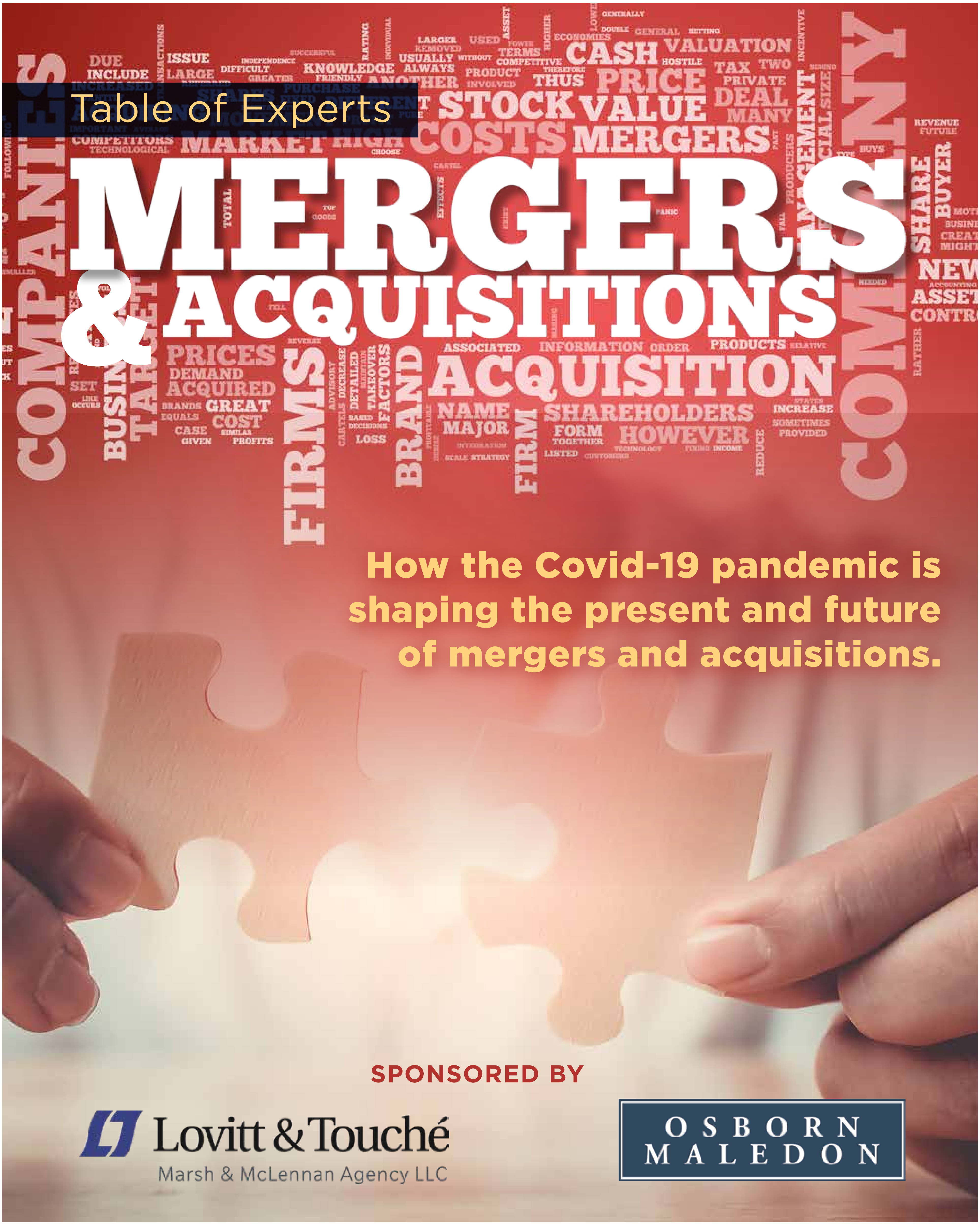

Table of Experts

MERGERS & ACQUISITIONS

How the Covid-19 pandemic is shaping the present and future of mergers and acquisitions.

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Dealing in turbulence, mergers, acquisitions find new footing in pandemic world

Ray Schey: What effect has the emergence of the coronavirus had on the M&A transactions that you've been working on?

Aaron Harmon: It's had a varied effect. Several of the deals we were working on when the lockdowns first began just stopped or, in some cases, they were characterized as going "on pause." That was particularly true if the target company was in an industry that looked like it was going to be negatively impacted, or if the buyer was a financial buyer that wanted to preserve the cash it planned to use for the acquisition for other immediate needs. Other deals went forward, but they re-traded. There were some buyers that negotiated a lower price, or perhaps a higher escrow amount. And some deals were completely unaffected, particularly if the target company was in an industry that was either neutrally impacted or was positively impacted by the pandemic. Those deals went forward. In fact, for those that were positively impacted, buyers were even more eager to get the deal done.

Ray Schey: Elise, what would you say is the status of the deal market currently and its activity right now?

Elise Thorpe: As a principal with Lovitt & Touché, which is now part of Marsh & McLennan Agency, and Marsh & McLennan Cos., my viewpoint is traditionally on the human capital side, but as my role as president of association for corporate growth, which is the deal making community, I'm surrounded by some of the experts like investment bankers, private equity groups, transaction attorneys.

At the beginning of this year, if there was a deal that was started in January or before Covid-19 really hit, that deal continued. I was involved in two of them that are continuing, although the process has been delayed somewhat. I'd say the first interview with management instead of being in March ended up being in April or May. I see four to eight weeks delay in that process.

In terms of deals that we're looking at, I think some people are waiting on the sidelines. There's more aggressiveness in the smaller or lower mid-market end than in the higher end. I see overall that it's slowing. I think investors are telling their business owners, "You might want to wait if you're in a healthy business until this is over. Wait at least six months to reevaluate the situation."

> *For any new capital, it's important that there's a good relationship between the buyer and seller, or the investor. If somebody already had that relationship before Covid-19 hit, then I think they're able to move forward with Zoom or WebEx. If they didn't, I think it's a little more difficult.*
>
> ELISE THORPE | Lovitt & Touché

Ray Schey: In the time of Covid-19, how is the due diligence being done?

Elise Thorpe: It's been interesting. Obviously with quarantine, it's been forced to be done via desktop analysis, which is difficult. As I said before, the process is taking longer because people are working remotely. Getting them coordinated, with them having access to all the documents that are needed in the due diligence process, takes a little longer. Also, for the in-person management meetings or site visits, nobody could do that for a while. Now that the cities are reopening there are more opportunities.

For any new capital, it's important that there's a good relationship between the buyer and seller, or the investor. If somebody already had that relationship before Covid-19 hit, then I think they're able to move forward with Zoom or WebEx. If they didn't, I think it's a little more difficult. That's, again, slowed the process until they're able to go face-to-face and meet the people they wanted to partner with.

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Ray Schey: Have any of the tours been held virtually as opposed to in person?

Elise Thorpe: I have not seen that, but I do know there are some people who are traveling now. Those site visits are happening now that more things are opening up. It's easier now, or will be in the future. I'm sure that (virtual tours) could happen, but I haven't been involved in that.

Ray Schey: What are the current hot topics for due diligence?

Elise Thorpe: There are a couple of different areas. Buyers need to really expand their due diligence to areas that are being impacted by COVID, such as really looking at supply chains, IT systems, insurance coverage, which is what our expertise is like cyber risk, business continuity, and workers' comp concerns. Also, there've been so many new laws that have passed regarding employment and health insurance. Making sure that people really look into all those areas.

In regard to government assistance programs, this is really new to all of us and we're all trying to figure it out. The questions are, for example, if you're acquiring a company with a PPP loan, which is meant to be forgiven, as long as they follow the criteria, then why would you require them to pay that off and get it off their books? For each chase, it really depends. The parties have to determine in their particular situation, what's the best answer because there is no right answer. Every situation is unique.

Ray Schey: Aaron, we'll turn back to you too. Obviously legally there's a lot involved here. What should business owners be doing today to prepare for acquisition in the next year to two years?

Aaron Harmon: In some ways, the pandemic hasn't changed traditional approaches to preparing for an acquisition. I would still say one of the best things a seller can do now is the same as a year ago. That is, before you start the sale process, get good advisers to help you prepare your company. Have a good CPA, have good insurance advisers, have good legal counsel. It also can be very advantageous to engage with an investment banker or a business broker to design a sale process to maximize the sale price for your company. Do all that early.

The clients I've had that had the most success during the sale process spent a lot of time making sure they would have a good due diligence process. One of the best ways to do that is to put your company through a mock diligence process. When you engage with advisers, they can provide a comprehensive due diligence checklist that will cover all the operational questions, the financial questions, the legal questions that typically come up. Going through that and making sure you have good answers to those questions will help you get ready. If you identify problems, solving those problems with your advisers in the preparation stage, as opposed to learning about those problems when the buyer brings them up, goes a long way.

I don't think the pandemic has changed that. Also, if you have a company that's been negatively impacted by the pandemic, try to assess the effects of that on your company as best you can over the mid- to long-term, and have good answers around how you're mitigating those negative impacts. That's easier said than done, given the uncertainty.

Ray Schey: Based on that comment, do you think there'll be more people looking to consider M&A, or less? Are people thinking, "Okay, maybe it is time to look around and consider opportunities," or not?

Aaron Harmon: So far, we're seeing a decrease in M&A activity overall, but deals are still happening. Before the pandemic started, we had several years of capital accumulation, in significant amounts. Private equity firms, venture capitalists, and also companies, strategic buyers, had accumulated a lot of capital and earmarked it for acquisition. There's a lot of dry powder out there. I think there will be opportunistic deals that are done, like there always are in recessions. There will be opportunities for buyers with a long view to get a good price on target companies. I think that will happen.

There are, maybe, 15% to 20% of the industries out there that have actually benefited from the pandemic. I think there will definitely be acquisitive activity in those areas too.

There are also things you have to do ahead of time. Good tax planning is an example of that. That's something that you want to do well ahead of the sale process. If you're an owner of the business, you want to have good tax advice. There are lots of things you can do to be tax efficient in your sale, but most of those things have to be done long before the sale process starts.

Ray Schey: That leads to a good question. What's the ramp up time from somebody who might be thinking of M&A activity from the time they're thinking about it and getting their house in order, as you alluded to and truly beginning the process?

Aaron Harmon: I don't think there's a single answer to that.

Elise Thorpe: I agree.

Ray Schey: It depends on the company and depends on the individuals, right?

Elise Thorpe: It depends on the state which the organization is in. There are sellers that think they're ready to go, and then when they have an adviser come in and they find out more about the internal operations, the seller may need to get more things in place before they can even think about selling. That can take a year or two before they're ready to sell. Or there's people that have the processes, procedures, and finances - everything that Aaron was talking about - those things in place, and they're ready to go. It really depends on the business state of the organization.

Aaron Harmon: And it can depend on what they do. If they're in a highly regulated industry, the diligence is going to be more robust. If they're in bad shape and they're in a highly regulated industry, the ramp-up time is going to be significant. Though, sometimes the irony of a highly regulated company is that it's in better shape because it had to be in good shape as it's operated. There's a lot of factors that go into ramp-up time.

Ray Schey: Elise, what are you seeing in terms of the valuation issues and the price structuring due to Covid-19?

Elise Thorpe: I think negotiations on a purchase price are going to be a bit more difficult because the impact of Covid on a seller's revenue or earnings forecast may widen the gap between the valuation of the target company. Buyers may insist on a purchase price adjustment or deferred payment so the purchase price reflects the impact of Covid-19 on the value of the target at closing. At the same time, the seller may insist that Covid-19 isn't a risk on their

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underlying business, and that if it is, it's the risk of the buyer and that's their responsibility. Each target company is unique and the buyers have to evaluate the current financial situation of the company. Some companies, at this time, are doing great and are very opportunistic, but could be a short-term financial value versus others that have more of a long-term trend and financially viable opportunity beyond Covid.

Then you have others, like the industries that are really hit hard — retail, hospitality — that you have to determine how are they going to bounce back? Right now they're really hurting. Is it going to be a slow progression, or is it going to be an industry that can bounce back pretty quickly?

I think all those things are taken into consideration. There's a lot of talk about earn-outs, which means they're deferring part of the value of the business post-close. They may say, "Well, we're going to wait 12 months post-close date." to see what the financial status and value is at that time and determine if the seller gets the full value at that time. That's something else that's been coming up more and more.

Aaron Harmon: I definitely have seen that. Earn-outs are a way of bridging the gap that's created by a difference of opinion between buyer and seller as to what the value is. They are a decent way of dealing with the uncertainty that Covid presents because they are tied to performance. What we're seeing is longer earn-out periods, where there's just more time to evaluate the true effects of Covid and how that plays into the value of the company. I think valuation is a very difficult topic right now, given the uncertainty in the macro-environment.

Ray Schey: We touched on this a bit earlier, but Aaron, when should a business owner engage legal counsel as well as other advisers in the sale process?

Aaron Harmon: Earlier is better, as a rule. I know whenever an adviser says that, it sounds somewhat self-serving, but it's actually not. As an adviser, it's much easier to help a company through a sale process if they are prepared. The old saying that an ounce of prevention is worth a pound of cure is really true in this context. The clients I've had that have done the best with the sale process are those that engaged all the necessary advisers long before they began the sale process, and have gotten everything in order.

Sometimes a sale process sneaks up on sellers. They weren't necessarily planning on selling the company, but an offer comes over the transom. Maybe they haven't been engaged in the preparatory process. If that happens, I would still say you want to get your advisers involved before you sign a letter of intent or a term sheet, as opposed to after. Often, there's more money that's made or lost at the term sheet stage than at the definitive documents stage. Good advisers can help you understand deal terms that, unless you've gone through a sale process before, are going to be unfamiliar. They can help you understand what's market or fair in the current environment, so that you're not taken advantage of.

Elise Thorpe: Your first question to him was if somebody's thinking about selling, or buying, when should advisers (insurance brokers, transaction attorneys, etc.) get involved? I agree, the sooner you get us involved, the better. Marsh has their private equity and M&A services. The whole point of that division is to help sellers, or the buyers, go through that due diligence, make sure they have the right risk-mitigation protocols, that they're priced appropriately, and the whole process is executed quickly. The sooner you get M&A advisers involved, the better that process is going to go. Those advisers can help you so you can get to the table quicker and get through the deal faster.

Ray Schey: I'd like to hear both of your responses to how the pandemic has affected representations and warranties in the M&A transactions.

Elise Thorpe: There's increased scrutiny, and buyers really need to look at the seller's customers, their suppliers and vendor relationships. With employees working more remotely, there's also increase in IT risks with cybersecurity, valuation of inventory and quality of accounts receivables. We think there's going to be more emphasis on this. Some of the carriers have already included a form exclusion to their policies. I think they're going to come more into play and have more emphasis. I don't know, Aaron, if you've got comments on that.

Aaron Harmon: Another area that's related to representations and warranties is rep and warranty insurance. Prior to the pandemic, rep and warranty insurance in M&A deals was becoming more common, and the effect of Covid-19 on that is evolving. One thing we're seeing is that rep and warranty insurers are proposing exclusions related to Covid-19 exposures. In some cases they attempt to completely exclude any business interruption or loss that arises out of the pandemic. But other insurers are open to making exclusions on a case-by-case basis. There's a negotiation that's happening now with rep and warranty insurers that didn't happen as much pre-pandemic.

Insurers are also much more carefully underwriting the deals that they do and looking closely at the Covid-19-related reps and warranties that show up in purchase agreements. So, the pandemic is affecting the rep and warranty insurance market in significant ways. But so far, we're still seeing rep and warranty insurance in many deals. As of at least a couple of weeks ago, I hadn't seen an appreciable effect on premiums or retentions yet. That could change.

Ray Schey: Elise, what are you seeing from the private equity companies and how they're managing their portfolios?

Elise Thorpe: I think they're being a little bit more conservative and sticking really to what they know, the industries that already are in their portfolios, rather than taking on the additional risk of broadening some of those industries. They're being cautious. That's what I've seen. I'm sure it depends on the private equity organization, but that's what I've seen.

Aaron Harmon: I've seen both private equity and venture capital firms doing a capital requirements assessment of their portfolio companies. Trying to determine not only the impact of the pandemic on those companies, but also what their capital requirements will be for the next 12-24 months. And figuring out strategies for bridging that gap. In some cases, I think that means they will make fewer investments in new portfolio companies, because they are preserving capital to support their existing portfolio companies.

Ray Schey: On the human capital side, what are you seeing as being important during the M&A deals?

Elise Thorpe: I know most people involved think the financial side is the most important, but I think also for the long-term success of the organization, they really need to think about the human capital sides. What's the culture of the two organizations? What's the philosophy towards benefits and compensation? What are turnover rates? What are the details of the benefits that are being offered? Contribution strategy? All of these have to do with the culture. If you have a buyer that's acquiring another company with completely different cultures, then those employees aren't going to last very long. There needs to be determination of what is the new organization culture going to look like, and how are they going to meld together. I think it's really important for the long-term success of any M&A situation.

Ray Schey: Elise, what can you share about the Association for Corporate Growth, in which you're the board chair there? Tell us a little bit about that organization and some of their efforts.

Elise Thorpe: Association for Corporate Growth is a global organization, and is considered the premier community for middle-market deal making. In Phoenix, I'm the Arizona chapter's president. We are comprised of private equity, and investment bankers, transaction attorneys, accountants, valuation companies, corporate executive professionals and more. And the point is to interact with those involved in deals so you can help each other with each other's business, share ideas, develop that network that's critical for promoting M&A deals.

> ***It's a challenging environment for everyone on the planet. There's not anyone that hasn't been affected by this in some way. Probably most of us alive today haven't experienced something like this, where literally everybody is affected.***
>
> AARON HARMON
> Osborn Maledon

Ray Schey: Is there anything that each of you have to add or would like to add, or other question? Again, this is pretty informal and each of you will have a chance to review the comments and the questions and so on, just to make sure that everything is teed up as you like. If there's something else that you'd like to add?

Elise Thorpe: Something else I've heard that's really important is transparency, and the seller being truly transparent and honest with the situation. Because if you start hiding things from the buyer, then there's that non-trustworthiness, and it's better to be honest and share what some of the challenges are, and work with the buyer. They just respond better to transparency and open honesty.

Aaron Harmon: I think the other thing is just the importance of continuing to be optimistic. It's a challenging environment for everyone on the planet. There's not anyone that hasn't been affected by this in some way. Probably most of us alive today haven't experienced something like this, where literally everybody is affected. Elisa and I work in professions where we see entrepreneurial-minded people solve problems every day. There's lots of those people in the world working on the problems of today. I think that over the long-term, this will pass and there will be new opportunities that arise out of it. Good will come of it, despite the challenges. I think it's important just to keep that in mind, and we'll get through it.

Elise Thorpe: That's a good point.

Ray Schey: Pre-pandemic, what was the Arizona M&A activity looking like? Was there an increase in that, or had at the same level over a period of time?

Elise Thorpe: Over the last, I'd say two years, it was pretty positive and robust. Again, I think it started slowing down when Covid hit. It hasn't stopped entirely, but it was pretty robust, we were seeing a lot of activity.

Aaron Harmon: It was robust and it was, for the most part, a very seller-favorable market. That obviously is changing.

Ray Schey: Is there certain industries that you've seen where there's been more activity, either pre-pandemic or since the pandemic started? Certain industries where there's more M&A activity.

Elise Thorpe: I've seen it all over the board from health care, to property management to utility. I've seen it everywhere. Technology. Manufacturing. It's all over the place.

Ray Schey: It's up to the seller, right? Somebody that's interested.

Elise Thorpe: And the buyer.