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Deal Making In a Pandemic

The pandemic brought positive changes to M&A transactions.

by Jay Schembs

In the wake of last year's COVID lockdowns, M&A markets became an absolute desert in the second quarter of 2020. Projects were put on hold and owners contemplating a transaction paused to focus on COVID impacts to their businesses. Surprisingly, once the dust settled and there was more clarity about how businesses would perform, 2020 ended with an extremely robust level of M&A activity.

Dynamic markets adapt, and the M&A market in 2020 was no exception. To understand what occurred, let's revisit what we said last summer: a well-functioning M&A market requires willing buyers and sellers, available capital, and exchange of information necessary to make informed decisions.

WILLING BUYERS AND SELLERS

One primary reason M&A markets are cyclical is that during periods of heightened uncertainty – often seen during recessions – a growing gap emerges between buyers and sellers. When such moves in the market occur quickly, it takes time for market participants to adjust their expectations. Last spring, no one could anticipate what the next year, or years, would look like, and as such most deals were put on hold.

Once business owners regained confidence in their ability to forecast near-term performance, the expectations gap began to narrow. Buyers, who remained eager to put capital to work, also began to get creative and flexible to grease the skids. For example, the "COVID adjustment" became common in diligence as buyers tried to understand a company's underlying earnings power.

While the concept of adjusted EBITDA is common in M&A transactions, the bar is high for accepting what is an adjustment. Buyers intensely try to quantify and verify what sellers argue are non-recurring or extraneous expenses. Over the last year, COVID adjustments became commonplace, greatly expanding the definition of adjusted EBITDA. Adjustments are often driven by costs, but COVID adjustments are often focused on revenue. For example, where orders were either delayed or cancelled because of factors believed to be attributable to the pandemic, buyers did concede some justification while sellers recognized the uncertainty of the claim. Earnouts re-emerged as a structure to bridge gaps to get deals done.

AVAILABLE CAPITAL

Part of what helped the markets quickly rebound was that most private equity groups (PEGs) did not like the alternative of staying on the sidelines and returning capital to investors. While strategic buyers are often fickle and unpredictable in their acquisition desires – particularly in times of uncertainty where they turn inward to focus on internal issues – PEGs oversee capital that contractually must be invested within a finite time horizon. No PEG builds its business plan assuming prolonged periods of inactivity, yet that is what every PEG faced last March. Most went on the offensive, doubling down on outreach efforts. Although initially it was much like pushing on a string, with each passing month, the imperative to put capital to work helped provide comfort on the sell-side that deals could still get done.

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The availability of debt capital over the last year was much less certain. Acquisition financing became a lost cause as commercial lenders were overwhelmed assessing the impact on their credit portfolios, fulfilling requests to maximize credit lines, and serving as the conduit for clients accessing the Paycheck Protection Program.

Even once the M&A market began to thaw during the summer, considerable uncertainty remained as to what lenders would be willing to do. Lenders returned to prior form in relative short order, but it certainly took some time for both equity and debt markets to align themselves to provide sellers more certainty that deals could be financed.

INFORMATION EXCHANGE

Uncertainty over how deals would get done – particularly due diligence and negotiations, both of which are often largely conducted in person – was a major obstacle last spring. Unprecedented travel restrictions and an inability to conduct in-person meetings meant that many critical aspects of a typical transaction were effectively impossible.

This was where adaptability proved critical to restarting the markets. First, buyers became increasingly flexible on how and to what extent they would conduct their diligence. Certain efforts, such as a site visit, still required in-person verification, but due diligence predominantly became virtual. Technology has for years improved efficiencies related to diligence (only our senior partners can recall the time when a data room was a literal room). While video calls remained inferior to in-person interactions, they were an improvement over conference calls for establishing personal familiarity and rapport.

Like diligence, negotiations became almost entirely virtual. While this also has its drawbacks, particularly in cases where reading body language and making emotional decisions is important, the market made do with a lesser alternative.

HOW THE PANDEMIC IMPROVED DEAL MAKING PROCESSES

While much of this adaptation and flexibility emerged out of necessity, certain areas in the deal making process may have been improved.

Most significant is the management meeting. Historically, investment bankers would solicit initial indications of interest, and then narrow that group for in-person management meetings. These meetings generally included a dinner the night before and four or more hours the following morning. Management then would repeat this process day after day, sometimes numbering more than ten meetings.

This process presents many suboptimal outcomes. First, what is the "right" number of

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meetings? For processes with significant interest, picking the best 8-10 parties is difficult, even after thoroughly vetting buyers during the initial phase. Second, while a larger group of meetings maintains competition deeper into the process, it puts significant strain on the management team. Lastly, these meetings are time consuming for both sides. Taking travel out of the equation offered buyers the chance for more meetings and for sellers to interview a greater number of interested parties.

The virtual management presentation emerged as an outstanding tool to refine the market. For example, last year we had a project with 23 indications of interest. Prior to COVID, we would have agonized over selecting the right number and composition among those bids to meet management, with a reasonable probability we excluded a seriously interested party. Instead of burdening the management team with two weeks of in-person meetings, we invited 13 parties for 2-hour video meetings. This enabled buyers to get their high priority questions answered, as well as get an initial feel for the team.

We then asked parties to refine their initial bids. From there, we had a much higher degree of confidence in picking five parties for in-person meetings. Of that group of five, all submitted final bids, which significantly improved our competitive position without putting undue stress on the management team.

Another improvement in deal processes is the increased virtualization of the due diligence process. Quality of earnings projects, which typically include exhaustive Q&A and line-by-line review of general ledger accounts, are an obvious candidate for virtual workstreams in lieu of onsite visits. Eliminating often significant travel time to and from a company frees up more time for both buyer and seller participants to focus on other matters.

WHERE DO WE GO FROM HERE?

We were pleasantly surpised and encouraged by the resiliency and adaptability of market participants to ensure M&A markets remained robust as we settled into pandemic life. Without question, removing uncertainty and increasing in-person interaction will continue to improve the market function. Meanwhile, we believe COVID-related EBITDA adjustments will become increasingly difficult to support, as businesses must prove their ability to navigate future uncertainties and expect EBITDA adjustments to converge with the historical framework. Finally, we strongly believe applying virtual means to achieve certain process objectives – such as with initial management meetings and confirmatory diligence – will remain in some form, helping to improve deal making efficiencies. **ZS**

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ABOUT ZACHARY SCOTT

Since 1991, Zachary Scott has assisted owners of privately-held businesses in the greater Pacific Northwest to plan and execute major business or ownership transitions by offering sell-side M&A and acquisition and investment advice. For more information on Zachary Scott, go to **ZacharyScott.com.**

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