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DEAL ADVISOR DIGEST

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ASSESSING
OPPORTUNITY AHEAD
OF UNCERTAINTY

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Deal Activity Overview

Q3 UNLEASHES A FLOOD OF DEAL ACTIVITY

The COVID-19 pandemic has brought severe consequences for public health around the globe, and it significantly disrupted business operations and deal activity as well. This environment produced a chilling effect on M&A as buyers and sellers waited to see how the global crisis unfolded and the related economic impacts. Although deal activity slowed to a trickle during the latter part of Q1 2020 and throughout much of Q2, that translated to a significant backlog in the M&A pipeline. The result: deal-making returned in full force during Q3.

Pent-up M&A activity made for eager buyers and sellers, which led to a record-setting deluge of deals as market conditions steadied somewhat. According to data from Refinitiv, Q3 2020 was the best third quarter for deal activity on record. September alone saw deals increase by more than 100% year-over-year, with the middle market in particular experiencing a precipitous rise in M&A.

While this flood of deals didn't completely make up for the pandemic-related slowdown in M&A during H1, it does indicate the healthy deal environment that currently prevails. Q3 activity was especially significant in certain sectors, such as technology and healthcare, which have not been undercut as severely by the public health crisis. The shock of COVID-19 also prompted many companies to re-examine their needs for diversification in terms of geographic footprint, product offerings and more, which added to the urgency in deal-making.

More than any year in recent memory, the economic landscape has shifted drastically, and repeatedly, during 2020. Relative stability today may turn to volatility tomorrow. However, unlike the 2008 recession, the present climate offers numerous favorable options for accessing capital. By examining and monitoring the specific needs of your business and the outlook for your industry, you can assess all available options and capitalize on the opportunities that best set up a path to sustained success.

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What's Driving Deal Activity Now and Through Calendar Year-End

OPPORTUNITY NOW, UNCERTAINTY AHEAD

Although the floodgates opened in Q3 2020, with deal-makers eager to act during a window of relative stability, buyers and sellers remain wary of the disruption that marked the spring, mindful that those conditions could return suddenly. The 2020 U.S. elections, along with concerns that the fall and winter could bring a rise in COVID-19 infections, have fostered a sense of urgency among deal-makers. Changes could be in store for tax and trade policies, and the historically large budget deficit will likely affect future policymaking as well.

Extraordinarily low interest rates have also been a factor in the rush to make a deal. One corollary of this is the increased role of special purpose acquisition companies (SPACs)—also known as blank check companies—in IPO activity, as some investors seek to take advantage of the higher return potential afforded by the lower interest rates and current market buzz around SPACs. Increased activity from private equity and venture capital have led to a multitude of sellers, and SPACs make for a convenient partner in certain cases. Through the end of September, more than 100 SPACs were formed and had raised more than \$40 billion, per Refinitiv.

It can be beneficial to act while capital is readily available and deal dynamics are favorable. This is especially true for entrepreneur-led businesses and family businesses that may be considering a cash out. With uncertainty on the horizon, reviewing all the current options available to your business can help maximize opportunities and provide solid footing on the path ahead. [Learn more about how BDO Capital Advisors can help business owners looking to sell their company or raise capital.](#)

THE EVOLVING DEAL PROCESS AND THE INCREASING ROLE OF DATA ANALYSIS

Buyers and sellers initially took a wait-and-see approach during the early weeks and months of the COVID-19 pandemic, but they soon adapted to travel restrictions and public health mandates by leveraging technology solutions for certain aspects of the process. Whether deal-making will revert to the previous level of in-person interaction remains to be seen, but there is a healthy appetite in the market to return to face-to-face discussions over deals.

Still, it's evident that technology and data analysis can play an increased role in the deal process. Analytics can provide many benefits for M&A, such as identifying patterns or outliers and using those to inform decisions ranging from operational and investigative due diligence to valuations and post-merger integration strategies. With ever-increasing amounts of data on hand for deal teams, experienced advisors with strong data analytics capabilities could help maximize outcomes and shape the future of deal-making.

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Goodwill Impairment and the Challenge of Private Company Forecasts

One impact of the economic downturn in 2020 has been added complexity in valuations. Volatility has made vetting a private company forecast much more difficult. Because private companies rely largely on forecasts to test goodwill for impairment, they may need to do more rigorous testing to determine fair value. The pandemic-related downturn likely constitutes a triggering event that has impacted valuation, so it should necessitate increased impairment testing of goodwill.

Additionally, private company forecasts need to have an industry lens, which helps account for the diverse effects that the downturn has had on certain industries. For example, while online retail and technology businesses have seen a boom, many companies in travel, hospitality, oil and gas, luxury retail, healthcare and other industries have faced significant revenue challenges.

When testing goodwill impairment, it's critical to assess the value of the overall business rather than just the value for a particular reporting unit. Using multiple methods can help provide a more accurate valuation, especially during periods of volatility. But there's a divergence between the income-based approach and the market-based approach to impairment testing. Public companies can glean insights based on stock price, but the market has been somewhat countercyclical in recent months. By contrast, private companies face unique challenges with their forecasts as they do not have the same clarity regarding their market value. The best approach will depend on the conditions unique to the business, the market data that's available and the type of asset or liability.

BDO's Valuation and Business Analytics practice can help advise businesses as they navigate complex questions related to goodwill and valuations.

[Learn more here about how BDO can help your business.](#)

Also, read more in BDO's quarterly [Forecast Engine Industry Impact Study](#) to uncover industry insights that can help plot your path forward. We use data algorithms and dashboard analytics to shed light on estimates for economic recovery amid COVID-19 and beyond.



Be Proactive When Tapping Capital

Volatility presents many challenges for a business and 2020 has delivered that in droves. If your business has held steady through the spring and summer, that likely demonstrates good management and sound fundamentals. However, while the measures taken by the Federal Reserve have significantly improved the business climate, considerable risk still exists, and the road ahead remains unpredictable. This current moment offers an opportunity to examine all avenues for raising additional capital and evaluating which option—or combination of options—would best help pave the way for the future growth and success of your business.

During the previous months, most organizations have taken a clear-eyed look at their operations, defined the profitable core business, focused their resources and developed a realistic revenue forecast for the next 12-18 months tied to key business drivers. They may have aligned the expense structure and capital expenditure plans with that revenue forecast, as well as formed an industry-specific timeline for the return of revenue to pre-pandemic levels. They may also have maximized internal capital by redeploying or selling underused assets and re-examining working capital management.

For businesses that have navigated the recent squall and come out the other side contemplating future growth, now is a time to reposition the organization in a forward-looking stance.

So, what is the most prudent next step? Compared to a few months ago, there is a wider range of options currently available for accessing capital, but the best option to help your business move forward will depend on a range of factors, including which levers have already been pulled. Each option offers specific advantages and disadvantages, such as the recurring payments and risk of default with debt financing or ceding partial ownership with equity financing.

This point in time can be an opportunity to increase your organization's resilience and agility and prepare to capitalize on future initiatives. Depending on your business and industry, you can consider various external financing options, including the following:



Debt Financing

Debt financing can allow your organization to raise new capital without giving up control. However, the regular payments and risks of default rise if the economy doesn't find its feet.



Equity Financing

Equity financing, on the other hand, allows you to raise substantial capital that can help fuel growth, if you are comfortable giving up partial ownership of the organization. Whether through private equity investors or an IPO, equity financing can bring in capital, but it comes with the expense of reduced control.



Government Grants & Subsidies

Applying for government grants or subsidies may help certain types of organizations bring in additional resources for specific purposes, often without the need for repayment, or it may provide such organizations with tax breaks or tax-favored funding.



Crowdfunding

In certain cases, crowdfunding may be an efficient way to raise startup capital at the same time as you validate a project or business.



Banks are once again lending and issuing term sheets, albeit on a much more selective basis than previously. Businesses should maintain regular communication with existing lenders to highlight the current and future health of the business. However, lenders also face their own pressures and leverage tolerances have declined. Many lenders have become stricter about offering waivers and amendments or extending covenants. In certain situations, lenders may only be willing to support a sale or liquidation of a business.

Lender fatigue could take hold in the future as debt service deadlines come due and write-offs mount, but this fatigue will not be uniform, so it can help to investigate new banking relationships for credit. Each business is unique, and there will be variation among credit providers in terms of how they evaluate different businesses and different industries. If existing lenders will not facilitate additional capital, a new lender may be willing to extend credit, especially if the business was healthy prior to the downturn and the underlying fundamentals are sound.

RESTRUCTURING DISTRESSED BUSINESSES

Leverage tolerances have contracted across the board, so distressed businesses face much greater difficulties in accessing capital. Restructuring services could help these businesses implement the strategic changes that are needed. Experienced advisors can address questions or concerns so that struggling organizations can make judicious decisions about next steps.

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

On the equity financing side, strategic buyers in many sectors also have ample capital and liquidity to invest and consolidate, and they are now looking to put their money to work to gain market share or expand product offerings. They have rekindled discussions to restart deals and are launching new ones.

On the financial buyer side, private equity continues to sit on record levels of dry powder, so they, along with family offices and high-net-worth individuals, are also looking to invest and can fill certain gaps. It can be advantageous to consider the range of options for financing, whether that includes debt, equity or a mixture of both. [Learn more about capital structuring by listening to BDO's recent webinar, Capital Structure Optimization.](#)

However, since the pandemic began, the upper hand has shifted from the seller to the buyer—and to the lender on the debt-financing side—so those with cash on the balance sheet are looking to take advantage, especially since multiples, for the most part, have decreased. While this means it's easier to access capital now than it was during Q2, the cost of that capital has also gone up—significantly in some cases. This cost may be prohibitive for some businesses, but proactively exploring those options will help make a sober assessment. The approvals process has also grown longer for reviews and commitments, but for the time being, capital is available for those in need.

If these options for capital are either unavailable or unappealing, businesses can also consider tapping government programs, such as the Main Street Lending Program (MSLP). When evaluating this course of action, it's important to bear in mind that applying for the MSLP entails a substantial amount of work, including a series of steps to navigate the regulatory requirements, but there can be notable advantages to using government stimulus programs.

There are many options available in the present moment. Taking a proactive approach and assessing the current options for your business can help to access capital under favorable conditions. Preparations made now can open new opportunities in the future.

FOUR STEPS TO TAKE NOW:

**STEP 1**

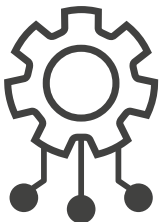
Take stock of the levers pulled during the initial months of the pandemic to assess what worked well and what didn't when it comes to managing cash flow and liquidity.

**STEP 2**

Evaluate—or re-evaluate, as the case may be—all available options for financing, including debt financing, equity financing, raising capital through the sale of assets, cost optimization employing large scale cost reduction initiatives in sync with the [80/20](#) rule, taking advantage of tax credits and incentives, or pursuing joint ventures or M&A.

**STEP 3**

Revisit your detailed revenue plan and update your near-, mid- and long-term cash forecasts.

**STEP 4**

Develop a post-raise plan to manage cash flow and make smart capital investments to fuel future growth.



Case Study: The MSLP in Action

BDO recently helped a parts manufacturer close a \$50 million financing facility through the MSLP. This much-needed additional capital helped the client restart operations, which had been shuttered for several months during the early stages of the pandemic.

Although the business was historically very profitable and had solid contracts to supply parts for several large manufacturers, the legacy lender had focused on borrowing base formulas during the nearly 90-day shutdown period, and the line of credit was contracting. In accordance with the legacy credit agreement, funds from collections on existing accounts receivable had been immediately applied to pay down the line of credit, further reducing the available funds under the borrowing base formula. The cash sweep made restarting production problematic once manufacturing demand resumed.

Because the government takes on most of the financial risk with MSLP loans, the new lender was able to add a borrowing relationship with a large target account that can generate attractive yields and only took on moderate risk in the near-term. The new lender also positioned itself to refinance this debt in the future when the borrower's operations return to normal. Most importantly, the parts manufacturer received the capital it needed to restart operations, so it was a win-win for both the borrower and the new lender.

TITLE IV LOANS / MAIN STREET LOAN FACILITIES

LOAN DETAILS	Main Street New Loan Facility	Main Street Priority Loan Facility	Main Street Expanded Loan Facility
Term	5 years	5 Years	5 years
Principal & Interest Payments	<ul style="list-style-type: none"> ▶ Y1 – No P&I ▶ Y2 – Interest Only ▶ Y3 & Y4 – 15%/Year ▶ Y5 – 70% 	<ul style="list-style-type: none"> ▶ Y1 – No P&I ▶ Y2 – Interest Only ▶ Y3 & Y4 – 15%/Year ▶ Y5 – 70% 	<ul style="list-style-type: none"> ▶ Y1 – No P&I ▶ Y2 – Interest Only ▶ Y3 & Y4 – 15%/Year ▶ Y5 – 70%
Rate	LIBOR + 300bps	LIBOR + 300bps	LIBOR + 300bps
Minimum Loan Size	\$100,000	\$100,000	\$10 million
Maximum Loan Size	Lesser of (a) \$35 million; or (b) the amount that does exceed borrower's leverage by 4x adjusted EBITDA (including undrawn available debt)	Lesser of (a) \$50 million; or (b) the amount that does exceed borrower's leverage by 6x adjusted EBITDA (including undrawn available debt)	Lesser of (a) \$300 million; or (b) the amount that does exceed borrower's leverage by 6x adjusted EBITDA (including undrawn available debt)
Loan Participation	(a) SPV – 95%; Lender – 5%; (b) Seniority – pari passu basis	(a) SPV – 95%; Lender – 5%; (b) Seniority – senior to or pari passu basis	(a) SPV – 95%; Lender – 5%; (b) Seniority – pari passu basis; (c) Collateral – pro rata basis

The Fed has also announced two additional facilities to address the needs of the Not-for-Profit (NFP) entities; lending terms differ to address the unique underwriting criteria of the NFP community.





Preparing for the Next Move

Many businesses have persevered through the darkest months of the COVID-19 pandemic and related economic downturn. Having repelled the many and varied challenges from all sides to date demonstrates the strength and savvy to forge ahead. Following the difficult wait-and-see period that prevailed throughout the spring months, summer and fall have brought renewed deal activity as well as a range of options for accessing capital.

Nevertheless, further uncertainty lies ahead, and inaction could leave a business flat-footed amid a rush of activity. Taking proactive steps now could help provide the information needed to make prudent decisions about how best to prepare and proceed in order to be well-positioned for future prosperity.

BDO Deal Advisor Leaders

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



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