BUILDING FINANCIAL FORTITUDE

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Surviving or acquiring

A guide on strategies for business success in uncertain times

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How can businesses be resilient, right-sized, re-focused and ready for opportunities in the post-COVID environment?

Frank Ofonagaro, a director in our Financial Advisory team and Ian Barton, a managing director in our Corporate Finance team answer the key questions for businesses looking to address the key challenges.

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What are the steps that businesses should be taking to address the ongoing impact of the pandemic?

Frank: I think it's fair to say that since the onset of the pandemic, most businesses have been in survival mode. I would imagine that most have kept their heads above water by cutting costs wherever they can, focusing on cash management and benefiting from the government's support, in terms of furlough and other schemes.

Having survived the initial wave of the pandemic, businesses should now start to turn their attention towards evaluating their current position – from both a micro and a macro perspective. At this evaluation stage, if businesses have the internal resource, they should undertake a strategic review, or get advisers on board to assist with this.

It's all about understanding if the business model is viable in a post-COVID world. For instance, are the products viable? Has there been any change in the market and in how consumers like to purchase? Also, if any businesses have been slow adopters of moving to digital, COVID-19 will have accelerated their move online, one way or another.

Businesses should now be focusing on understanding whether their business is still fit for purpose. And that extends to their supply chain – is it as robust as it once was, or are there any gaps in the supply chain that need to be addressed? Also, have the company's channels changed? Has its customer base changed? I think that only by understanding its current position, can the business be best placed to understand what to do next and what the options are.

Once a business understands its position in the market, what options they should look at next?

Frank: I think that having understood and gained a clear insight into where the business is going and what its prospects are, then armed with that information, the business should undertake an options analysis. The impact of COVID-19 has been so dramatic, that all options should be on the table for businesses when considering what to do next. These could include going for an exit, as market conditions start to improve, post-vaccine.

We've seen many instances where shareholders of a certain age, who were looking to exit before COVID-19 happened, have indicated that they might not have the appetite now to spend three or four years building back equity value to where it was. We're finding that some of those shareholders are planning to exit as soon as market conditions allow and improve.

Other options might include shedding non-core businesses and focusing on core businesses, as a risk-management measure, or adding capabilities to the business. For example, if a business needs to develop an online channel, strategic acquisitions may be the way forward.

You could also have a scenario where it is decided that the company or its business model is no longer fit for purpose but is solvent. In this case, an orderly wind-down of the operating business might suit the needs and wishes of the stakeholders. You could be looking at an accelerated merger and acquisition (M&A) strategy in the form of an insolvency pre-pack, or just an insolvency. If the business has run its course, this might be an option a director(s) would need to consider.

What areas do you expect businesses to focus on in the next 12 months or so when it comes to M&A strategies?

Ian: The first stage for many businesses has been survival, so fundamentally, the focus has been on the state of your balance sheet. But it's very much about getting your head up now and thinking about restructuring debt, and ensuring you've got enough 'headroom' and cash funding for whatever the future might bring.

It's difficult for businesses to plan but plan you must. And you really need to try to put together some strategic thoughts around how you want the business to look in the next 'normal', whatever that might look like, and whenever it might kick in. So, I'd expect businesses to be:

- renegotiating debts;
- looking at their covenant testing and payment profiles; and
- understanding how they're going to pay VAT deferrals or repay CBILS (coronavirus business interruption loan scheme) loans.

This might mean they then introduce new equity into the business, whether that's from private sources or private equity, or from merging with another entity or bringing in new partners. So, I think we will start to see businesses get their balance sheets settled. They'll be starting to think about the type of M&A that might be most suitable, whether that's a 'defensive' M&A, to protect the business or an 'offensive' M&A, which creates change.

What is the difference between those two types of M&A and what are the scenarios in which you would deploy those strategies?

Ian: Defensive M&A is brought about through necessity as much as anything else. It refers to actions such as salvaging value from your balance sheet, where perhaps you might dispose of a non-core business or assets. You might decide that you want to realise some capital – perhaps from something that's not going to be part of your long-term future, and then try to use that funding elsewhere in the business.

It can also mean exiting a distressed business that's draining cash now, so you'd be better off closing it or selling it to a third party. Or you might be looking to safeguard the markets you're in, so hunkering down a little where you've got capital-intensive needs in a particular part of your business. Or perhaps you spread the risk by bringing in some co-investment or a partnership to defray some of that risk.

Offensive M&A activity is more about choice. Typically, this relates to where you see growth coming from, so it's about activities to transform your operations, such as enhancing your digital capabilities. Some business owners might in the past have been doing some 'blue-sky' thinking about goals that have always been slightly out of reach. Maybe they are still out of reach, but it's imperative to accelerate the path of the business towards these goals and make that strategic change. For some businesses, it might be about acquisitions that they never thought they could afford, but which are now a little bit cheaper, because the 'frothiness' of the M&A market has dissipated a little over the last 12 months.

What will be the difference between businesses that survive and those that thrive?

Ian: It's very difficult for businesses to know when it's the right moment to switch from survival to a more opportunistic or thriving mode. Much of that is often driven by their reaction to the market. The trouble is the market is very unpredictable now.

When I spoke to business owners during the second wave of the pandemic, they were starting to say that there was no point in waiting for something to happen, and that they needed to be the catalyst for change in their business – whether that was to be M&A or tilting their business in a certain way for the future. So, businesses are having to take a view on where the future might lead them. But the most important thing is to have plenty of cash headroom, whether that's due to taking advantage of government-backed schemes or from bringing new funding into the business. It's also important to make sure that all the equity holders in your business are contributing in some way.

I've been talking to many business owners who are perhaps thinking about doing something different. Some are looking to exit, but some are looking to exit owners who perhaps have been passive shareholders for some time – and they want to use that equity for a new investor, to bring new capital and new momentum to take the business forward. It's because business owners know that the next couple of years are going to be hard and they need to be as well prepared for that, as possible.

What tips do you have on how to deal with things when the objectives of stakeholders diverge? How do you cope with that situation?

Frank: I think it comes down to just having a grown-up conversation about value. My starting point in these scenarios is always to understand the common value of the business and where does value break. It comes back to the question of what the prospects of this business are, in terms of not only preserving but also going on to grow value. It's about putting personalities and emotions aside, and just bringing it back to the 'boring' conversation about what is the value of the business now, what value do all of you ideally want to get to, and how best to achieve that, to take things forward.

Ian: One of the points I would make is that it comes down to people's own personal analysis of risk. In a normally operating market, there are narrower bands of risk. I think what we're seeing now is a huge spectrum of people on that risk register. Some people are prepared to take a chance. These are the people who are investing in their businesses and thinking what this might mean for them in five years' time and making acquisitions.

At the other end of the spectrum, we have people who have gone through the last six months and just thought: "This has been really hard and I think I'm reaching the end of my business career – it's time to exit and pass this business on to somebody new, and to realise what I can from it at this time." So, people's risk profiles are really key here, as is being honest with themselves about what they want to get out of the coming period, because there are 'hard yards' ahead and people have to decide where they stand on that.

How do you see the funding landscape this year, for banks and other funders such as asset-based lenders (ABLs)? Do you think they will have opportunities, or will they be busy with problems?

Ian: The speed at which the pandemic came on meant that businesses weren't drained of cash resources in the way that often you see going into a typical recession. Businesses that were in decent shape prior to the pandemic, hopefully had some cash resources. They've also had the opportunity to take advantage of government schemes, which should have shored up their balance sheets. That's why we're not seeing a huge acceleration in receiverships or administrations, or huge amounts of distress now.

For banks that took part in the CBILS and the BBLS (Bounce Back Loan Scheme), this was an opportunity for lots of those providers to put money into businesses and protect the debts that they already perhaps had with those businesses. For one or two of those providers, particularly the crowdfunding or peer-to-peer lenders, it's been a huge opportunity to make a breakthrough into the market, by putting their funding into those businesses, which gives them a foothold for future debt.

Frank: When I speak to lenders there are not a lot of deals being written at the moment. We have this strange phenomenon where we have profit-poor but cash-rich businesses, which is quite a contradiction in terms. So, I think the real need isn't there yet. There are, however, some good businesses that will need working-capital support, especially if their sector recovers quite quickly. At the same time, I think alternative lenders will be exercising some caution as well, because clearly there are a lot of leveraged businesses there, so they will be quite judicious about what they take on. But there certainly is a 'war chest' and a lot of appetite in the alternative lenders' space to write deals when the need arises.

With regard to commercial lenders, I think it's fair to say that those lenders have been more risk-averse anyway, even before the pandemic. Now in response to the coming tide of business failures, especially when the government support is stopped, it remains to be seen whether those banks will have the bandwidth to support as many clients that they can, or will just embark on selling parcels of debt, as the path of least resistance. The uncertainty in the market does create lots of opportunity, but there is quite a lot of risk as well.

For businesses that want to diversify by growth of new services, would it be wise to build a plan and wait until things are more stable? Or is the real opportunity when things appear unstable?

Frank: A lot of good businesses will be coming up for sale, at relatively cheaper prices than previously, because lots are viable in terms of their business model and customer channels and so on, but they have an impaired balance sheet. In that scenario, they present a great opportunity for 'distress' investors to pick up some bargains.

We've been speaking to a few investors who wouldn't normally class themselves as shoppers in the 'distressed' space, because of the realisation that there are businesses that would ordinarily be viable, and which would in no way be classed as distressed, but have taken a hit to their balance sheet because of COVID-19. So, you find some investors looking in this space for bargains, who wouldn't have done so previously.

There will be plenty of opportunity. A note of caution, though, especially to management teams or people looking to buy businesses – understanding the working-capital requirements as a business comes into the recovery phase, is going to be critical. In my experience, many businesses fail, not due to not making money, but due to running out of cash because they don't understand their working-capital needs. It's going to be important that people get a handle on that.

How do you get a set of accounts signed off these days without a going concern qualification? How do finance directors and business owners get round or address this problem? And what about businesses' credit taking a hit, due to late filing, yet having a fundamentally sound business?

Ian: I've worked with a large business recently with a 'big four' auditor, which has had enormous challenges in being able to get out to businesses and do their audits last year, because of social distancing. They lost three or four seasons of their work. So, I sympathise on the point of the late filing. I think that it will only be worse this year because lots of audit firms will prioritise certain clients, particularly listed businesses, who they will have to audit first. Private companies might therefore suffer a little bit in terms of that timing.

Regarding the question about going concern, an auditor will always look at forecasts and free cash that the business thinks it has available to fund itself for the next 12 months – that's essentially the definition of going concern. So, going back to the point previously made – while it is difficult to forecast and plan anything – plan you must. And you need to plan for a series of scenarios, including things coming back to normal for your business, in the early part of this year and also for a longer, more drawn-out process, if you're in the hospitality sector, for instance. I would say, therefore, be flexible on planning, take advice and prepare for a range of different scenarios.

Have too many bad businesses been saved at the expense of more sustainable businesses?

Frank: There are some 'zombie' companies out there. By that, I mean companies that are in effect insolvent, in that they would be unable to pay their debts as and when they fall due, if they were not receiving government support.

The reality is that any business failure is always a tragedy; ultimately people are losing their livelihoods. But I also have sympathy for those that take the view that at some point the government does need to allow some businesses that are no longer viable, to fail, to allow the recycling of resources for viable businesses.

In a scenario where there appears to be a 30-40% drop in business, how should you approach right sizing the business?

Frank: You can't look at that situation in isolation. You need to understand what that drop in business means for your profitability. A 40% drop, for most businesses, means that they are in loss-making territory. The first step is to undertake analysis, to understand how much cost you can shed to get yourself at least close to breakeven without fundamentally damaging the business and its ability to operate efficiently. This would be the first thing for the board to look at but trimming costs should also be looked at with one eye on the current level of demand.

Another key point to bear in mind when trimming costs now is – when the recovery comes, how quickly and what would the cost be, of ramping back up again to take advantage of that recovery? The sense check is about how much cost can be trimmed now to get as close to breakeven point as possible, to keep the business going sustainably until the recovery comes.

If the outcome is that on a 40% drop it won't be possible, then directors, to protect themselves and the company's creditors, need to be asking whether they need to be exploring other options, whether going down the formal route, an accelerated M&A route or perhaps trying to look for a strategic investor, to bridge the gap and buy time until they can take advantage of the recovery. It comes down to cold, hard analysis and understanding the numbers, but also keeping an eye on the sector as well.

If you're able to get your costs down close to breakeven and identify a source of finance to keep your head above water, you also need to look at whether you've still got a market and if the sector is still viable – because if it isn't, trying to get to breakeven is a waste of time. So, there is a two-pronged analysis here – the micro approach, which looks at how close you can get to breakeven and survive, but also the wider view – looking at the market, to see if your business is viable.

What are you optimistic about for this year?

Ian: I'm optimistic about the volume of activity in the world of M&A. There are of course areas of distress and difficulty, but what we we're seeing is businesses being adaptable and changing some of their processes – perhaps shedding some approaches that they would have otherwise got rid of over a longer period of time. They might have more debt on the balance sheet than they would like and that might cause them to change plans or bring in new equity, but in terms of their operations and focus on the market, those businesses that are able to survive will emerge stronger.

Frank: I'm looking forward to an increasingly more open business culture. What I've seen as a result of the pandemic is that because the impact has been so catastrophic and so sudden, a lot of C-suite executives have been a lot more open than they otherwise would have been. In the coaching conversations I've had with some senior clients, they've been talking about their fears – not just their worries about their business, but personally as well – which has made for more productive conversations.

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