White Paper
M&A Advisory

PRAIRIE

The COVID-19 Pandemic: Potential M&A Transaction Issues & The Way Forward

May 2020

by Terry Bressler

Overview

This year began with a strong economy and an improving middle-market M&A environment. There was a significant increase in M&A activity as many business owners, reacting to the strong economy and excellent business conditions, began developing ownership transition plans. For some, this included the sale of their company.

However, as it became clear that the novel coronavirus ("COVID-19") could not be contained, a worldwide panic set in almost overnight, causing a significant decline in global financial markets and some of the highest market volatility in history. In the U.S., in an effort to "flatten the curve"—or reduce the spread of the virus and avoid overwhelming the healthcare system with patients—all but essential business activities were ordered closed by local, state and federal governments. Overnight, businesses that were excelling prior to the pandemic were put into jeopardy as their revenues and operations were affected by the forced closures. Unlike the Great Recession, where the market calamity started with bad business decisions and mismanagement issues, these events were forced on business by all levels of government.

Adding to the decline were the decisions of individuals to avoid in-person commercial activities in an effort to avoid contracting the virus. This resulted in a swift decline in revenues, followed by dramatic attempts at cost reduction and the eventual elimination of millions of jobs. Early indications are that the strategy succeeded; the curve is being flattened. Still, this success came at a tremendous economic cost.

The Treasury Department and Federal Reserve have attempted to mitigate the shutdown's effects with a number of government programs intended to keep employees on the payroll and businesses afloat until the economy reopens. While these programs provided a measure of business support, the economic damage was too significant to be contained. Many businesses have experienced significant operational issues and a dramatic reduction in their company's value. Indeed, the pandemic's true cost to business will not truly be known for months or possibly years.

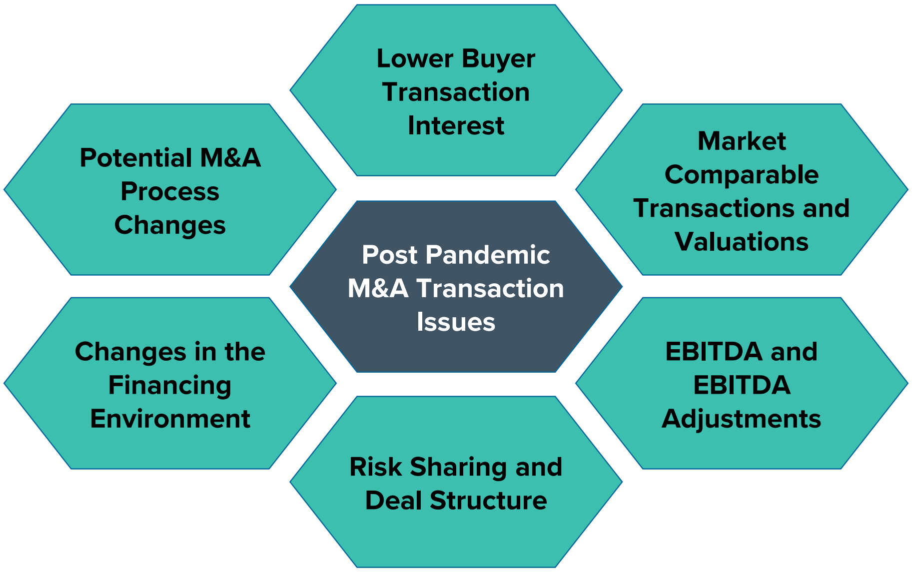
The uncertainty caused by virus-related health issues as well as the economic damage caused by the shutdown has negatively affected the M&A market. While most deals that were already in an M&A process when the crisis began did attempt to move forward, many have stalled over the last couple of months. There seems to be a higher risk of failure for most M&A deals in the current environment. It appears that the only deals that are being consummated are those that involve companies with significant strategic value to a strategic buyer that were already near closing in an M&A process.

In this paper, we highlight what we view as the major post-pandemic M&A transaction issues. Our intent is to create issue awareness for both sellers and their advisors so they can begin to address the effects of the pandemic on their business and assemble and organize supporting data for later use in an M&A process. It will be critical for business owners to thoroughly understand and describe the effects of the pandemic on their business so they can begin to develop mitigation and positioning strategies for a post-pandemic sale of their company.

Post-Pandemic M&A Transaction Issues

The following is a summary of what we currently view as major post-pandemic M&A transaction issues. While we believe this is a comprehensive list of the major issues, as business conditions change and the COVID-19 situation continues to evolve, there may be changes or additions to the issues listed herein.

Each transaction issue detailed below also includes our suggestions on preparation and mitigation strategies to address the situation.



Lower Buyer Interest in Transactions

As reported in the spring edition of the *Prairie Middle Market Perspective*, our assessment of the valuation data before the pandemic was that middle-market companies were trading about 20% to 30% higher (reflecting an EBITDA multiple increase of 1.0x to 1.5x) than their valuations of five years ago. The shortage of good middle-market company acquisition opportunities led to a strong seller's market. Large undeployed private equity fund balances and strategic buyers with debt capacity, excess cash and high market capitalizations led to outsized demand for middle-market acquisitions. Banks and other non-bank credit providers, hungry to make new loans, added to the upward pressure on valuations as these institutions allowed acquirers to borrow to leverage acquisitions and to bid up acquisition prices.

All of this changed when the pandemic hit. Now, most companies—including both buyers and sellers—are dealing with business uncertainty resulting from the slowdown in economic activity. Many potential acquirers, both strategic and private equity, are in survival mode, which has reduced their desire to seek acquisition opportunities.

The shutdown has forced many private equity funds to focus on repairing and supporting their shutdown-affected portfolio companies rather than making new platform acquisitions. In time, private equity buyers will return to the market, but these groups may be more focused on lower-risk portfolio company add-on investments in the near-term.

Many potential acquirers, both strategic and private equity, are in survival mode, which has reduced their desire to seek acquisition opportunities.

Many of the strategic buyers are also focused on repairing their businesses and are less likely to aggressively look for acquisitions. Focusing on generating revenue, fitting cost structures to lower business levels and building cash cushions are the main goals of most businesses. Only clear strategic-fit deals of “got to own it” businesses will be considered in the short-run by strategic buyers.

In short, it is our view that the increased business and market uncertainty will limit the number of strategic buyers and private equity funds participating in any near-term M&A process. The lack of demand for new deals will likely reduce valuations and shift M&A into a buyer’s market, at least through the summer. We expect that conducting a robust market-clearing auction will be difficult in the next three to six months. Unless there is a clear strategic fit with a potential buyer or group of buyers, it is probably better to begin preparations now and reassess the timing of an approach to the M&A market in late summer.

Market Comparable Transactions & Valuations

Shutting down most “non-essential” businesses has had a serious effect on the general economy and business transactions. Since February’s high point, public equity markets have been volatile and subject to substantial swings. Additionally, many individual companies have had significant revenue declines and negative impacts on their business operations. This is not a good set of conditions for selling a business. As a result, “clean” transaction market information typically used for valuations, such as public market comparable analysis or comparable transaction M&A multiples, will be difficult to find and analyze for any period subsequent to mid-February.

While the public market’s volatility has been reduced somewhat in May, many of the industrial sectors and individual companies continue to trade at valuations which include a significant measure of the timing uncertainty related to when business will reopen. Furthermore, many merger and sale transactions have been delayed, seriously restructured or abandoned in this environment. Any relevant information derived from the few transactions that actually close will be highly tailored to the specific deal and is not likely to be useful as comparable information. Obviously, these market comparisons are somewhat valid for companies being sold at this moment, but perhaps not later in the year. This highlights the difficulty in determining a business value that can be used by a business owner contemplating a sale.

The M&A market value estimation model is temporarily not working. Normal market comparable information for M&A transactions is difficult to obtain and may not even be relevant now. Accurately developing an appropriate estimate of a company’s market value will be difficult. The deal-pricing mechanism of finding a willing buyer and willing seller, which requires a defendable seller’s valuation “ask” and supporting data, will be difficult to achieve. In this environment, we believe that the prudent strategy is to prepare for a deal process but wait until late summer to reassess when to approach the market.

EBITDA & EBITDA Adjustments

It is safe to state that all businesses have been affected, in some way, by the pandemic shutdown. Some, like food manufacturers or e-commerce retailers, may have experienced some positive effects, but the majority of businesses have suffered negative impacts. Financial performance in 2020 will be dramatically different than pre-pandemic and post-pandemic performance. The "2020 earnings valley," or in some cases, "2020 earnings hill," poses an interesting analytical problem. How will potential acquirers look at this period and incorporate that in their valuation analysis to make an offer for a business?

In a regular M&A process, the financial performance of a business is "normalized" with EBITDA adjustments to isolate and remove unusual, non-recurring and owner-related expenses. The pandemic was undoubtedly unusual and—one hopes—non-recurring. This event could lead to a large list of potential EBITDA adjustments such as lost revenues, expenses associated with employee layoffs and furloughs, operating inefficiencies and other shutdown-related costs. These adjustments could also include "negative EBITDA" adjustments like the U.S. Small Business Administration's ("SBA") Paycheck Protection Program ("PPP") loans that turn into grants, rent forgiveness, interest forbearance and other items. The overall company operations should be carefully reviewed to determine the type and amount of these unusual adjustment items. All of these adjustments should be carefully supported and documented for use later in the M&A process. The end goal is to normalize the business operations for the sale process and attempt to remove the effects of the pandemic in the business.

Furthermore, this pandemic information and related adjustments may also be a positive investment consideration. This information could potentially help buyers evaluate the management team's response to a major crisis and the company's preparedness for the pandemic situation. A successful rapid return to profitable post-pandemic operations may be positively viewed and valued by buyers.

COVID-19 has affected all businesses. These EBITDA adjustments will likely be very complicated, and an argument could be made that these adjustments should not be used in an acquisition analysis. The pandemic imposes a unique and unusual situation on all of us, which may result in multiple M&A valuation analytical approaches. It will be important to logically position and justify whatever analytical approach is used in the M&A process.

Proper preparation and documentation of these EBITDA adjustments will be critical to successfully using them in a future M&A process.

Financial performance in 2020 will be dramatically different than pre-pandemic and post-pandemic performance.

Risk Sharing & Deal Structure

In the midst of the pre-pandemic seller's market, all-cash M&A deals were the market norm. Occasionally, rolled equity structures were used if the seller wanted to ride along with the buyer for a "second bite of the apple," but generally, cash was king. Earn-outs and seller notes were reserved for deals where a full valuation could not be supported by the current cash flow, but the buyer still wanted to entertain the seller's high valuation expectations. In a majority of the transactions, most—if not all—of the deal valuation risk was borne by the buyer. Those were the "good old days" in the M&A market.

However, because of the pandemic, we are in a new M&A environment. The results of the economic shutdown have seriously affected companies' short-run financial results. Many potential company sell-side candidates will have good historical operating results through 2019 and then a significant change in 2020, with expectations of a return to normal in 2021 and beyond. The EBITDA adjustments described earlier can be used to explain 2020 and will have to be fully documented and supported. Nevertheless, these adjustments may not be as useful to support the return to normal projections provided by the seller.

When EBITDA adjustments or projected financial results are not fully accepted by the buyer, an earn-out or special escrow can be used to bridge the gap and create risk sharing between the buyer and the seller. It is anticipated that many of the pandemic-related EBITDA adjustments and projected performance will be at least partially challenged by buyers, which will lead to potentially larger deal escrows and earn-out provisions.

In addition, it is anticipated that many banks will become more conservative in their lending practices. If buyers have difficulty in arranging outside financing, sellers will need to bridge the gap and accept seller notes as part of their proceeds in order to close the deal at a higher valuation.

Uncertainty has shifted the M&A market into a buyer's market. In this market, if sellers want to attain higher deal valuations, they will need to be more flexible in accepting deal terms. If sellers and their advisors are creative in deal structuring and are flexible in accepting some of the purchase terms, they may be able to attract buyers and still achieve a reasonable valuation.

Changes in the Financing Environment

Pre-COVID-19, the volume of new middle-market bank financing opportunities was far lower than desired by most banks. Furthermore, non-regulated lenders and mezzanine funds were eliminating the use of intermediary financial institutions, such as banks, and taking many of the financing opportunities. This competition led to borrower-friendly lending terms and aggressive bank loan pricing.

That changed in late March 2020 as many borrowers drew down their lines of credit and set up "cash cushions" to survive the economic shutdown. According to an article in *Financial Times*, new loan volume during the last week of March was greater than new loan volume in all of 2019. Furthermore, many of the unregulated lenders faced funding issues within their own operations and reduced their participation in the new deal market. While new loan situations are still attractive to bank lenders, it is no longer a borrower's market. The credit market has become more conservative, and the terms and pricing will be more lender-friendly.

While new loan situations are still attractive to bank lenders, it is no longer a borrower's market.

Beyond the SBA's PPP program, debt financing has become harder to find. While banks are still interested in looking at new lending opportunities, lenders' internal credit processes are more protracted and risk-averse. Many lenders expect pricing increases of 100 to 200 basis points, more conservative loan structures, shorter loan tenors and tighter loan covenants. Total leverage will be lower and borrowing costs will be higher, thus increasing financing uncertainty and putting further downward pressure on M&A deal valuations.

What was once a borrower's market has now become a lender's market. In this environment, preparation will be key to successfully securing a new credit facility or asking for changes to terms or covenant relief to existing facilities. An analysis of how the company handled the crisis and a detailed projection, including a weekly cash flow plan for the projection's first three months and how the loan will be paid back, will be important information for lenders.

Potential M&A Process Changes

One of the primary strategies to lower the COVID-19 infection rate and take pressure off the healthcare system was the elimination of most in-person non-essential business activity, working from home and avoiding large social interactions including in-person meetings. Obviously, these strategies prohibit face-to-face management meetings, plant tours and other due diligence meetings that require air travel, as well as larger meetings in a business setting. Furthermore, closed business facilities are not very impressive and will not showcase a company's operations. Even when the various state governors allow the reopening of non-essential businesses and social activities within their state, how quickly deal professionals and business personnel will feel comfortable traveling, spending time in larger groups and generally conducting "business as usual" is unknown.

It is likely that many of the physical business meetings can be replaced with Zoom, GoToMeeting and other software platforms. In addition, plant tours can be conducted virtually using mobile video technology to film the tour or provide a live walk-through of the facility. Unfortunately, these are not perfect substitutes for actual in-person activities and can only take a deal so far. Even with these preliminary measures, it is certain that a buyer will want to meet the management team in person and walk the facility before closing.

Creativity and flexibility will be important in the "new normal" M&A process.

Conclusions

We are optimistic that there will be an M&A market revival in the near future. Post-pandemic private equity funds will still have abundant balances of capital to invest. Strategic buyers will still want to add to their businesses and return to their pre-pandemic growth plans. M&A transactions may look different, but they will still happen.

The current pandemic shows that issues well outside the daily thoughts of most business owners may nevertheless end up exerting a large influence. Such highly consequential exogenous shocks may have a low probability of occurring in any given year, but when they do occur, they can create dramatic disturbances in the M&A market. The magnitude of the current pandemic is worse than the downside cases included in many business plans. While it is not possible to predict when such an event will occur again, this event highlights the importance of robust contingency plans for all business owners. Going forward, buyers will be impressed with those companies and business owners that are prepared for a crisis and have formulated a plan to deal with negative events.

Likewise, the current crisis suggests that there is no time like the present to consider ownership transition plans. Private equity funds—professional buyers and sellers of businesses—provide an important example to other business owners. They rarely acquire a new business without having a plan for their future exit.

Addressing many of the current M&A transaction issues will require thought and preparation that can be used in a future M&A process. Never let a crisis go to waste. Use the COVID-19 crisis to develop or improve your ownership transition plan. Start preparations for your exit even if it will be years ahead.

About Prairie Capital Advisors

Prairie Capital Advisors offers investment banking, ESOP advisory, valuation advisory and financial reporting valuations to support the growth and ownership transition strategies of middle-market companies. Headquartered in Oakbrook Terrace, Illinois, the company is a leading advisor to closely-held companies nationwide. For more information, call 630.413.5574 or visit www.prairiecap.com.

Securities transactions are offered through Prairie Capital Markets, LLC. Member of FINRA/SIPC.

For More Information, Contact:

Terry Bressler
Managing Director
312.348.1323
tbressler@prairiecap.com