Mergers and Acquisitions: Doing Deals in a COVID World

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As 2021 brings hopes of a better year for people across the world, business owners, buyers and deal makers here in the U.S. are eager for insights about the M&A environment. What industries will emerge as winners, and which will be left behind in the new year? What new tactics and approaches will make their way into the deal making playbook? With the election behind us and progress on COVID-19 vaccines, I believe 2021 is poised to be a strong year for M&A.

In the wake of the pandemic's financial toll, a range of players—from strategic industry buyers to financial buyers (private equity, family office, venture capital)—appear eager to ramp up investments.

According to the data site PitchBook, the growth rate of private market dry powder had been flattening prior to the pandemic from steep gains in recent years. Even so, the amount of private capital seeking investment opportunities is growing as institutional investors continue to allocate investments to the private markets.

While 2020 might well be categorized as a crisis year, the crisis certainly was not one of liquidity. Capital raised for private equity funds in the trailing 12 months (TTM) through September 2020 totaled \$950.6 billion, down only 7.0% from the same period in 2019. Furthermore, a total of 237 private equity funds closed in the third quarter of 2020, with an average fund size of \$536 million, according to financial data provider Preqin. Private investors have been raising money for investing in both healthy and distressed companies. According to PitchBook, \$14 billion has been raised in 2020 specifically for turnarounds and rescue buyouts.

Larger, well-capitalized strategic industry buyers are also actively pursuing M&A deals. While some are motivated to acquire technology and capabilities discovered lacking during the pandemic, others seek to capture market share or enter new growth markets. Strategic operators in a number of industries may have experienced further deterioration in 2020 in underperforming divisions and have started or expedited divestiture efforts. As a result, we have witnessed an increase in business development outreach from financial buyers focused on corporate carveout opportunities.

The year 2020 was uniquely challenging for individual and family-owned businesses, as virtually all have been impacted by the pandemic. Some have prospered while others have struggled as industries rose and fell. Companies that entered the crisis with a direct-to-consumer, e-commerce strategy experienced unprecedented growth in 2020. However, many that marketed through traditional sales channels discovered they were late to the game and promptly shifted to fast track digital capabilities.

A large number of individual and family-owned businesses are owned by soon-to-retire baby boomers. Other owners of privately held lower-middle market businesses may not be of retirement age, but see an opportunity to capitalize on premiums that exist in certain industry sectors. The challenge for both types of owners is how and when they will exit their businesses.

For many, the answer in 2021 will be M&A. Whether related to positive forces (growth in market share and profitability during the pandemic), negative forces (the election and looming threat of higher taxes under the new administration and unknown status of the Senate pending Georgia runoffs) or generalized crisis burnout, we see heightened interest in M&A exits in the new year.

Without the benefit of a crystal ball (and challenged by a mid-December publication deadline!), we turn to our deal making activities of 2020 to shed light on what lies ahead.

Seller Considerations in a COVID World

<u>Human resources and return to work.</u> Buyers are looking for sound policies that adhere to

government and industry-leading guidelines for the sector in which the seller operates. One of

our 2020 deals involved a manufacturing operation with personnel working in separate shifts and pods. In the event of an outbreak, the seller would not lose its entire manufacturing workforce at once. Office personnel, meanwhile, continued to work from home.

<u>Supply chain risk mitigation</u>. The focus here is on planning for additional shutdowns, supply chain delays and alternative sourcing. Buyers want to see well thought-out contingency plans and new supply chain alternatives. Several 2020 clients have analyzed their supply chain disruptions, considering alternate vendors and diversifying risk through nearshoring and reshoring of manufacturing. Still others have opted to carry more inventory on hand than they did pre-COVID.

<u>Specifics of readying a business for sale.</u> How prepared is a business to undergo enhanced scrutiny by outside buyers? Audited financials, ERP systems, cybersecurity, data analytics and robust management teams were all important pre-pandemic; now they matter more than ever.

<u>Performance during and post COVID.</u> It's not enough to look at historical performance. As part of their risk assessments going forward, buyers will need to understand exactly how a business performed and why. Otherwise, a buyer will be concerned that positive COVID effects are unsustainable as the economy recovers and returns to a new normal. Sellers with pre-COVID e-commerce strategies maintain that the crisis sped up existing trends by two-to-three years rather than magnifying a one-time growth pickup in 2020. Negative COVID effects also require careful analysis to assure buyers that a business is now in recovery.

<u>Defending a seller forecast</u>. Key questions include: What evidence supports both positive and negative growth during COVID? Selling a business is really selling the future. Is the company prepared to offer a defensible five-year forecast?

<u>Specifics of marketing a business in a COVID world</u>. With corporate video productions now the norm, virtual management presentation capability is essential. Clients need to be prepared to host in-person buyer visits, combined with virtual guests in a hybrid forma. Robust virtual data rooms are a must. A longer marketing cycle is also needed to reach both strategic and financial buyers, as many executives continue to work remotely, adding complexity to the deal making process.

Buyer Considerations in a COVID World

Most deals completed in the first three quarters of 2020 were either those that had been in process, those with known targets with previous interaction, or deals that were highly strategic or complementary. As we entered the last three months of 2020, buyers have also started to consider broader, more generalized acquisition opportunities.

<u>Sourcing deal flow.</u> Traditional methods used by private equity and strategic buyers have been upended in the effort to identify and evaluate potential targets in a pandemic environment. Tactics like trade show visits and in-person meetings with targets are on indefinite hold. Discussions over lunch or coffee with investment banks and deal professionals have been replaced with conference calls, Microsoft Teams and Zoom sessions. Virtual roundtables among deal professionals are now the norm. Many private equity and strategic buyers are developing or doubling down on existing direct sourcing through email and telemarketing campaigns.

<u>Investigating acquisitions.</u> In-person site visits and management meetings may still not be possible, depending on geographies and specific seller dynamics. Many traditional face-to-face sessions have been replaced by video conferences and virtual presentations.

<u>Assessing risk.</u> Emerging risks must be carefully identified and evaluated, especially if an acquisition represents a new market or business opportunity with which the buyer has little experience. Risk analysis will need to determine the sustainability of the selling entity's future cash flows. Cultural alignment is key to the success of an acquisition, though assessment of culture is challenging via teleconference with remote employees.

Valuation of a business. Valuation is always a subjective discussion until a market is made for a private company as an actual bid, or bids come in at the conclusion of a competitive market process. Nonetheless, we often like to consider data sourced from private equity as a baseline for where private valuations may fall during a particular quarter.

According to GF Data, average valuations eased to 6.7x TTM Adjusted EBITDA as of September 30, 2020, down from 7.4x in the first half of the year with companies ranging from $10-250 million in Total Enterprise Value. In a deeper analysis of nearly 300 participating private equity groups with a total of 172 submit deals, GF Data points to a likely general COVID valuation adjustment of approximately 0.3-0.4x TTM Adjusted EBITDA as a downward adjustment to valuations during the last two quarters reported, where the COVID crisis has adversely impacted private company valuations.

Trends are improving, and by Q1 2021, assuming more good news on the broader economy and vaccine fronts, we expect to see valuations approaching or exceeding pre-COVID levels in many industries. In some sectors, however, the road back will be much longer.

Increased use of earnouts and/or seller rolled equity reinvestment have also served as COVID risk mitigation tools, shifting risk from buyer to seller and ensuring that a business will continue to perform as forecast post transaction. We expect the increased use of these tools to continue at least until widespread immunity following mass availability and acceptance of vaccination.

Financing transactions. While debt utilization in deals bounced back from Q2 2020 lows, senior debt providers have remained extremely cautious. This approach has forced higher equity contributions and debt capital costs, as well as reliance on debt from nonbank lenders involving subordinated or mezzanine debt.

Performing due diligence. Coordinating diligence is never easy, and in a COVID environment this has proven especially true. Working around new policies at target companies, while scheduling outside advisors assisting with diligence visits and their information demands is quite a juggling act.

Closing deals. New issues, from escrows surrounding PPP loan forgiveness, to new representations and warranties in purchase agreements allocating COVID-related general and specific risks, are among negotiation challenges facing buyers and sellers.

Glass Half Full

Despite historic pressures, mid- and lower-middle market M&A and private capital markets have recovered impressively. Buyers and sellers are hard at work and have found ways to successfully get deals done, reflected in rising transaction numbers quarter over quarter. Even in dark times, American capitalism has always found a pathway to prosperity. At Bravaldo Capital Advisors, bravaldocapitaladvisors.com, we stand ready to help our business owner and buyer clients navigate still-choppy waters in a new era of deal making!