SPOTLIGHT MIDDLE MARKET

PREPARING TO DEAL

The middle market survived 2020, but 'reckoning' coming in M&A activity

By Mark Curriden and Caroline Evans THE TEXAS LAWBOOK

John Cornwell, a bankruptcy partner at Houston-based Munsch Hardt, said bankruptcies are expected to soar in 2021.

Elizabeth Conley / Staff photographer

Middle-market businesses in Texas braced for potentially disastrous results nearly a year ago, fearing the COVID-19 pandemic and declining oil prices would halt all activity in mergers, acquisitions, joint ventures and capital markets and that bankruptcies would skyrocket.

New data show that exactly the opposite occurred.

M&A activity involving middle-market and lower-middle-market companies increased in 2020, according to two data sources. At the same time, bankruptcies among businesses in those same categories rose only slightly.

Those positive data points nevertheless belie serious financial troubles that will unquestionably surface in 2021, according to corporate lawyers who specialize in representing middle-market companies.

“A lot of Band-Aids have been put on small- and middle-market businesses,” said Joe Coleman, a corporate restructuring partner at Kane Russell Coleman & Logan. “PPP money helped delay the inevitable. But a day of reckoning is coming, and it is coming soon for many.”

First, the good news: M&A activity in Texas declined in every category in 2020 except for companies that sold for $250 million or less, according to exclusive data from The Texas Lawbook’s Corporate Deal Tracker and from independent research firm Mergermarket.

Overall, M&A in Texas dropped 14 percent in 2020 from the prior year and hit its lowest level since 2011. Still, the Corporate Deal Tracker shows corporate transactions with price tags of $250 million or less actually increased by 29 percent in 2020.

In fact, 48 percent of all Texas M&A in 2020 had deal values between $25 million and $250 million, according to Merger-market. The Corporate Deal Tracker puts that data point even higher – 55 percent.

Those statistics show that corporate sellers were increasingly willing to make steep concessions to buyers amid a weak market made weaker by the pandemic, according to Locke Lord partner Joe Perillo.

“Finding a willing buyer is obviously a bit more difficult in this market,” said Perillo, who is based in Houston. “So what otherwise may have been considered upper middle market – $500 million to $1 billion — in some of those cases where they were on the lower end of the higher middle-market, they then basically are selling in the middle market-area.”

Corporate Deal Tracker seems to support this. M&A deals valued between $250 million and $500 million declined 36 percent.

Gregg Schmitt, a partner at Hunton Andrews Kurth, said sellers were more willing to meet buyers halfway and were finding creative ways of bridging the “bid-ask spread,” such asearnout payments.

“Rather than selling 100 percent, maybe they’re selling 80 percent, maybe they’re selling 60 percent. They’re rolling over a little bit more,” Schmitt said.

Overall, the middle market tracked the same pattern as the overall deal market over the course of 2020: It started out the year fairly evenly, ground to a halt in the second quarter, and recovered in the third and fourth quarters as the corporate world adjusted to work-from-home measures and aslockdown restrictions were lifted.

Thompson & Knight partner Doug Lionberger said part of the robustness of the middle market in 2020 was due to increased investment in smaller companies focused on energy technology.

“There are some really fast-growing companies,” said Lionberger, who is based in Houston. “So, I think it’s going to be really interesting to see how these energy technology companies, in terms of the energy transition for lack of a better word, to see how that affects the Texas market as awhole.”

The bankruptcy data regarding middle market businesses may be considerably more disturbing.

Corporate bankruptcies in Texas shattered all records in 2020 – increasing by 145 percent over the previous year, according to research by Androvett Legal Media.

Elizabeth Conley / Staff photographer

Bankruptcy attorney John Cornwell suggests more education may be needed.

Yi-Chin Lee / Staff photographer

Doug Lionberger is a partner at Thompson & Knight law firm in Houston.

In all, 1,789 companies filed in Texas to restructure in 2020, making the state the most popular in the union for declaring bankruptcy. The previous high was 2009, in the heart of the Great Recession when 1,060 businesses went to bankruptcy court to reorganize.

An analysis of the 2020 bankruptcy data, however, shows that nearly all the increase in Chapter 11s in Texas involved companies that cited assets or debts of $500 million or more.

By contrast, filings by Texas middle-market and lower-middle-market businesses – those with $250 million of assets or liabilities – grew by only 3.5 percent.

Business bankruptcy experts see no reason to celebrate. The lack of formal restructurings among lower-revenue-generating companies, according to analysts, is a bad sign because it likely means business owners are exhausting cash reserves, hurting their long-term credit by missing vendor payments or, worst of all, turning to predatory lenders instead of seeking court-protected reorganization.

As a result, a record number of small and mid-sized companies are expected to reorganize under Chapter 11 in the second and third quarters of 2021.

“There are huge issues in the mid-market that we haven’t seen yet,” Chief Bankruptcy Judge David Jones of the Southern District of Texas said. “I don’t know what those are going to look like. I don’t know if things can be saved. There’s a lot of uncertainty.”

Jones said the business bankruptcy cases that have yet to be filed “are going to get harder” to resolve. Many trying to restructure may end up becoming liquidations.

“There are an awful lot of forbearances out there with no resolution on the horizon,” he said. “We’ve seen a lot of cases filed where we have a pie and we just need to rearrange the pie and give everybody a different slice. A lot of cases are now a cupcake and people at the table expect apie.”

John Cornwell, a bankruptcy partner at Munsch Hardt in Houston, said it is difficult to understand why more middle-market and lower-middle-market companies have been slow to restructure.

“We know these businesses are experiencing significant distress and there are restructuring tools that are available to help them,” he said. “Maybe we need to do abetter job of educating (small- and mid-sized business) owners.”

Once the pandemic is in the rearview mirror, the banks will start calling in the loans and there will be a flood of middle-market and smaller-company bankruptcies, experts predict.

Part of the problem, according to bankruptcy experts, is that owners and CEOs of family-owned and mid-sized companies wait too long before seeking legal advice about financial restructuring.

Robert Forshey, a partner at Forshey Prostok in Fort Worth, said management of larger companies are more proactive in identifying the early factors of financial distress that may require restructuring.

"Many small- and middle-market business owners are in denial," he said. "They wait too long to see about reorganizing. If they don't have the cash, it is very difficult to reorganize. You need cash to effectively reorganize."

Cash flow issues are a clear signal that business should consider the Chapter 11 route.

"The business isn't paying its vendors on a timely basis and is surviving on arobbing Peter to pay Paul basis," Forshey said. "Many middle market managers play that game as long as possible until the cash runs out. The problem by then is that their credibility may be lost with the lender and vendors and they often lack the necessary cash to make abankruptcy case work."

Dozens of desperate owners of restaurants, bars and liquor stores turned to lenderd for quick infusions of cash ranging from $25,000 to $500,000 in return for a percentage of receipts.

"Most small- and middle-market businesses try to do it on their own, and then they have to use anuclear option and it is just too late for many of them," said Houston bankruptcy lawyer Chip Lane, referring to predatory lending. "The terms seem fine to unsuspecting business managers, who are not lawyers and who don't get lawyers involved.

"The predatory lenders want daily cuts and weekly cuts. The interest rate in one of my current cases ended up being 1184 percent," Lane said. "It is modern day loansharking."

In some such loan agreements, the lenders get access to the business's bank accounts and they can get liens and then can freeze activity.

The next escalation in Chapter 11 filings will likely involve middle-market companies in health care, elder care, hospitality, entertainment, fitness and commercial real estate.

"The question for many in these industries is, what are their businesses going to look like at the end of this?" Coleman said. "I don't think bankruptcy filings by oil and gas companies are going to slow down in the near future. There are a lot of middle market oil and gas service companies, suppliers and even E&P companies that are barely surviving."

For a longer version of this article, please visit ***TexasLawbook.net****.*

"PPP money helped delay the inevitable. But a day of reckoning is coming, and it is coming soon for many (small- and middle-market businesses)."
Joe Coleman, a corporate restructuring partner at Kane Russell Coleman & Logan