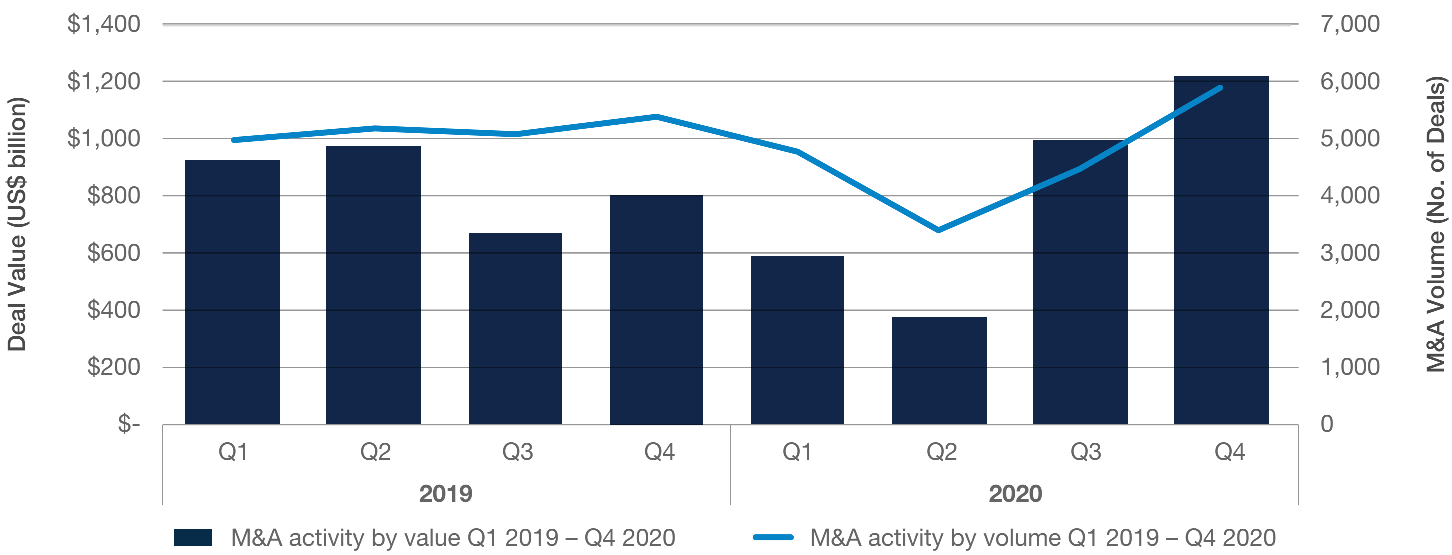
A CORPORATE M&A SERIES:

Your Next Deal Will Be Different

Part 2: M&A in a COVID-19 Adjusted Economy

As the COVID-19 pandemic spread across the globe in early 2020, its impact on M&A volume was immediate. Global transactions announced during the 2nd quarter of 2020 were down 35 percent from the prior year. However, as the world adjusted to the "new norm," transaction activity sharply rebounded with announced volumes for the 4th quarter of 2020 exceeding 2019 levels.[1]

Global M&A Activity by Value and Volume Q1 2019 - Q4 2020



Although M&A activity has bounced back, the pandemic recalibrated the ways in which buyers and sellers analyze and value targets, including the use of COVID-19 adjustments to calculate EBITDA and increased use of contingent consideration provisions (e.g. earn-outs).

The Rise of EBITDAC

In the early days of the pandemic, transaction professionals coined the acronym "EBITDAC," with the "C" short for COVID. A variety of COVID-related adjustments were introduced to normalize or strip out the impact of COVID, ranging from adding back one-time costs such as personal protective equipment (PPE), cleaning supplies and hazard pay, to more subjective adjustments like normalizing for lost revenue and depressed margins. Some sellers sought an increase in valuation for the savings from operational improvements made as a result of the pandemic. On the other hand, bidders, their advisors and lenders placed varying levels of reliance and scrutiny on these adjustments with size, facts and circumstances, and availability of supporting evidence influencing final valuations.

[1] *Mergermarket*

[2] *EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization*

The list below details some common adjustments that buyers and sellers are making to EBITDA related to the COVID-19 pandemic:

- Non-recurring expenses for supplies including PPE, cleaning supplies, cleaning services, etc.
- One-time COVID-related spot bonuses, hazard pay, sick pay, etc.
- Professional fees with respect to PPP loans, negotiations with landlords, etc.
- Purchase of equipment for employee home offices, if expensed
- Reduced volume/revenue for facility shutdowns, lost or delayed revenue, closed stores, etc.
- Increased volume/revenue (e.g. non-recurring COVID spike in demand), although less common
- Reduced headcount expenses for furloughs, bonus reductions, etc.
- Operational improvements made during the pandemic (e.g. changes in supply chain, fixed cost structure)
- Changes to facility costs (e.g. rent, utilities, cleaning)
- Reduced travel, entertainment, marketing, trade show or other similar expenses.

Rethinking Valuation and Contingent Consideration

While the pandemic and subsequent shutdowns rocked the entire global economy, individual businesses were unevenly impacted. For example, some companies benefited significantly from the pandemic – though it is not clear whether the benefits will be one-time or sustained. This has made it even more difficult to accurately assess the health and long-term growth prospects of a target, making the valuation and negotiation of the purchase price challenging.

Trends in Valuation and Forecasts

- **Multiple Scenarios with an Operational Focus**: Buyers have expanded deal analyses and forecasts to reflect multiple scenarios to evaluate the likelihood of achieving a desired rate of return on investment. Emphasis on the existence and contribution of long-term contracts, strength of customer relationships and supply chains, as well as margin protection are high priorities. At times, forecast scenarios are probability weighted based on the minimum return requirements that buyers have for acquisitions.

- **“Diligent” Diligence**: Buy-side management teams are scrutinizing every aspect of modeling and forecasting. As a result, operational and financial diligence requires a more focused view to dissect key drivers and assumptions. This is particularly true when attempting to bridge historical results that have been adjusted for COVID to the forecast, and corporate development and/or management teams will be expected to pressure test those inputs against market data and previous acquisitions.

- **Making Sense of Multiples**: While the use of forward multiples of revenue or EBITDA is common, aberrations in performance linked to COVID require a different tack. Teams can anchor implied multiples based on pre-COVID results or assess a “normalized” multiple to proposed post-COVID performance (depending on the industry and nature of operations). Normalized valuation multiples are typically developed using historical averages over a longer period of time, which would include recessionary periods and other downturns.

Trends in Contingent Consideration

- **Earnouts**: While less common for corporate buyers pre-pandemic, earnouts have emerged as a popular tool to hedge against a permanent or prolonged impact from COVID. Negotiating a longer earnout period or a “catch-up payment” provision creates mutually beneficial scenarios where motivated sellers can still be compensated in the event pandemic impediments last longer than expected, and buyers can continue to shift risk and defer consideration.

- **Holdback Payments**: Although typically less restrictive than earnouts, buyers can also layer in holdback payments tied to deadlines for achieving specific thresholds or milestones.

As always, clearly defined terms and operating covenants will help alleviate ambiguities that often arise post-close.

Trends in Action

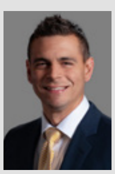
- A buyer in the upstream oil and gas sector negotiated a price based on asset utilization rates, returning to pre-pandemic levels by 2022
- A buyer designed its earnout formula based on forecast scenarios that applied different probability weights to various customer retention and revenue levels

2021 and Beyond – Activity to Remain Strong

Based on the experiences to date from COVID, corporations revisiting their core competencies and long-term business strategy may find divestitures of certain business segments or sales of minority interest investments very attractive to hungry capital currently sitting on the sidelines. Latest estimates indicate that private equity and venture capital have $1-2 trillion of dry powder. Also, the flurry of recently announced SPACs will look to fulfill their mandate over the next 12-24 months, resulting in an increasingly competitive deal landscape. With so much money chasing too few deals at a time where valuations are at record highs, we could see more competitive bids and increased deal values, even during a time of such uncertainty.

In the U.S., low interest rates and additional government stimulus telegraphed by the Federal Reserve and Treasury Department are likely to keep market conditions and valuations elevated. Furthermore, tax uncertainty ushered in with a new Biden Administration and Democrat-controlled Congress may encourage acquisitive corporations to move quickly before changes are enacted. Despite the remaining uncertainty surrounding the pandemic globally, positive factors like the roll-out of multiple vaccines, easing of lockdowns and renewed trade with partners across the world are likely to fuel the optimism among companies looking to make productive use of idle cash.

Key Contacts:



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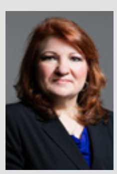

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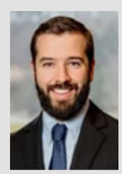

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