Getting Back to the Business of Business

By Jonathan Moore, CPA, CM&AA, Partner

We don't know for sure whether the U.S. economy will rebound and boom once the lockdown ends and we are all back to business. We do know – at least for the short-term – it will not be "business as usual" as we enter the "new normal" of social distancing. However, based on historical and anecdotal perspectives, we can be optimistic. After all, the Great Depression, participation in two World Wars, and the terrorist attacks of September 11, 2001 proved we can withstand economic hardship. As billionaire investor Warren Buffet says: "Nothing can stop America when you get right down to it. Never bet against it."

So, let's be positive and consider what we can do to prepare our businesses to move forward.

M&A Scene

After the tech bubble burst in 2000 and the terrorist attacks of 2001, M&A deal activity dropped 49% and 26%, respectively. The 2008 financial crisis triggered a 27% drop in M&A activity. A similar drop in M&A activity is very possible as a result of COVID-19. EBITDA multiples also declined after recent economic downturns and, while history is not always an indicator of future performance, the smart money points toward declining multiples during the current crisis.

While there's likely to be downward pressure on business valuations and deal volume for at least the near-term, it's not all "doom and gloom." An analysis of Fortune 1000 companies by a "Big Four" accounting firm showed that companies that made significant acquisitions during the economic downturn of the global financial crisis outperformed those that did not. In addition, deal volume for companies in the Healthcare, Life Sciences and Technology sectors showed particular resilience through past economic downturns.

Business Resilience

With shelter-in-place and other restrictions on commercial activities easing and while we prepare and brace for the "new normal," business owners should also be taking this time to stabilize their business and identify areas for improvement that will be critical for demonstrating resilience when M&A activity resumes. For example, consider the following areas.

- **EBITDAC**. To illustrate the impact of the pandemic on business, a new tongue-in-cheek acronym "EBITDA**C**" was coined. It stands for Earnings before Interest, Taxes, Depreciation, Amortization **and COVID-19**. On a more serious note, with EBITDA being such an important valuation metric in the middle and lower middle market, quantifying the impact of COVID-19 will be critical. While it's too early to know which adjustments will be viewed as credible, business owners should invest the time to take a deep dive into business performance, and evaluate revenue and cost trends as well as trends by customer, vendor, product/service, location, or any other relevant categories for the business being evaluated.

  For some industries, the pandemic may have resulted in a surge in business and new opportunities. Are these spikes in the business temporary or permanent? While some impacts such as "lost opportunities" could be difficult to measure and validate in due diligence, the more data a business has, the stronger its position will be in negotiations.

- **Working Capital**. Measuring working capital can be a complex task in and of itself and, while there is no "standard" method of determining a working capital target in a business acquisition, the most common approach in the middle market has been starting with a trailing 12-month average. Unfortunately, that metric may not be relevant for deals transacted in the next six to 12 months. Business managers will need to challenge and understand customer and vendor payment patterns and be prepared to defend assumptions regarding working capital requirements of a business.

- **Budget/Forecast Process**. Many closely-held businesses do not have a formal budgeting process but having a formal and rigorous budgeting process will be critical as buyers will be acutely focused on near-term cash flow. Budgets should ideally be monthly and include a rolling 13-week cash flow forecast. Business managers should also become well-versed in understanding the nuances between earnings and cash flow for their business. Once developed, these budgets can be used as a “report card” demonstrating performance against plan. The budgets should also be flexible and revisited often as new information becomes available.

- **Cost Structure**. Clearly understanding fixed, variable and semi-variable expenses has been and will become an even more important exercise to understand how the business reacts to operational changes. It’s one thing to know qualitatively what these costs are, but does the company have controls in place to accurately measure and monitor these costs? How has the pandemic impacted these types of expenses? What will the impact be on the cash burn rate if there’s a sudden need to re-implement shelter-in-place and business lockdowns? Will social distancing and other workplace safety measures result in a shift in cost structures and a change in operations (e.g., adding a shift to reduce the number of employees on site at any given time, providing employees with personal protective equipment, implementing additional sanitation protocols, having a higher percentage of employees working remotely, etc.)?

- **Safely Managing Personal Interaction**. Remote interaction on video conference calls and virtual facility tours can only take the M&A process so far. As one middle market private equity investor noted, “it will be very hard to justify writing an equity check for tens of millions of dollars without having the opportunity to meet the founder or the management team in person and to ‘walk the plant floor’ because developing strong relationships with founders and management teams is such an integral part of our investment process.” While some of these interactions may be limited due to governmental restrictions, business managers will want to proactively address implementing appropriate safety measures to be positioned for facilitating relationship development and in-person meetings.

- **Consider Tuck-in Acquisitions**. Businesses with strong balance sheets, cash reserves and available capacity on existing debt facilities should include M&A in their strategic planning process as new opportunities may surface to acquire a competitor, expand into a new geography, product offering or marketplace at a reasonable price.

- **Due Diligence:** Sell-side due diligence will no doubt become a more critical part of a sales process as buyers will be laser-focused on any adjustments put forth to normalize the impact of COVID-19 on business operations. In addition, clearly articulating how the business has addressed the aforementioned focus areas can be a differentiator in a crowded market where buyers are seeking the highest quality opportunities.

Let’s Roll

Not only will COVID-19 be a turning-point in our business life, but in every facet of our life. While we might not see anything positive coming out of this disaster, we can do our best moving forward in any way we can by getting back to business and doing our best to thrive.

Contact Us and Resources

Be sure to check our COVID-19 Resource Center. Please reach out to your engagement team if you have questions or contact Jonathan Moore, CPA, CM&AA, Partner at jmoore@pkfod.com.

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