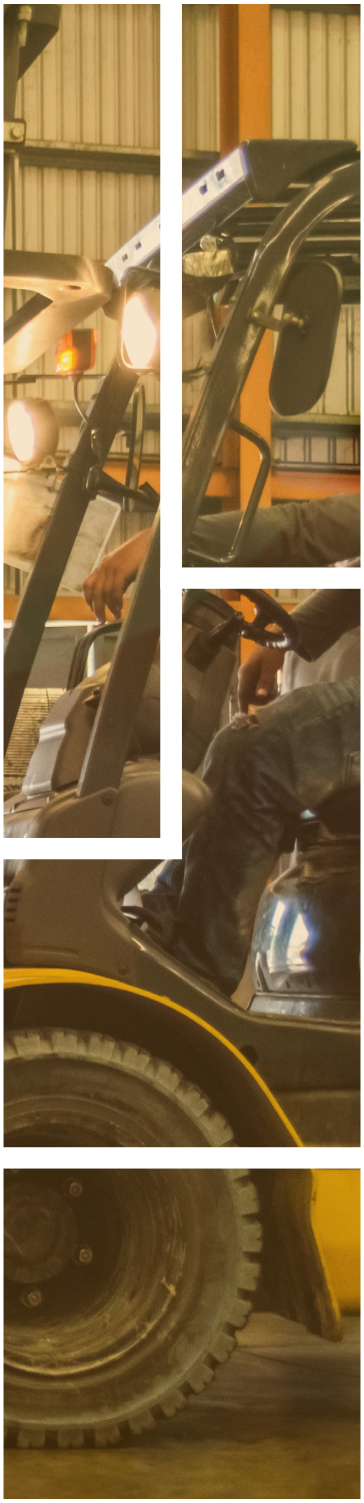
In Manufacturing and Distribution, "Recession Resilience" is No Longer Enough



CONTRIBUTOR

Brad Keyworth, Managing Director
Tom Williams, Managing Director

For years, potential buyers asked management teams how their companies weathered in the Great Recession. The present pandemic will be the next test of company resilience and value.

Until recently, the U.S. benefited from the longest economic expansion in its history, breaking the past record in July 2019 and representing a decade of growth. As the growth trend extended beyond previous economic cycles, investor interest in companies that would not be materially impacted if the economy softened heightened. Accordingly, companies that demonstrated "recession resilience"—such as those serving the education and food service end markets—sold at premium valuations compared to those businesses that were deemed more cyclical, with a valuation difference that ranged as high as 20% to 30% in some cases.

Today, the barometer of recession resilience is simply not enough. Investors are looking for companies that can weather the unanticipated and unimaginable—circumstances akin to a global pandemic.

STORIES OF AGILITY IN MANUFACTURING AND DISTRIBUTION

As COVID-19 has swept the world, some large cap companies like Apple, Cisco, Microsoft, and Subaru are earning goodwill through donations of cash, resources, and supplies to address societal needs. Meanwhile, middle market companies contending with slower demand in their core businesses are pivoting to ensure their survival in this unprecedented time.

For example, one Lincoln client has been able to capitalize on the increased demand for personal protective equipment (PPE) caused by COVID-19. Before the pandemic, this distribution business sold safety products to various industrial markets. As an essential service, the company was able to stay fully operational during this stay at home period. Anticipating a demand slowdown in aspects of its business, however, management leveraged the company's sourcing competency to pivot the business to source and sell N95 masks, surgical masks, and other medical PPE. Management's speed in reshaping the business to align with demand has allowed the company to not only meet but exceed monthly revenue targets during this challenging time—while demonstrating safety expertise and sourcing competency to future buyers.

Many manufacturers from John Deere and Alliance Rubber Company to Milliken & Company have likewise risen to meet the demand for PPE.

While the companies above pivoted in response to seeing an opportunity in the market, others adapted their business models to keep their doors open and cash coming in. Another Lincoln client in the consumer products space was deemed nonessential and

(continued next page)

As investors look to deploy capital during or coming out of this COVID-19 period, corporate and private equity buyers will continue to be focused on recession resilience.

forced to close their doors across the country. To help get to the other side of the curve, management knew they needed to get reclassified as an essential business. They introduced face masks as a product offering and the company is now able to reopen their warehouses.

We see a stark bifurcation between companies that have adapted to the current climate and those that have not. This bifurcation will translate into valuations post-COVID-19.

LINCOLN PERSPECTIVE

While the world looks different than it did at the beginning of March, the economy and markets will recover with time. Many of the prevalent themes that fueled M&A for years such as strong corporate balance sheets and the amount of private equity sitting on the sidelines remain true. As investors look to deploy capital during or coming out of this COVID-19 period, corporate and private equity buyers will continue to be focused on recession resilience. However, what has changed is that there will be a new gold standard in the market, and that is companies that have shown to withstand a pandemic.

To help identify companies that meet this heightened standard, investors will search for the following characteristics:

An entrepreneurial management team: Look for business leaders that are thinking about what they can do now to adjust their business models to make it to the other side of this crisis. Are they creatively creating new revenue streams? Are they identifying ways to cut costs or take advantage of government programs that do not sacrifice the company's position in the industry or ability to aggressively take market share during the recovery? Management teams that are tested and thrive during unforeseen circumstances are signs of attractive targets.

Sourcing and supply chain agility: The US-China trade wars and related tariffs marked a significant disruption to global supply chains. The coronavirus has proven to be an even greater disruption, signaling to investors that supply chain resilience is an essential skill set in our interconnected, global business climate. Companies that are able to quickly find new sources of supply and have adequate access to global markets can nimbly adjust their supply chains to meet heightened demand. As the next disruption is always around the bend, this skill will remain critical in a post-COVID-19 climate.

Multi-channel strategy with an e-commerce presence: Both in this climate and looking ahead to tomorrow, the e-commerce component of a multichannel strategy is non-negotiable. Manufacturers and distributors with direct access to their customer base can target those users through highly effective digital marketing. Conversely, middle market companies without a digital strategy will struggle to compete—and may become targets for opportunistic consolidations at a discount.

How middle market manufacturers and distributors respond now will shape new narratives for these companies and how they will be positioned in the marketplace when they, or their private equity owners, look to sell post-crisis. For this reason, it's critical for companies to keep close records of how they are pivoting their strategy, and the implications for their bottom line. Today's actions will become fodder for tomorrow's pitch deck.

For other perspectives, visit us at www.lincolninternational.com/perspectives.

Interested in learning more? Get to know Lincoln's Industrials professionals at www.lincolninternational.com/industrials.
