Coronavirus and the U.S. middle market

Implications for M&A activity

Rapid rise drives market uncertainty

As the 2019 December holidays rolled around in the U.S., consumer sentiment was high, unemployment was at or near historic lows and U.S equity markets were near all-time highs. As the ball dropped on a new year, a then little understood ailment began impacting residents of Wuhan, China.

Enter COVID-19 Coronavirus. Since December 2019, more than 100,000 cases of this virus have been diagnosed in dozens of countries.

Community spread of COVID-19 has arrived and actions are being taken by corporations and governments to address the spread of COVID-19 and foster the health and safety of their employees and citizens alike.

While how widespread this virus will become in the United States is not yet fully understood, the virus's impact will likely remain a disruptive force for a yet undetermined period of time. Employers, employees, supply chains, customers, and regulatory bodies will likely all be tested to varying degrees.

What follows is Deloitte Corporate Finance LLC's ("DCF") perspective on how coronavirus might impact middle market M&A, and more importantly, how operators in this market might proactively prepare for what could become a protracted period of uncertainty. At the very least, this period should push businesses to evaluate contingency plans in the face of disruption.

Business strategies to promote continuity

Employees. Employees are the foundation of any business. During times of uncertainty, employees crave leadership and communication. Management teams and owners should demonstrate that they are proactively thinking through the impacts that the current environment may have on business demand, supplier fulfillment, and working arrangements. Safety comes first.

DCF feels that employers that consider the optimal means of maximizing worker wellness without compromising business functions stand to deliver benefits to stakeholders during this period and engender loyalty in the long run. Encourage flexible arrangements for those feeling under the weather or for those for whom transportation has or will become an issue. Consider the cost-benefit of travel, particularly if the destination will result in large groups of people in close quarters.

Supply Chains. Supply chains are interconnected webs of functionality that can prove challenging, or even impossible, for customers to fully trace. Whether you operate a multinational company or a business that exclusively serves domestic customers reliant on a chain of Tier 1 suppliers headquartered in the U.S., we believe it is likely that your supply chain will experience some disruption. If not already underway, take care to secure visibility into the fulfillment, production, and potential scheduling delays of Tier 1 suppliers. Assuming that direct visibility to Tier 2 suppliers is not readily available, consider inquiring with Tier 1s about their own supplier networks.

Even if no disruption is visible today, situations could change rapidly if mandatory quarantines become more widespread or if travel between key geographies becomes restricted. Consider your ability to pivot accordingly if Tier 1 suppliers experience delays, shortages, or outright cancellations.

Customers. We believe it is always important to be in front of your customers. Let them know how you are behaving in this environment. Inspire confidence by highlighting efforts to safeguard employees, stress test supply chains, and efforts to proactively manage uncertainty.

If your company primarily serves other businesses, it is likely that customer management teams and ownership are facing many of the same challenges. This could be an opportunity to collaborate to tackle tricky issues and increase the stickiness of a long-term relationship.

If your business serves consumers, consider reaching out to them through available communication channels. Empathize that your business and employee base shares many of the same challenges they do, but you are preparing accordingly so as to not be caught flat footed.

Business strategies to promote continuity

Cash Flow Management. Whether it is temporary or elongated, most businesses are likely to experience some level of demand destruction in the current environment.

With fewer people traveling, many large scale events being cancelled or postponed, and potentially significant changes to working arrangements, reduced spending across many categories may be on the horizon.

Additionally, it is possible that large corporates delay capital spending plans until the health situation becomes more understandable.

Accordingly, we think businesses should consider preparing for some leaner revenue months than anticipated at the outset of 2020.

If you operate in a seasonal business in which the next few calendar months are typically key, you might consider workforce management strategies that account for a changed 2020 environment. Can full-time employees be repurposed to shoulder responsibilities typically fulfilled by seasonal workers or temps? Does the company need to rethink plant shifts and consider swings, splits, or alternatives to our typical operations?

On the liquidity front, stay connected with your financing partners. Let your lenders know that you aren't waiting for the market to create financing challenges. If required, some companies may be able to explore federal government programs that are being erected to assist small to medium sized businesses ("SMEs") that have interim liquidity needs.

Re-Forecasting. Many business owners have told us that they entered 2020 with optimism about the year's prospects. They viewed consumer confidence as strong, unemployment low, and their corporate coffers comfortably filled with cash. However, since most 2020 forecasts were baked, the world has decidedly changed.

For some businesses (e.g. surgical mask manufacturers) prospects might have improved significantly. For airline businesses, at least temporarily, the opposite has occurred. Most companies will have much more muted impacts. However, we certainly think it is worth the time of executives and financial officers to dust off those 2020 numbers and evaluate how they may have changed.

Should domestic containment expand from the levels already present in certain localities and persist for significant periods of time, the situation could prove highly interruptive to initially forecast 2020 results.

No models are perfect, but this particular situation seems to warrant scenario analysis, updated for new information (e.g. actuals) as it becomes available.

Implications for middle market M&A

Timing Considerations. Deals currently in market are victims of unfortunate timing. On the bright side, some counterparties have already demonstrated willingness to close into this environment.

The current circumstances have not changed the fact that many corporates and private equity firms are sitting on significant amounts of dry powder. And, for those that do not need access to third-party financing, the environment could provide a strategic competitive advantage for these participants. Further, for strategics that are acquiring targets with a permanent home mindset, the temporary dislocation is unlikely to change investment theses.

On the downside, we are seeing some closing friction related to the prevailing uncertainty. At a minimum, those in market should be prepared for acquirors to ask for a reforecast of 2020 results. For deals that were already priced, this may prompt revisiting valuation. For deals that were not yet priced, particularly those in sectors that could be considerably impacted, we will likely see the pause button hit until greater visibility prevails.

As for market entry on new deals, we expect to see a considerable decline year over year in the next two months as middle market companies and dealmakers search for solid footing. We believe this will likely result in a flood of pent-up opportunities hitting the market when greater clarity arises; something for both sellers and buyers to consider as they weigh priority and timing.

Availability of Debt Capital. Based on discussions we have had with lenders, debt capital in the middle market remains available from both banks and non-traditional credit providers, such as Business Development Companies ("BDCs") and credit funds for many sectors. For those industries most directly impacted by the virus, dynamics are changing daily and warrant frequent updating.

The cost of funds for banks is very low, so opportunities to put money to work at a spread alongside reputable sponsors (in the case of private equity-backed transactions) seems prudent. While we might see spreads rise in the short-term, from an all-in cost of capital perspective, it looks like a historically attractive time to borrow.

In addition to increased spreads, we will likely start to see more conservative lending behavior as it relates to total leverage capacity. More fulsome covenant packages may also be on the horizon, allowing lenders to closely monitor their credits. Should traditional banks become more conservative in the near-term, we expect BDCs and other credit funds to move in to fill the void for middle market M&A appetite.

Implications for middle market M&A

Pricing and Structure. Pricing in middle market M&A is dictated by a host of factors, including availability of capital, growth prospects, and the supply of quality businesses versus the demand for such businesses in the buying community. For two of these components: availability of capital, and supply/demand balance, the fundamentals remain intact. In our experience, outsized valuation multiples in the past several years have been driven as much by too many qualified acquirors chasing too few high-quality opportunities, as by sheer availability of capital (though they are often interrelated). We think this dynamic should persist.

As for growth prospects, it is too early to tell, other than the categoric conclusion that growth in 2020 for most businesses will likely be lower than initially anticipated. Herein lies the progression to structural solutions for bridging seller valuation expectations with economic and financial uncertainty. The current climate feels ripe for the re-emergence of contingent considerations (i.e. earnouts) to be paid to sellers based on 2020 or multiperiod financial performance. In fact, such valuation bridges may become fundamental to getting transactions closed.

Another structural introduction we expect to observe is elongated exclusivity periods, intentional or otherwise.

While it had become very vogue and even expected in some competitive processes for buyers to conduct confirmatory diligence in 30 to 45 days, we will likely see longer terms persist. Additionally, lawyers may spend more time finessing the definition of what qualifies as a “Material Adverse Event” in purchase agreements.

Diligence. We would expect the entire M&A diligence process, both preliminary and confirmatory, to receive added scrutiny in coming months.

Two areas of particular focus, as we have already heard from private equity firms and lenders, will be supply chain and customers.

On supply chain, buyers will want to see that sellers have done the work to explore the reliability of Tier 1s, visibility into Tier 2s, and the installation of redundancies where sensible.

For customers, buyers will likely be looking deeply at how the COVID-19 situation impacts purchasing behavior.

Those contemplating market entry in 2020 might proactively consider the use of Vendor Due Diligence (“VDD”) at the outset of a process. Popular in Europe, VDD entails sellers engaging a third party to conduct a robust inspection of the financials and operations of a business prior to launching a sellside process.

Implications for middle market M&A

Business Interruption. It is possible that businesses currently in sale processes or the M&A market itself could experience outright interruption or standstill. Brokering a transaction between a Bay Area software firm and a Boston-based private equity fund, for example, would prove difficult if air travel between the locations is prohibited. In these cases, professionals on both sides will have to think creatively and dynamically.

M&A professionals will need to ask themselves important questions around how business can be conducted differently in the interim. Can we use technology to fill gaps that we dismissed historically, given the relative ease of travel? Can we order processes differently to push forward on critical items that can be checked off, while tabling others? While the likelihood of such dramatic disruption might seem remote, the situation at hand is fast-moving and not immune from unpredictable outcomes.

Conclusion

The balance of 2020 will likely be one of the most interesting years in recent memory for middle market businesses and associated M&A. Not since the Financial Crisis of 2008/2009 has so much uncertainty pervaded the market so quickly.

History indicates that those who prepare early and adjust often are best poised to navigate the choppy waters ahead. To thrive, businesses must first survive. We hope that the above view on business continuity is instructive for middle market companies in evaluating current procedures and considering new ones.

On the M&A front, many of the underpinnings which had recently driven strong volume remain unchanged. We feel one of the biggest question marks, albeit a critical one, is how long businesses and individuals remain in a holding pattern. Both businesses and governments will emerge from this crisis with critical lessons and improved infrastructure to address future similar events. Until then, be proactive, be prudent, and continue to be educated.

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