

April 5, 2020

Searchers/Prospective Searchers:

I hope you and your families are safe and settled. Katie, the kids, and me escaped to long Island where we are sheltered in place and adjusting to our new routines.

For starters, what a great time to have money and no business problems to think about 😊! I have taken way too long to get some thoughts on paper for you, and I am very sorry for the delay. I have promised this email to a few of you and continued to get sidetracked with board work and virtual school (which is actually just another name for home schooling). Given that I started my search on Sept 1, 2008 and searched for 3 years during the recession, I've gotten a bunch of questions about what it was like and what I would do differently. Below are some reflections and some ideas about how you might apply my experiences to our current environment. Also, I am sure it goes without saying, but every crisis is different, and this one is certain to be different from the financial crisis. There are already a ton of data points showing that some industries have been unimpacted or even improved, while others have been decimated in days, which is a stark contrast to the more universal downturn of '08.

Reflections from the 2008 Recession

1. **Great businesses don't trade easily in highly uncertain times.** Contrary to what you might be thinking, people who own great businesses don't transact in difficult markets. The logic is two-fold: first, they know their businesses are valuable, this is their one shot to sell their baby, and they can be patient. Second, their business is *their* flight to quality. In a crisis, people invest in gold or bonds to stay "safe" - for the owner of a great business, their business is better than gold. They know the stability afforded by their great company better than anyone. Plus, as they look at external options, they will be hard-pressed to find excitement investing in the markets. *Note: its hard to buy great businesses in good times too (they usually price you out 😊)*
2. **The early days of the crisis made sourcing near impossible.** From Oct 2008 through January 2009, people were glued to their TVs and news outlets. It was not a time to contact sellers, it was a time to read and reflect on the world. That didn't stop me from calling, but many owners were buried in their internal projects. In some cases, my outreach was viewed negatively given the state of the world. Fortunately, I think this crisis is a bit different; some businesses are getting crushed, while others are profiting. As such, I think you can pick your spots for outreach. With those businesses that are struggling, take a consultative tone, and with those that are doing well, perhaps you approach them with a more traditional outreach.
3. **"Deals" can be distracting.** During the early innings of the recession (months 6-18), I looked at a ton of "deals"; an opportunity to buy cheap consumer auto loans, a specialty finance company focused on legal settlements, a metals recycling facility that fell on tough times as the commodity markets collapsed, etc. I haven't done the hind-sighting on these, but I am pretty sure we would have made money on any of these investments. That said, if you reconnect with why you are searching (both to find a great investment and to develop as a leader/CEO), these "deals" will fall flat of your second goal – developing as a leader. These potential investments were speculative value plays, not opportunities to build great companies. You could do one of these deals and probably make money, but you would be waiting for the markets to stabilize so

you could sell, versus building a team and long-term value. I spent way too much time looking at these transactions, which took me away from a focused, industry search (and ultimately might have extended my time searching)

4. **Private market prices reset slower than the public markets.** While you watch the news every day and can reprice your personal investments each second, small business owners are, for the most part, focused on their employees and customers and view the stock market as noise. They feel somewhat disconnected from Wall Street and if they are selling their life's work, their perception of its value is likely based on their retirement needs more than a DCF. Given this, you will need a more creative structuring mind. Often referred to as "your price, my terms". If the value gap is big, but manageable, you can look at seller notes, earn-outs, contingent payments, rollover equity, etc. Either way, their expectations do moderate, but I think it takes a combination of expectation moderation, good structuring, and market stabilization (i.e. the market coming to meet their prices) for mutually agreeable deals to get done.
5. **Debt capital was scarce, so structure and price became more important.** This might have been specific to financial crisis, but I doubt it. During the financial crisis, small business lending dried up. It was very difficult, if not impossible, to debt finance transactions. I remember trying to develop relationships with community banks and niche lenders as they were the only entities lending to SMBs. Unfortunately, community banks couldn't lend more than a few million dollars and were sub 2x Debt/EBITDA lenders (i.e. sub-optimal capital structures). Given the debt markets, you either need to buy a growth asset (tougher to find in difficult financial markets), use structure (seller notes, etc.), or get a deal done at a lower price. As you build your LBO models, make sure to think about realistic capital structures as it will impact your willingness to stretch on price.
6. **You can't do good business with bad people.** Unfortunately, financial distress brings out the worst in people. I found that many potential sellers were not being honest with me about their businesses or intentions. Many times I would talk to an owner or get a first cut of financials that were 25-50% inflated (i.e. showing \$2mm of EBITDA that turned into \$1 or \$1.5mm), so get a QuickBooks extract as quickly as possible (not a napkin or excel build-up). As well, all owners will tell you their business is terrific and they are selling because they want to focus on other things - I found that people were either running to something, like a retirement dream home, or away from something; a very challenging business. During the recession, I saw many more people running away from their businesses than running to a new life stage. Keep a skeptical eye in your early conversations so you don't waste a lot of time researching a business, only to find the emperor has no clothes. Come up with some probing questions early that can help you identify financial issues, working capital problems, end customer concentration, distress, etc. Another great diligence tool is to find someone in the industry to talk to about the industry environment (i.e. don't just listen to the seller's narrative).

So what might I have told my 2008 self?

1. **Quiet the "Deal" noise and focus on an Industry Search.** In 2008, there was healthy debate regarding industry vs opportunistic searching. Today, the data and my personal experience show that an industry search is superior to opportunistic deal sourcing. If done again, I would have focused on a handful of industries and pursued them with intensity (vs. the scattershot of

opportunistic sourcing). In addition, I would not try to take advantage of the current environment – i.e. buy hand sanitizer companies or n95 mask manufacturers. This crisis will pass and great companies will remain great companies – don't invest in "fads". That said, the world will be fundamentally altered from this experience, so its worth thinking about your industries through new lenses.

2. **Build relationships vs. hunting for transactions.** During the peak fear/panic stage of the financial crisis, I couldn't call on companies with the intent to transact and I expect that is the same today for many industries. Given that context, my time would have been best spent researching industries, building relationships with intermediaries specific to my target industries, and trying to build some content that I might share with business owners to help them navigate the hard times. Building a consultative relationship with targets seems like it would have been quite an effective differentiator. If you do research and build insights that you can use to create relationships within an industry participant, as things settle down, they might view you as a colleague.
3. **Plan for a longer search (mentally and w/r/t capital).** I searched for 3 years before closing on Integra. Given my reflections, my process was way less efficient than it could have been, but regardless, I think it takes longer to acquire businesses in troubled markets for many of the reasons I have referenced. Manage your cash and plan for a longer search. If feasible, take a lower salary, save on travel (not going to be hard), WFH (also easy to do 😊), try to use school resources for research vs. signing up for expensive data services, etc. While I recognize that many of you envisioned a 12-18 month search when you embarked on this journey, and doubling that timeframe may feel daunting, I assure you, in the grand scheme of your career, 12 months will feel like an instant in the rearview. Remember, the worst outcome is buying a bad business, not failing to buy a business.
4. **Phone a Friend.** Not so different from working in a non-recessionary environment, you have investors who have seen market turmoil before and who can be incredibly helpful during your search. Find ways to engage with your investors on industries, theses, market trends, etc. Source the collective wisdom from your investors now more than ever. Investors can really help you power through industries so you can find some great hunting grounds faster and more efficiently (talk to them frequently about your ideas and ask what makes this a good or bad industry so you can rapidly prototype and improve). You may have to be patient as many of these folks are helping their portfolio companies, but your investors want you to be successful and this is a time for you to build/deepen relationships with mentors who will ultimately form your board. At least quarterly, I used to make a ppt presentation on an industry or two that I was pursuing. I would find time to go through it with investors (often in person) to get their guidance and hone my thinking. It also proved to create great relationships that made it easier to form my board when the time came.

You are a unique group of talented professionals, and you have a great opportunity to find a platform to grow for the long term. Searching is not a race, it's a methodical process to find a good business, in a good/great industry, at a fair price. Be patient and pick your spots!

Im sure I missed stuff and I am happy to connect live or email me feedback/questions. Hope this helps!

Andrew Saltoun