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Is M&A the Best Post-Pandemic Growth Strategy?

For all of the craziness and unpredictability of the past year, 2020 turned out to be a big year for mergers and acquisitions (M&A).

Not surprisingly, the business world stood still at the beginning of the pandemic as companies focused on keeping their businesses running and their employees safe. But the second half of the year brought a surge in M&A activity, according to Bain's 2020 M&A Year in Review.

Deals that were shelved were reconsidered with a focus on customer demands in the new post-pandemic reality. Unprecedented levels of stimulus money helped stabilize some sectors and made financing possible, and low interest rates persisted.

Bain reports that global deal value rose by more than 30 percent in the third and fourth quarters of 2020, and more than 28,500 deals were closed by the end of the year for a total value of $2.8 trillion. As of early June 2021, global M&A activity was up 158 percent over the same period last year, according to Fortune.

While U.S. deal-making didn't quite keep up with global volume, U.S. dealmakers were busy—and continue to be optimistic. Sixty-one percent of respondents to Deloitte's most recent M&A Trends Survey believe that U.S. M&A activity will return to pre-COVID levels within the year, with a significant focus on domestic deals.

Trend Watch

Bain's research suggests that the pandemic accelerated some existing M&A trends:

Buying new capabilities: The pandemic created an urgency to acquire new capabilities that support a digital economy. For example, companies acquired targets that provide or augment technological capabilities for online ordering and delivery, payments, telemedicine, and teleconferencing.

Partnering for innovation: Many companies also turned to alliances and joint ventures as alternatives to traditional M&A. The development of the COVID-19 vaccine is an excellent example of competitive pharmaceutical companies partnering to accelerate research and development (R&D).

Similarly, several car manufacturers invested in common battery technology, sharing the required R&D investment in hopes of reaping the benefits of accelerating development of a common standard.

Looking local: More deals were done locally and regionally during the pandemic, which likely reflects supply chain concerns. Nearly 60 percent of respondents to the Bain survey said that localizing their supply chains will be a significant factor in deals going forward.

ESG focus: Acquiring companies also paid more attention to the environmental, social, and governance (ESG) approaches of their targets, assessing both risks and opportunities. A recent Deloitte survey reported that 72 percent of respondents believe that a diverse makeup of a target company's workforce, including representation of women and minorities, is either important or very important in the target selection process. For many deal makers, this represents a new category in their due diligence process.

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Fraud Expected to Rise During Recovery

In mid-June 2021, the Association of Certified Fraud Examiners (ACFE) released a report detailing the results of a poll taken at its annual global conference. The news was not good: Seventy-one percent of attendees, a group of anti-fraud professionals, expect the level of fraud impacting their organizations to increase over the next year. More than half said their organizations had uncovered more fraud since the onset of the pandemic, and about 20 percent indicated a significant increase in the amount of fraud detected.

Top Risks

1. Shifts in business operations: Remote work has made it harder for companies to carefully control access to their networks, including their financial and accounting systems. For many, it was difficult to collect and issue payments, keep up with internal controls, and conduct audits in person during the pandemic, so oversight was loose. These risks continue.

2. Changing consumer behavior: Similarly, the increase in online transactions opened the door to fraudsters accessing business networks.

Given these risk factors, it's no surprise that the types of fraud expected to rise include cyberfraud, such as business email compromise, hacking, ransomware, and malware; and social engineering, such as phishing, brandjacking, and baiting. In fact, more than 80 percent of the ACFE survey respondents are anticipating growth in these two fraud arenas. Other notable areas of concern include identity crimes, such as identity theft, synthetic identity schemes, and account takeovers; unemployment fraud; and payment fraud such as credit card fraud and fraudulent mobile payments.

Anti-Fraud Measures

In response to fraud unease, a little over a third of organizations have increased their budgets for anti-fraud technology, and 80 percent have already implemented anti-fraud program changes. Enhanced fraud risk awareness tops the list of how to make anti-fraud programs more robust in the future, followed by increased collaboration across the organization. Updating or conducting a fraud risk assessment is also a commonly anticipated adjustment.

With several extremely expensive and debilitating ransomware attacks making recent headlines, executives are even more highly motivated to avoid virtual private network (VPN) and similar breaches. Best practices against them include the following:

Keeping software up to date. Antivirus software and operational software packages must be kept current. Regular software updates—sometimes ignored by harried executives—often contain security patches.

Using security alerts. A security package provides insight about network traffic, intrusion attempts, and anomalies. With employees working from home and portals available for suppliers and customers, companies are at risk for backdoor entry. Segmenting networks can reduce risk.

Watching emails. Don't click links. Don't open unknown attachments. Don't respond to emails from an untrusted source. No matter how many times the company reminds employees to use smart email protocols, it's never enough. Regular training is a must.

Changing passwords. Until there's a stronger and universally adopted system for gaining access to networks and files, passwords are a necessary evil. Changing them regularly is inconvenient but mandatory. Also, consider two-factor authentication to augment your password security.

Fraud Kills Value

Remember that fraud negatively affects value. Potential buyers and investors are attracted to companies with strong anti-fraud programs aimed at both external attacks and employee fraud. Don't let fraud stand in the way of a healthy post-pandemic recovery.

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Digitizing due diligence: Bain reports a majority of M&A players found it more challenging to manage deals during the pandemic, resulting in the adoption of online platforms for collaboration, risk analytics, and insights. Using new data sources to create profiles and find target companies also accelerated.

Increased valuations: Deal multiples increased in 2020, according to Bain. Certain industries thrived during the pandemic, including technology, telecommunications, digital media, and pharmaceuticals. Other industries, such as retail and energy, saw weaker valuations as fewer consumers shopped in stores and lockdowns dampened travel.

The Crystal Ball

Bain's survey respondents expect M&A to account for nearly half of their revenue growth over the next three years, which is up 30 percent over the past three years.

What is the fuel for this activity? Morgan Stanley suggests several drivers:

Plentiful capital: The U.S. is emerging from the pandemic, the stock market is strong, and companies and consumers seem confident. Persistently low interest rates are expected to keep the cost of capital down. If this combination of factors continues, deal flows could keep increasing.

Private equity firms are flush with cash, and this "dry powder," as Morgan Stanley calls it, may spark transactions. Also, special purpose acquisition companies (SPACs), which are shell companies created to take private companies public, will likely remain a significant force in the M&A arena, representing an interesting alternative to traditional IPOs or private sales.

Rebound in COVID-affected sectors: A clearer vision of the future is finally surfacing for businesses that were heavily impacted by the pandemic, such as transportation and energy. This clarity makes valuations and deal pricing easier, and pent-up M&A demand in these industries may burst through as the outlook continues to improve.

Increasing scale: Bigger was generally better during the pandemic, so companies may continue to look for operational scale. This may drive consolidation in some industries.

Nimble Always Wins

Perhaps the biggest takeaway from last year's M&A activity and the surge in 2021 is this: nimble wins. Companies—and their leaders—that were able to pivot, make quick decisions, and take advantage of unique opportunities have survived and thrived.

Executives are learning from the past year and are eager to pounce on the right opportunities for growth moving forward.

Finding the Deal

Smart executives always have their ears to the ground when it comes to M&A. They're actively listening and seeking out what's next for their growth strategy, whether that's buying, selling, or partnering.

Sharing strategy and vetting ideas with a trusted team can help dealmakers find the right opportunities and be ready to strike at the right time.

Sources: Bain & Company, M&A Report 2021; Deloitte, M&A Trends Survey: The Future of M&A; Morgan Stanley, M&A in 2021: An Accelerating Rebound.

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Considering a COVID-19 DLOM

Forward-looking valuation of small businesses has always been a challenge. Few comparable transactions exist, in-house financial information may be scant, and projections are complicated for owners—even in the best of times.

The pandemic magnified these difficulties. Using a COVID-19 discount for lack of marketability (DLOM) has been suggested as a way to adjust for pandemic-related uncertainty and risk in small business valuations.

For some businesses, the pandemic increased the risk of future cash flows.

In normal times, valuation analysts accommodate this risk by lowering the multiple in the market method or adjusting the company-specific risk in the capitalization of earnings method.

Another option is adding a specific COVID-19 marketability discount on control interests to show the analyst's thought process and the actual discount being applied for the current high level of uncertainty.

The COVID-19 DLOM assesses additional risk due to COVID-19-related matters specific to the business.

These matters might include excessive uncertainty about pandemic recovery, supply chain issues, shutdown orders, employee response to vaccination, and market issues.

Government action, the emergence of COVID-19 variants, and confidence in the company's product or service relative to recovery are also likely elements.

Of course, some companies are fully recovered. But many are still catching up—and some may not be recovering at all, which makes a COVID-19 DLOM worthy of consideration.

A high level of professional judgment is required in these types of valuations. Be sure you are working with experienced valuation analysts who can support their opinions.

Source: Business Valuation Update