Navigating Complexities in Industrials M&A, A Conversation with Don Levy, MD at Kroll

Podcast Episode Release – October 2024

Don Levy
Managing Director,
Transaction Advisory Services
KROLL

David Waldstein
Managing Director,
Industrials, Aerospace & Defense
ALANTRA

Episode Highlights

- Don Levy joins David Waldstein to discuss common challenges in M&A processes in the Industrials sector, emphasizing the crucial roles of time and financial projections.
- They examine project accounting in sectors like aerospace and defense, focusing on how percentage completion revenue recognition affects M&A deals.
- The conversation highlights examples from HVAC and mechanical contracting, demonstrating how revenue recognition errors can complicate valuations and hinder transactions.
- The importance of sell-side diligence is also stressed; early identification of financial issues helps manage the narrative and avoid surprises.
- Don explains how complex accounting practices, like over- and under-billings, can impact EBITDA and working capital, sometimes leading to deal collapses.
- Despite these hurdles, both express optimism for the future. Don anticipates a rise in M&A activity in 2025, bolstered by potential interest rate cuts and a clearer political landscape, a sentiment echoed by David across industries like industrials, aerospace, and healthcare.

Episode Transcript

David Waldstein (00:06):

Hi, my name is David Waldstein, and I'm a managing director at Alantra, focused on industrials and specifically aerospace and defense and power generation. I'm pleased to be joined today by Don Levy of Kroll. Don, thank you for joining our podcast. To start, perhaps you could provide the listeners with some background on yourself and on your practice.

Don Levy (00:29):

Yeah, sure. I appreciate you guys having me on. Excited to talk through some of these issues here with you guys. So, I've been with Kroll for about 12-and-a-half years now, primarily focused on financial diligence, which most people know as quality of earnings, quality of working capital, really any types of financial analysis our clients need some assistance with as it relates to acquisitions and sales primarily in the private markets. Prior to joining Kroll, I spent some time in restructuring and turnaround work with BDO Consulting. And toward the kind of tail-end of my tenure there, I got into the financial due diligence, which propelled me to Kroll.

At the time, I figured I'd like to help my clients in a different way outside of an accounting firm, and that's what I found at Kroll, given we are not an accounting firm, we don't have any independence issues or Sarbanes-Oxley issues, and we're able to provide not just financial diligence services, but a whole suite of other types of financial services. So, over the past 12 plus years or so, I focused primarily on financial diligence, but given my background in turnaround and restructuring, I have done some operations work as well.

David Waldstein (01:44):

That's great. And as a result of all that background and the work you're doing, I'm curious to hear how you're finding the market from an M&A perspective. Are you seeing anything in terms of consistent challenges companies are facing as they either come to market or are going through the process of being in market?

Don Levy (02:05):

Yeah, so collectively with our group and the various entities, we work on hundreds of transactions a year. And I think it's been a bit of a mix from a level of deal flow perspective. It really all depends on the specific sector and the partner or managing director and their business specifically. I personally have been pretty comfortably busy over the year. It hasn't really been a crazy year, 2024, in comparison to others, call it '21 or '22, but it's been consistently busy. And so, I've seen a fair amount of flow in the HVAC space specifically, both on the residential services side as well as mechanical contracting.

And so that touches various end markets. So, we've worked with a number of other companies' kind of in the A&D space, general manufacturing and distribution, so I'd say really in general, it's just been a flow of business and M&A over the year. There are some sectors that I've worked in over the past years, which quite frankly haven't been as robust for me. For example, healthcare. And I actually worked with you guys on a healthcare deal, but it was more consulting services company to the healthcare industry, not necessarily clinical type services. So, I really think it's a mix across various sectors, and obviously the partners in the various M&A shops that we work with.

Episode Transcript

David Waldstein (03:28):

Yes. And I know one opportunity in the aerospace and defense and power gen sector that we worked on together came across a relatively common challenge within the large manufacturing space, and that being the challenge of proper project accounting. Maybe you could describe first what is project accounting, and then further for our listeners, when it's applicable.

Don Levy (03:58):

Yeah, sure. One question that I didn't necessarily answer specifically and then I'll get right into the project accounting, is just general challenges that we've seen in the M&A markets just in general, which I'm sure you've seen as well. I think there are a couple of things that have been a little bit more consistent than others. One is time, of course. Time, as everyone knows, is a bit of a deal killer. So, the longer a deal is in the market, in most cases, at least the ones that I've seen, the less likely it is to close just because things can happen with respect to financial results as time goes on, in some cases companies aren't doing as well as their projections have been forecasted to, so that's a challenge. In many cases, sellers present pro forma adjustments to EBITDA, which may not necessarily come to fruition in the timeframe that's originally planned, and therefore the potential value is decreased, and buyers potentially request a revaluation. And I'd say in a lot of those cases, sellers are reluctant to revalue, which has been a challenge that I've seen, especially with some of the larger deals.

Now, as it relates to project accounting, it's really a concept where revenue is recognized based on a percentage of completion. And when we talk about that, it's contract accounting for long-term type projects. So, what exactly does that mean? The cost incurred to date on a project is really then taken as a percentage of the total estimated cost of that project. And so it is a little bit more of a complex concept as it relates to revenue recognition. And then that percentage is finally applied to a contract value, in order to report what your recognized revenue should be over a certain point of time of that contract. And really the basis of the method is to ensure that you're accurately matching your revenue to the cost that you're incurring.

Now, the applicability of this, it's really general and applicable, like I said, in long-term construction type contracts and projects that can span multiple months or years. And this is across various sectors. Of course, A&D where they're manufacturing, call it, large equipment type projects, any real construction type project, and it doesn't necessarily have to be what people think of as construction, like building a building or a project site. It's really any type of construction project that spans a longer period of time. And again, it all comes back to essentially matching your cost to your revenue.

David Waldstein (06:38):

And I know when we face some of these challenges together, it was for an A&D business that was making very large components in assemblies that took long periods of time to complete. When it becomes a challenge, what are the most common mistakes or improper accounting that you see?

Don Levy (06:58):

Yeah, so there are definitely a number of ways, and I can tell you I'm currently working on two deals specifically that are in the mechanical contracting space. They provide products and components to the A&D space, they provide components to the HVAC space, and various other types of mechanical businesses that need these components.

Episode Transcript

So that being said, some of the issues that we face is ... Perfect example is we have a client that's seeking to acquire a target that's recognizing revenue based on billing. Just straight billing. So, it's almost as if it's a cash basis, which is totally incorrect if you're looking to report on a cruel basis of accounting in accordance with GAAP. So, in those situations where there are errors, what we do is we come in and we assess the percentage of completion accounting and the respective revenue recognition for each project over that project's life.

And what does that do? That, number one, allows us to see what the revenue that should have been recognized over each of the years that we're assessing in our diligence is. And secondly, there's a balance sheet component to it. So, you have billings in excess of costs, and then cost in excess of billings. So, one's an asset, one's a liability. And what does that mean? You're essentially reporting an asset when you've incurred more cost than you've billed. On the flip side, you're reporting a liability when you've billed more revenue, or more fees, than the cost that you've incurred. And so, in the industry, it's referred to as over and under billings. And so that then plays into networking capital and how to treat those things from a networking capital perspective. So, revenue is obviously the aspect of adjusted EBITDA, which impacts value in deals, and then the asset and liability side of this with the over-under billings is going to have a direct impact on your working capital.

And it's not just that. There's a lot of complexities that go into project accounting just in general, especially with these very large contracts. They're evolving on a day-to-day basis, there are change orders that can play into things, if change orders aren't necessarily worked into the calculations accurately, you're going to have misstated revenue and over-under billings, of course. If project managers aren't timely in submitting paperwork or whatever it is that they're using from a technology perspective as it relates to costs and billings, there are going to be errors. So, the analysis that we do essentially ties all that together, compares it to what is being reported, and then provides us with the necessary adjustments that we illustrate through our quality of earnings and our quality of working capital analysis.

David Waldstein (09:54):

Do you see this negatively, or perhaps positively, affecting a process and ultimately affecting value when done either correctly or incorrectly as the case may be?

Don Levy (10:07):

It really depends. It could be both positive and negative. In addition to just doing that job-level analysis, what we do is also like a hindsight cross-margin analysis. And that's actually very telling with respect to whether companies are recognizing margin earlier in a job's life or later in a job's life. From a deal perspective, if you're pushing margin out to the future, you're likely going to have a negative adjustment. Because what we do is we look at the project over its life and we want to see a consistent margin.

Episode Transcript

And so, what we'll do is we'll adjust it so there's a consistent margin. And in some cases, you're either pushing margin backward, in some cases you're pushing margin forward. It really all depends on what the company has been doing from a revenue recognition and a margin recognition perspective. So, it could go either way. I've seen it go both ways in different deals and the couple deals that I'm working on now, it's actually a negative impact because the company was recognizing more margin later in the job. And obviously as you know, all of us are focused more on the later years. So, if we're pushing margin into the earlier years, it's going to negatively impact your trailing 12-month period.

David Waldstein (11:23):

So, I'm interested to hear if you've had some cases or horror stories as a result of the accounting treatment or perhaps improper accounting treatment throughout the course of a process.

Don Levy (11:35):

Yeah. Everyone likes to think that they're doing it the right way, but then when you have a second set of eyes and a third set of eyes when it comes to these M&A processes, you pick up on errors unfortunately, because again, this really isn't the most straightforward accounting concept. And there are a lot of nuances that factor into improper revenue recognition when applying it to real life situation. We have the benefit of hindsight coming into these situations. It's a third-party kind of looking in. We're not doing the day-to-day.

So, when we come in and we look at these things and we say, "Well, there's a pretty significant negative impact," the company's obviously not going to be happy about that. But sometimes it's really impacted a deal, sometimes it's not as material. It really all depends on the level of sophistication with the respective accounting group and the finance group within that company. And yeah, there have been horror stories where it's killed a deal, and it's unfortunate, but at the end of the day, I think it's a life lesson and a lesson learned in general just as it relates to, "Okay, now we know what we were doing incorrectly, let's fix that so that we can then come to market at a future date with accurate and reasonable results in numbers."

David Waldstein (12:54):

Yes, and that's a good point. It's interesting you say that about having the benefit of hindsight. I think when we've experienced some of these issues together, as in most cases, there is a sophisticated finance lead in these companies who are smart individuals, very experienced, and they believe they're handling the accounting for these long duration projects correctly. What I would imagine they haven't spent a lot of time thinking about is in the context of a transaction, how what they're doing is going to be viewed by somebody with an outside perspective. It really sounds like the moral of the story is to start preparing early so that these types of conventions are being properly considered before a process starts, right?

Episode Transcript

Don Levy (13:44):

Definitely. Not to go off on a tangent here, but that's really the benefit of sell-side due diligence. That's how we've come to work together over the years is through sell-side due diligence and kind of helping your clients prepare for the processes. And I think it's invaluable to them where we're finding, call it, issues, but it's about presenting those issues with a positive narrative so that we on the sell-side can control that narrative and position our clients the best way we can, even though there could potentially be a negative issue. And if it's that bad, then maybe we hold the process for two, three, four months, whatever it may be, in order to fix the issue so that it doesn't necessarily come up as a company comes to market.

David Waldstein (14:34):

Well, this topic is an interesting one because I do think there is a consistency to it in that it's complicated enough, it comes up frequently, there are differences in the way people deal with it, especially in the manufacturing world, and certainly in aerospace and defense and power generation. It's not uncommon for it to end up being a hot topic within a process. So to wrap, given where we're at in the year, how are you seeing 2025 shape up? And I guess based on the work you're doing, are there certain sectors that going forward you anticipate seeing a pick-up in activity?

Don Levy (15:15):

Yeah, sure. So, I mean for '24 I'd say I expect a pretty consistent flow of deals through the end of the year. And we're in September, so we have about three and a half, four months left. Specific to my practice, but overall, I think there's still a fair amount of uncertainty with respect to interest rates, of course. We have the Fed coming up next week, I think, likely going to increase rates. We'll see if it's 25 bps or 50 bps. I think the industry's probably hoping for 50 bps, so that'll ease some of the debt service pressure. The other kind of areas that may impact M&A is the outcome of the upcoming election, of course. And that'll obviously trail into '25, '26 and so on. I could tell you I have clients that have backed out of deals due to companies' exposure with respect to China and the uncertainty around future of tariffs and that type of thing.

But as it relates to '25 specifically, I can't see the level of deal flow being less than or lower than in 2024. And if rate cuts start as early as next week and continue into 2025, I would imagine deal flow to increase. Specific to sectors, I think that would have an impact primarily on sectors and companies that are heavily reliant on leveraging debt. And it really all depends on where in the life cycle that company is. Like I said earlier, I haven't seen all that much in healthcare. Maybe healthcare will pick up. I've seen a fair amount in A&D and mechanical contracting and manufacturing this year, that may stay at the same levels. It's really hard to tell. I wish I had a crystal ball like everyone else. At the end of the day, PE groups and other investors have a ton of money that needs to be put to work. I'm sure there are a lot of companies out there that are just waiting to pull the trigger on potential processes.

Episode Transcript

David Waldstein (17:05):

And we're seeing similar trends in terms of strong deal flow throughout the industrials. People certainly feel a fair amount of anxiety around the election and in some cases, they're taking a wait-and-see attitude. But I think overall, there's a very positive feeling that there'll be decreasing rates and overall optimism that is going to drive more deal flow, more opportunities, and not just in the coming months, but into next year and even beyond. And I think the folks we're speaking with, whether it be our clients or others in the industry, are feeling quite a bit of optimism.

Don Levy (17:50):

Yeah, I definitely agree with you there on the optimism. I think people are looking at next year as what they thought this year would be. I think coming into '24, a lot of people, especially the bankers that I've been speaking to over the years, thought that '24 was going to be a little bit more robust than it was, and I think that's been pushed into '25, and I'm hoping that is the case for all of us.

David Waldstein (18:13):

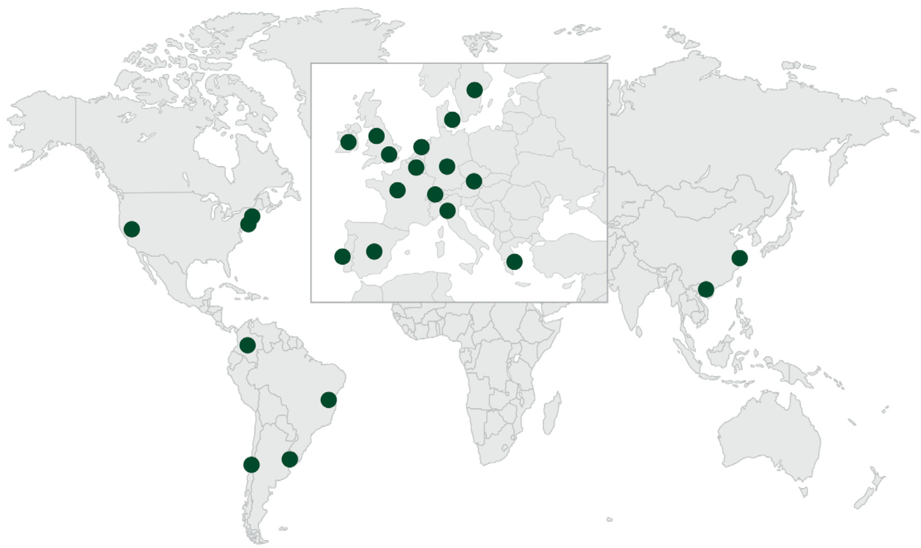
Don, I appreciate your taking the time and joining our podcast. Your expertise and perspective is something that we've always appreciated and respected and being able to share it with our clients and listeners, I think it's going to be valuable for a lot of folks.

Don Levy (18:31):

Yeah, I appreciate you guys having me on, and it's always a pleasure collaborating with you on things like this, and deals, and just general kind of information flow. So, we look forward to staying in touch, of course, and potentially doing another one of these in the future.

Alantra – Group Summary

Alantra is an independent global mid-market financial services firm that provides investment banking and asset management services to companies, families, and investors in the mid-market segment.



20 Offices Worldwide	530+ Financial Professionals[1]	100+ Partners[1]
$575bn+ Deal Volume[2]	1,800+ Completed Transactions[2]	1,300+ Clients Advised[2]

(1) As of Sep 2024. Excludes professionals from strategic partnerships where Alantra holds a minority stake (Singer CM, ACP, Wealth Management, Asabys and Indigo), includes Corporate Services professionals
(2) Since 2013

ALANTRA

Possibility is in the ascent

Argentina
Austria & CEE
Belgium
Brazil
Chile
China
Colombia
France
Germany
Greece
Hong Kong
Ireland
Italy
Netherlands
Nordics
Portugal
Spain
Switzerland
UAE
United Kingdom
United States