Expert note June 2020

« This economic and health crisis reveals more than ever the challenges of valuation, auditing and performance and cash management. »

Impact of the crisis on schedules of operations

In view of the missions handled by **NG Finance**, i.e. nearly 70 active projects at the start of the lockdown, it appears that very few of the operations undertaken have been cancelled since the beginning of the health crisis. However, we have noted postponements or price renegotiations on advanced projects. In this respect, the breakdown is relatively equal between a temporary freeze (postponement sine die) and an expected recovery in May 2020 at the earliest.

Delayed operations should therefore evolve according to their stage of completion:

(i) Without a firm signed commitment, investors could withdraw depending on their analysis of the new business plans and the ability to use financing instruments;

(ii) In the case of signed operations, investors wishing to withdraw will have to turn to the specific clauses to the extent that they are feasible in the European legal environment.[1]

Nevertheless, if there is no conditional commitment, the acquisition will have to be completed regardless of the impact of the health crisis on the business.

__1__. The notion of unforeseeability in Article 1195 of the Civil Code, which includes the risk of an acquisition that turns out to be suddenly expensive for the purchaser, is regularly set aside by the parties in contracts of sale until today. French practice, and more generally European practice, only very rarely includes clauses such as Material Adverse Change (or "MAC" clause or significant adverse change clause) in their sale contract, unlike M&A transactions subject to US law.

Pressure on valuation levels

Based on new transactions conducted since the beginning of the lockdown, it is difficult to predict an overall decline in valuation levels. These value changes will be unpredictable; however, we note that certain sectors such as Food and Pharmaceuticals remain resilient. Conversely, we can see significant downside impacts in the Tourism and Leisure, Foodservices, Aeronautics and Automotive sectors and its sub-sectors.

This trend will have an impact on the **management of the upcoming transactions and restructurings**. The importance of the work of experts will be crucial in the context of revisions to the valuation of unlisted companies valuation, where values are measured mainly by what we call "intrinsic" valuation levels. On the latter, we can observe an **average fall of about 15% to 20% in valuations**, subject to a "normal" recovery in activity from September 2020, particularly in industrial sectors such as luxury leather goods, ready-to-wear and industrial tools.

On the listed markets, the steep fall in stock market valuations since the end of February 2020 will continue to have a significant impact, as valuation gains have been very timid and will not compensate for the valuation levels lost in the short term. The **CAC 40** has fallen by **nearly 25%** since 20 February 2020.

This crisis could increase the interest of some investors in listed securities due to acquisition opportunities at lower prices, on the one hand, and in delisting transactions, on the other. Furthermore, the clear uncorrelation between stock market trends and the economic situation, both on a national and international levels, should lead stakeholders to consider valuation approaches (intrinsic or by market comparison) with caution.

The question of valuation and the unpredictability of its evolution will be central to **today's issues**, both for Private Equity players and for the companies themselves. Which methods and relevant parameters should be used? What economic and financial assumptions should be considered? What risks should be considered according to economic models, sizes, and stages of development? In any case, valuation approaches will have to integrate several scenarios, bullish and bearish, with probabilities of occurrence and a further rationalisation of economic fundamentals. Note that this will have an equivalent impact on the implicit multiple of enterprise value. Questions may also arise about the "terminal value" attributed to companies depending on the economic environment.

In this context, **NG Finance's Valuation and Transaction Services** departments will work together with you to support you in the **rationalisation and modelling of the Business Plan**, as well as in the **audit** and **standardisation of historical financial data**.

As you have understood, the subject of valuation will certainly be a major challenge, both for investment funds and for company managers. However, it cannot be dealt effectively without preliminary work in terms of accounting and financial audits during mergers, acquisitions, and build-ups.

Upcoming Changes in the approach of Financial Auditing

The impact of the crisis on 2020 activity of target companies will certainly lead our **Transaction Services** teams at **NG Finance** to carry out new due diligence, depending on the issues at stake.

Within the scope of the analyses, specific matters will be taken into consideration, today more than in the past. These include particularly the effect on targets due to the crisis' impact on business partners (suspension of customer obligations, disruptions in the supply chain, etc.), the financial resilience, or non-financial elements such as the management quality, the implemented governance structures and the measures taken by the company with regard to its employees.

Moreover, the so-called « **EBITDAC** » (Earnings before interest, taxes, depreciation, amortization, and Coronavirus) has gained increasing attention recently and is considered as relevant for certain actors, particularly in the context of covenants.

The **cash position** will also represent a major part of the analysis, particularly regarding shifts in settlement and payment due dates.

With respect to the schedule of an operation, the different actors might tend to organise the audits in two or even three phases. Some transactions will require the investors to have a preliminary understanding of the fundamentals of the target company and, depending on the results, might proceed to a more in-depth analysis only in a second step. Eventually, a final assessment of the target's performance and financial situation before the closing may prove necessary: in addition to the audit carried out on the target's historical and current trading, "flash" due diligences might be conducted prior to the closing.

The acquirer party must always have an up-to-date view on the target's activity, and net financial debt, as well as on the EBITDA.

Staying well informed also remains crucial in the context of price adjustment clauses, which buyers and investors usually put in place.

In the context of external challenges arising from the economic environment, some companies will draw lessons from the Covid19 crisis. Will it be necessary to relocate some parts of the production or to alter elements of the value chain?

Analyses conducted as part of financial due diligences have to take into account, at least to some extent, the impact of upcoming restructuring measures as well as those already implemented by the target companies.

However, the most important issue relates to the analyses concerning cash monitoring, and in particular the period of time the target company can survive under different scenarios.

Management of priorities, at the heart of the crisis strategy

(CASH, CASH, CASH !)

The transactional activities resumption should occur as soon as the accounts are released on 30 June 2020. Nonetheless, companies are going through the stages of the **crisis** managing priorities.

Whether alone or alongside their investors, companies have first been occupied by the operational management of activities and the preservation of their cash positions. Then they had to deal with requests for state-guaranteed loans.

Cash management is therefore at the heart of efforts. From now on, the **main challenge** for companies lies in the **management and control of cash**. However, reporting and cash flow tables are not widely used in some companies, or are even absent, in a background where the assessment of cash in the short term has become the priority. It is crucial for every company to model impacts of the health crisis, and to assess their capacity to survive.

Budget forecasts must be adapted, as well as the different possible scenarios when the Business Plan is overhauled (incorporating "Best/Worst case scenario" considerations).

The point consists in assessing day after day the impacts of the crisis and in adapting right away to the evolution of the situation.

In this context, the expertise of **NG Finance** teams in financial modelling allows companies to forecast their cash in the short term, so as to determine their needs and actions to be carried out. Our fields of intervention in Modelling and Financial Engineering will also enable us to prepare companies in the best possible way to requests for financing, the maturity dates of which remain poorly understood up to now.

Conclusion

To conclude, we can notice that the current crisis can create opportunities for companies.

It can serve as a catalyst and lead to the overhaul of operational and digitalisation processes, as well as reporting tools in companies. In that respect, real opportunities to create value can be identified.

It also points out the common needs of companies and Private Equity players (investment funds, family office, etc.) both on valuation matters and accounting and financial audit, as well as cash management.

As such, **NG Finance** experts are at your disposal to support you on all of these challenges during the business resumption and investment recovery that we hope will last after the lockdown restrictions are lifted.

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