WELLVEST CAPITAL
Wellness Investing™

"It is a joke in Britain to say that the War Office is always preparing for the last war."
– Winston Churchill

THE NEW M&A CALCULUS

HUMAN BIASES

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Humans have inherent hard-wired biases that significantly influence our behavior. In business this is manifested in multiple ways. For example, the anchoring effect is a cognitive bias that describes the tendency to rely too heavily on the first piece of information offered (the "anchor") when making decisions. During decision making, anchoring occurs when individuals use an initial piece of information to make subsequent judgments[1]. In the stock market, investors will often hang on to a losing position until it gets back to their break even (cost) because taking a loss is too emotionally painful. When often the better decision is to take the loss and move on to another opportunity. In business and warfare, people tend to fixate on what happened in the recent past and extrapolate that into the near future, thinking that any changes to the status quo are temporary. These biases and others can lead to poor decision making and unwanted outcomes.

Consider the dynamic recent history of the health and wellness industry. The hottest trends that impacted H&W from about 2015 to late 2021 where:

- Growth at all costs was the #1 priority for investors and management
- Consumer were willing to pay a high premium for mission driven and social conscience brands, products, and services
- Debt financing was relatively easy to get, had light covenants and very low interest rates
- Near zero interest rates justified increased leverage and high valuations
- Valuations of 15-20+ EBITDA multiples for "on-trend" companies were common
- Questionable Start-Ups often got funded
- VC capital flowed freely into red-hot disruptive categories regardless of the quality of the business models
- Strategic buyers had a never-ending appetite for innovators as their market share of legacy products slipped

Our suspicion is that many market participants today believe that these trends are only on "pause" and will return once interest rates drop or global conflicts are settled, or the Bruins win the Stanley Cup or whatever catalyst comes to mind at any given time. This is preparing for the "last war" so to speak, it is a mental trap; the world has changed.

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PRONOUNCED TREND CHANGES ARE HERE TO STAY

BACK TO THE FUTURE

While everyone would love for the recent "good-old-days" to return, don't hold your breath for these trends to come back any time soon. This historical period was an anomaly driven by the convergence of multiple factors including near zero interest rates and the coming of age of Millennials and Gen Z. The reverse is now driving business and M&A. Interest rates have risen substantially but are still low relative to the last 100 years. Millennials and Gen Z are aging up into parenthood, home ownership and the financial pressures of family and approaching middle age. Sounds just like the 1970's and early 80's; high and rising rates and a huge transitioning demographic.

The implications of these trends can be complicated but here is our current thinking on potential impacts on the health and wellness sector, specifically capital raising, and M&A.

Debt will be less plentiful, have more restrictions and cost more
ABL credit lines have become the life blood of many companies in the H&W sector, used to fund working capital requirements and support growth. Due to the variable rate structure of this financing the impact of higher rates has already been felt. Expect these higher costs, more stringent covenants, and lower leverage ratios to become the norm going forward. This applies to senior, unitrache, and mezzanine financing as well. Marginal credits will be pushed out of the market.

Leverage has decreased and will remain lower for longer
The amount of leverage has already pulled in. For companies across the EBITDA spectrum total debt to EBITDA ratios have pulled in nearly two full turns in some instances, from 5.5X back in 2021 to 2.5-3x on the low end today. Given economic uncertainty, banking sector struggles and persistent inflation, it is unlikely this scenario will change soon.

More equity in deals
With the cost of borrowing increasing and the amount of leverage decreasing, buyers, and investors, both financial and strategic, must contribute more equity to transactions. What sounds simple on the surface can have a meaningful impact on deal economics and investment return metrics (IRR, MOIC). As mentioned above, cheap money and heavy leverage dramatically increased the pool of investable targets. This trend has reversed as reflected in a recent report of 50% equity in many recent LBO deals. A new high.

Less deal activity means buyers are more selective
As widely reported, M&A transaction volume has been down significantly over the last 12 to 18 months. For sellers this means there is more competition for buyers' dollars. This influences what deals get done and at what valuations. While high quality companies with strong financial performance attract buyers' attention, more marginal players will find the market very challenging.

Lower valuations
The attributes highlighted above all conspire to bring down valuations. Deals that made sense at double digit EBITDA multiples in the past may trade in the upper single digits. Sellers need to have realistic and reasonable valuation expectations going into a process. Comps from the last five years while informative need to be discounted to align to today's market environment.

QUALTIY COMPANIES ARE ALWAYS IN DEMAND

THE MAGIC OF ROCK BOTTOM RATES IS UNLIKELY TO RETURN SOON

TAKE A DISCIPLINED APPROACH

The new M&A calculus requires acknowledgement that conditions have changed, warranting a disciplined practical approach. Waiting for market conditions to change meaningfully in one's favor is unrealistic for all but a small handful of companies and investors.

Wellvest believes that common sense sound business practices never go out of style and apply to all M&A participants, especially now. These basic principles include:

Be a good steward of capital
M&A and capital raising pitch decks lead with P&L statements. We can all agree that these are critical to the process, however, consider showcasing the Cash Flow statement. These statements are a reflection of the companies' ability to not only generate cash but more importantly, allocate capital properly.

Drive to profitability
Investable companies and desirable acquisition targets are characterized by healthy gross margins and EBITDA margins. Balancing profitability versus growth is a never-ending challenge, in most instances profitability will offer all parties long term benefits, especially in a rising interest rate environment. Look for growth capital PE players to be very weary of money losing businesses. VC investors are focused on supporting existing portfolio companies and have only limited capacity to make new investments in money losing businesses.

Build Intrinsic Value, do not rely on high valuation multiples
The most respected and valued companies in the world are characterized by widely recognized intrinsic value. Coke has tremendous brand recognition and global distribution, JP Morgan has a fortress balance sheet, Berkshire Hathaway is an industry leader in dozens of industries and more liquidity than many countries, and Google has functionality no one can live without. The market capitalization of these companies shifts daily, at times they are incredible values and other times wildly overpriced. But over time the intrinsic value ultimately drives the valuation.

STICK WITH SOUND BUSINESS FUNDAMENTALS

BUILD LONG TERM INTRINSIC VALUE

Coil the Spring – *be prepared*

The normalization of interest rates and the ebb and flow of the business cycle, while at times uncomfortable, are signs of a healthy and well-functioning economy. Extreme volatility in the economy undermines stability on Wall Street and Main Street, something that no one should desire. Adapting to the new M&A calculus requires overcoming biases and focusing on the present-day market realities. M&A is a tool to achieve business and shareholder objectives. For sellers it can mean monetizing a lifetime of work and/or enabling the business to achieve its next level of success. For buyers it can be an accelerant to desired markets or new capabilities. The headline valuation news may get the spotlight and stir emotions, but it's the sound businesses with defensible product lines and market positions that generate successful M&A transactions.

**Source: SPP Capital Markets and Wellvest Capital proprietary data*
[1] Harvard Law School - The Program on Negotiation

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