Deal making: Sector forecast report

Deal making in the East Midlands during 2020

Dealmaking during 2020 was generally a year of two halves. Following a strong level of M&A activity up to lockdown there was 6- 8 weeks of paralysis in April and May – largely as a result of COVID-19 concerns (as everyone acclimatised to the pandemic and its effect on funding and asset prices), but also fuelled by Brexit uncertainty, and potential further changes to Entrepreneurs' Relief (aka BADR) and tax generally. Despite all of this, M&A activity began to recover (variably dependant on sector) in late May, a trend which has continued and since strengthened, gaining notable traction in September/ October – driven by sellers spooked by the unpredictability of the pandemic and fears of adverse capital tax changes, and steady demand from buyers, especially those with funding.

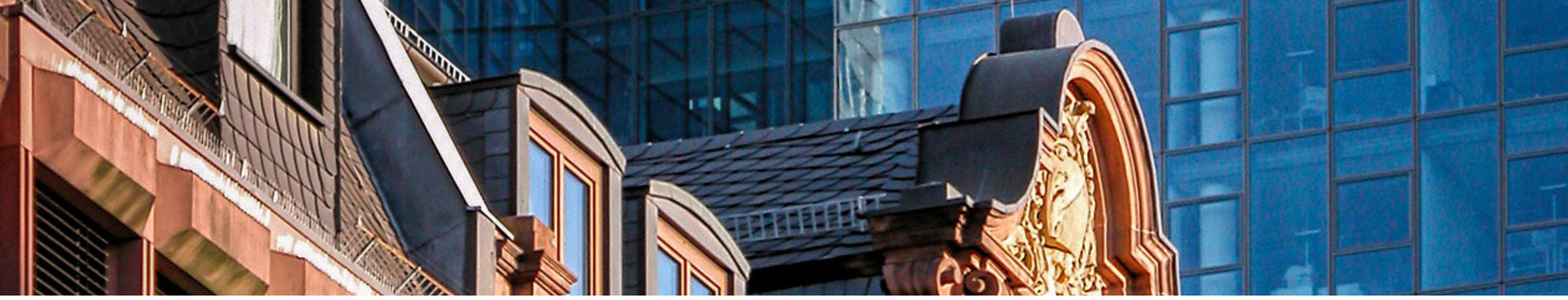
Whilst we have seen fewer large transactions complete this year, there has been a surge in small-medium sized deals – those that benefit owner managers – and the small-mid market has recovered much quicker.

As ever, there have been good and bad sectors – but again many sectors detrimentally affected by COVID have restarted with spirit, fuelled by prospects of early budget which has led to increase in deal activity.

Emerging deal structures

The severe restrictions introduced by the Government to combat the spread of COVID-19 created a need for new deal structures. During this period of market uncertainty, many buyers are keen to defer part of the purchase price and make the price payable contingent upon performance.

Consequently, here at Smith Cooper Corporate Finance, we have seen a real increase in the use of performance-based earn-outs, as a way of bridging valuation gaps and mitigating the risk of profitability being damaged by the effects of the pandemic.



Financing of deals

Undoubtedly, at the start of the crisis, high-street debt lenders focused on supporting existing clients. High-street lenders became harder to access, making deal lending trickier to obtain as they became bogged down with requests for Government initiated bounce-back and CBILS loans – many were inundated with other requirements. As conditions started to ease following the first lockdown, the request for CBILS loans also eased and allowed banks to assess new opportunities, which were more likely to be considered for the right deal and right opportunity.

However, less-mainstream alternative funders and ABL providers remained active, and Private Equity was very keen to invest the massive unutilised funds they still hold.

Capital is always priced according to risk, and COVID-19 shows a higher level of risk than previously thought. Whilst it is unlikely specific funders will change their pricing, for many businesses they may need to speak to alternative funders who are prepared to take higher risks and price accordingly.

Whilst many businesses may not be trading at pre-lockdown levels, we've found many funders are taking a view that pre-lockdown trading could be a good indicator of future trading performance, providing some reassurance against forecast earnings. Many funders are taking a thoughtful, and more cautious approach.

Banks seem to have reacted to being in a much more volatile position by becoming far more reluctant to go back to Credit more than once in case offers are withdrawn or revised.

Back in August, we held a roundtable event, inviting experts from key financial institutions such as Northedge Capital, HSBC, Beechbrook Capital, Shawbrook Bank, ABN AMRO and SME Capital. Our intention was to challenge the experts on lending appetite and how they assess trading risk during the COVID-19 pandemic. We also wanted to understand if there are any long-term repercussions for the funding sector. General consensus was that:

- Whilst many businesses may not be trading at pre-lockdown levels funders are taking a view that pre-lockdown trading could be a good indicator of future trading performance, providing some reassurance against forecast earnings.

- The panel agreed that it is not just the underlying earnings of the business that need to be taken into consideration when assessing new deals but also how a management team reacted to the initial crisis. This will act as a barometer for future behaviours and funders will want to assess any future recovery plan should a second lockdown be necessary.

- Although it will be difficult to hold businesses to their forecasts in the current climate, a sensible assessment of how a team is likely to cope will be made based on whether they have coherent, forward-looking plans in place.

- The potential of additional lockdowns and the Governments tiered systems no doubt had major impact on fundraising, meaning that whilst financial measures didn't disappear completely, funders needed to get creative with KPI's, ensuring meaningful monitoring measures were in place. Pricing risk into different structures also became a factor.

The impact on pricing and – just as importantly – expectations

Despite an economic downturn, a volatile stock market, and no clarity on the long-term impact of the pandemic on consumer behaviour deal pricing has remained remarkably robust – at similar to pre-lockdown levels - especially SME deal pricing.

Valuation metrics have widened from current financial performance to take a more considered approach, ensuring that businesses have reacted with flexibility to safeguard profit, and are robust.

Sector wise, post lockdown we have concluded several deals where values have remained remarkably robust, and even increased in some cases. Some of the sectors that have flourished and retained value in our experience have been construction, steel engineering of infrastructure products, well-run care operators and civil engineering - all of which have garnered a lot of interest and attracted good offers. We also completed a significant transaction in the Fast-food restaurant sector at the pre-pandemic agreed price. This sale came during a period when many casual dining and pub restaurant chains – which could deploy Drive-Thru, click-and-collect and delivery channels - endured immense financial pressure.

An increasing use of small equity positions may also occur as companies move into equity risk funding, but only time will tell how this manifest in deal flow going forward.

Predictions for deal making in 2021 in the East Midlands

We hope, and fully expect to see businesses deftly adapt to changing circumstances as we emerge from the pandemic and recover.

Here in the East Midlands, there are so many opportunities for deal making to excel in 2021. Central England is an ideal location for international import/export trade, and for road distribution hubs that serve home delivery of online-ordered products. Take East Midlands Airport (EMA) as an example - EMA is the UK's second largest freight airport , handling over 320,000 tonnes of flown cargo every year. It's the UK hub for DHL and UPS, and also supports operations for TNT and Royal Mail. And with ample room to grow, their thriving cargo facility is expanding to meet the demands of importers and exporters from across the UK.

Furthermore, we have the East Midlands Distribution Centre (EMDC) on our doorstep, a 2.5 million sq ft National Distribution Centre at the heart of the UK. A prime distribution centre with excellent access to regional, national and international markets, EMDC enables the shift towards online shopping for many international businesses and retailers by plugging directly into the UK's transport networks. From EMDC, 70% of the UK's population can be reached within two hours' drive time.

EMDC already hosts the likes of M&S, Alliance and Redrow, transforming supply chain operations to make them fit for the future as leading international, multi-channel retailers.

Following on from this, we anticipate a significant shift in sales channels for many businesses – particularly those who have been hit especially hard by the Government imposed restrictions. Take retail for example - those who have prospered include the quite widely defined "essential" stores, and online retailers (or those that were able to quickly shift online) and their associated delivery partners which both benefited from changing consumer trends. Take Leicestershire based Next. Next were early movers into online shopping, reducing their high St presence in recent years quite considerably down to manageable level. Their business model allowed them to adapt well to reduced high street shopping - which is what we expect to see from other businesses in the region as we emerge from pandemic and recover.

There is undoubtedly a short-term concern around the impact of the withdrawal of many of the Government's support schemes, which is likely to lead to a wave of businesses needing to reduce manpower, access additional funding or falling into insolvency.

Fewer sales auction processes are likely in future, extending a pattern that developed this year of having more private discussions with fewer suitors – as compared with offering businesses out to a wide population of buyers.

We expect to see many sectors consolidating – grasping opportunities and/or actively pursuing opportunities to gain a larger portion of overall market share, particularly in sectors and markets disrupted or weakened by the pandemic.

We anticipate a strong stream of completions in Q1, given the impending Spring budget, given the rumours of potential tax changes, particularly in regard to CGT.

We also anticipate an increase in the number of distressed deals emerging.

All in all however, our overall outlook remains positive, and we expect to deliver more deals than in 2020, our focus being on the more robust, good quality businesses.

Other issues to consider

Virtual deal making – Does this hinder or enhance the deal making process?

COVID-19 vaccinations - The Rest of world will be at different points in regard to vaccination roll-outs – it would therefore be prudent to consider whether this will hamper international deals.

UK has finally left the EU – This might encourage more deals which were otherwise on hold as dealmakers and business owners awaited details of the deal/ no deal scenario. The exchange rate has also strengthened against some currencies.

Greater need for UK-based intellectual property – The pandemic has highlighted that we do not want to rely on importing. It has exposed cracks, and indeed opportunities for UK companies to enhance our capabilities as a nation.

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