

AN OFFERING FROM BDO'S
CORPORATE FINANCE PRACTICE

DEAL ADVISOR DIGEST

M&A Trends Report

ISSUE 5

NAVIGATING
DEAL-MAKING IN THE
TIME OF COVID-19

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Deal Activity Overview

THE CHILLING EFFECTS OF THE PANDEMIC ON M&A

The COVID-19 pandemic has severely impacted billions of people around the globe, and businesses have seen a historic 10-year run of economic expansion suddenly upended. As governments scramble to respond to the public health emergency, virtually all industries have faced a significant slowdown in economic activity, with many retailers and service businesses shuttered and supply chains disrupted. Consequently, deal activity slowed to a crawl as many buyers hit pause because of unprecedented uncertainty.

Overall, 2019 had brought another strong year of M&A activity, as deals of all sizes cumulatively surpassed \$3 trillion for the sixth year in a row, which marked the fourth-largest year on record since tracking began in 1980, according to Refinitiv. However, the black swan of COVID-19 transformed mostly sound economic fundamentals into a sharp downturn across the board. As a result, it's much more difficult to determine accurate valuations for deals and conduct thorough due diligence, leading many potential buyers and sellers to adopt a "wait and see" approach for transactions in 2020. In the meantime, many deals that close will be those that were already in progress prior to the pandemic.

On the plus side, there are some indications that deal activity is starting to pick up. The current M&A landscape varies from industry to industry, and certain sectors have seen more movement than others in recent weeks. The sharp recovery in the equity markets may restart IPOs and related VC and PE exit activity, and there's a chance that the equity recovery will ease pressure on a decline in limited partner commitments. Many funds have also launched new funds, or re-launched funds that were on hold, as the uncertainty has waned and overall returns on the equity and debt markets have rebounded. Restructuring and turnaround activity has also increased. These signs indicate that an uptick in M&A activity could be on the horizon.

The economy will rebound and deal activity will bounce back. But this will not happen all at once, and the timeline for recovery remains uncertain. As we look toward the future, it's important to examine the near-term measures that businesses and investors should consider and assess the opportunities that may be available in this down market, which can help inform expectations for the outlook on deal activity going forward.

Spotlight on Private Equity

PE FIRMS FOCUSED ON PORTCOS BUT WELL-POSITIONED FOR DEALS

Private equity firms are uniquely positioned to take advantage of opportunities in a down economy, thanks in large part to ample dry powder at their disposal while many organizations confront declining revenues and tightened credit markets. So, it's likely that PE firms will continue to drive a significant amount of deal activity in 2020. The proportion of PE buyouts had risen again in 2019, representing 24.1% of global mid-market deal value during Q3. That was nearly double the 12.2% proportion from Q4 2016 just three years prior, according to Mergermarket. Market volatility and uncertainty have combined to drive down valuations for targets from the stubbornly high multiples seen in previous years. That combination of dry powder and lower valuations make PE firms likely to regain their appetite for deal-making before other buyers do, at least once the "wait and see" period subsides.

However, amid a chaotic Q1 that saw COVID-19 stun markets and bring unprecedented economic disruption, PE firms have focused on their portfolio companies to address any immediate cash needs there. Before proceeding with any new deals, firms must shore up their existing portfolios. The primary concern is ensuring those companies can persevere through the immediate crisis and maintain operations until the economic outlook improves. All available cost reduction synergies will need to be accelerated.

While many businesses may be able to avail themselves of relief through government stimulus programs, the majority of PE-backed companies are not eligible for Paycheck Protection Program (PPP) loans under the Coronavirus Aid, Relief, and Economic Security (CARES) Act, due to the affiliation rules of the Small Business Administration (SBA). That's all the more reason why PE firms need to carefully examine any potential liquidity issues that are affecting their portcos.

Beyond PPP loans, there are other loan options available to PE-backed businesses of various sizes through Title IV of the CARES Act. These options include funds available through the Main Street Lending Program (MSLP). The MSLP has been set up as a special purpose vehicle by the Federal Reserve System (Fed) with the goal of stabilizing small and medium sized businesses that were in sound financial condition prior to the onset of the COVID-19 pandemic.

The program will either expand businesses' existing lines of credit—Main Street Existing Loan Facility (MSELF)—or originate a new credit facility to augment the existing balance sheet using the Main Street New Loan Facility (MSNLF), or replace an existing credit facility via the Main Street Priority Loan Facility (MSPLF). The Fed released expanded guidance for the MSLP on June 8, and the program opened for lender registration on June 15 ([summarized in our insight here](#)).

The Fed has issued term sheets which may not be modified by the originating lending institution. These terms include rate (L+300 bps), term (5 years), amortization (Y1 no principal & interest (P&I), Y2 I only, Y3&4 15% P, and Y5 70%) and seniority (pari passu). Other affirmative covenants, beyond those described below, are at the lender's discretion.

Unlike PPP Loans, Title IV loans are not forgivable and do come with a number of conditions. These restrictions are offset by the ability to potentially refinance with various MSLP options and reduce the weighted average cost of capital through various restructuring strategies.

The MSLP loan conditions for PE-backed organizations include:

- ▶ The same affiliation rules will be applied that were used for PPP loans, so portcos must meet the eligibility criteria and maximum loan size criteria for the relevant loan facility.
- ▶ The MSLP limits are for the entire portfolio of companies from one fund and only one facility can be used per fund.
- ▶ There are restrictions on compensation in excess of \$425,000.
- ▶ There are restrictions on dividend payments.

All loans must be originated from a U.S. federally insured depository institution (including a bank, savings association, or credit union), a U.S. branch or agency of a foreign bank, a U.S. bank holding company, a U.S. savings and loan holding company, a U.S. intermediate holding company of a foreign banking organization, or a U.S. subsidiary of any of the foregoing. These institutions will use their underwriting criteria and will determine if a loan can be justified. Lenders will be responsible for evaluating Adjusted EBITDA as well as all other non-enumerated terms of the Fed's term sheet.

Regardless of loan status, once economic conditions have stabilized to some degree, many PE firms will likely take a more cautious approach to deals than they previously had, as they seek to mitigate risk going forward. Many will pursue targets through more conservative capital structures and a lower leverage ratio. For the foreseeable future, it can be expected that PE deals will include a higher proportion of equity and a lower debt-to-EBITDA ratio than has been standard practice.

TURNAROUNDS, SPECIAL SITUATIONS AND DISTRESSED ASSETS

PE buyers willing to address turnaround needs in their portfolios will likely drive a higher proportion of deals in 2020. Firms that target distressed assets will have ample options, but it's challenging to mitigate risk with considerable upheaval in the markets. An increase in fundraising for special situations and distressed debt is anticipated, with opportunities in some cases for bridge financing where the potential to take control of the distressed company helps to balance the level of risk. As banks become wary of buyouts, private lenders can seize that opportunity to provide financing for deals. There can often be potential value in the tax attributes of distressed companies as well, so the structure and financing of such deals need to be evaluated with tax optimization strategies in mind.

A key driver of distressed M&A is the rising level of overall corporate debt, which some companies will struggle to service or refinance in the new economic climate. Another driver of such deals will be the increasing consolidation in some industries and the trend toward onshoring to mitigate supply chain disruption.

Unique market conditions and varying effects on certain industries also make it challenging to accurately value distressed prospects. In some cases, strong companies have been forced into a position of distress due to unavoidable market conditions, while other companies have become distressed because sudden economic headwinds have exposed underlying weaknesses in that business.

Certain industries have been hit particularly hard by the effects of the pandemic, including hospitality, travel, retail and oil & gas. Importantly, some of those industries were already facing challenges. Given this dynamic, it's critical to understand the prevailing conditions within each respective industry—including when and how demand is expected to bounce back, and what lasting challenges are expected to continue during the recovery period—and carefully examine the value proposition for the specific company. As with any deal, thorough due diligence will be crucial to assess value and make accurate projections for the future, but there are many opportunities in a down market.

Transaction Issues

NEAR-TERM FOCUS ON LIQUIDITY AND COST-CUTTING

As a result of the COVID-19 outbreak, many companies suddenly faced declining or even zero revenue. This has led to acute cash flow challenges that threaten the very existence of some longstanding businesses. In response, cost-cutting measures are a frontline defense to preserve available capital and address liquidity concerns. Companies experiencing such difficulties will also look to optimize processes, increase efficiencies and focus on revenue-generating core operations.

Organizations that are not able to address liquidity challenges through such measures and expect to have ongoing cash flow concerns may be forced to seek bridge financing from private lenders or even resort to bankruptcy proceedings. The most obvious warning signs of liquidity problems include fully drawn credit facilities, declining profitability and debt in excess of the book value of assets. Some companies may also be in danger of not being able to meet their debt covenants, necessitating negotiations with the lender in hopes of a waiver, but that is only a temporary solution to one problem among many. As the economic volatility drags on, bankruptcy proceedings could become a major driver of deals for distressed assets.

MORE SPINOFFS AND CARVE-OUTS AHEAD

Divestitures are likely to increase once deal activity ramps up again. As occurred in the wake of the 2008 recession, there will be more spinoff and carve-out deals as companies seek to streamline operations and raise capital. In these cases, transition services agreements (TSAs) will be critical to help define what services, if any, the seller will provide for a temporary period during the transition. Also, a transaction risk insurance policy, such as representations and warranties insurance, can help facilitate the closing of a deal and provide the necessary mitigation for further uncertainty.

THE SLOWDOWN OF EXITS

In many cases, holding periods will be extended for longer than planned as exits are delayed, where possible. Sellers will want to wait for recovery in the markets after the sharp decline that began in late February. The dual factors of volatile markets and an uncertain economic outlook have created divergent expectations between buyers and sellers. Because lenders are being more cautious about potential risk during the underwriting process, buyers will also need to contribute more equity in many cases to complete deals in the near term. But as markets stabilize to some degree—and there have been positive indications of such a recovery—exits will begin to increase again, though it will take time to approach pre-pandemic levels.

VCS FOCUS ON SUSTAINABLE GROWTH AND PROFITABILITY

During 2019, there were already signs that the trend of high valuations for companies prioritizing growth over earnings was in for a reckoning. Several high-profile IPO flops signaled that many investors were particularly skeptical of companies that had burned through substantial amounts of cash for the sake of disrupting traditional industry models. As a result, companies that pursue growth plans with no clear path to achieving profitability are much less likely to secure funding and the ripple effects of COVID-19 make this even more true going forward.

Venture capital funds will take this opportunity to course-correct and identify investment opportunities that demonstrate models for sustainable growth. Not only is this a prudent way of limiting risk, it's also rooted in sound economic fundamentals at a time when the economic outlook and the next stages of the pandemic remain uncertain. While VCs will still seek to strike gold with early investments in promising companies, the unbridled funding of unicorns may well have come to an end.

VCs will put greater focus on corporate governance for startups moving forward. Strategic growth in lockstep with continued financial health will be vital, while also contending with increased scrutiny on manageable scalability. In the months ahead, it will be even more important to fund growth strategically, manage costs and keep realistic long-term goals in mind.

FEWER LP COMMITMENTS TO VC AND PE FUNDS

During the 2008-09 recession, institutional investors pulled back on investment in VC and PE funds, and some level of that caution should be expected from limited partners during the current crisis. The denominator effect will impact this dynamic by increasing the proportion of PE allocation due to the drop in public markets, which could limit new commitments and potentially prompt some to sell off their stakes. For limited partners that have restrictions on PE allocation, this will reduce their options. Fewer exits will also result in fewer payouts to LPs.

General partners may also need to draw on funds to aid ailing portcos. Capital calls will be driven by funds focused on distressed debt and special situations, too. This will complicate fundraising efforts for GPs as the flow of capital is constrained and LPs look to reduce commitments to VC and PE, although there are recent signs that the pressure on LPs is easing due to improved equity markets.



Checklist - Perseverance and Resiliency During Times of Distress

The economic strain of the COVID-19 pandemic has pushed many businesses to the brink, with weakened economic activity impacting revenues. So, each business should evaluate whether their current difficulties are just temporary bumps in the road or obstacles that require a change in course.

Operational resiliency requires a plan that matches the current needs of the business, and there are four phases to resiliency during a downturn: Persevere, Maintain, Recover and Thrive. In order to persevere, a business must identify signs of distress as quickly as possible, and then implement measures to mitigate that distress. The road to recovery can be a difficult trek, but increasing resilience is the first step toward a business that thrives once again.

Key signs of distress to look for include:

Tight liquidity (i.e., insufficient cash on hand, inability to obtain new financing, inability to pay debts when due).

Fully drawn credit facilities (i.e., covenant violations lower borrowing base availability, reliance on amendments or forbearances, deteriorating relationship with lenders).

Declining profitability (i.e., significant decreases in revenue, cash flow and EBITDA).

Debt in excess of book value of assets (i.e., significant near-term debt maturities).

Loss of key customers/vendors, staff turnover and/or layoffs, product line reductions, service lapses.


Strategies for perseverance include:

Analyze the causes and impacts of distress signs (i.e., lower revenue, supply chain disruption, workforce disruption).

Make a realistic, accurate and detailed forecast of the required near-term cash flow (i.e., for the next three to six months).

Evaluate options that ensure business continuity, such as:

- ▶ Focus on revenue-generating activities and reallocate resources if necessary.
- ▶ Manage liquidity and reduce outflows by delaying some payments (i.e., defer taxes, reduce headcount or furlough staff, seek applicable refunds on taxes or prepaid insurance policies).
- ▶ Manage lender relationships as covenant compliance likely will be an issue for many companies given the slow revenue recovery for many businesses.
- ▶ Assess various funding alternatives for the business and engage with lenders on potential alternatives to recapitalize the business.
- ▶ Apply for applicable federal stimulus programs, such as the MSLP.

A close-up, low-angle shot of a sailboat's deck at sunset. The sun is low on the horizon, casting a warm, golden glow over the scene. The water is dark blue with gentle ripples. In the foreground, a coiled rope with blue and white patterns lies on the deck. To the right, a large, dark, cylindrical object, possibly a winch or a part of the boat's equipment, is visible. The background shows the white sails of the sailboat and the distant horizon line where the sun is setting.

BDO's Restructuring and Turnaround Services team is available to advise clients as they assess their operating and financial issues during this challenging period. [Learn more about how BDO can help your business.](#) ►



The Journey Ahead

With questions looming about effective treatments for COVID-19, the timeline for developing a vaccine and the potential for another wave of infections later in the year, the ongoing pandemic remains the main source of economic uncertainty. However, it's far from the only one. Buyers and sellers still need to assess a range of geopolitical concerns, including trade tensions and the U.S. elections looming in November, which will face significant challenges due to ongoing public health concerns.

At some point, economic conditions will stabilize and uncertainty will subside, which could prompt a surge in pent-up deal activity, but the fallout of COVID-19 will bring widespread and lasting changes to the economic landscape. There remains ample value to capture in deals but determining an accurate valuation and conducting due diligence remain an uphill battle.

In BDO's quarterly Forecast Engine Industry Impact Study, we use data algorithms and dashboard analytics to shed light on analyst estimates for economic recovery amid and beyond COVID-19. **[Read the inaugural issue from BDO's Valuation & Business Analytics \(VBA\) Practice to uncover industry insights to help plot your path ahead.](#)**



BDO Deal Advisor Leaders

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



RYAN GUTHRIE

Partner, Corporate Finance Co-Leader and
Transaction Advisory Services Practice
National Leader
714-668-7385 / rguthrie@bdo.com



BOB SNAPE

President, BDO Capital Advisors, LLC
617-239-4177 / bsnape@bdocap.com



ANTHONY ALFONSO

Global Valuation Leader and Corporate
Finance Co-Leader
602-293-2358 / aalfonso@bdo.com



JIM LOUGHLIN

Managing Director, National Leader
Business Restructuring Services
917-414-1411 / jloughlin@bdo-ba.com

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