M&A opportunities in a post-COVID world

The COVID-19 pandemic has cut a swathe through global economies, indiscriminately affecting not only businesses but livelihoods and, with that, placing on hold the plans of thousands of investors, lenders, backers and founders as they struggle to cope with lockdowns, an impacted revenue environment, the collapse of equity valuations and the focus on banking covenants that many businesses have suffered.

Reduction in equity value is not the only outcome either as the pandemic has highlighted long term structural weakness in many sectors, from an over-reliance on debt, to unsustainable rents, an overdependence on specific suppliers and surplus staffing levels. At present, many industries are facing existential challenges.

And whilst this struggle plays out in front of our eyes, so too are we seeing a new generation of funds and entrepreneurs readying themselves to strike and raising capital in order to capitalise on the opportunities that await on the other side of the COVID pandemic.

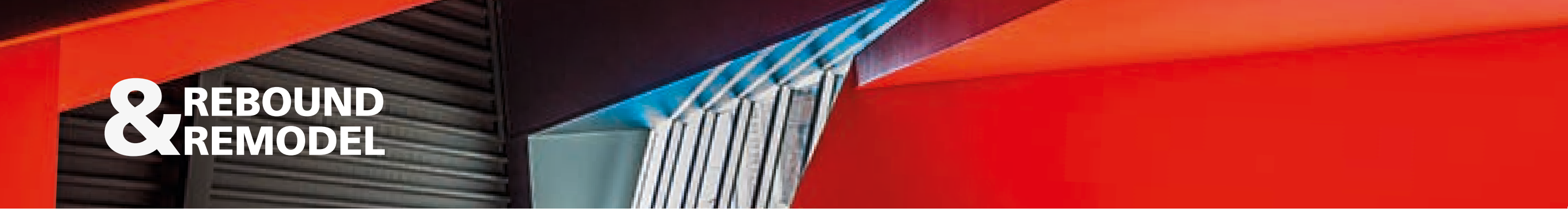
We believe there are several opportunities of interest for such groups.

Unprecedented property deals

Many believe that we are on the verge of a once in a generation opportunity for sector focused investors that understand the business cycle to enter the property market, with a 24-month window where property deals previously thought unimaginable will emerge.

Key strategies

- **Property strategy** – cashed up and ready to grow? Exploit a current window of opportunity to invest in property
- **PE exit strategy** – funds or listed vehicles could offer an exit opportunity for PE investments, buying low now and funding the businesses until investment multiples return.
- **Debt trade strategy** – opportunities will emerge to pick up distressed debt at a fraction of its face value and then execute a "loan to own" strategy.
- **Merger strategy** – normally competitive groups could combine to form larger, more robust businesses, using the synergies generated to deliver profit improvement.
- **Pre-pack strategy** – exploit the Insolvency Act 1986, using a pre-packaged administration sale to cleanse a business of legacy issues and trade going forward with a tidier corporate and debt structure.
- **SPAC strategy** – use the "Special Purpose Acquisition Company" to acquire troubled groups and unlock value by generating synergies.



A deluge of commercial premises will be returning to the market via landlord surrenders, administrations and liquidations as more and more businesses will continue to fail. This will lead to an oversupply of commercial property and landlords and asset managers will be doing their level best to get them re-tenanted in a market where there may well be very little appetite to invest.

Hence, we expect to see landlords surrender potentially valuable property with new lease premiums disappearing, capital contributions returning, lengthy rent-free periods becoming normal as well as break clauses and turnover rent as the landlord community does its best to get their sites in the hands of new tenants that are ready and willing to gamble on a return to the market.

This may very well lead to a new lease dynamic, re-balancing the risk and reward between landlord and tenant. Perhaps we will see tenants having a carry in the upside that landlords generate when they sell their buildings and, conversely, landlords taking equity stakes alongside rent in their tenants.

This window will close when the market comes back, but for the next while lease deals are likely to be terrific and if you are cashed up and ready to grow and want to do what many did after 2007, then some would argue the time is right to consider amassing a land bank in new special purpose vehicles and, again, wait for the market to return.

The PE exit strategy

We also see an opportunity for private funds or listed vehicles to focus on allowing PE houses to exit some of their non-performing investments. Many planned PE exits have been derailed, with the boom expected in 2020 now unlikely to materialise before 2023 at the earliest.

As CBILS seems to have been denied to PE funded businesses, the investment IRRs that PE need to generate are now looking difficult to attain. PE has the choice of either battening down the hatches and funding their portfolios for the next two to three years in an uncertain environment, or, alternatively, finding a purchaser who will allow them a damage-limiting exit.

That is to say allowing them to get their money back, but possibly not much more. The investment thesis would be obtaining the stake that PE owned for the same price paid originally and to then fund the business until investment multiples return in three or four years' time and then sell at a healthy multiple.

It will be up to PE funds to assess their situations and many may well decide to exit, clean up and move forward, whilst others may seek to ride out the storm. This will create opportunities for M&A deals aplenty.

The Debt Trade strategy

There are also opportunities for investors who understand that much (or at least a fair portion) of the debt that has been fuelling business growth for the last decade may potentially be vulnerable and that, unlike the post-Lehman crash, when banks were more than willing to bring assets on board and build enormous "Special Situations" teams to manage assets until the market returned, there isn't a similar appetite now; particularly given how much negative publicity the banks got for foreclosing on their customers only to profit down the track.

Thus, an opportunity will emerge soon to bid for and pick up distressed debt from many larger groups at a fraction of its face value and then execute a "loan to own" strategy where the debt purchaser enforces the underlying security package and acquires the borrower.

The investment thesis is to acquire 100% control for as little as possible, re-set the management team, re-write the business plan and fund the business back to growth, holding until investment multiples return in three or four years' time and selling at a healthy multiple. Alternatively, a break up strategy may be enforced, particularly if a target group has non-core assets.

Mergers

Opportunities also exist for business competitors to become allies by carrying out good old-fashioned mergers, probably paid for by cash and shares, with the cash element just sufficient to pay out the existing lenders but no cash out for founders.

Under this route, similar sized groups could combine to form larger, more robust businesses and use the synergies generated by having one central management team managing two (or more) businesses to generate profit improvement.

This will allow one backer to exit the combined business and probably allow one bank to exit while one will need to stay on. However this will all depend upon the vision and the business plan to be adopted by the merged business going forward.

Pre-pack administration

We also see lots of opportunity for businesses that have lost their way or for whom post-COVID business strategies need to radically differ to look at the remedies offered by the Insolvency Act 1986 to potentially restructure their operations going forward.

The option of placing a group into administration and then buying key assets back via a pre-packaged administration sale may well become very appealing to some founders.

Following some negative publicity, "pre-packs" as they are known are now a little more regulated and the administrator has to undertake some marketing of the business beforehand. Generally speaking though, if a founder wishes to cleanse the business of difficult leases, legacy issues, troublesome litigation, historic lenders or partners and trade going forward with a tidier corporate and debt structure, then this option may well be one to consider.

A return of the SPAC

Finally, when all else fails, why not consider a SPAC.

A SPAC is a "Special Purpose Acquisition Company" or, in other words, a company with no commercial operations that is formed strictly to raise capital through an initial public offering (IPO) for the purpose of acquiring an existing company or companies. The thesis is to list a SPAC on AIM or take an existing SPAC (there are plenty that are sitting on the market like cherries hanging from a tree) and start acquiring troubled groups using a mixture of cash and shares, generating synergies as you shut down surplus central operating teams of each subsequent target and running multiple groups centrally. Estates could be trimmed via CVA down the track and the business capitalised via rights issues. Further acquisitions could be made by issuing SPA shares, not cash, and hence SPACs can get big rather quickly.

A SPAC could be used to execute many of the above strategies.

Conclusion

Most of these strategies need three things. One is access to capital; the second is an understanding of the relevant sector; and the third is the confidence to know that investment multiples will return in due course and now is the time to buy low, hold and then sell high. As ever, fortune will favour the brave.

David Roberts
Partner
T +44 20 7067 3537
E david.roberts@cms-cmno.com