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Heightened diligence is the name of the game in post-COVID-19 transactions

Many economic activities have been impacted by COVID-19, mergers and acquisitions among them. With borders closed, travel restricted and face-to-face meetings impossible, transactions have slowed dramatically. But deals will resume.

In fact, the pandemic may create a wave of new deals as troubled companies look for exit strategies, investors poise for a market correction and companies that emerge healthier seek buyers.

Yet, in a post-pandemic world, where historical measures —such as market multiples and past cash flow—may no longer provide clues into future performance, how can buyers and sellers accurately gauge value and risk?

Treading this new terrain, buyers will need a more diligent approach, while sellers must prepare for greater scrutiny. Beyond the traditional review of historical business information, due diligence post-COVID-19 will require increased focus on forward-looking information—including forecasts, budgets, backlogs, pipelines and qualitative factors that shed light on altered business practices.

> “in a post-pandemic world...how can buyers and sellers accurately gauge value and risk?”

Due diligence for the COVID-19 era

To mitigate risk and maximize opportunities in a post-pandemic world, buyers must understand the impact of COVID-19 on a target company, while sellers must stand ready to share their crisis response plans and explain the pandemic’s effect on their near- and long-term operations. There are five main areas of supplemental due diligence to consider:

- **Expanded EBITDA benchmarks:** In assessing earnings before interest, taxes, depreciation and amortization (EBITDA), it seems clear that the months directly affected by the pandemic likely don’t represent historical financial performance or indicate future results. As such, 2020 financials should probably be adjusted to reflect normal operations. To do so, compare EBITDA trends for the quarter before COVID-19 to impacted months and management’s near-term forecasts, benchmark the company’s EBITDA trends to its industry peers and evaluate performance against growth rates from prior years and future projections. It’s also important to understand operating leverage and breakeven points to determine how a change in revenues may impact EBITDA over time.

- **Top-line impact:** In addition to profitability metrics, you'll need to discern the short- and long-term revenue impact of COVID-19. This means analyzing sales trends before, during and after the pandemic by customer, product, end-market and channel. Consider, too, the company's position in the value chain to gauge the potential for delayed pandemic impacts. Beyond looking at historical results, examine forecasts as well—and test their strength forecasts by scrutinizing historical win rates, comparing budgets against actuals and tracking post-COVID-19 cancellation rates.
- **Vendors and supply chains:** To ascertain a company's supply chain strength, assess the reliability of the company's material sources (particularly for sole-sourced materials) to determine if those relationships will survive the pandemic. You'll also need to look at the ongoing impact on vendors and product pricing, whether the company has vendor agreements with purchase commitments and if the company can diversify supply risk by sourcing from multiple vendors or other countries.
- **Employees and contractors:** With Canada's unemployment rate up to 13 percent in April 2020, and roughly three million jobs lost in March and April,[1] it's critical to examine the financial and operational ramifications of the company's COVID-related talent decisions. Pay attention to headcount fluctuations during the pandemic to see if the company can rehire skilled workers once the crisis recedes. If the company temporarily deferred compensation to employees, reduced salaries, or delayed payout of severance, payroll taxes, bonuses or discretionary RRSP contributions, funds may need to be left behind at close to settle these deferred obligations.
- **Working capital and debt:** Given the upheaval that COVID-19 has caused, historical metrics may not reflect all risks on the balance sheet or indicate working capital needs going forward. This mandates a fresh look at accounting methodology. For instance, consider the potential deterioration of the company's accounts receivable portfolio and whether the allowance for bad debts has been updated to reflect the risk of these assets. If a drop-in demand extended aging of inventories, see if there are inventory reserves to account for spoilage, slow moving, excess or obsolete inventory. Ask, too, how the company is accounting for stimulus funds and whether extended payables (including rent concessions) should be considered indebtedness in closing agreements.

1 The Canadian Press, May 8, 2020. "Canada's jobless rate soars to 13 per cent in April." Accessed at https://www.ctvnews.ca/business/canada-s-jobless-rate-soars-to-13-per-cent-in-april-1.4930397

Adapting to change

While no one can predict what our "new normal" will look like in the months and years to come, the merger and acquisition environment will likely be altered as a result—particularly in the near-term. To adapt to these shifted realities, buyers must be prepared to engage in more in-depth due diligence, seeking out metrics they may not have considered in the past. For their part, sellers must be ready to disclose more detailed information if they hope to maximize value and play their part in mitigating transactional risk.

If you are considering engaging in a merger or acquisition amid this new terrain, we can help. Our experienced team can help you with preparing for and undertaking due diligence to ensure you have the clarity and confidence you need to optimize transaction value, mitigate risks and achieve speed to close.

We're here to help

We understand that you want to be agile and responsive as the situation unfolds. Having access to experts, insights and accurate information as quickly as possible is critical—but your resources may be stretched at this time.

We're here to support you as you navigate through the impacts of coronavirus on your business and your investments.

Grant Thornton LLP wants to caution that these rules are still new and continue to evolve as the government continues to re-evaluate the economic impact caused by the COVID-19 pandemic. We may still see changes to these measures—as well as new measures—as the government attempts to address the issues that have been raised by us and the tax community. Therefore, any analysis included herein, reflects our knowledge as of the date and time of this email and may no longer be applicable if changes do occur and you should proceed with caution before making any decisions.

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