Perspective from Dimitri Sayegh, Kevin Pacourek & Marc Blythe:
Key Considerations For M&A Transactions During COVID

The COVID-19 pandemic has drastically changed the business environment, presenting a challenge for mergers and acquisitions.

HISTORICAL COMPANY PERFORMANCE used to be one of the principal bases of due diligence, but the impacts of the pandemic has made it even more difficult for buyers and sellers to accurately assess value and risk based simply on historical operational results.

Due Diligence Risks

In typical due diligence, buyers would look at the target's revenue and develop an understanding of the customer base: where the revenue came from, from what channel, which customers and under what terms and conditions. Then they would evaluate whether these conditions apply on a go-forward basis, and if they did not apply, buyers were accustomed to project sales by channel into the future.

When conducting due diligence during COVID, it has become more necessary than ever before to increase focus on forward-looking information such as projections, forecasts, budgets, outlooks, backlogs and pipelines.

Below are certain key considerations for buyers when conducting due diligence prior to an M&A transaction in the current environment.

1. ***Extended timelines:*** Expect M&A transactions to take more time.
    - Consider whether internal as well as external due diligence activities that previously involved in-person meetings or site visits can be conducted remotely.
    - Implement internal collaboration tools to share information among the in-house evaluating team in an easy to navigate format.
    - Although seller virtual data rooms have been in use for over 15 years, effective virtual collaboration tools with external resources such as service providers, advisors and sellers have yet to catch on. COVID-19 has accelerated the adoption of such tools to the point they have now become “expected” and a “necessity.”
    - Reduced functionality of remote teams could affect negotiation processes and access to information. Ensure that activities and milestones are scheduled in advance to keep the process moving forward and meet deadlines.
    - Expect extended transition periods between the signing of buy/sell agreements and transaction closing.
2. ***Forecasting scenarios:*** Forecasting base case, best case and worse case scenarios is no longer sufficient. For buyer and seller financial models to be effective tools in targeting and negotiating M&A deals, they need to be constructed with built-in capabilities to run scenarios constantly using different data sources and business strategies. They also need to present directional forecasts under differing granular level assumptions that can be quickly updated as macro-level, industry-level and company-level economic conditions change and that plan for contingencies.
3. ***Revenue:*** How to evaluate the predictability of revenue in an M&A transaction has shifted considerably. It has always been important to understand a target’s revenue model and its planned growth path and to assess the ability of its management to meet revenue goals. However, due to clear and present demand uncertainties, it’s now equally important to consider many other factors as well in order to develop a comprehensive view on the survivability of a business.
    - Historical growth trajectories may no longer be indicative of future performance.
    - Existing promotion, advertising, and product distribution channels may have to replaced.
    - Customer behaviors might have changed.
    - Competitive landscape may well have expanded or contracted, thus necessitating adjustments to price points and/or the profiles of chased customers.
    - The accelerated adoption of technology by suppliers and customers could have re-arranged the availability of raw materials and the desirability of the target’s products and services.
4. ***Employee impact:*** The success of a business is a function of the quality of its work force and the level of engagement of the work force with the company’s purpose. COVID-19 has dramatically altered how employees operate within a business and how employees interact with management and external resources. Due to COVID-19 fears, the ability of a business to retain, empower and effectively deploy its employees is now driven by employee perceptions that may or may not be in line with management intentions. M&A buyers should explore the following human capital matters in diligence:
    - Has the target been able to support remote working structures for some or all of its employees?
    - Has the target provided/promised employees with paid leave?
    - What measures has the target taken to ensure a safe and

hazard-free work environment for on-site employees?

- Has COVID-19 resulted in workforce reductions or disruptions, or other changes to employment conditions for employees?
- What is the employee cost impact of all the above?

5. ***Real property considerations:*** Consider whether remote workers present opportunities or issues under existing real property lease commitments, including understanding whether the target has any "give back," termination, or similar rights under its leases.
6. ***Supply chain management:*** Understand the target's level of dependence on particular suppliers, the availability of alternative sources and current and projected inventory levels.
7. ***Contract performance:*** Many companies have faced challenges performing under existing contracts. Consider evaluating the following:
    - Have any covenants, obligations, or other contract terms been breached?
    - What are the consequences of any contract breaches?
    - Have any of the target's suppliers taken any actions that indicate they might cease performance?
    - Is there material credit risk associated with a particular customer?
    - How will risks relating to COVID-19 be addressed in future contract negotiations?
8. ***Debt obligations:*** Have there been any defaults, waivers, amendments, concessions or similar consequences resulting from COVID-19?
9. ***Government programs:*** Determine whether the target has obtained assistance under federal, state, or local programs such as the CARES Act. Targets that are recipients of Paycheck Protection Program (PPP) loans present specific risks that buyers must consider.
10. ***Tax considerations:*** The CARES Act creates several new tax issues for both parties involved in M&A transactions, including:
    - Which party will pay the 2020 payroll taxes that have been deferred under The Act?
    - Which party will get any refunds caused by provisions of The Act, including the changes to the rules regarding net operating loss (NOL) carrybacks, AMT minimum tax credit recovery, and the interest expense limitation rules?
    - Which party will claim the employee retention credit or is a split appropriate?
11. ***Pension plan liability:*** What is the potential impact of COVID-19 on employee benefit plans? Has there been an impact on plan contributions?
12. ***Insurance:*** Understand the terms and conditions of insurance the target company carries, including the costs, coverage, and renewability, and the response of the insurers to COVID-19 related claims.
13. ***Liquidity management:*** Last but not least, does the target utilize cash management tools (such as 13 week rolling cashflow forecasts) that provide its management with a view of the company's future cash availability for a period of time that is sufficient for management to be able to react to changes in market conditions? Are such tools updated frequently enough to provide insightful data for decision making purposes?

Assessing Enterprise Value

The continuing viability of many businesses has been difficult to determine due to the actual, perceived and anticipated effects of the COVID-19 pandemic, which is likely to create significant valuation discrepancies between buyer and seller expectations.

Sellers may find their business model analyzed beyond the normal levels of due diligence, and be asked to demonstrate how the pandemic's long-term impact will affect customers, supply chains, employees, marketing and infrastructure.

When buyers are looking at a target company's performance in 2020, they're going to have to try to determine what it would have looked like on a normalized basis had this

disruptive event not happened, and make a judgment call.

A valuation discrepancy could be addressed through post-close purchase price adjustment mechanisms. These could include earn-out formulas based on future performance that can be paid on a sliding scale or when reaching financial milestones.

Conclusion

The rate of transactions has slowed, but we already see that deal making is ready for a strong comeback as both buyers and sellers adapt to the "new normal" and pent-up demand hits the market. Some companies that have been negatively impacted are going to be looking for exit strategies. Deals will also develop in specific markets and industries that are seeing increased growth during the pandemic.

M&A transactions during this time of uncertainty require special efforts and well designed and executed due diligence in an attempt to safeguard against the unpredictability associated with the COVID-19 pandemic.

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- Provided part-time controller/CFO services to several private equity- and venture capital-backed companies ranging from startups to $50 million businesses.
- Successfully assisted a large cannabis company with an interim/permanent search for a CFO.

To discuss this important topic further
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Dimitri Sayegh

Kevin Pacourek

Marc Blythe

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Irvine (HC)
949-757-4180

Los Angeles
213-228-5002

San Diego
619-391-7385