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The Pandemic End Game: Preparing for a Resurgent M&A Market

By Terry Bressler

The Time is Right to Consider a Sale

Many economists are comparing the current pandemic situation to a natural disaster rather than a cyclical downturn. The economy was shut down quickly in March 2020 for a healthcare crisis and not for any underlying financial system issue. As a result, when the lockdowns are lessened or removed and the virus risks are understood or reduced, the economy will likely improve as quickly as it was shut down.

The foundation for a resurgent M&A market is the U.S. economy's resilience demonstrated over the last six months of 2020. The year began with a strong economy and an M&A bull market where sellers were achieving attractive valuations for their businesses. When the U.S. economy was shut down, we rapidly descended into a recession and a short period of high unemployment. Since mid-2020, the economy has started to recover quickly, with some sectors recovering faster than others.

- The manufacturing economy experienced a strong recovery, evidenced by the ISM Manufacturing Index reaching a two-year high of 60.7 in December 2020.
- The business service sector showed a similar recovery, with the December ISM Non-Manufacturing Index climbing to 57.2 from the 55.9 value in November 2020.
- In contrast, restrictions on indoor activities and social interaction coupled with fear of infection from others in group settings caused extreme difficulties in large parts of the leisure, hospitality and travel service economy. For example, according to the National Restaurant Association, approximately 17% of restaurants, more than 110,000 establishments nationwide, are likely closed permanently.

Vaccines and the successful inoculation of a large portion of the U.S. population are key to continue this economic improvement. The arrival of the vaccines has quickly improved the outlook for the economy. The rapid production of a number of effective vaccines and the widespread distribution and inoculation of the U.S. population will lead to a change in consumer and business owner psyche.

- Once a growing number of people are inoculated, there should be a marked reduction in the number of COVID-19 hospitalizations and eventually a decline in the number of COVID-19 -related deaths.
- These changes should lead to a more positive news cycle narrative and improved consumer and business owner sentiment. Soon, we could see a post-pandemic euphoria as recovered and/or inoculated individuals become more comfortable in public spaces and return to restaurants, bars, theaters and other public gatherings.
- Many of these individuals have built up significant savings during the pandemic and have been limited in their ability to spend these savings. These savings will fuel the resurgence of the leisure, hospitality and travel sectors.
- Once the spending cycle begins, the consumer service sector venues will begin to hire employees, thus reducing the number of the unemployed. In turn, this will lead to more consumer spending and, ultimately, more hiring.

A recovery in the leisure, hospitality and travel sectors coupled with a more positive consumer and business sentiment will lead to more rapid growth and further improvements in the economy. According to Goldman Sachs, annual GDP growth in 2021 could reach 5.4%, up significantly from the negative 3.5% annual GDP initially reported in 2020.

Even through the pandemic, the private equity ("PE") sector has adapted to the current economic environment and has begun preparing for a rapid recovery in M&A.

- According to PitchBook (an M&A database), the U.S. PE funds raised more than $200 billion in a total of 231 new funds during 2020.
- According to Preqin (a PE Fund database), there was $40 billion raised in distressed and turnaround funds in the first nine months of 2020.

PE funds are actively hunting for new deal opportunities and are ready to invest the estimated $1.5 trillion in undeployed PE capital commitments.

Furthermore, large strategic buyers with access to the public debt and equity markets have been very active in raising pools of capital.

- Due to Fed support during the pandemic, interest rates are at record low levels.
- The Securities Industry and Financial Markets Association (SIFMA) data indicated that approximately $2.3 trillion has been raised in the corporate debt markets during 2020, taking advantage of the low borrowing rates. This amount is 60% higher than the $1.4 trillion raised in 2019.
- There were a record 480 Initial Public Offerings ("IPO") in 2020 during the pandemic, up 20% from the previous annual record of 387 IPOs established 20 years earlier in 2000.
- In 2020, Special Purpose Acquisition Companies (SPACs) became more acceptable as a way to raise acquisition capital in the public markets. Collectively, these entities raised just short of $80 billion in capital during 2020.

All of this new capital is available for M&A transactions and ready to make acquisitions. As a result, the demand for M&A deals is expected to be high during 2021.

Finally, there is a real possibility that the current capital gains tax rate could double with the Democrats in control of the Presidency and the Congress. However, given the currently high unemployment of 6.7% and the pandemic's continuing effects on the economy in 2021, it is less likely that taxes will increase this year, but it is entirely possible that tax increases will occur in 2022 or 2023.

Given the improving economy, the vaccine rollout, the large pools of capital looking for deals and the potential for capital gains increases, there is a window of opportunity for sellers in 2021. All business owners with a desire to sell should consult with their advisors to develop an exit strategy and properly prepare for an M&A sales process.

What Preparation is Necessary to Take Advantage of the Resurgent M&A Market?

Well-prepared companies are better able to attract buyer attention and achieve higher valuations in the M&A market. Thinking like a buyer and considering how to position the company with potential acquirors is critical to a successful company sale. Preparation is key.

The remainder of this article will highlight important issues to consider in preparing for a sale. It is best to work with a skilled investment banker to evaluate the readiness of your company, determine the important value drivers and review your strategic options. Once that is accomplished, specific preparations can be made for an M&A sale process.

There are a number of basic preparations that should be made before any sale process. In addition, in the current pandemic environment, there are a number of pandemic-specific preparations that should be made as well.

The basic M&A process preparations include:

- *Financial Information* - Make sure the business has strong accounting systems to accurately report on its operations and that its financial information follows GAAP. Although compiled financial statements can be used in an M&A process, it is better to have audited or reviewed financial statements. A strong CFO or accounting controller should be part of the management team.
- *Owner Expenses and Normalizing Add-Backs* - Preparation should include identifying owner expenses and one-time or unusual expenses in the Company. This information will be used to develop a financial proforma of the business to show the business performance as if it were owned by an outside institutional owner.
- *Management Team and Succession* - Make sure you have a deep bench of managers and a plan for succession, especially if you intend to leave the business after the sale. A Company with a complete, strong team is more valuable than one with significant openings in the management group.
- *Management Team Incentives* - In most deal situations, the participation of the non-owner management team in the sale process is essential. It is important to determine who to include in the process and build a retention and incentive bonus plan to reward them for aiding in the business sale.
- *Put Your Legal Affairs in Order* - Work with your attorney to make sure your corporate books and records are complete. In addition, important customer or supplier contracts and agreements should be properly documented. It is best if these agreements can be transferred easily to the buyer, so they do not create issues in the sale process.
- *Determine the Tax Consequences of a Sale* - Remember that as a seller, you will have to pay taxes on the sale gain. Consult with your tax professional to determine whether a stock or asset sale is preferred and what tax saving options, such as personal goodwill, are available to you. Knowing were you stand on important tax issues will aid in negotiating the deal structure.
- *The Company's Facilities and Real Estate* - If the facility is owned outside the Company, determine whether you want to continue to own the real estate or sell it in the transaction. An appraisal and an evaluation of the rental market will be useful to determine real estate value and aid in developing the add-backs relative to this asset.
- *Competitive Landscape and Business Strategy* - Make sure you have a firm grasp on your industry, the competition and your Company's position in your industry space. It will be important to articulate the Company's competitive strategy and how it will build value in the future. Business acquirers are interested in future potential, so provide them with a road map.
- *Company Forecast* - When selling a business, we look at the past for performance metrics, but the acquirer is really buying the future. It is important to have a well-thought-out three- to five-year business plan to show the potential buyer what the business could become.

This is an initial summary of the basic preparations necessary for a sale. Work with your advisory team to address the specific preparations that are necessary to prepare for the sale of your business.

Additional preparation is necessary to address issues that are unique to the pandemic period. Many of these pandemic issues require the collection of unique information, so cultivate an awareness of what could be asked by buyers and why. Anticipating what additional risks and concerns will be articulated by the buyers will be important to develop the proper information package and address buyer concerns.

- *Pandemic Period Revenue Issues* - If the Company had revenue declines specific to the pandemic, develop a list of "lost revenue or cancelled orders" and the supporting documentation. This information will be important to show a proforma picture of the Company revenues without a pandemic. On the other hand, if the Company had a pandemic revenue pickup, document that increased revenue and, if possible, develop supporting data to explain why the pickup might be sustained post-pandemic.

- *Pandemic Period Expenses* - Think of your business during the pandemic and what you did to ensure safety and continuation of the operations. Develop a list of pandemic-related expenses such as extra cleaning, personal protective equipment, pandemic bonuses, etc. to proforma the company operations for a non-pandemic environment.

- *Pandemic Supply Chain Issues* - Look at your supply chain and any issues that affected your business. Were there excess freight charges due to strained shipping capacity? Were your orders delayed? Were there premium charges due to raw material scarcity? Also, with the pandemic experience, do you now have a better supply chain contingency plan that will help the business in the future? While these concerns may be difficult to quantify or document, these types of issues could be important in explaining the Company financial performance and highlighting the future business preparedness.

- *Company Risk and Mitigation Strategy* - Your Company has just survived a significant natural disaster. Be prepared to provide a candid risk assessment of your business, including what worked and what did not work during the pandemic. The goal is to show how the Company survived and how future events such as this one will be mitigated.

- *Government Support* - Many companies availed themselves of the PPP Loan program and other federal and state support during the pandemic. Provide documented evidence of these programs and determine how they will be treated in a deal. These loans are attractive financing and may be passed on to the buyer, or, in the case of "granted" PPP loans, may benefit the seller. In any case, details will be critical to the proper treatment of these loans and support in the deal process.

Even with the pandemic, the current deal environment provides an excellent opportunity for business owners to contemplate a transition event for their Company. In the short run, the pandemic can still pose deal challenges, but the investment banking community is developing work-around strategies to address these challenges. In the meantime, all business owners with a desire to sell should begin preparing their business for a sale process. Preparation is key. Keep in mind that the typical M&A deal takes six to nine months from engagement to closing. If you want to consider a Company sale, it is critical that you work with your advisor to prepare your Company for an M&A process. If you want to sell in 2021, the time to begin is now.

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