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YFM Equity Partners

Creating opportunities from adversity

How private equity can drive business growth in a post-COVID world

Foreword

The economic impact of a COVID-19 driven recession remains uncertain but is likely to be significant and far reaching. Historical downturns, such as that experienced in 2008, may provide a frame of reference as to potential short-term outcomes, but the uniqueness of a pandemic driven financial crisis could pose different challenges to business owners considering M&A activity in the North West.

The 2008 crisis was sector agnostic with few businesses emerging unscathed. The 2020 situation is very different, with certain sectors being damaged more than others; there will be a clear distinction between winners and losers. Business owners and investors will therefore not only be faced with unfamiliar challenges but the potential to exploit unprecedented opportunities.

We anticipate that the relative availability of debt will sustain leveraged buy out activity to a level that would not have been possible back in 2008-2009. For businesses that have proven to be COVID-19 resilient, this could make a full or partial exit to private equity an attractive option and an alternative that many vendors may not have considered.

With many trade buyers likely to be focussing on restoring their own houses to order, in the short to medium term, businesses should consider PE as a viable alternative.

Taking full advantage of the opportunities PE can offer will require a degree of flexibility and pragmatism with regards to deal structure. Striking the right deal with the right PE firm could provide business owners with both an opportunity to take cash off the table now but also an investment partner that could help unlock future value.

In short, finding a suitable investment partner, and working with the right corporate finance advisor, will be key to maximising value both now and in the longer term.

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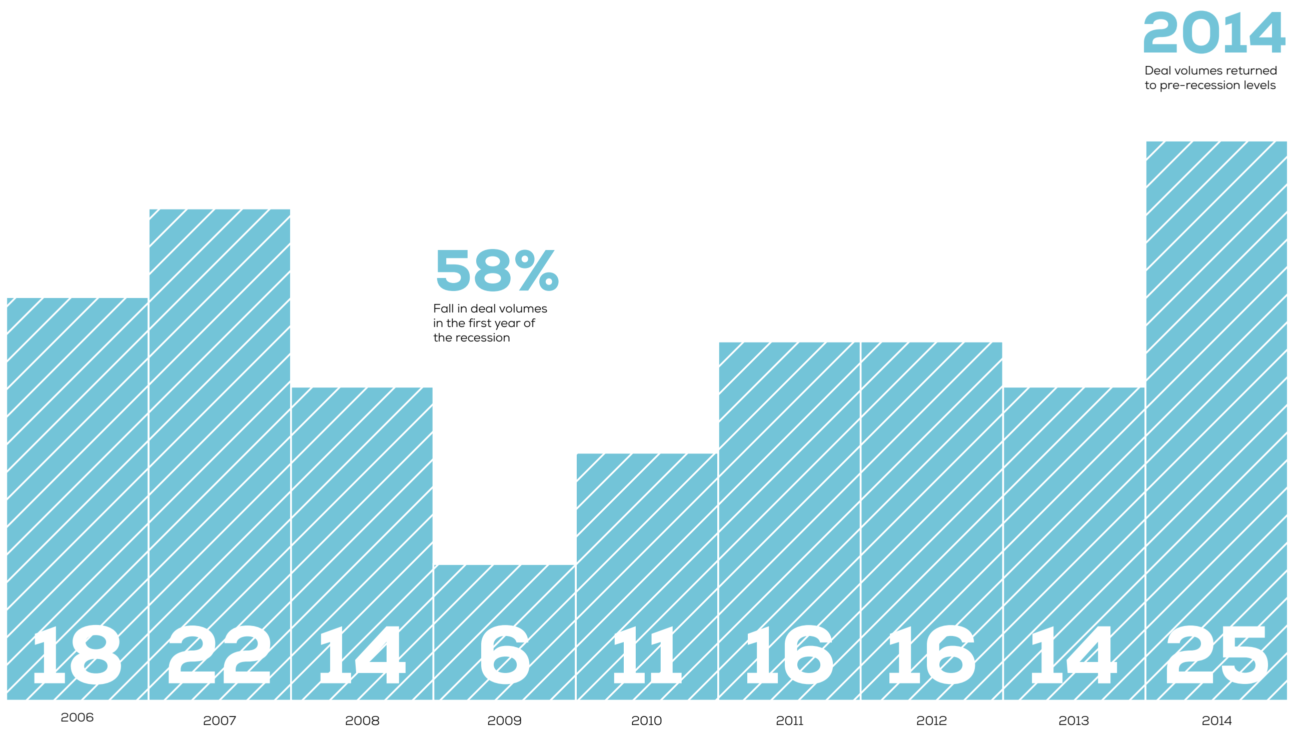
Looking back

The credit crunch hit the North West private equity community hard. As the initial crisis was financial, transactions stopped before the economy did.



Source: Experian MarketiQ

While the initial warning signs of the run on Northern Rock's liquidity in 2007 did not deter dealmakers, the collapse of Lehmann Brothers in September 2008 sparked a chain of events that would force companies to look at consolidation rather than growth.

Many deals were far enough down the line to complete during the initial phase of the crisis in 2008, but the market fell off a cliff as we entered the following year – more than halving to just six transactions.

Private equity's attention initially turned towards protecting their existing portfolio rather than new investments, but the industry was quick to bounce back in 2010. As sellers got used to the 'new normal', volumes returned to three quarters of pre-crisis levels, before surpassing 2008 numbers in both 2011 and 2012 as the UK avoided a triple-dip recession.

Looking forward

What lessons can we take from the last recession to boost growth now?

Drive an acquisition growth strategy

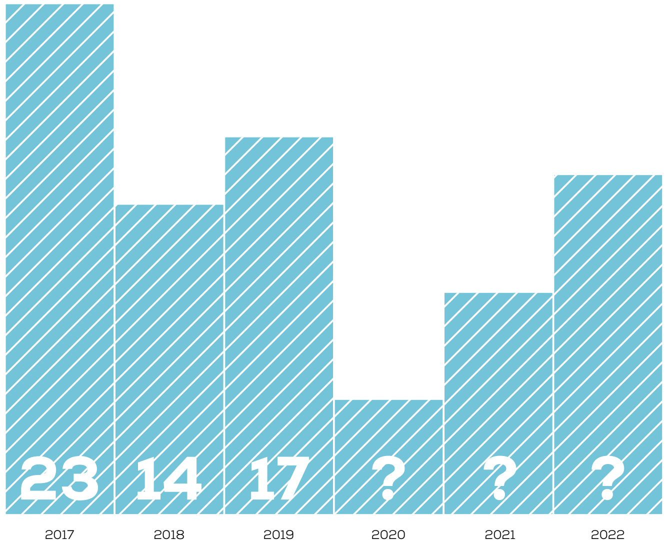
With organic growth difficult to achieve for some, a partnership with private equity now offers businesses the liquidity to adopt a successful buy and build strategy. By making bolt-on acquisitions that complement ongoing growth strategies, companies can deliver immediate EBITDA improvements and will provide a stronger base to exit from in the coming years.

Valuation matters

As with any transaction, historical management information will play a significant part in determining the valuation of any company. This will be even more important in the current environment where purchasers are likely to view forward looking projections with an even greater degree of caution, if not outright scepticism.

In many cases, a best guess of future maintainable earnings may need businesses to look back to pre COVID-19 results. Many business owners will be seeking to price using an "EBITDAC" performance measure, where EBITDA is adjusted for any specific items arising directly from COVID-19. Although the temptation for owners will be to pass off any negative performance effects as COVID-related, we would advise business-owners to only include those items that you can prove have been impacted. This will be crucial when it comes to maintaining both vendor credibility and avoiding unnecessary issues arising in due diligence.

Engaging an experienced corporate finance advisor early in the sale process as part of a broader vendor assist exercise would help vendors address these issues.



Source: Centre for Management Buyout Research (CMBOR)

Engaging an experienced corporate finance advisor early in the sale process will help vendors address any issues

Sensible deal structuring can deliver value to both vendor and purchaser

Vendors wishing to fully exit now may need to be realistic about the current valuation of their business if it has been adversely impacted by COVID-19. This doesn't necessarily mean leaving huge levels of value on the table. A properly structured earn out arrangement will allow business owners to maximise value without exposing the purchaser to a disproportionate level of risk.

Partial exits can achieve the best of both worlds

By partnering with a private equity house, owners can look to achieve a partial exit - something that a typical trade sale would not allow. This also enables any shareholders unwilling or unable to continue on the journey to a full exit, which may now be further away than previously envisaged. This will enable the business to crystallise value, whilst allowing remaining shareholders to achieve further growth in the short to medium term in partnership with an investor.

Innovation now can set a business apart from its competitors

Businesses that were able to invest and innovate in the aftermath of the credit crunch were able to create strategic advantage over competitors that sustained them over subsequent years. Typically, business investment falls during recessions, meaning those that have the balance sheet strength to look at the long term can create big differentiators to drive growth and value for years to come.

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How is the post-COVID recession different?

Liquidity is not the main issue

Our expectation is that deals that would have been affected last time are likely to still happen in this recession. With the capital immediately available to put to work, private equity may become the best route to creating and realising value for many companies in the North West.

While many business owners will not have thought about private equity as a viable option – and others may have been actively opposed to it – management should be willing to consider this possibility going forward.

The impact of the crisis will be felt unevenly across industries

Some sectors will face bigger consequences, and take longer to recover, than others. Conversely, several sectors have seen a boost in demand, directly or indirectly, as a result of the crisis. While commentators are predicting an overall reduction of UK national income of around 10 per cent this year, this overall figure hides stark divergences between the winners and losers.

The crisis resulted in an immediate impact on trading for many

The last recession began with a severe liquidity shock but took some time to impact trading in the real economy. By contrast, the current crisis, and in particular the lockdown measures, resulted in an immediate impact on trading. In either case where businesses have seen an overall positive or negative trading impact of COVID, this could affect the valuation and the potential timing of any potential transaction.

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Our advice to businesses looking to sell

1

Be open to a private equity transaction

It may not be what you initially considered, but private equity may be the best chance to drive value in your business in the short term. Ensure that you work collaboratively with investors from an early stage and be willing to be creative with the deal structure.

2

Adopt a flexible approach to deal structuring

In many cases, now won't be the time for vendors to insist on a substantial portion of consideration being paid on completion. Be willing to consider earn out agreements and work with your advisor to structure them in a way which gives you the best chance to maximise exit value but doesn't deter potential purchasers by expecting them to take on an undue level of risk.

3

Check that your shareholders are up for the journey

Once you've made your decision, you need to ensure that all shareholders are aligned. The crisis may have delayed previous plans for everyone, and it is important that all stakeholders are committed to driving the business forward.

4

Think about taking two bites of the cherry

With some valuations reduced at present, maybe now isn't the time for a full exit. However, there is the option to take some cash out of the business and provide personal stability at a lower rate, while working with private equity to drive value back to pre-crisis levels and beyond.

5

Now is a great time to grow your business through acquisitions

There is an unprecedented opportunity to make complementary bolt-ons at a reduced price. Partner with someone with the knowledge of your business and the wider marketplace to ensure any acquisitions fit with your business and will work with you to assimilate correctly.

Case study

Name: Fishawack
Sector: Medical communications
Based: Knutsford
Date of investment: 2008
Date of exit: 2013
Return: 1.9x

Background

YFM backed Knutsford-based medical communications agency Fishawack in 2008, to support its organic growth plan. The start of the credit crunch forced a rethink on strategy.

How YFM helped

Due to its flexible approach, YFM was able to quickly adapt an acquisitive growth plan, making two additional investments into Fishawack to support three bolt-on transactions, both in the UK and overseas. The deals provided the company with greater access to new customers and international markets.

The result

Despite operating in one of the most turbulent times in global economic memory, the business hit its original growth ambition of £9m turnover in 2013. It completed a £14m secondary buyout later that same year, generating a 1.9x return for its investors.

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