Teneo
The Global CEO Advisory Firm

The Accelerated M&A Paradox

Teneo Insights
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Introduction

With the global COVID-19 pandemic not yet leading to the wave of financial distress and associated acquisition opportunities that many anticipated, when can we expect there to be a resurgence of activity in the accelerated M&A ("AMA") market?

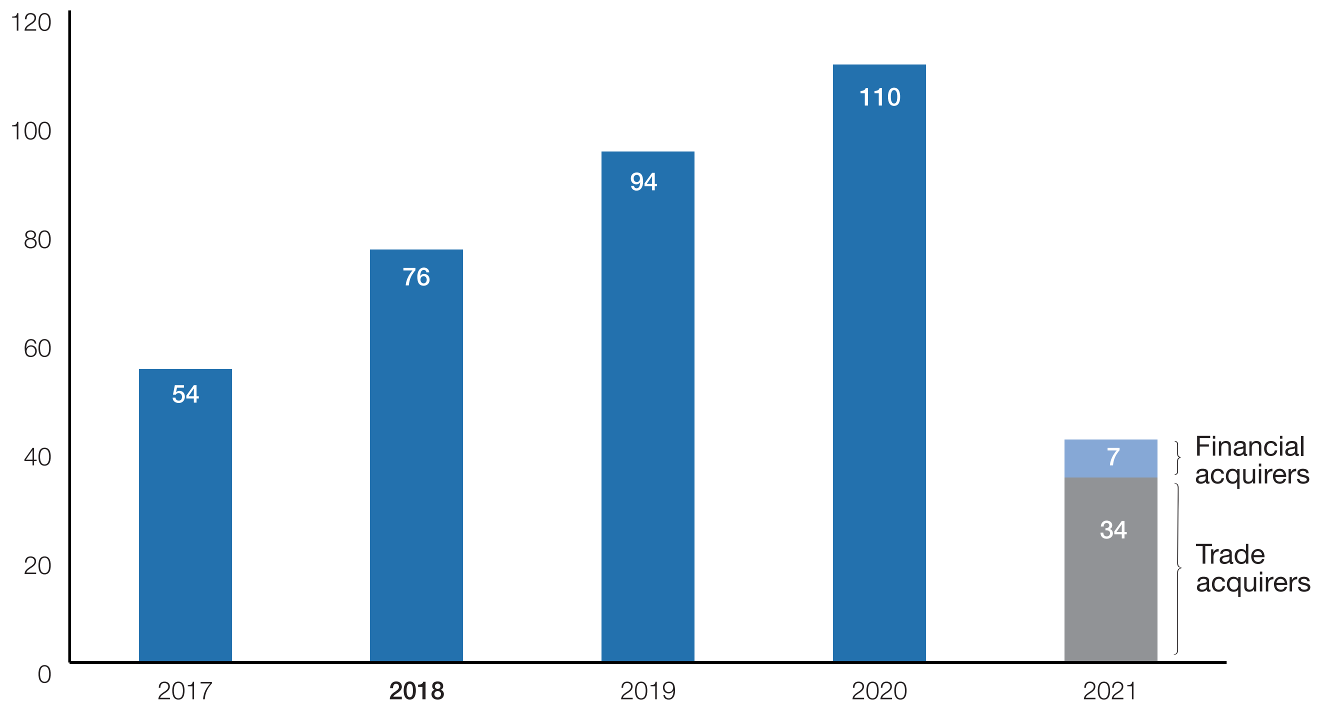
The Teneo Special Situations M&A team shares some observations below on both the recent AMA market and predictions for the future.

Recent trends in the Accelerated M&A Market

Prior to the onset of COVID-19 in Q1 2020, levels of AMA transactions were growing year over year (as shown in Figure 1). The shift to online in the retail sector and a realignment of supply and demand in the hospitality industry have created more pronounced activity in those sectors.

At the start of the pandemic, many expected a sharp rise in AMA activity. In Q2 2020, there was an initial wave of distressed transactions, mainly centred around the leisure, hospitality and retail sectors. As noted above, these sectors were already structurally challenged and had been most immediately, and obviously, hit the hardest by the lockdown. Despite rapid UK government financial and legal initiatives preventing a complete collapse across the economy, **AMA transaction levels continued to remain relatively buoyant throughout 2020** driven by the impact of ongoing lockdowns, continued uncertainty around the duration of the crisis, businesses facing a lack of liquidity and stakeholders looking for rapid restructuring solutions from challenging situations.

Figure 1: UK insolvent M&A activity 2017 - 2021



Note 1: Completed transactions in the UK which have been delivered through a pre-pack to a new shareholder or out of adminstration.
Source: PitchBook Data, Inc.; data has not been reviewed by PitchBook analysts.

Recent trends in the Accelerated M&A Market (continued)

The pandemic served to push boards of some underperforming companies into making difficult decisions about the long-term viability of their businesses. Whilst for some of these businesses, COVID-19 may have been a catalyst to rapidly divest from an existing investment, others have managed to survive due to a combination of:

1. External factors such as government support schemes (principally the introduction of furlough, a material VAT concession and the Coronavirus Business Interruption Loan Scheme (CBILS));
2. Legislation (including the relaxation of wrongful trading laws, rent moratoriums and other initiatives to prevent creditors taking precipitative action);
3. A real focus on performance improvement and cash generation; and
4. Lender and other stakeholder support.

We have seen the majority of businesses impacted by COVID-19, where possible, seeking to weather the storm and **looking to cut costs or pivot to new business models** (in conjunction with leveraging the above support measures). This should benefit them, as they emerge leaner and stronger from the pandemic – enabling the ‘hold or sell?’ decision to be made at a later point and from a position of greater financial strength.

Whilst COVID-19 resulted in a decline of over 20% of GDP in H1 2020, these support measures served to halt a prolonged fall in the levels of financial distress across the economy with UK GDP rebounding by about 17% in Q3 2020. This corresponded with **a drop in the level of AMA deal activity and an increase in non-distressed M&A** (good book M&A) throughout 2021. In turn, many Special Situations funds started to look up the curve at less distressed opportunities in order to make investments.

As interest rates have remained at historic lows, we have seen increasing levels of private equity and alternative debt in the market seeking yields and looking to deploy capital. This has led to a wall of money generating strong demand in good book M&A processes and driving inflated asset prices as these investors compete for the best assets – underpinned by high levels of leverage provided from the debt markets. As this debt financing approaches maturity in three to five years (in what may be a different economic environment), **there may be a resulting uptick in balance sheet restructuring requirements as well as an increase in AMA opportunities** – time will tell.

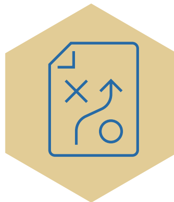
Accelerated M&A investor attitudes

Whilst the Special Situations investor appetite has remained strong for good opportunities, over the last few years, many have been understandably focused on ensuring that their portfolio companies remain on track. Recently, the **more limited deal pipeline of distressed assets** has led to **increased competition** with many investors now looking for complex carve-outs, off-market transactions or even considering a switch in focus to the more mainstream good book M&A market.

There has been a rise in the number of corporates looking for acquisitions via AMA processes (either opportunistic or strategic) to gain scale and secure a greater market share. As an example, of the 21 transactions we have been involved in over the last two years, about **65% have ultimately been sold to trade/strategic buyers**. When participating in distressed auctions, larger corporates are increasingly more adept at navigating the challenges of these processes such as short timelines, requirement for very focused due diligence, transacting with administrators and lack of warranties. The most successful trade purchasers often benefit from having both **prior experience in AMA transactions and using specialist AMA advisors** to support the process.

Interestingly, we have started to see a **collaboration between both of the above buyer groups** in certain AMA processes, with strategic parties working in conjunction with Special Situations investors to deliver a more compelling and deliverable bid – which is key in competitive AMA processes. These partnerships can provide a number of benefits, including:

Providing additional financial firepower and know-how for the strategic buyer



Combining sector knowledge from the strategic buyer with operational turnaround expertise from the investor

Potentially laying the foundations for an eventual split into “core” assets to the strategic trade buyer and “non-core” assets to the Special Situations investor as more of a yield play

Investors now understand what to look for when evaluating acquisitions in a post COVID-19 environment. Targets that can **identify and articulate a robust underlying business model** (with or without the need for a formal restructuring mechanism) and which are **capable of trading successfully post pandemic** are likely to attract competitive tension from a wider buyer pool – which should deliver higher valuation multiples.

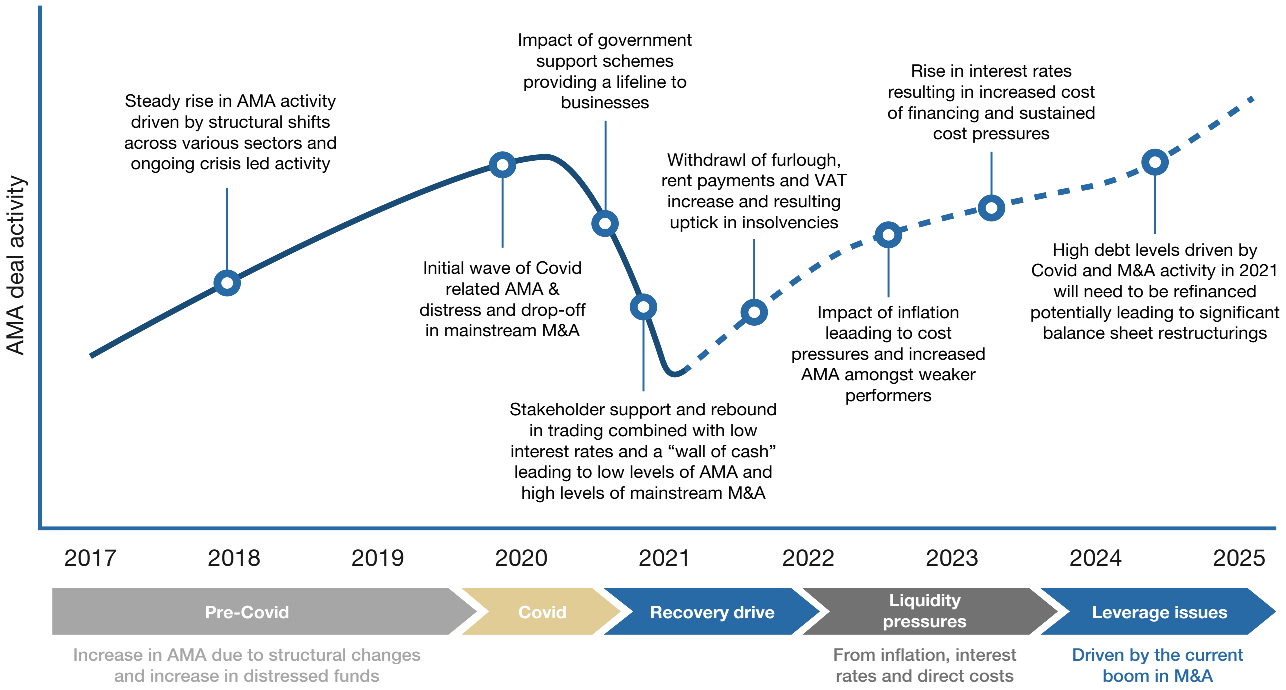
The current situation and direction of travel

Whilst the market for good book M&A activity is expected to remain buoyant for the short term (at least), businesses in those sectors of the economy where COVID-19 has had more of an impact will have a more uncertain road ahead.

Boards and financial stakeholders in these companies have survived by managing costs and leveraging government support schemes. As these schemes subside, boards should now be considering the **full suite of operational and financial restructuring and funding options to provide a platform from which to recover and grow post pandemic.**

Having survived the trading challenges of the last two years (see Teneo's piece "Is Your Business Fit for the Next Normal?" for further discussion – https://www.teneo.com/is-your-business-fit-for-the-next-normal/), many shareholders will have supported significant losses (and/or extended material working capital funding) to fund their businesses. They may now be **reaching a tipping point on future equity support** driven by the withdrawal of Government support and a rise in underlying cost inflation. With potential new variants, alongside the ongoing impact from Brexit and an uncertain economic environment, we may start to see a rise in AMA opportunities as stakeholders look to exit challenging positions.

Figure 2: Potential uptick in AMA activity? – 2017 (actual) to 2025 (directional)



Note: Historic information as per Figure 1 PitchBook Data, Inc.; data has not been reviewed by PitchBook analysts. Forecast view is illustrative and based on the latest Teneo view.

It is likely that over the next 12–18 months, more companies will suffer from the pressure of **increasing staff costs, rising energy bills, escalating logistics and freight costs** (the impact of which has been significant), **general cost inflation pressures and an impending rise in interest rates.** In conjunction with the withdrawal of furlough, a return to the normal VAT regime and material unsettled rent liabilities, it is likely that we will start to see an **uptick in general restructuring and insolvency activity and associated AMA** (as illustrated by Figure 2) from those companies who struggled during COVID-19 and are currently just getting by (a new iteration of zombie companies).

In addition, **many companies have exited the pandemic with overleveraged balance sheets and high levels of arrears** (e.g. HMRC, rent, creditors and bank debt) which will continue to present a significant drag on liquidity and future growth plans. Businesses will need to understand how they can address this, whilst proactively planning to ensure they can manage cashflows adequately in order to avoid a liquidity crisis.

Whilst many mainstream lenders have to date amended and extended current loan facilities, they will now be **focused on the delivery of business plans** and evidence of suitable repayment plans. If these are not achieved, debt providers may look to reduce their current exposure in certain sectors and seek alternative methods of recouping their debt.

In the event that further funding is provided by way of CBILS, the lending community will need to be cautious in ensuring that their approach to working with borrowers does not contradict normal policies. This may invalidate their government guarantees under the CBILS and **may be an important factor in determining their preferred work out strategy.**

The longer term impact

Now that investors are aware of the sectors and businesses that are COVID-19 proof (or perhaps, more correctly, COVID-19 resistant), investment appetite is likely to increase in the short term, supported by cheap sources of finance and a desire to deploy capital.

There remains a laser focus on cash liquidity and an achievable post COVID-19 business plan which is no longer reliant on government funding schemes and lender support. It is **likely that we will see a gradual rise in the number of distressed AMA transactions** in those businesses unable to deliver the above. Well-funded trade and financial acquirers (supported by a wall of capital in both the equity and debt markets) will be well positioned to capitalise on these opportunities driving M&A over the coming months.

In the longer term, with the spectre of inflation leading to a likely rise in interest rates, there may be a gradual drop off in good book M&A activity as investors re-focus on more traditional, lower risk investments, such as bonds and equities.

This may affect a large number of highly levered businesses which, when looking to refinance their debt in three to five years, **may struggle to raise the necessary funding at suitable pricing levels**, potentially fuelling a large-scale leverage problem and a requirement for a material restructuring of balance sheets.

Final thoughts

Given their exposure to the pandemic, rising costs and a reliance on the above-mentioned support measures, alongside the underlying long-term changes to consumer trends, we expect that the **retail, hospitality, travel and aviation sectors** are expected to continue to provide distressed M&A opportunities. In the short term, businesses reliant on freight or exposed to energy costs will be starting to face stock shortages and margin pressures which will **further reduce liquidity and lead to a need for funding solutions**.

With a new normal emerging from the pandemic, the uncertainty of the wider economic environment continues to test many businesses and their financial stakeholders in certain sectors. This backdrop is likely to drive the next wave of AMA activity and generate some attractive investment opportunities for both opportunistic strategic buyers and Special Situations investors.

About Teneo

Teneo provides M&A solutions for clients facing challenging, complex or business critical issues, where specialist situational expertise and advice (often in accelerated circumstances) is the key to maximising value. With a long-standing reputation for delivering outstanding results, the Teneo Special Situations M&A team remains the advisor of choice for investors, lender and corporates.

If any of these issues resonate with you, please contact Teneo's Special Situations M&A team below:

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