VALUE MANAGEMENT INC.

Investment Banking + Valuation Services

ISSUES + UPDATES 1ST QUARTER 2023

M&A Outlook for 2023: Inflation and Uncertainty Challenge Sellers' Market

Business owners and M&A industry insiders are wondering if 2023 will continue to present excellent opportunities to sell a business. Considering that it has been a sellers' market for most of the last decade or more, some expect that the market can shake off anything and resume its record-shattering pace. Even the COVID pandemic couldn't stop the sellers' market. Despite the country practically closing for a few months in 2020 and being forced to do business virtually, the 4th quarter saw more M&A records fall!

The M&A market picked up in 2021 right where 4Q 2020 left off, with record-high transaction volume and valuations.

And then came 2022.

What changed from 2021 to 2022?

In short, inflation and economic uncertainty became issues to be reckoned with for policy setters and consumers/investors.

On February 24, 2022, Russia invaded Ukraine and the ensuing war introduced economic uncertainty as energy availability and pricing became major concerns.

Also, on March 17, 2022, the U.S. Federal Reserve (the "Fed") increased the federal fund rate for the first time since December 20, 2018. The Fed has a dual mandate of keeping inflation and unemployment in check. While high unemployment rates began to recede, the cost of living did not and in many instances continued to grow. Consequently, the Fed took action to reduce inflation by increasing the federal funds rate. It is the Fed's primary benchmark interest rate and the rate that U.S.

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VMI Highlights:

Congratulations to Katie Wilusz who was appointed to the board of directors at Liguori Academy. Liguori Academy is a private, non- profit high school committed to serving the Philadelphia community.

Congratulations also to Max Lesoine, who passed the American Society of Appraisers' BV201 course, the first step toward earning his Accredited Senior Appraiser ("ASA") designation.

Value Management Inc. continues to support the PA Center for Employee Ownership ("PACEO"). PACEO's main mission is to raise awareness about employee stock ownership plans ("ESOP") in Pennsylvania. In 2022, the second highest number of ESOPs were created in PA (following CA). Pretty impressive!

Greg Kniesel will be speaking at the National Center for Employee Ownership's Annual Conference being held in Kansas City at the end of April. His topic is "ESOP Valuation in Uncertain Times".

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banks charge each other to lend funds overnight. It influences how much consumers/investors pay to borrow and how much they are paid to save. The Fed increased the federal funds rate seven times in 2022 and once through February 2023, with increases totaling 450 basis points (or 4.5%).

Why did inflation and uncertainty decrease M&A activity in 2022?

It is believed that in 2022 M&A activity decreased 30% - 40% from the prior year, starting off well but spiraling down as the year progressed. This timing makes sense, given that the Russo-Ukraine war began in late February and the first of seven interest rate hikes occurred in mid-March.

In the investment world, uncertainty equals risk. Buyers, particularly financial buyers such as private equity groups who invest other people's money, try to minimize the unknown to maximize their investments. Unless investing in risky ventures is their thing, most buyers tend to avoid or reduce their exposure to situations with too much uncertainty.

Some buyers pay with cash, but many leverage deals heavily with debt. Hence, buyers are often borrowers. Their desire to leverage deals can diminish with increased uncertainty as can the amount of leverage that they are comfortable using. Just as importantly, lenders address uncertainty by tightening leverage ratios (that is, how much they will allow buyers to borrow relative to the total value of the deal and how much the buyers will invest themselves) and terms for leveraged deals (including financial covenants). All of this makes it more difficult for buyers to do leveraged deals and/or borrow for these deals.

Of course, lenders increase rates charged when interest rates increase, making it more costly for buyers to transact.

Buyers who still want to transact despite the tightened leverage conditions and increased borrowing costs need to make up the difference somehow. Often, such buyers will address the increased cost and uncertainty by decreasing the values to be paid to sellers.

A problem for buyers can be a problem for sellers. More buyers can mean more competitive interest, which tends to drive up values; fewer buyers can mean lower pricing. In 2022, the deal world saw a disconnect between buyer and seller value expectations. Sellers still expected the high values that seemed to become more of the norm. Buyers, on the other hand, needed to account for additional risk and cost.

So, in 2022 it became increasingly harder and more expensive for buyers to borrow money to leverage transactions. Buyers reacted by backing away from some deals, exercising more caution in general (many adopting a wait-and-see approach), and by reducing overall valuations for deals. Sellers presented with what they saw as low offers decided not to transact; some also subscribed to the wait-and-see philosophy.

What does this all mean for 2023?

The number of buyers, their ability to fund/finance deals, consumer confidence in the economy and business (sometimes measured by the performance of publicly traded stocks), business values, and business owners' willingness to transact all impact the prospects for the M&A market.

While some buyers have adopted a wait-and-see attitude, there are still many active buyers seeking the right deal, be they strategic, financial, or entrepreneurial buyers. While entrepreneurs have had a hard time competing in recent years, they still desire to buy. Strategic buyers are always out there, sometimes more so when the financial buyers pull back. And financial buyers, who are in business to buy, are best represented by the estimated 5,000+ private equity firms who seemingly scan the country and beyond daily for businesses to buy.

It's harder to borrow this year than it was last year and it will likely cost more. And while buyers still want to borrow and lenders still want to lend, everyone seems to be approaching buying, borrowing, and lending more cautiously.

All the major stock market indices decreased in 2022 with many investors adopting – you guessed it – a wait-and-see attitude. However, many business owners are still optimistic about their companies chances, more than they are about the economy in general.

Buyers are decreasing values for many businesses

while sellers still expect relatively high multiples. However, top performing businesses are still getting top multiples, but other companies may see lower values than were available in 2021.

Demographics show that many U.S. business owners are approaching retirement age. They will need to transition eventually, with many ready to do so when they find the right deal.

Deals will be made in 2023, but it is a tougher environment to transact. Buyers want to buy, but will likely do so selectively and with caution. Sellers want to sell, but desire to be paid the high multiples they've heard about. The Fed may increase the federal funds rate further in 2023 and the war in Ukraine rages on, no end in sight.

There is still ample supply and good demand in M&A, but circumstances would lead one to think that M&A in 2023 will start off slowly, waiting for less uncertainty on key issues. Hopefully, the second half of the year will bring clarity, and more deals!

CFOs Ignoring Cyber Risk Despite Huge Losses

A Kroll report finds that 82% of the executives in its survey said their companies suffered a loss of 5% or more in their valuations following their largest cyber security incident in the previous 18 months. At the same time, 87% of CFOs are either very or extremely confident in their organization's cyberattack response, the report says. This is at odds with the level of visibility CFOs have into cyber risk issues, given only four out of 10 surveyed have regular briefings with their cyber teams. The report, "Cyber Risk and CFOs: Over-Confidence Is Costly."

Value of Copyrighted Tattoos?

In Hayden v. 2k Games, Inc., 2022 U.S. Dist. LEXIS 139184 (Aug. 4, 2022), plaintiff James Hayden alleged copyright infringement by the defendants. Defendants 2K Games Inc. and Take-Two Interactive Software Inc. are the developers of the video game series NBA 2K, an annually released game depicting players from the NBA in interactive simulations. The plaintiff alleged that he was the tattoo artist who inked copyrighted tattoos on several NBA players who are depicted in Take Two's basketball simulation, NBA 2K. Plaintiff's expert was to evaluate whether the defendants benefited financially from reproduction of the tattoo designs and whether there were substantial economic impediments for the formation of a market for licensing of tattoo designs. He was also to testify to the potential market for licensing tattoo designs for reproduction in video games.

The defendants offered arguments as to why plaintiff expert's opinions were unreliable and will confuse a jury and were counter to copyright law. The plaintiff argued that the expert's opinions were reliable and grounded in copyright law.

The court found that expert's opinions were reliable, relevant, and helpful in part. It ruled that the expert may testify that realism was a primary driver of NBA 2K's successful market position and thus was a primary driver of its revenues and profits. However, his testimony about the popularity of certain players attributing significantly more value to the plaintiff's tattoos on those players as opposed to being on the average player was not helpful.

The court also found the expert was outside his area of expertise when he opined about an inevitable potential market for licensing of tattoos for video games. It was unreliable and "dangerously misleading to a jury" and was overstepping and usurping the role of the court as well as the fact-finder.

Environmental, Social, and Governance (ESG) Ratings: A Compass Without Direction

That's the title of a new paper out of the Stanford Graduate School of Business that examines the concerns over the reliability of the various ratings schemes for environmental, social, and governance factors. ESG has become a "new" hot topic (although much of it has been around for years) in the investment world, and

it, of course, has implications for valuation. But the various ratings that have emerged are (still) not ready for prime time. “We find that while ESG ratings providers may convey important insights into the nonfinancial impact of companies, significant shortcomings exist in their objectives, methodologies, and incentives which detract from the informativeness of their assessments,” the authors write.

Required Returns According to an Update Survey

The 2022 Pepperdine survey provides an analysis based on expected rates of senior lenders, asset-based lenders, mezzanine funds, private equity groups, venture capital firms, angel investors, privately held businesses, investment bankers, business brokers, limited partners, and business appraisers. Bank loans have the lowest average expected returns (a median return of 4.0% to 6.0% depending on loan size (and prior to the recent increases in interest rates)) while capital obtained from angels has the highest expected returns (ranging from a median of 33% for later-stage financing to 43% for seed money).

2022 Pepperdine Private Capital Markets Rates of Return

Type of Private Capital Funding	Pepperdine Median Rate of Return (Range)
Banks	4.0%-6.0%
Asset-based lenders	3.8%-16.0%
Mezzanine financers	10.0%-15.0%
Private equity groups	22.0%-30.0%
Venture capital groups	30.0%-43.0%
Angel investors	33.0%-43.0%

In addition to questions on rates of return, the survey contains much more information. It examines the senior leverage multiple by EBITDA size, which ranges from 2.5x for companies with $1 million in EBITDA to 3.7x for companies with $50 million in EBITDA. The survey also has the most prevalent current and emerging issues facing privately held businesses. The largest issues were labor availability, inflation and economic uncertainty.

IRS Plans to Beef-Up its Business Valuation

Expect to see increased scrutiny on business valuations for tax purposes as a result of the Inflation Reduction Act of 2022. The new law provides additional funding for the Internal Revenue Service to beef up its enforcement efforts. Part of the agency’s new efforts is its search for 14 new business valuation experts to join its ranks. Of course, estate and gift valuations will get caught up in the agency’s widening net, but so will other tax-related valuations, such as stock-based compensation (409A “cheap stock”), valuations for deductions of worthless stock, intangible property valuations for intercompany transactions, and more.

5 Good Questions Often Asked About Selling A Business

1. How much is the business worth/is this a good price/how much will this cost?
2. How long will it take to find a buyer and sell it/are these the right buyers?
3. How will the sale be kept confidential?
4. What will happen to my people?
5. Do I still have to work, and if so, for how long?

5 Better Questions To Ask About Selling A Business

1. How do I know if it’s a good time to sell/am I ready, is the business ready, how does the market look for a business like this?
2. What should I say if someone asks me if my business is for sale?
3. What planning should be done to prepare for a sale/what are the different facets of transition planning that I should be considering?
4. How much will buyers likely pay for my business, how and when will it be paid, and what will be the estimated net proceeds from the sale?
5. Will I be able to continue operating business as usual during the process of selling it?

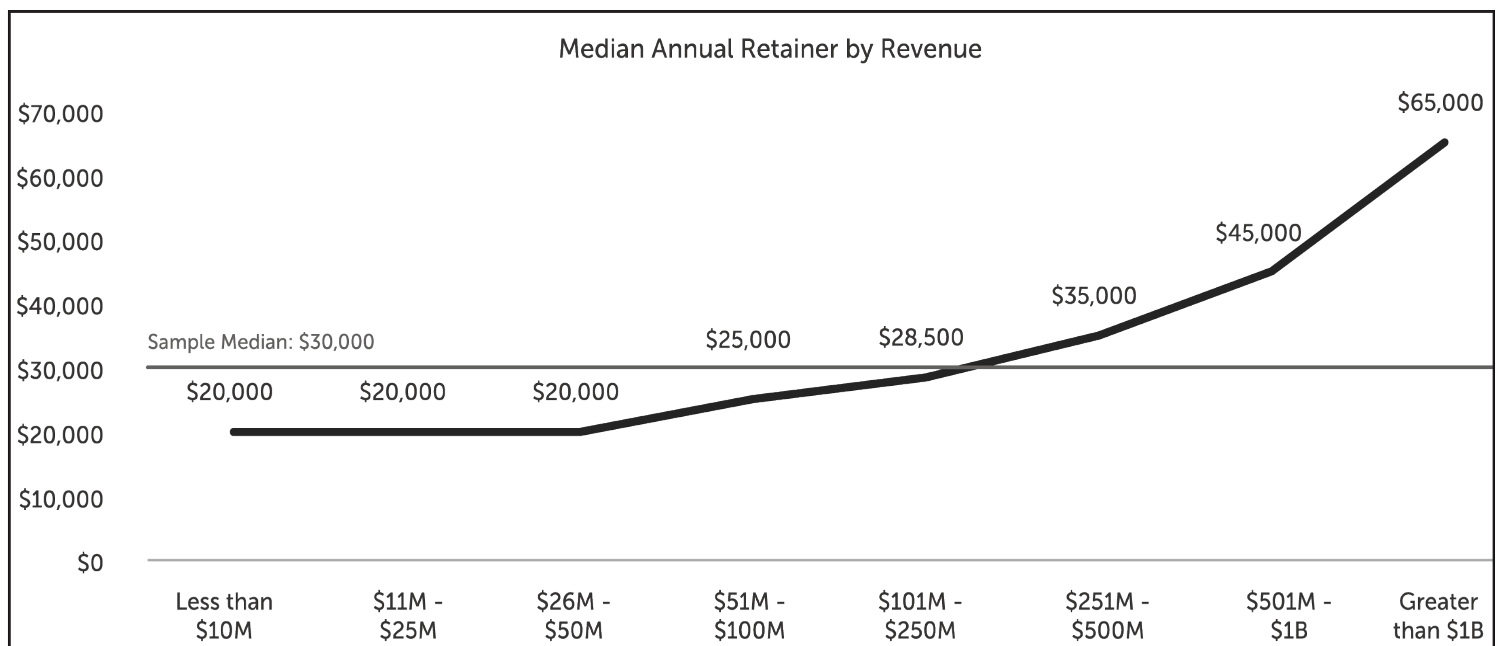
Private Firms and Board Pay

One source for private-company board member compensation is the "Private Company Board Compensation and Governance Survey," conducted by Compensation Advisory Partners (CAP) and *Family Business and Private Company Director* magazines. The new 2022 third edition of the survey contains over 1,200 responses.

The survey found that 86 percent of participants provide some form of compensation to board members. In contrast to public companies, 44 percent of private companies compensate "inside" directors (defined as family members or shareholders who serve on the board). For these companies that compensate inside directors, 67 percent compensate them on the same basis as the outside directors. The survey results reflect the differences from public company board pay. Private companies are more likely to compensate a larger group of directors and are more likely to use meeting fees in addition to annual retainers. Only a minority of private companies use long-term incentives, such as phantom and real equity, in their director pay programs.

Annual cash retainers are part of a typical director's compensation package. Of the private companies surveyed, 45 percent compensate directors through cash retainers only, while another 27 percent use both retainers and meeting fees. As presented in the below graph, the amount of the cash retainer is highly correlated with company size. Companies with less than $50 million in revenue have retainers of $20,000, $51 million to $100 million have $25,000 retainers, $101 million to $250 million have $28,500 retainers, etc. the overall median is $30,000. In addition to retainers, other elements of cash compensation for private-company directors are annual travel reimbursements and in-person meeting fees, provided by about half of the respondents.

Not surprisingly, the survey found that the prevalence of long-term incentives for private company board service is low since private companies do not have stock that is easily liquid. Only 26 percent of private companies offer long-term incentives for directors, with real equity – stock options or restricted stock/units – being the favored vehicles. Typical practices for private company long-term incentive awards are to grant the awards either annually or when the director is appointed to the board, and to have the awards subject to vesting, either immediately or over three years. The use of long-term incentives indicates that private companies continue to compete for board talent and are working to retain and align board members with the company's overall success.



Other key survey findings are:

The most common elements of cash compensation for private company directors are annual retainers (71%), travel reimbursements (53%) and in-person meeting fees (49%).

As with retainers, meeting fees increase with company size. The median in-person meeting fee is $2,500.

The use of telephonic/virtual meeting fees is reported by 25 percent of companies in 2022, which reflects a normalized level as more companies have returned to in-person meetings. The median telephonic/virtual meeting fee is $1,000.

Some private companies provide additional compensation for board leadership roles. The typical incremental retainer for a committee chair is $6,000 at median but is only provided by a minority of companies.

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