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CORPORATE FINANCE PRACTICE

DEAL ADVISOR DIGEST

M&A Trends Report

ISSUE 7

A NEW DAY AHEAD

Maintaining Focus While Keeping Pace

In This Issue

A New Day

2020 delivered uncertainty and disruption in droves, but businesses know that a crisis can also lead to new opportunities. After a frenzy of second-half M&A activity, a strong appetite for deal making has continued into 2021. As a new day dawns, there is additional government stimulus, an expanded vaccine roll-out and favorable Federal Reserve policies that all contribute to a brighter economic outlook for the months ahead.

The COVID-19 pandemic has caused significant shifts in consumer behavior and reshaped the marketplace for multiple industries. These disruptions put renewed focus on the benefits of fostering agility and resilience. The need to diversify product offerings, geographic footprint and other aspects of business operations has pushed a new set of priorities to the forefront, many of which M&A can help address.

The window of opportunity remains open for deal makers, although changes could be on the horizon, with an unprecedented federal budget deficit, concerns over inflationary pressures and the potential for shifts in tax and trade policies. The climate for deals will shift at some point, but it's a seller's market for now, and that's a significant driver of deals with eager buyers seeking the right target to meet their needs.

In assessing the deal landscape, buyers and sellers alike should be mindful of several factors that will shape the coming months: compressed deal timelines, the increased importance of post-merger integration, the continuing rise of special purpose acquisition companies (SPACs) and evolving considerations around business restructuring.

Transaction Trends Continuing in 2021

On the heels of the holding pattern that prevailed during Q2 2020, pent-up deal activity surged at an explosive rate. H2 2020 brought two consecutive quarters with cumulative global deal value above $1 trillion, totaling $2.3 trillion in announced deals. That marked a 90% increase compared to H1 and set a record for the strongest second half since records began in 1980, according to data from Refinitiv. 2021 is shaping up to be another busy year for deal activity and several trends are impacting the M&A landscape.

ACCELERATED DEAL TIMELINES

The pace and timeline of M&A deals has accelerated drastically in the past year. What previously may have taken months from the letter of intent through closing is often now occurring in a matter of weeks. These compressed deal timelines can pose challenges for due diligence, synergy capture, negotiations and valuation. Nevertheless, the acceleration of deal making puts even greater emphasis on the post-merger integration process and swift execution of the deal rationale. Focusing on the value drivers for a deal, confirming the target's viability and diligently strategizing how to unlock value post-close will provide a roadmap for success.

PRIORITIZING DIGITAL TRANSFORMATION

The pandemic has **also accelerated digital transformation plans** for most industries. This trend has led to intense competition for acquisition targets in the technology sector, which has kept valuations especially high. M&A activity spiked for technology companies during 2020 as deal value exceeded $684 billion, a new annual high for the sector and a 50% increase from 2019 levels, per Refinitiv.

Digital initiatives have become a pressing need for many companies eager to leverage automation, data analytics, e-commerce platforms, supply chain technology, remote working solutions and more. The increased need to expand technology capabilities and digital service offerings—to improve operational efficiencies, meet heightened customer expectations and maintain a competitive edge—also boosted cross-sector M&A. As companies look to accelerate their digital strategy, assessing whether to build or buy is a calculation of cost, time and expertise that informs deals as well, and the shortened timelines for rolling out these initiatives has kept tech targets in high demand. Read more about technology M&A trends in **BDO Capital's** latest **Technology M&A Market Update**.

PRIVATE EQUITY-BACKED DEALS

Private equity and venture capital firms continue to hunt for attractive targets, and conditions are ripe for the flurry of deal activity to continue. Despite the lull during H1 2020, Refinitiv's data shows PE-backed deals of all sizes rose 26% in terms of volume and 27% in terms of value for 2020 globally compared to 2019. For the full year, PE deals accounted for 16% of all M&A activity, the highest level recorded since 2007.

Q1 2021 saw the proportion of PE buyouts in the middle market rise even higher compared to Q4 2020, according to Mergermarket data. PE firms have an estimated $1.5 trillion or more in dry powder at their disposal, and the cost of debt remains low, so PE will continue to play a significant role in the deal landscape this year.

CROSS-BORDER M&A

Despite the logistical challenges for deal making and due diligence posed by pandemic-related restrictions on travel and business operations, cross-border deals still rose 12% in 2020 compared to 2019, per Refinitiv. Overall, deal flow was relatively more favorable in the U.S. than internationally in H2 2020, and total deal value for U.S. targets tripled in H2 compared to the first half of the year. Deal flow will likely increase abroad as pending deals and pent-up activity proceed once again. In particular, companies based in China will likely be much more active in 2021 as well, potentially setting up a banner year for global M&A.

CARVE-OUTS AND DIVESTITURES

The disruptions brought by COVID-19 have highlighted the benefits of organizational agility, which is likely to contribute to a rise in carve-outs and divestitures. According to BDO's ***2021 Middle Market CFO Outlook Survey***, more than one in five CFOs (21%) say they are considering a carve-out or divestiture this year.

Some organizations will place greater focus on their profitable core business and will look to shed non-core business units. Strategic divestitures can also help companies focus their resources as they prepare to pursue and fund new growth opportunities.

However, in many cases, financials are typically created specifically for the transaction since the part of the business that's carved out did not have its own separate set of financials and had not been tracked historically. Additionally, the business that's carved out will need to be operationally disentangled from its parent, which is typically not a simple exercise, and will require transitional support from the parent (i.e., in the form of Transition Services Agreements or TSAs). So, thorough due diligence is particularly critical for these deals to gain an accurate picture of the business unit and avoid potential issues or disputes.

M&A Insights from BDO's *2021 Middle Market CFO Outlook Survey*

After the headwinds and market shifts that defined 2020, growth plans are top of mind for many finance executives. BDO's ***2021 Middle Market CFO Outlook Survey*** polled 600 CFOs at middle market companies across six industries—Energy, Healthcare, Life Sciences, Manufacturing, Retail and Technology—and one quarter say they are pursuing M&A during 2021.

24%
are considering a merger or acquisition

29%
are seeking PE investment

20%
of private companies are considering an IPO

Developing the right digital capabilities is also high on the agenda, as 13% of CFOs say that falling behind on technology innovation will be the single greatest threat to their business in 2021, aside from the continuing pandemic. That indicates that deals in the tech sector will continue to be a priority for many businesses.

Post-Merger Integration is More Important Than Ever

Similar to accelerated deal timelines, the timelines for post-merger integration have also compressed. With higher deal flow, executing on integration better than the competition can help capitalize on emerging opportunities in the marketplace and provide a significant competitive advantage. And if a target has been purchased at a relatively high valuation it can be even more difficult to maximize expected value, making it critical to capture synergies and execute on the deal thesis promptly.

The deal rationale should have identified the expected opportunities for value creation, so it's vital to act swiftly and capture that value before it dissipates. Time is of the essence, and every day of unrecognized synergy is a significant loss. The diligence process will have provided ample detail about the target company to help inform the integration strategy and identify potential stumbling blocks. Data analytics can also help detect value, highlighting where and how to unlock deal synergies.

Preparing the new organization for long-term success requires a holistic strategy that's focused on the deal value drivers. Optimizing capital management and ensuring sufficient liquidity should be a focus area during the transition. However, challenges can arise during integration stemming from issues that can't be quantified on a financial report. There may also be certain negative synergies inherent in the deal, so identifying those and devising solutions before closing will help mitigate any adverse effects.

Meticulous IT due diligence represents another critical aspect of integration planning. This process will help uncover any gaps or needs from a technology standpoint, such as infrastructure improvements or data migration needs. It's important to avoid any negative synergies in areas such as data governance (i.e., a lack of master data management that could hamper the combined organization) or cybersecurity where steps would need to be taken to mitigate added risk.

Diligent change management and transparent communication throughout the organization help to achieve successful integration on the expected timeline. Without this, a litany of problems can sprout like weeds. Competitors will seek to poach clients and top talent during the transition period, so communicating with all stakeholders involved will reassure them about the integration process. Effective change management and clear, consistent communication can help put the new organization on the path to success and sustainable growth.

A realistic integration timeline focused on activities that help realize the deal rationale and gain competitive advantage will expedite solid business outcomes. Integration management tactics, such as the "two-in-a-box" approach—with a manager from both the buyer's and seller's sides on the team—can also help smooth a speedy transition.

Additional priorities include maximizing human capital to ensure the combined organization has the right people in the right roles. Full visibility into compensation and benefits for the acquired organization is an important aspect of this, and it may be necessary in some cases to increase salary and/or benefits for the added staff to bring that in line with the acquiring company. Internal processes will also need to be reviewed and aligned, such as accessing timely information for key decisions and adjusting delegation authority to provide clarity around organizational structure and decision-making powers.

An integration is typically a transformative process for an organization, one which requires extensive collaboration and coordination. In-person meetings can be an important facilitator in that process, but holding in-person meetings can be difficult during the pandemic. Now more than ever, it is critical for an integration to have a well-defined governance structure and process to enable cross-functional communications, decision-making and issue resolution. It is also very important for integration teams to leverage digital communications, as well as tools and platforms for collaboration and project management.

There could be a more challenging economic environment in the years ahead, so it's beneficial to establish a solid foundation swiftly following any transaction. Implementing a deliberate integration strategy that focuses on the deal value drivers will help protect and optimize the investment.

Spotlight: The Boom in SPACs

The formation of SPACs surged during 2020, and that trend has increased even further in 2021. SPACs are shell companies with no assets designed to raise funds from investors and then acquire or merge with a private company to take it public. There were 248 SPAC IPOs in the U.S. in 2020, and those raised more than $83 billion, representing a dramatic increase from 59 SPAC IPOs with $13.6 billion raised in 2019. SPACs also accounted for more than half of all U.S. IPOs in 2020. Incredibly, by mid-March, SPAC IPOs had already raised more than $89 billion in 2021—surpassing the 2020 total in a matter of weeks and significantly outpacing non-SPAC IPOs.

Despite their surging popularity, SPACs offer advantages and disadvantages, and they won't be right for every business or sector. Overall, going public via a SPAC avoids the expenses and various administrative and operational requirements of a traditional IPO. The timing of taking a company public through a SPAC also offers advantages over the traditional IPO process, with a shorter time to market, no capital-raising event and no need to aim for timing that maximizes value based on market conditions. The funds have already been raised by the SPAC and placed in an investment vehicle, which eliminates potential funding concerns. The SPAC will also have a fresh operating and reporting history as a purpose-created shell company, so auditing and due diligence is less invasive than with a standard IPO. There is typically continuity with experienced members of the management team following the transaction as well. And there is no threshold to meet for smaller companies, so more startups can consider that path to liquidity.

However, SPACs won't be a fit for all companies evaluating whether to go public. The valuation is not based on market demand, but rather on negotiation with the SPAC sponsor, and stockholders also have redemption rights. It's critical to have alignment between the SPAC management team, the investor base and the purchased company, which will have a SPAC sponsor on the board, so the founders will have less control over planning. As the rush on SPACs expands significantly, there may also be sponsors that don't have the detailed industry experience and technical knowledge to help ensure the purchased company thrives, especially in the case of smaller growth companies.

There is no doubt that the SPAC trend has gone mainstream. However, as investors rush in to capitalize on this growing trend, there is a risk that the supply of suitable target companies could be insufficient to meet the growing demand. SPACs should be considered as an option for going public, but it's critical to evaluate all available options and scrutinize the potential SPAC sponsor carefully.

To learn more, read our BDO Knows SPACs series ▶

On April 12, 2021, the SEC publicly announced that SPAC warrants may need to be classified as liabilities depending on the following key features:

- Payout structure
- Settlement in cash or stock
- Indexation

Liability classification would require SPAC warrants to be valued as of the IPO closing date as well as subsequent reporting dates.

Business Restructuring Considerations Ahead

As the pandemic recovery proceeds, certain industries still face significant challenges, including retail, hospitality, energy and healthcare. Consumer behavior impacting many sectors may not bounce back fully, or it may return more slowly than anticipated. In some cases, companies face irreversible changes that will require them to adapt to shifting demand and to be increasingly agile.

It's vital for struggling businesses to assess their current state and evaluate when revenue is likely to return (if ever) to pre-pandemic levels, which should be based on a realistic outlook for their specific industry sector and their business lines. That will guide business restructuring requirements and assist in identifying the potential options for capital raises, debt restructuring and strategic M&A. Earnouts and creative deal structuring could become more common in these situations to account for the current risk profile.

37% of middle market CFOs plan to pursue a restructuring or reorganization

According to BDO's survey, 32% of retail CFOs plan to pursue M&A in the next 12 months, which is the highest percentage among any of the six industries surveyed. E-commerce initiatives have gained more importance than ever, while brick-and-mortar locations face even greater challenges. That shakeup has led many retailers to reevaluate their business models and make the necessary pivots to meet ever-changing consumer demand. In the energy industry, 22% of oil & gas CFOs say low oil prices prevented M&A during 2020. Now, with oil prices on the upswing, that could lead to a rise of deal activity and capital investment in that sector. And in healthcare, 42% of CFOs anticipate industry consolidation will increase in 2021.

For those businesses that expect their struggles to persist for the next year, especially in industries that still face significant headwinds as a result of COVID-19, a debt restructuring or operational reorganization may be the best option available. Proceeding sooner rather than later can help optimize costs and maximize the opportunities going forward. The objectives and initiatives for restructuring will vary based on the industry and company, but these could include extending the runway for recovery by amending credit agreements and pursuing debt conversions to address overleveraged balance sheets.

To date, most lenders have been relatively flexible in dealing with their borrowers' individual issues. For those borrowers that refinanced or added debt, challenges could be on the horizon. While generally favorable conditions still prevail in the capital markets, and interest rates remain low, the environment may change suddenly. Events could unfold that quickly alter lender and investor behavior. For example, recent volatility involving certain investment banks and hedge funds could negatively impact the credit markets.

It's prudent to evaluate all available options for accessing capital, including debt financing, equity financing, government grants and subsidies. Taking a proactive approach will help make the most of the current window of opportunity and can extend the recovery runway to improve outcomes.

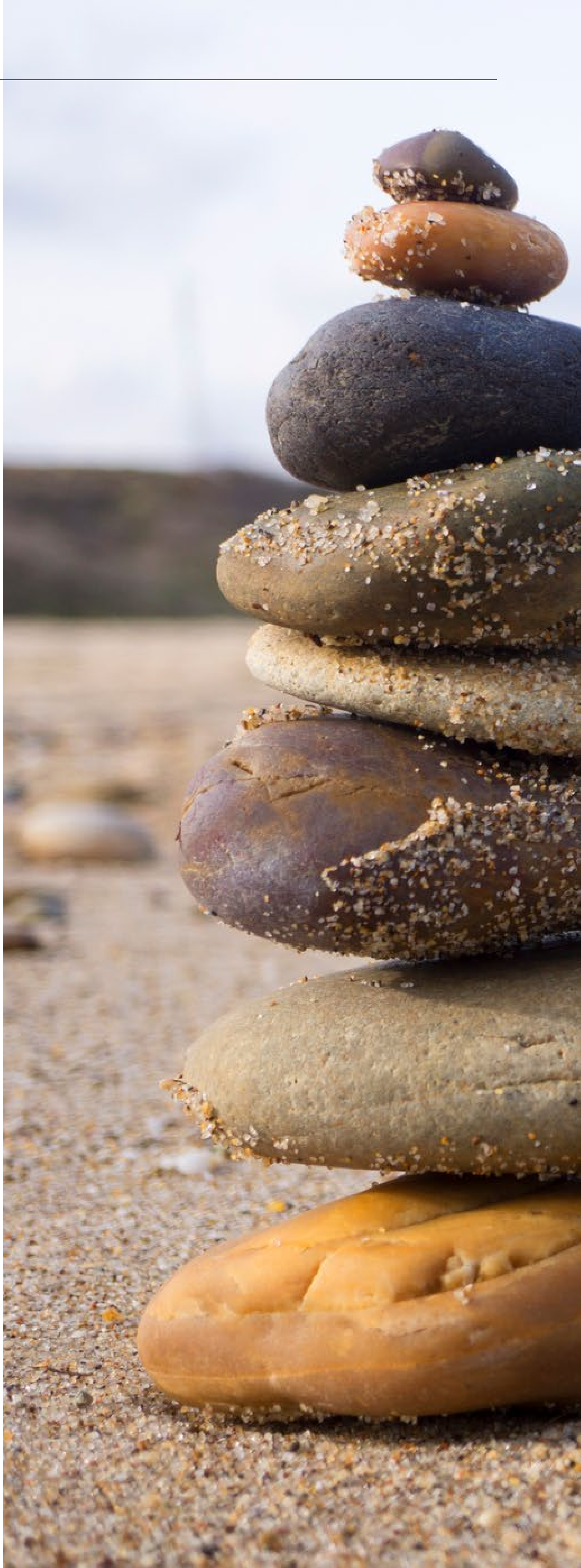
Implementing strategic changes within the organization could clear a path to future success, and experienced restructuring advisors can help assess the current state of the business to identify the most impactful changes. BDO's Business Restructuring and Turnaround Services team is available to advise clients as they assess their financial needs when challenges present themselves.

Learn more about how BDO can help your business ▶

Post-Merger Integration Checklist

- [ ] Focus on the deal rationale to capture expected value.
- [ ] Devise an integration timeline focused on the needs relevant to the integration process.
- [ ] Leverage data analytics if and where applicable.
- [ ] Review and optimize capital management to secure sufficient liquidity.
- [ ] Assess and maximize human capital to confirm the right people are in the right roles for the new organization.
- [ ] Identify potential negative synergies inherent in the deal and prepare solutions before closing.
- [ ] Conduct thorough IT due diligence to pinpoint infrastructure or data migration needs and evaluate potential cyber risks.
- [ ] Ensure organization-wide change management and transparent communication with all stakeholders.
- [ ] Establish a well-defined integration governance structure and process to enable cross-functional communications, decision-making and issue resolution.

Learn more about how BDO's Transaction Advisory Services team can help your business at every stage of the transaction lifecycle.



Maintaining Focus While Keeping Pace

The future looks bright, with signs of green shoots sprouting amid the rising economic recovery. As robust deal activity continues, companies are evaluating their needs with fresh eyes and planning to hit the ground running. Agility and resilience have taken on renewed importance and strategic M&A can help organizations achieve those goals. With compressed deal timelines, urgent digital initiatives and timely integration strategies, speed has become a virtue, but these priorities all help put businesses on the path to long-term success.

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To learn more about how we can help your company through a transaction process, reach out to our key leaders:

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