Exploring the M&A landscape

2019 was a busy year in the mergers and acquisitions world, with both private equity firms and strategic buyers looking for deals in an environment shaped by tax reform, a looser regulatory climate and increased cash reserves at many companies.

To gather insight into current market conditions, **Crain's Content Studio** spoke with Gene Barton and Jonathan Stein, directors at Goulston & Storrs.

Barton is a corporate attorney who advises private equity firms, strategic acquirers, and entrepreneurs on middle-market mergers and acquisitions. He also serves as an outside general counsel to corporations seeking strategic business advice. He draws on more than 30 years of experience working with U.S. and international clients in industries including health care, manufacturing, retail and technology.

Stein provides tax advice across a range of commercial and real estate transactions. Among the real estate clients he advises are REITs, developers, institutions, family-office investors, fund sponsors and lenders. He handles tax matters that include joint ventures, cross-border and tax-exempt structuring, tax-free exchanges, leasing and finance matters. He also represents investment fund sponsors and portfolio companies in taxable and tax-free M&A transactions.

They addressed what is needed for a successful M&A transaction in an environment where levels of M&A activity have been significant in recent months. In the pharmaceutical world, for instance, Bristol Meyers acquired Celgene in a deal that closed in November. AbbVie also said it would buy Allergan for $84.1 billion in June. Meanwhile, in the energy market, Saudi Aramco agreed to acquire a 70% stake in Saudi Basic Industries Corporation in March.

As 2020 begins, analysts predict that private equity firms will be looking for companies to acquire as a route into industries where they want to implement "rollups" and smaller deals to add to their acquisitions.

Against this backdrop, the New York City market has been the site of some headline-grabbing deals. In October 2019, Siebert Cisneros Shank & Co., an underwriter of municipal bonds, merged with Williams Capital Group, a dealer in corporate debt, to become Siebert Williams Shank & Co.—the largest woman and minority-owned firm on Wall Street. The same month, WebMD agreed to acquire Aptus Health, a Merck subsidiary.

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Q *Crain's:* Many M&A deals in recent months have been focused on acquiring a customer base or diversification of a company's products and services. How can sellers of middle-market firms make the most of this trend?

A Barton: Buyers are very wary of customer concentration. When we sell businesses that are heavily dependent on a single customer, they must frequently be discounted in value, sometimes significantly. We are now seeing companies with significant customer concentration acquiring other businesses with the express purpose of reducing this risk.

Similarly, buyers tend to be concerned about companies that have a sole source for an important component. Sometimes, companies buy small suppliers to prevent this risk.

Q *Crain's:* What do you see as the most important factors for a successful M&A transaction in today's environment?

A Barton: Quality of earnings is the most important factor today in an M&A deal. Is a company really getting the earnings before interest, taxes, depreciation and amortization (EBITDA) margins it says it is? Will a transaction have any adverse effect on the customer base?

Q *Crain's:* Are there any unique market characteristics in New York City that come into play?

A Barton: In New York City, the cost of real estate will always need to be taken into account. Also, state and city income taxes could have an effect on the company's ability to attract and retain talent.

Q *Crain's:* Some transactions fall apart during the due diligence process. How can sellers of middle-market firms bulletproof their deals?

A Barton: We recommend that all sellers engage in their own due diligence before they go to market. It is important that a seller not be caught unaware when the buyer discovers an issue, as they inevitably will. We see sellers increasingly engaging audit firms to do a quality of earnings report in anticipation of a deal. We recommend they also do a full legal audit as well.

Q *Crain's:* What external factors do you see impacting deals, and how can both sellers and buyers prepare for them?

A Barton: The biggest external factor affecting deals is the debt market. Private equity buyers need leverage to get their expected returns. As leverage ratios go down, it becomes harder to do deals. Will the M&A market completely dry up if debt costs go up and up? Of course not. More likely you'll see markets retreat.

Q *Crain's:* How do you see tax reform affecting the M&A climate in New York City?

A Stein: Tax reform is a double-edged sword in this climate. The lower corporate tax rate and the availability of immediate expensing for tangible assets ("bonus deprecation") can provide additional incentives for some transactions. On the other hand, interest deduction limitations (which limit interest deductions to 30% of EBITDA, and to 30% of EBIT starting in 2021) could make highly leveraged deals more expensive; and the loss of the deduction for state and local taxes means sellers will be paying higher taxes.

The good news for New York City's emerging tech sector is that foreign earnings on intangibles are more lightly taxed after the tax reform. On balance then, we see tax reform as a net positive for the M&A climate in New York City.

Q *Crain's:* What are your expectations for M&A deals in New York City in 2020?

A Barton: I think the market in New York City in 2020 will be tepid. Good deals will continue to get done, but I expect at slightly lower multiples. Marginal deals will be tough to do. ■