HERE'S THE DEAL: M&A INSIGHTS

Recalibrating Your Approach to M&A as a Result of COVID-19

By Hunter Early

COVID-19 has impacted every industry and changed the way millions of businesses operate around the globe. While it's safe to say we have not seen a disruptor of this magnitude in our lifetime, past pandemics have also forced industries to innovate and adapt. SARS, H1N1 and Ebola, although to a lesser scale, each affected the way companies operated during their respective outbreaks. But even macro-economic events such as the burst of the internet bubble to the subprime mortgage crisis can cause a tectonic shift in the status quo. As recently as last year, government-imposed tariffs impacted manufacturing entities of all sizes, causing these companies to either implement lean production measures or pass the additional costs on to customers.

The impact of COVID-19 has certainly brought a more substantial and far-reaching impact than that of tariffs; bringing with it several unique deal considerations. While a number of deals have come to a screeching halt, many financial sponsors are still looking to put dry powder to work both opportunistically, in terms of investing in distressed assets, as well as strategically investing in counter-cyclical assets. When considering deals in this environment, it is important to understand the unique circumstances brought about by COVID-19 from both a performance and liquidity perspective. Prior to executing a term sheet or letter of intent, we would recommend buyers and sellers address the following:

Run-Rate Revenue and Earnings

As mentioned previously, all industries have been impacted by this pandemic. Therefore, except in a few unique circumstances, a decline in revenue should be expected. Many companies are offering promotional sales in order to drive revenue. In such cases, if top-line revenue has not been negatively affected, a decrease in margin should be evident. When extraordinary events have impacted the financials in the past, historical results are often used as a proxy to fill the void and close the gap in the run-rate. However, given the impact of this pandemic and many effects still unknown, historical levels may not be indicative of future performance. Credence should be given to that from a pro forma perspective. Additionally, organizations may benefit from business interruption proceeds via insurance claims for lost sales. Proceeds from business insurance should be factored into any of the abovementioned pro forma revenue and earnings adjustments. From an expense perspective, an understanding of concessions provided by vendors and how these concessions will be treated going forward is important to identify run-rate expense levels as well. It is important that all of these items are discussed holistically when arriving at a purchase price for a particular asset.

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Operating Cycle and Working Capital

Given the current climate, many companies are in cash conservation mode. As such, an increase in both accounts receivable and accounts payable is to be expected. It is important to understand the payment terms for significant customers and vendors, including any payment reprieve that may have been granted. Evaluating aging of receivables and payables relative to payment terms and historical DSOs and DPOs will help to identify working capital adjustments that may be necessary. Industry-specific implications should also be considered. For example, manufacturing companies will likely see a negative impact to inventory efficiencies highlighted by rising DIO levels. All of these points should be addressed earlier in a deal process to make sure that the working capital target is set appropriately, and buyers don't step into a shortfall.

Concentration Risk and Going Concern

As a potential impact to both the financial results and financial position of a target company, customer and supplier concentration risk should be assessed. The COVID-19 pandemic has brought about a significant going concern risk for companies across a multitude of industries. For a company that has a high concentration of customers and/or vendors, the loss of one customer or vendor could threaten its own going concern assumption. It is important to assess whether the loss of a significant customer or supplier would constitute a material adverse condition that could threaten the overall deal.

Debt-Free Transactions and COVID Lending

Certain companies are eligible to receive relief from government programs, such as the Payroll Protection Program (PPP) and Main Street Lending Program (MSLP). The PPP offers a loan to help small businesses cover payroll and other essential costs such as mortgage interest, rent and utilities. The loan can be forgiven provided employee and compensation costs are maintained and the proceeds are used for the intended purposes. Given that most deals are structured on a cash-free and debt-free basis, treatment as it pertains to these loans within the context of a transaction should be clearly stipulated prior to executing an agreement. If a target company received a PPP loan, and requirements are met for the loan to be forgiven, cash proceeds from the loan should be identified and set aside to ensure these proceeds are not swept at closing and remain with the business to cover such costs. If the seller intends on sweeping the loan proceeds at closing, and the loan will be forgiven, the PPP loan should be treated as debt-like in nature. The MSLP provides non-forgivable loans to small businesses and allows for a one-year deferral of principal and interest payments. Both MSLP loans and PPP loans that will not be forgiven should be treated as traditional debt in the net debt schedule.

Hunter Early is an associate in our Transaction Advisory Services practice. Hunter works with strategic investors in addition to financial sponsors to perform financial due diligence. Hunter primarily focuses on quality of earnings, working capital, and net-debt analyses as a part of financial due diligence engagements.

If you are embarking on a transaction opportunity and want to evaluate the impact of COVID-19 on your deal, please contact Vijay Vaswani or call 770.396.2200.

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