do a ton of diligence to make this work in this situation you are going to be digging deep, you probably buying from a financial sponsor who has already done the same thing on their end, so in that situation do you just not step back and say look we are going to basically take what we would have spent on the premium and essentially view that our own backstop and we will deal with that to handle the claims and if the claims don't come up because we did such a good job of diligence, we bought a clean asset, then that's even better. I wouldn't be surprised to see that. I don't know if that's the risk profile of every sponsor. I think that some of them certainly sleep better at night having that policy in place and have gotten used to it but it will be interesting to see as this year develops you see more of that happening in the market.

[JEREMY LEVY]

Yeah, I wonder if that arose more from the expedited timelines than it did from the pricing. I had conversations with clients of mine in the same vain and we are talking about the pros and cons of RWI, especially given that historically there haven't been tons and tons of indemnity claims. Now you are coming out of pocket in order to pay for the premiums. There have been a lot of discussions about the value proposition. But in my experience, and I'm curious if yours has been the same, before the sort of frenzy of the end of last year, the value proposition was worth considering but we sort of more frequently saw our clients actually going ahead and pulling the trigger on the policy. Whereas toward the end of last year, my clients at least who chose to self-insure did so for a combination of the reasons of the value perspective but also the time like you said the ability to skip diligence effectively or at least do it on a much more streamlined basis and not have to show your work to your insurer. That really helped my client out on that decision. Are you seeing similar types of decision marking?

[ALEC WATSON]

I think that will be interesting to see. We did have one client who literally went back and sort of looked at their claim history and deal history over several years and just modeled it out and said here is how much we have been spending on premiums and in this entire time, we have made no claims on police and we have made one of two claims under sort of general, the old school indemnification package. They look at that and just said this just doesn't make any sense. Now they may regret those words if you end up in the sort of worst case scenario down the line, but I think you are right, I think it is a combination of both of those.

[JEREMY LEVY]

So I started the podcast asking what it was like going to a big conference in person again in light of COVID. Let's talk about COVID and its continuing impact on deals in 2022. How has COVID affected sponsors and where do we think we are headed?

[ALEC WATSON]

I think a lot of folks actually talked about some of the good things that have come out of it. The fact that basically a lot this travel that everybody did in terms of your bankers and sponsors and so forth. It's just not necessary. I think a lot of folks realize now that the video conferencing just wasn't utilized to the way it could have been and that we actually can get a lot done the same way. Is it a perfect replacement for being in the same room with somebody? No. And I think everybody on our panel and those folks I have spoken with and JI would expect you are in the same place, they weren't doing deals without seeing somebody. Like they would be in the room at some point with somebody. It certainly may be a fewer number of times in a pre-COVID environment but you are going to expect to have that in person communication. But it does save them from a lot of diligence meetings that probably didn't have to take place. Most of the diligence that you do can be done on a remote basis and this sort of gave everybody an excuse to re-examine that and kind of revisit exactly how that process should play out on a more efficient basis. The one thing that really resonated with the folks we talked to was the sort of biggest disadvantages weren't so much related to the process themselves, but were more so related to integration post-closing and the fact that you have got this new asset. You have these new employees. They have not at that point will not have met in person with the sponsor as much as they would have otherwise. Relationships may not be as extensive and then just sort of throughout the general employee base. Trying to integrate people in an environment where you really can't get in front of them. Those seem to be the biggest challenges that people were facing and trying to adjust to. But by in large I think everybody has gotten used to it at this point.

[JEREMY LEVY]

In my experience I am really seeing that play out. If you compare the relationship, the personal relationship that my sponsor clients have with their portfolio company CEOs as you contrast a company that was purchased prior to COVID with the old fashioned diligence process, lots of management meetings, lots of hand holding, prior to acquisition, contrast that with the relationship that the sponsors have with their portfolio companies CEOs who they bought during COVID, I experience board meetings where there is a noticeable different between the relationship. That is sort of playing itself out as we become more accustomed to this new normal. It will be interesting to see how that plays out both in the operational period and also on exit. So let's look at some macro-economic issues that are commensary with

COVID. Are the labor shortage and supply chain issues we are seeing in the global economy going to impact dealing making this year.?

[ALEC WATSON]

I think it certainly continues to impact things on the deal side. I think you see it more frequently in some industries than others. For example, hospitality, manufacturing, I think it is very prevalent in those. Generally speaking, I think that the vendor shortage on the deal side, that I think was more temporary and probably not something that we will see on an ongoing basis, maybe peaks and valleys obviously, when that stuff does come up, but it's hard not to think that it doesn't have some impact generally speaking on deal making as we move forward.

[JEREMY LEVY]

You mentioned the elephant in the room in 2021 was pending tax reform. Now that we are in calendar 22, the calendar year flipped, are you finding sellers still focused on the pending tax law change or has that lessened?

[ALEC WATSON]

I think there is still a focus there. We are talking about dealing with our federal government right? And so nothing happens quickly. Nothing happens efficiently. For the last two years its been a big driver of yearend deal flow. Will that happen again? I guess that depends on what happens during the year. One thing we certainly are seeing is that given the high valuations one way to combat that is through the use of things like earnouts and seller financings. Those become more difficult certainly in an environment where you are expecting tax rates to increase obviously. I think whether that sort of mitigates the use of some of those tools going forward we may see more of that. But I think everybody still, we have all heard predictions and we all continue to wait and see how it's going to play out.

[JEREMY LEVY]

How about inflation and rising interest rates? What impact do you see that having?

[ALEC WATSON]

The consensus we hear is that interest rates are at a such an historically low]place right now that it's relative. So rising interest rates environment from the perspective of how you finance your deal The mix between debt and equity. That is still significantly cheaper than equity is. So while you would like to pay lower rates it's not, I don't think anyone thinks interest rates to become so prohibitive, that it materially impacts the availability of debt financing. Does it change the mix between debt and equity? Maybe. I think the bigger issue would be if the rising interest rates lead to a broader economic slowdown that sort of puts a damper on the market generally. If that happens, then I think you will see the bigger impact rather than sort of the moderate increase in the cost of capital.

[JEREMY LEVY]

We will have to see how that plays out over the course of the year. There are obviously lots of commentators predicting that slowdown. So we will see what happens. Fingers crossed.

Alec, that's all the questions I have for you today. Thank you for your time and discussing your panel at ACG South. It' s been a great discussion.

[ALEC WATSON]

Thanks Jeremy. I enjoyed catching up.

[JEREMY LEVY]

Absolutely. I also wanted to thank our listeners and I hope you found our conversation insightful as we continue further into 2022. Consistently recognized as a top tier national practice, Troutman Pepper's corporate attorneys regularly handle multi million and multi-billion dollar transactions and the firm has particular expertise in the private equity and private funds services bases. We advise clients on matters from fund formation to acquisitions, investments and exit transactions. For more information about Troutman Pepper and our private equity group in particular, and for the latest insights from our attorneys, please visit www.troutman.com.