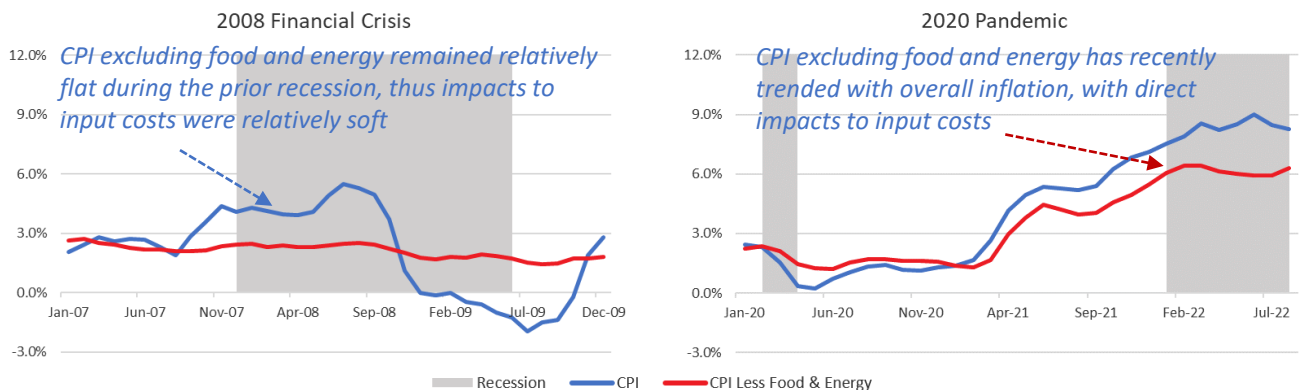


# BMO Middle Market M&A update

## Introduction: M&A During Inflationary Periods

The US marketplace has not observed the impacts of elevated inflation in over a decade, as the Great Recession of 2008 marks the last time the Consumer Price Index (“CPI”) was recorded as exceeding five percent. Further, as it relates to businesses in particular, recent CPI observations suggest that inflation is not only greater than in 2008, but has also permeated more production inputs with a greater impact than at the time of the Great Recession.

### Consumer Price Index (“CPI”) of recent periods



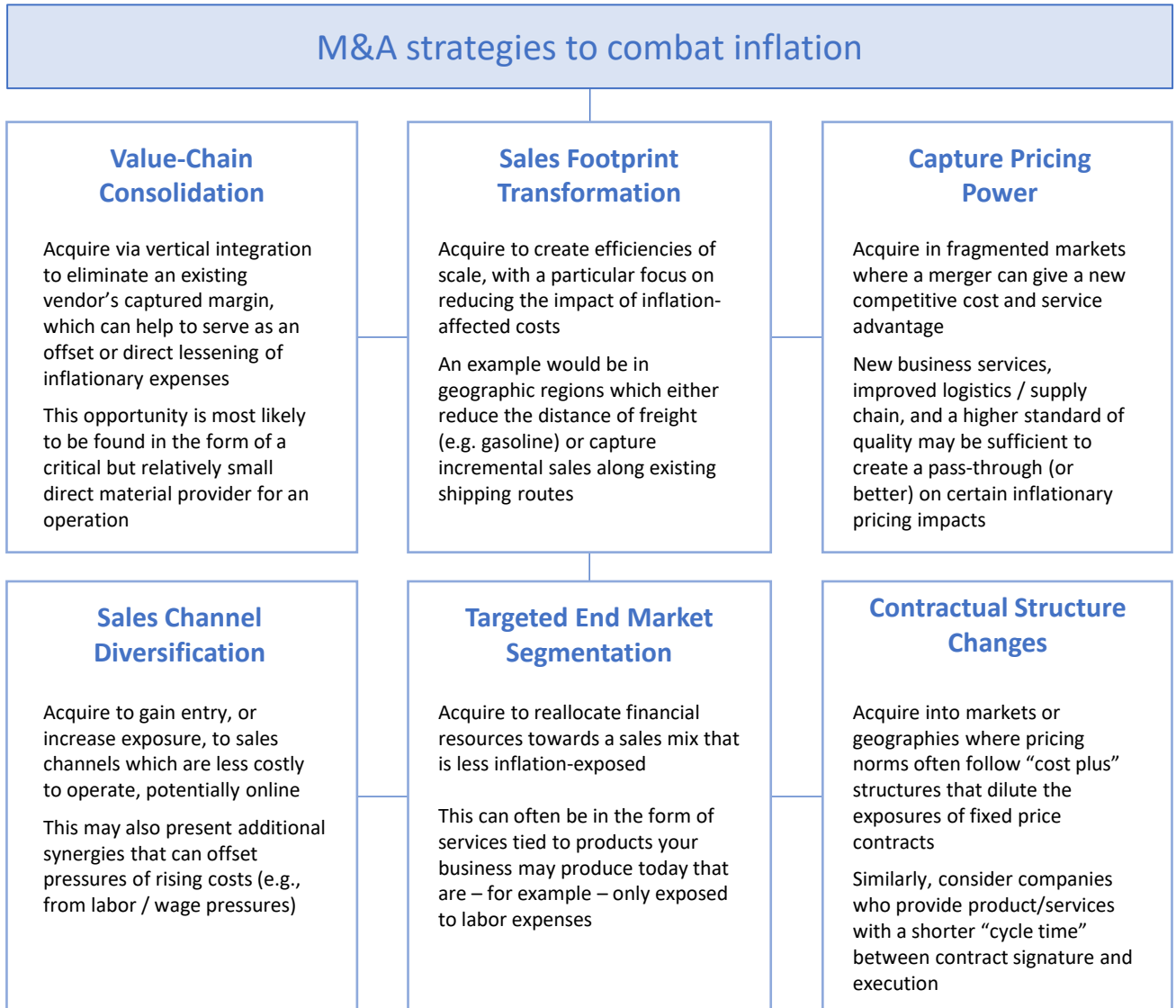
Source: U.S. Bureau of Labor Statistics

With this history in mind, and with the possibility that the recent trends may persist in the near-term, our update this quarter explores two key topics where M&A and inflation intersect: (1) How can M&A be a method to combat the pressures of inflation? (2) How should buy-side M&A diligence adapt to uncover risks that may be otherwise disguised by the impacts of inflation?

## How can M&A be applied to combat the pressures of inflation?

Traditionally, Fed rates are likely to be increased as a result of improved economic outlooks - a development that tends to drive acquisition multiples, and consequently purchase prices, higher. Conversely, Fed rate increases which occur as a result of inflation *outpacing* growth tend to negatively impact purchase price multiples in certain cases. As a result, some acquisitions in today's environment can not only combat threatened profits, but can also generally be a source for generating outsized returns given the potentially lower acquisition costs. M&A additionally provides an opportunity for an accelerated introduction of talent, process, and commercial relationships, which can require considerably more time if achieved from organic means. The opportunity to attain talent through M&A can be particularly relevant in today's challenged labor market. Further, there are often other considerations that can provide longer-term benefits for strategic acquirors, as highlighted below.

## How can M&A be a method to combat the pressures of inflation (cont.)



## How can buy-side M&A diligence adapt to uncover risks that may be otherwise hidden by inflation?

Acquiring during inflationary periods may have benefits, but it also presents unique risks that require an altered approach to diligence in comparison with more "normal" economic environments. While the support of M&A advisors and / or quality of earnings experts can help to identify target-specific risks, it can also be beneficial to remain mindful of the following list of potential factors to consider during an acquisition in an inflationary period.

# How should buy-side M&A diligence adapt to uncover risks that may be obfuscated by the financial results of inflation? (cont.)

## Diligence tactics to uncover potentially hidden risks

### Pricing Pressure

Pricing pressures can present exaggerated and unsustainable gross margins, especially if a business can temporarily take advantage of supply shocks

This can present an unclear long-run margin for buyers. Isolating price and volume over time can provide visibility into both stable pricing and anticipated margins

### Capital Expenditures

If recurring capital investments are periodic in nature and relatively dated since their last incurrence, buyers should – more than usual – rely on market replacement quotes in lieu of historical expenditures to forecast future capital requirements

### Inventory Methodology

The effects that inventory accounting methods (FIFO, LIFO, etc.) have on net working capital ("NWC") can become exacerbated during inflationary periods

Additional attention to NWC calculations to ensure they accommodate effects of longer-term normalization, if a trend reversal is detrimental

### Backlog Changes

While backlogs are generally stated in terms of revenue, fixed price businesses may have recorded anticipated margins before inflationary pressures initially took effect. Buyers should be wary of backlogs whose projects are longer-dated or without sufficient detail to explain the anticipated margins

### Interest Expense

Since many businesses are sold on a cash-free debt-free basis, capital structure details can be left out of a seller's documentation. Evaluate the company's interest expense, or look for modification / extinguishment fees which could be an indication of whether a seller seeks to isolate themselves from rising rates through an exit

### Critical Contracts

Buyers should evaluate material arrangements to identify (a) contracts whose duration is long-dated and due for re-negotiation in the near-term or (b) have key language which provides the counterparty an ability to pass through inflation pressures. The effects of these contracts may not yet be fully present

While these risks present a challenge for buyers to project the financials of an acquisition, it does not mean they cannot be properly accounted for. Considering financial adjustments for a business's future potential is also likely to assist buyers in revealing a target's true drivers of strategic value.

## Let's connect

Whether you're expanding through acquisition or are ready to transition the business, our middle-market M&A experts are ready to help you take your company to the next phase.

**Kent Adams**  
Managing Director  
*Sponsor Coverage*  
Direct: 612-904-5706  
[kent.adams@bmo.com](mailto:kent.adams@bmo.com)

**Michel Bayard**  
Managing Director  
*Sponsor Coverage*  
Direct: 508-250-8598  
[michel.bayard@bmo.com](mailto:michel.bayard@bmo.com)

**John Siegler**  
Managing Director  
*Food, Consumer, & Retail*  
Direct: 206-906-5451  
[john.siegler@bmo.com](mailto:john.siegler@bmo.com)

**Kyle Crowe**  
Managing Director  
*Diversified/Commercial Bank Industrials*  
Direct: 612-904-5705  
[kyle.crowe@bmo.com](mailto:kyle.crowe@bmo.com)

**Chris Dopp**  
Managing Director  
*Industrials*  
Direct: 917-442-9356  
[chris.dopp@bmo.com](mailto:chris.dopp@bmo.com)

**Bob Dovenberg**  
Managing Director  
*Industrials*  
Direct: 612-904-5725  
[bob.dovenberg@bmo.com](mailto:bob.dovenberg@bmo.com)

**Cameron Hewes**  
Head of Middle Market M&A  
*Industrials*  
Direct: 206-452-5569  
[cameron.hewes@bmo.com](mailto:cameron.hewes@bmo.com)

**Lowell Jacobson**  
Managing Director  
*Industrials*  
Direct: 914-774-6371  
[lowell.jacobson@bmo.com](mailto:lowell.jacobson@bmo.com)

**Jay Schembs**  
Managing Director  
*Industrials*  
Direct: 206-390-7414  
[jay.schembs@bmo.com](mailto:jay.schembs@bmo.com)

**Chris Headrick**  
Managing Director  
*Technology & Business Services*  
Direct: 708-723-4846  
[chris.headrick@bmo.com](mailto:chris.headrick@bmo.com)

**Dev Navare**  
Managing Director  
*Technology & Business Services*  
Direct: 708-553-6427  
[dev.navare@bmo.com](mailto:dev.navare@bmo.com)



The opinions, estimates and projections, if any, contained in this document are those of BMO as of the date hereof, and are subject to change without notice and may differ from those of other BMO employees and affiliates. BMO endeavors to ensure that the contents herein have been compiled or derived from sources that it believes to be reliable and which it believes contain information and opinions which are accurate and complete. However, BMO makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions which may be contained herein and accepts no liability whatsoever for any loss (whether direct or consequential) arising from any use of or reliance on this report or its contents. Information may be available to BMO and its affiliates which is not reflected herein. This report is for informational purposes only.

Banking products and services are subject to approval and are provided by BMO Harris Bank N.A. Member FDIC.