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Maximizing Value for Stakeholders: Strategies for Uncertain Times

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Since the beginning of the year, financial headlines have been daunting. Inflation rates have risen to their highest rates in nearly 40 years, cryptocurrencies have crashed and major stock indexes entered bear territory.

Business and geopolitical news has likewise been sobering. Supply chain issues and labor shortages continue and geopolitical events (including Russia's invasion of Ukraine and the slow reopening of COVID-19 lockdowns in China) have either blocked or done little to speed up deliveries of commodities, agricultural products and other goods worldwide.

In such uncertain times, investors and deal sponsors are understandably cautious. However, certain upside factors remain in place, despite current economic challenges. For example, there remains a surfeit of capital, private debt markets have grown significantly, and creative investment options and rescue financing, continue to offer alternatives to traditional structures.

As past market cycles have shown, during times of volatility stakeholders in the acquisition space are best served when they remain nimble and take advantage of hidden opportunities. The following strategies may help maximize value creation for equity and debt investors, particularly in industries facing a high degree of complexity or dislocation.

Expect a New Mix of Seller- and Buyer-Friendly Terms

In the face of rising interest rates, inflation and geopolitical uncertainty, market corrections are to be expected. That said, the M&A space largely remains a seller's market, particularly with respect to pricing and EBITDA multiples. An unprecedented amount of capital continues to compete for a finite number of potential deals.

This has the effect of driving valuations up, especially for the relatively small number of quality assets that did not trade during the deal frenzy starting the second half of 2020 and continuing through 2021. In addition to higher valuations, buyers should also expect to see more lender-friendly terms in their acquisition financing documentation. Recessionary concerns of lenders will be built into the underwriting process for new financings going forward to ensure that new credits can withstand further potential reductions in economic growth as well as the impacts of higher prices.

However, non-economic deal terms (including timing of the deal, pre-closing covenants, employee and benefits issues, leadership transitions, indemnification provisions and risk

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allocations), are likely to shift toward buyers. Some of this will be lender driven and some the result of longer timelines, more keen diligence and price sellers will need to accept in exchange for valuations continuing at elevated levels.

Emphasize Subject-Matter Expertise

In the current competitive market, deal participants will need to bring subject-matter expertise to bear on the rapidly evolving challenges facing businesses today. Such expertise is critical to increasing efficiency in existing operations and for finding and exploiting less-evident areas for improvement around the edges.

Sponsors can serve as a source of referrals to subject-matter experts, through their connections and relationships with industry experts and operational advisors with whom they have pursued prior deals or who are known through various professional networks.

Consider Co-Investments to Align Interests with Lenders

The degree to which lender co-investment can help align the interests of sponsors and lenders, particularly in terms of value maximization, is a complex calculation. Some argue that the return on the equity co-investment, relative to the size of a given facility, is insufficient to influence a lender's views on a particular business in any meaningful respect. However, when the relationship between the sponsor and the lender is viewed by both as more of a partnership, co-investment can benefit the underlying business, both in terms of bringing additional business expertise to the business and of having a sympathetic lender in the event that amendments or waivers are needed during periods of poor performance.

Transparency between sponsors and lenders with respect to the health of the business is an important foundation of this type of relationship and where clear, accurate information is available, all parties can assess the opportunities and risks more effectively. This perspective aligns with recent market trends toward transparency and away from more traditional views that lenders should receive only the information that the borrower is contractually obligated to provide.

Don't Overlook Providers of Junior Capital

Providers of junior capital can play a key role in driving value creation through the alignment of sponsor and lender interests with respect to products such as preferred equity paper and Holdco PIK notes. Junior capital can also provide buyers with somewhat more leverage when competing to purchase assets at high valuations.

Analyze Carve-Outs of Underperforming Companies

If the current market downturn continues, it is possible that large companies will become more aggressive in divesting themselves of underperforming segments within their current operations. In this context, carve-out transactions may offer buyers opportunities to drive value creation, particularly where sponsors can identify the root causes of underperforming businesses and can translate this knowledge into higher returns.

Before the Deal, Keep Post-Deal Implementation in Mind

Many deals involve some element of transformation, often taking an underperforming business and launching a full or partial makeover to improve efficiencies, expand market share and increase profitability. All too frequently, however, deal negotiations hinge almost exclusively on the financials and overlook the many other requirements for success. While this focus on the numbers may move the deal through negotiation to closing, "hoped-for" changes are rarely as effective as "planned-for" changes. Investment stakeholders must establish and execute concrete strategies for how they will implement and manage leadership, operational and other necessary changes, with a particular eye toward winning buy-in from remaining executives, managers and other key staff.

Use Due Diligence to Assess the Lifespan of Distressed Target

In today's volatile market, in which excess capital has offered many investors the option to explore new opportunities and sectors, they should not rely on valuations alone to make effective decisions. Due diligence — particularly in markets for distressed assets — remains the keystone for deal participants. Careful diligence can be vital in assessing the lifespan of a target company and the likelihood that it will create cash flow or offer a solution that provides additional capital.

In particular, stakeholders should keep an eye out for less conventional opportunities such as distressed companies that, with infusions of liquidity, can successfully maintain their businesses while also exploring niche areas and, ultimately, reach the other side of an economic downturn, provide cash flow and continue to operate successfully.

Of course, any investment in a distressed company should be undertaken with caution. For example, if a company appears likely to file for bankruptcy in the near term (one to two years), investors may want to keep an eye out for potential fraudulent-transfer liabilities. Similarly, a buyer of a distressed company's debt may determine that there is a strong probability of being repaid because they believe that the company is undervalued, or they have a strong opinion of the company's management. Such buyers might buy this type of debt at below par and exit at par, but they might also end up owning the company if things go awry.

Conduct "Front-End" Assessments and Consider New Metrics

Issues such as rising wages and consumer prices, supply chain and energy disruptions, and other concerns have caused new volatility in a number of previously stable industries.

Investment firms and sponsors that conduct equity screens, review cash-flow structures and perform other "front-end" analytics can uncover hidden or overlooked data that can clarify the target's value-creation potential. Advanced analytics can also provide important information on asset utilization, inventory management, demand forecasting and marketing and sales, among other areas (and potentially accelerate the effects of deal synergies on costs and revenues).

Look for Sectors with Value in Their DNA

Certain sectors have made a clear and public turn toward value. For some, it is literally written into their business structures. Many health care service providers, for example, are pursuing value-based care, under which providers (including physicians, nurses, clinics, hospitals and laboratories) are paid based on the health outcomes of their patients and other quality measures. Many health care companies also are avoiding the pursuit of scaling for scaling's sake and are instead developing effective strategies for growth; such companies are also moving beyond risk identification toward defining specific responses to future risks and are strengthening the interconnections within their platform businesses.

Like these health care examples, businesses that have invested in consumer engagement, have developed agile operating models and are well integrated across their platforms are a natural fit for stakeholders pursuing value creation in a fast-moving and unpredictable economy.

Explore Digital Capabilities and Risks

Even for non-technology companies, digital capabilities can play a positive role in deal value. Software platforms (particularly niche or industry-specific tools), IT assets and enterprise resource planning systems, as well as digital talent (including data scientists, system architects and developers) can often be tied to or maximized to increase revenue, reduce costs or make more efficient use of capital.

At the same time, cybersecurity and other technology risks must be identified. In addition to data privacy and security concerns, stakeholders should examine existing or planned IT initiatives to ensure that they are on target, both in terms of costs and schedule, and ensure that they have a high likelihood of contributing positively to the bottom line.

Conclusion: Opportunities Are Available If You Know How (and Where) to Look for Them

Given today's global challenges, dabbling in an industry without true expertise, diligence short-cuts and failing to consider all financing options are particularly dangerous characteristics for an investor in today's economy. That said, a failure to pursue opportunities even in the face of risk is likewise a poor recipe for success.

Value remains to be found — and created — in today's market. The strategies noted above can help dealmakers navigate this challenging market and identify and maximize opportunities for success in the unpredictable economy of today and tomorrow.

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