2018 M&A Outlook & Impact of Tax Laws on M&A

About Us

Calabasas Capital is a boutique investment banking firm focused on serving lower middle-market privately-held companies and their business owners. We specialize in representing and advising businesses on sell-side and buy-side mergers, sales and acquisitions and we raise private equity and debt capital.

2018 M&A Outlook

In the fourth quarter of 2017, the environment for mid-market M&A in the U.S. was muted due to concerns about, among other things, the economy, political and regulatory uncertainty, market volatility, and valuations. Fast forward one quarter and now with significant pro-business legislation, including tax reform, having materialized, the coast is once again clear for the continuation of robust M&A activity. Corporate cash balances are at historical highs and the potential for repatriation of taxable overseas cash represents another $900 billion to $1 trillion in dry powder for deal making, according to Forbes.

The Intralinks Deal Flow Predictor Report suggests that the pace of M&A activity will increase in 2018, based on "a combination of gradual acceleration in global economic growth, low inflation in advanced and emerging economies, buoyant asset markets and low-interest rates that continue to bolster the M&A markets."

Deloitte's "The State of the Deal-M&A Trends 2018" report takes a similar view. The Deloitte report, based on a survey of business executives, notes that a significant majority of respondents expect M&A deal flow to increase over the next 12 months, while deal size is expected to increase as well. The Deloitte report cites acquiring technology, expanding customer base in existing markets and expanding/diversifying products and services as the leading drivers for M&A deals. Among other positive factors, the Deloitte report notes that cash reserves are up significantly at potential acquirers, and that the primary intended use of that cash is for acquisitions.

Valuations remain elevated for sure by many measures. However, growth-seeking financial and strategic buyers with continued access to abundant and inexpensive financing have continued to rationalize paying up for growth.

Here is our brief outlook by sectors we are tracking closely:

- **Technology** – Arguably the technology sector has continued to enjoy the highest growth rates of any other industry sector. In terms of mid-market M&A, the interest in **software** companies across multiple verticals by private equity has never been higher. Mid-to-high double-digit EBITDA multiples for upper mid-market software company transactions have

resulted from the high operating leverage, high margins and high growth rates of the industry. Products and services companies focused on **data analytics** that provide companies with invaluable insights into their customer verticals have also been in high demand from buyers.

- **Ecommerce** – Retailers are playing catch-up establishing omni-channel distribution. Emerging players that were founded as omni-channel retailers and providers of technology solutions that help old-line retailers enter the millennium have been attractive M&A targets.

- **Industrial Manufacturing & Distribution** – The modest yet continuous expansion in economic growth and increase in infrastructure spending has led to a consistent flow of deals in industrial manufacturing and distribution among many verticals including **building products**, commodities (most notably **chemicals**), **aerospace/defense**, **3D printing** and **packaging**.
  - **Building Products** – Despite the conventional wisdom that we are late in the cycle, homebuilders continue to aggressively acquire land, new construction remains strong and manufacturers and distributors of building products see clear skies ahead for at least another 2 – 3 years. Astute buyers have done well and would be wise to continue to take advantage of strong fundamentals and continue consolidating lower mid-market companies in the space.
- **Business Services –** The outsourcing trend sees no signs of abating. From **digital marketing to IT, logistics, human resource management, healthcare practice management, safety and training, transaction processing, equipment rental, facilities services and repair and maintenance services**, companies are leveraging third party vendors to focus on core competencies and become more efficient. Over the past couple of years, many business services companies have enjoyed high growth rates, high margins and recurring revenues, which are all key characteristics sought after by buyers and investors.
- **Restaurants** – We expect the oversaturation-induced shakeout in the fast-casual sector to accelerate in 2018. Couple that with the continued consolidation in family dining and among QSR franchisees, and we see a pickup in restaurant M&A activity this year.
- **Food** – The food industry has benefitted greatly from the consumer trend of eating out less and eating more at home. Companies focused on frozen foods or prepared foods have seen the most benefit from this trend and buyers have taken notice over the past two years as food industry deal flow has been strong. Consumer trends have also benefitted snack food and healthy food companies which have also been in high demand from buyers.
- **Personal Care** – Cosmetics, skin care, hair care and other personal care products companies have seen tremendous demand by aging baby boomers and a conscious younger generation. Several financial buyers have established platforms in the space and have been making add-on acquisitions while large corporate buyers seeking to enter higher growth sectors have also been active.

- **Private Label Consumer Products Manufacturing** – More and more branded consumer products companies are outsourcing manufacturing to contract manufacturers. Those that can add value to their clients in terms of R&D or logistics and those that focus on innovation and can meet rapidly changing consumer preferences can avoid or at least mitigate the impact of cut-throat price competition. The food sector is also immune from offshore manufacturing (for the most part) since the products need to be fresh so contract manufacturers of food products have and can continue to do well. Industry fragmentation, extending product capabilities, and geographic expansion have all been key drivers of M&A activity in this sector.

Impact of Tax Laws on Lower Mid-Market M&A

What will be the real impact of the new tax laws on mid-market M&A? Clearly large corporates will have more cash to deploy on growth, which will be a boost to M&A. More motivated buyers with cash to deploy will be great for sellers.

Will some owners decide to hold on to their companies longer because their after-tax free cash flow will be higher? Maybe but demographic trends are still intact and lower taxes cannot reverse aging.

Will sellers demand higher multiples because their after-tax free cash flow is higher? Sellers always want higher multiples and EBITDA will remain the prevailing valuation metric, which of course is a pre-tax measure of cash flow. Valuation and leverage multiples are already stretched and let's face it, sellers don't really pay taxes on their true net income anyway.

But what about the limitations on interest expense deductibility? Going forward, companies can only deduct interest expense up to 30% of EBITDA. Now this could impact valuations to the extent less leverage is utilized in acquisitions. But let's look at a hypothetical deal and see how it would work mathematically.

Target with $8 million in EBITDA is acquired for 8x or $64 million. Buyer borrows 5x, or $40MM and puts in 3x in equity representing 38% of the capital structure. Let's assume the $64MM is unitranche debt at 9%. Interest expense would equate to $3.6MM, which represents 45% of the $8MM in EBITDA. Uh oh. Even at an 8% rate, interest expense would represent 40% of EBITDA. At a 9% rate, the buyer would have $1.2MM in nondeductible interest expense in the first year. Certainly, some buyers will use this as an excuse to lower their offers especially those financial buyers who generally don't put in more than 25% - 30% equity in any deal. Maintaining this stubborn approach would not be wise however especially in the seller's market we are in today and have been for a few years. An optimist may say that buyers will in fact be more conservative, use less leverage and be forced to focus on increasing EBITDA by making real operational improvements rather than using financial engineering to generate returns. One can only hope.

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