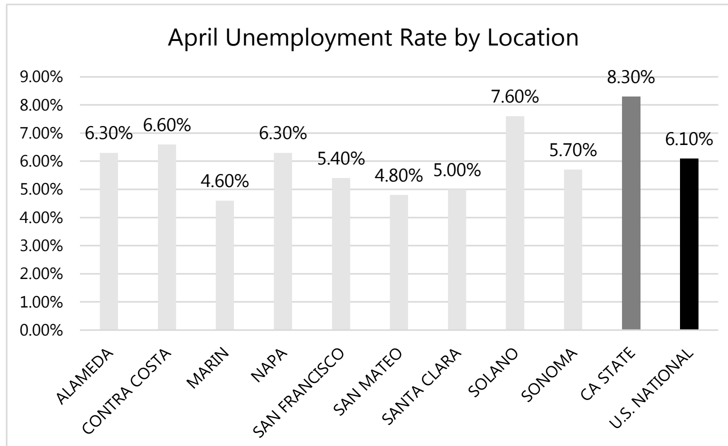
Executive Highlights: California Business Reopening and Economic Recovery

On June 15th, almost 15 months after the first shutdown orders were issued in the Bay Area, California "fully reopened" its economy. This is an important milestone and an opportunity for us to both reflect and plan. As we look forward and discuss what the reopening means for business, at ClearPath we believe it is important to keep each new challenge in the context of the past 15 months. Just one year ago, business leaders were fighting for survival: setting up remote networks, struggling to obtain everything from PPE to laptops, adapting to constantly changing restrictions, obtaining PPP loans and other financing, and above all trying to protect the health and livelihoods of their employees. We overcame those challenges and more, both business and personal. The problems business leaders face in the second half of 2021 are small by comparison.

The most significant obstacles facing business going forward are: red-hot inflation, supply chain issues, and unprecedented labor shortages. Meanwhile, there are opportunities to take advantage of: a growing economy, strong valuations, and a booming M&A market.



Source: California Employee Development Department, U.S. Bureau of Labor Statistics

Here's a high-level summary of what you need to know, with additional analysis in the following pages:

Inflation

- Inflation and higher commodity prices are here to stay for 2021. Specific materials may have reached their peak, but prices will remain elevated into 2022 driven by consumer demand in 2021 and production lag. This may be exacerbated by labor shortages that are expected to increase wages in some areas.
- In the face of rising prices and logistics issues, consider increasing how frequently you place orders and allow for longer lead times. Higher order frequency can help average out rising costs without increasing inventory risk or tying up cash. Limit stock increases to fast-moving, hard-to-find, or strategic items only.

Labor Shortages

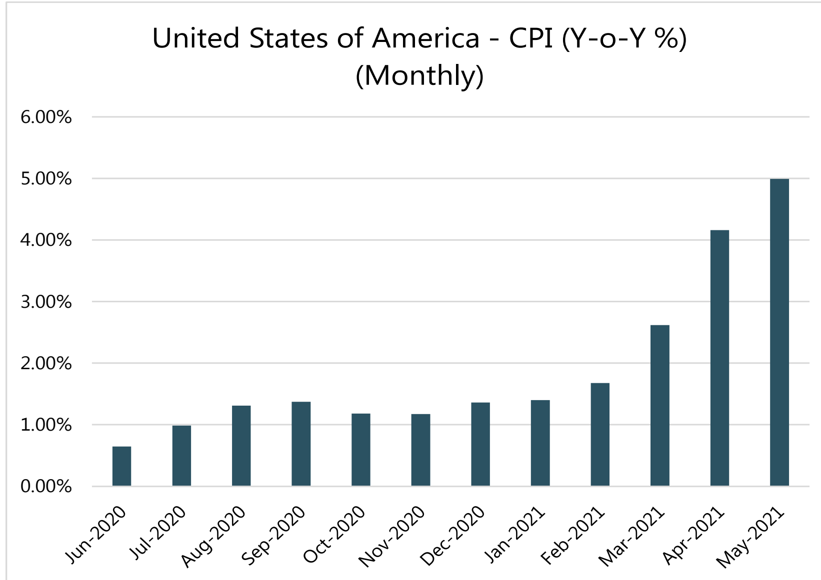
- Consider flexible scheduling, remote or hybrid models. If your business does not support that flexibility, then predictable scheduling for hourly workers will help them arrange childcare at consistent times. Explore programs to assist employees with childcare, such as Dependent Care Assistance Programs (DCAPs) or FSAs.
- Expect pay increases for minimum wage and some skilled labor in the first few months of the summer. Pent-up demand will encourage businesses to staff up and compete on wages – but remember that the federal unemployment boost expires on September 5th. At that point there will be a higher incentive for workers to seek employment.
- People want stable employment, and they want *careers* - not jobs. A clear progression up through the ranks of the company, job training, or educational benefits can help employees see a future for themselves at your company. Employees also want to maintain or improve work-life balance, and employers who offer remote work or flexible scheduling are going to attract better candidates in the labor market. Competition will ensure that remote work and flexible/hybrid scheduling models are here to stay.

M&A Activity

- M&A activity is hot and showing no signs of slowing down. Financial and strategic acquirers have significant amounts of capital to work with and are making up for lost time, while some sell-side mandates that were paused during COVID-19 are going back out to market. As the Fed continues easy monetary policy, expect a healthy M&A market into 2022.
- Whether or not business owners want to exit soon, businesses should be prepared to take advantage of potential opportunities today. That means ensuring you have a growing, cash-generating, scalable business model, and limit dependencies on key personnel, suppliers, and customers.

Inflation and Supply Chain Issues:

Inflation is the decrease in purchasing power per unit of currency, reflected by a broad increase in prices. Prior to COVID-19 the inflation rate for the United States was just 1.8%. As a result of COVID-19 and related business restrictions, it decreased to 1.2% during 2020.

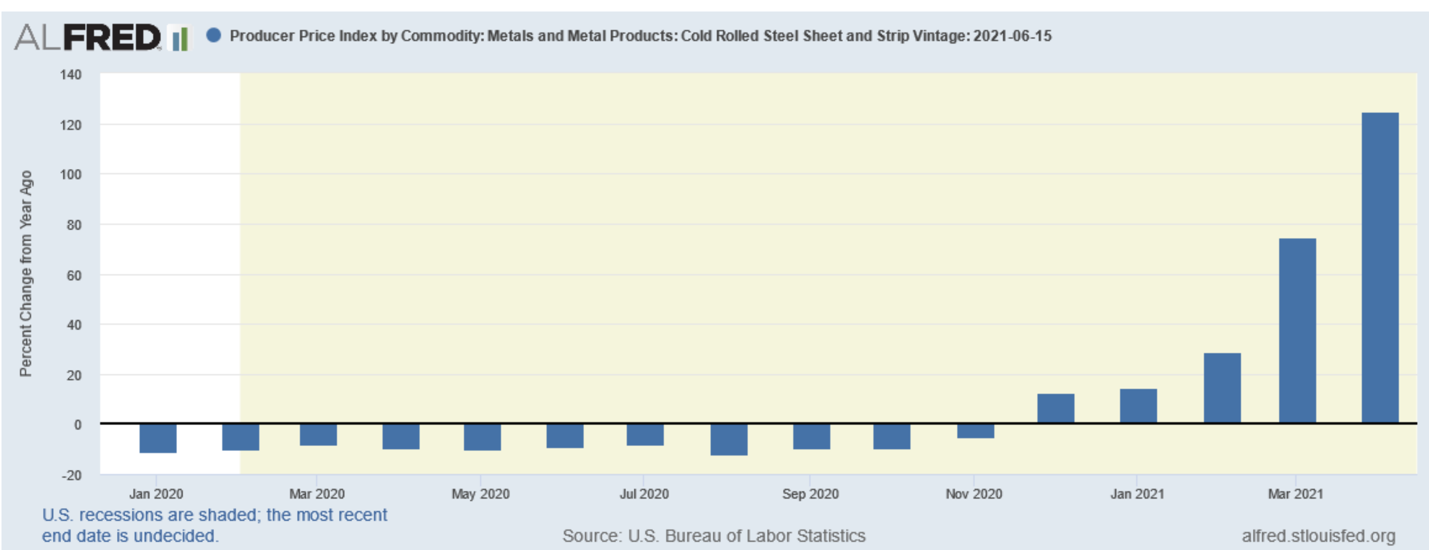


One measure of inflation is the Consumer Price Index (CPI), which measures the change in price levels for eight major groups such as food and beverages, housing, apparel, transportation, medical care, recreation, education & communication, and other goods and services. The 12-month change in the overall CPI as of May 2021 is a massive 5.0% increase. April and May saw the CPI rise at 0.8% and 0.6%, the first and second largest increases in the last decade, respectively.[1]

What this means, is that prices have increased significantly. In fact, they are above their pre-COVID-19 levels in travel and entertainment, real estate, and energy sectors. Some of this is driven by price increases in important commodities that are used in production of other goods and services. Increasing oil and gas prices lead to higher freight costs, and thus higher product costs. High steel and lumber costs increase the cost of everything from furniture to housing.

Gasoline: Gas prices increased by 25% since the end of 2020[2] driven by increased demand, cyber-attacks, and price increases in corn (a main ingredient for ethanol and 10% mix gasolines). Prices are expected to peak by the end of July as demand tapers off, U.S. production rebounds, and OPEC countries increase output through July.

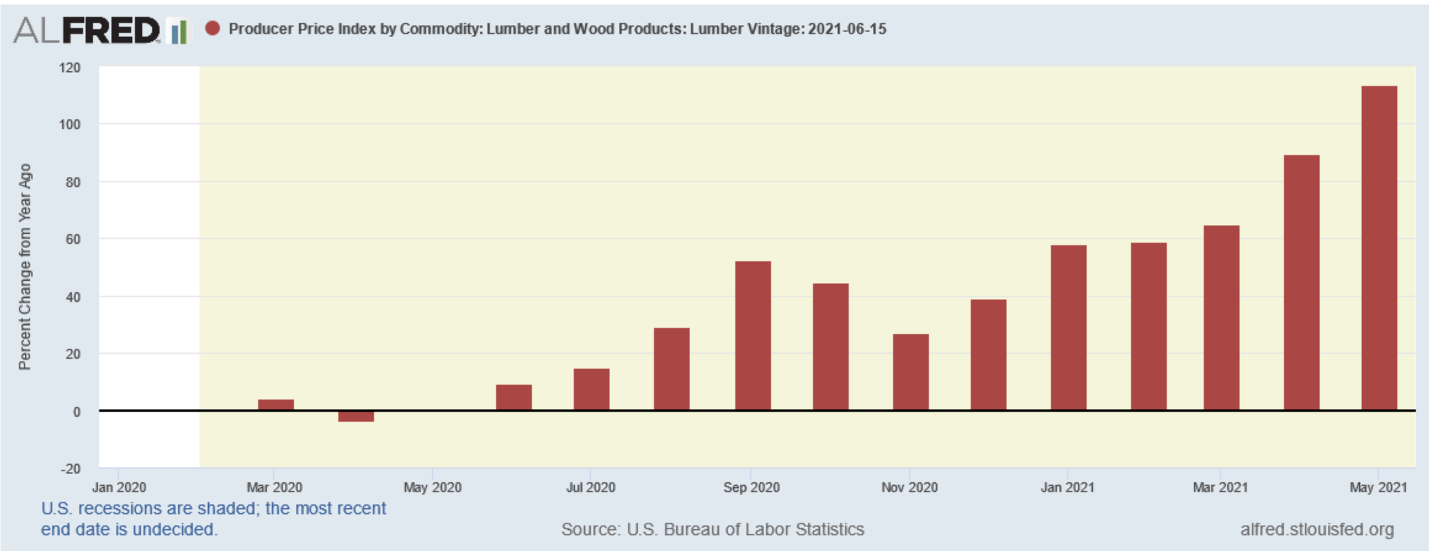
Steel: Hot-rolled steel prices have increased from $460 per ton last year to $1,500 per ton[3], which is triple the 20-year average and more than double year over year. This is due to a decline in steel inventories at the beginning of the pandemic



[1] U.S. Bureau of Labor Statistics. (2021, June 10). *Consumer Price Index*. https://www.bls.gov/cpi/
[2] Hartman, M. (2021, February 20). *Inflation hits gasoline, lumber and meat*. Marketplace. https://www.marketplace.org/2021/02/19/inflation-hits-gasoline-lumber-and-meat/.
[3] U.S. Midwest Domestic Hot-Rolled Coil Steel (CRU) Index Futures Quotes - CME Group. (n.d.). https://www.cmegroup.com/trading/metals/ferrous/hrc-steel_quotes_globex.html.

and steel production taking time to ramp up to meet demand in the recent months. Steel prices have also increased with higher freight rates, tariffs, oil prices, and increased shipping orders which were not seen prior to COVID-19. Production increases are expected to restore balance to the market by 2022.

Lumber: Prices of finished, ready-for-use lumber have more than quadrupled amid high demand and less supply, and the Producer Price Index for Lumber and Wood Products has more than doubled from a year prior. Like the steel industry, many lumber businesses dialed back production in 2020 expecting low demand. However, construction (an essential industry) did not stop and consumers spending more time at home embarked on new home-improvement projects. Now, as it tries to ramp production, the industry faces skilled-labor and entry-level worker shortages. As a result, prices are not expected to return to normal levels until 2023.



Chips: Microchips power an ever-growing proportion of products. In 2020, unexpected demand for automobiles and massive spending on consumer electronics, along with trade restrictions on China helped fuel the shortage. In 2021, it was exacerbated by a drought in Taiwan, which relies on large amounts of pure water to clean wafers and factories, and an ice storm in Texas which shut down several chip fabs for several weeks. The shortages are worst for products that use older process chips, including everything from consumer electronics to worst-hit auto manufacturers, with Ford reducing production at six plants and losing up to $2.5BB in earnings as a result[4].

Global chipmakers expect manufacturing capacity to catch up to demand by the end of this year, but shortages are expected to last until mid-2022 to early 2023.

Shipping/Freight: Lower production levels in 2019 and 2020 combined with COVID-19 restrictions to cause both a container shortage and an imbalance in their locations. Initial restrictions in Asia meant containers could not be sent to or processed at Asian ports. Subsequent restrictions on shipping and travel in the Americas and Europe meant containers located in Asian ports were not being sent back to ports in the Americas. All the while, COVID-19 restrictions and staffing shortages reduced the efficiency of the entire logistics network – from ports to inland trucking. More than 80% of large shipping containers are produced by just three companies located in China (*CIMC*, *CXIC Group*, and *Dong Fang International Containers*), which do not plan to increase production in favor of maintaining higher prices. Much of existing production is only serving to replace older containers. Because there is no significant new-container production increase planned and labor shortages affecting the logistics industry are expected to worsen, shipping and freight shortages are expected to continue until mid-late 2022.

[4] Team, T. (2021, June 4). *Ford Stock Vulnerable To Semiconductor Chip Shortage?* Forbes. https://www.forbes.com/sites/greatspeculations/2021/06/04/ford-stock-vulnerable-to-semiconductor-chip-shortage/?sh=6d9cf6ca4dc7.

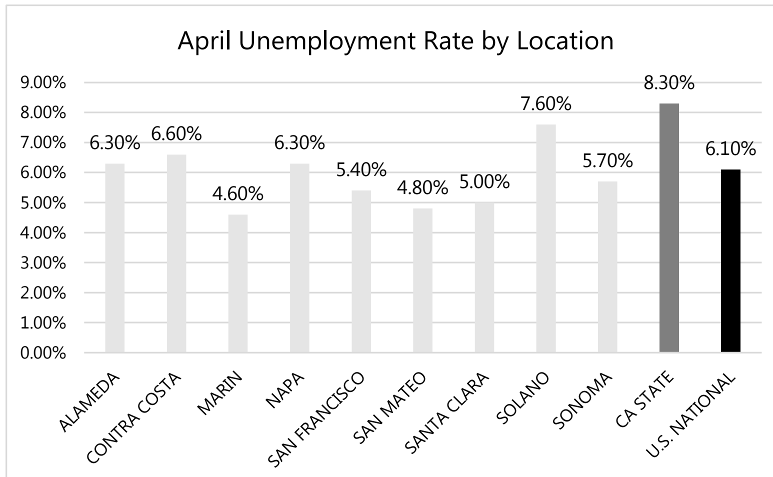
Takeaways: We expect inflation and higher commodity prices are here to stay for 2021. While specific materials may have reached their peak, prices will remain significantly elevated into 2022 driven by consumer demand and production lag, exacerbated by skilled and minimum-wage labor shortages.

In the face of rising prices and logistics issues, consider increasing how frequently you place orders and allow for longer lead times before resorting to holding more inventory. Higher order frequency can help average out rising costs without increasing inventory risk and tying up cash. Consider limited inventory increases on fast-moving products, critical or hard-to-find items, or low-risk products/materials that you are confident you can get cash out of.

Labor Shortage:

While it is tempting to compare the recovery after 2020 to the recovery after the Great Recession, four times more jobs were lost in 2020 than in 2009. 8.8% of all work hours were destroyed, or 255 million full-time jobs.[5] This marks one of the largest labor displacements in history – and its effects will be long lasting, with unemployment still at 6.1% nationally.

The picture in California, with a large share of its economy dependent on tourism, entertainment, and hospitality, is even more grim. Although it declined during the first quarter, statewide unemployment held at 8.3% during April. Alarmingly, much of the drop in the unemployment rate in the first quarter of the year was due to Californians *dropping out* of the labor force. The state now boasts one of the highest unemployment rates in the nation.

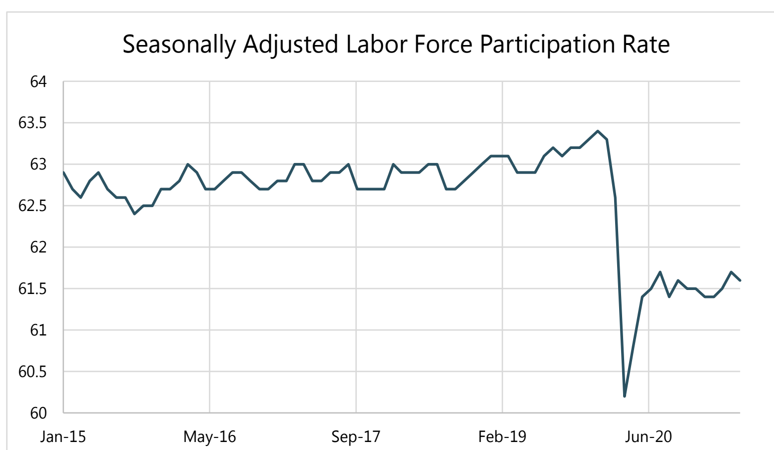


Source: California Employee Development Department, U.S. Bureau of Labor Statistics

The distribution of the problem is uneven, as the Bay Area, buoyed by technology and professional services industries that were able to work remotely, has a combined unemployment rate of only 5.69%.

Paradoxically, the number one problem facing business leaders right now is not high unemployment, but a shortage of workers who are willing to take the positions that are open. In early June, the U.S. Chamber of Commerce reported there were 8.1 million open positions across the U.S. as of March 2021 - which is a record. Some sectors, such as education and health services, have fewer available workers than open jobs. 67% of surveyed Chamber of Commerce leaders said finding workers was "very difficult", mirroring other surveys of business leaders.[6]

The causes of the labor shortage are now clear, and include childcare, compensation relative to unemployment benefits, and workers seeking work-life balance or a career change.

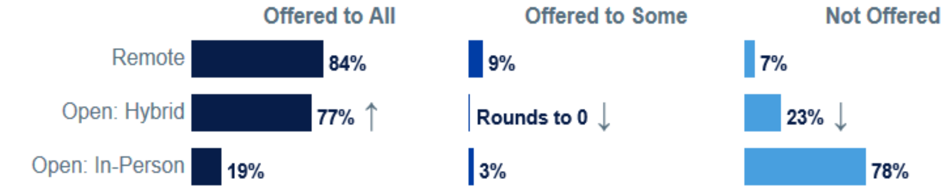


Source: United States Bureau of Labor Statistics

[5] United Nations. (2021, January 25). COVID led to 'massive' income and productivity losses, UN labour estimates show. Retrieved from UN News: https://news.un.org/en/story/2021/01/1082852

[6] U.S. Chamber of Commerce. (2021, June 1). *The America Works Report: Quantifying the Nation's Workforce Crisis*. Retrieved from U.S. Chamber of Commerce: https://www.uschamber.com/report/the-america-works-report-quantifying-the-nations-workforce-crisis

Childcare: While most California public schools are at least *partially* reopened for in-person instruction, many are not yet 100% in-person. As schools go on summer break, large numbers of public-school children still do not have access to full-time in-person education. Additionally, the CA state exemption which allows remote learning in public schools does not expire until June 30th. Compounding the problem is that schools in lower-income districts are less likely to be fully in-person than schools in more affluent neighborhoods. Workers in lower-income neighborhoods have the most difficulty arranging childcare for kids without in-person school, as their jobs are less likely to accommodate flexible scheduling or remote-work.



Source: Institute of Educational Sciences

Takeaways: This is a significant piece of the labor problem, particularly for low-income families and women who have not returned to the workforce. Consider flexible scheduling, remote or hybrid models. If your business does not support that flexibility, then predictable scheduling for hourly workers will help them arrange childcare at consistent times.

Explore programs to assist employees with childcare, such as Dependent Care Assistance Programs (DCAPs) which function like FSAs. DCAPs provide up to $5,000 tax-free childcare benefits to employees without paying the employer portion of Social Security or Medicare taxes either. In CA, businesses may also claim a 30% state tax credit on money put into a DCAP up to $360 per child.

Compensation: In 2021, the minimum wage for California employers (with more than 25 workers) is $14.00 per hour. Assuming a minimum wage worker can get 40 hours per week (this is frequently not the case), they could stand to earn $560 per week. That stands in contrast to CA state unemployment benefits, which have averaged between $280-$314 since the beginning of the pandemic.[7] When we factor in the $300 weekly federal unemployment benefit boost, the gap between minimum wage earnings and unemployment benefits effectively vanishes.

Keep in mind that not all hourly workers get 40 hours' worth of shifts per week. Some jobs (by design) limit workers to less than 30 hours, meaning that minimum wage earnings would be closer to $420 per week, or just 70% of what a worker could stand to make on unemployment. Practically speaking, at 25-30 hours per week, obtaining a second minimum wage job with a schedule that aligns with your first is quite difficult.

Takeaways: Pay increases are already happening, with companies like Chipotle and McDonald's leading the way. Expect this trend to continue for the first few months of the summer. Pent up demand for goods and services will encourage businesses to staff up and compete on wages – but remember that the federal unemployment boost expires on September 5th. At that point, the difference between UI payments and full-time employment at the CA state minimum wage will be restored and there will be a higher incentive for workers to seek employment.

Life Balance and Career Changes: In 2008 there was a 12% jump in college enrollment as many laid-off workers went back to school to change careers. As college campuses reopen, restoring the value-proposition of higher education, many of the Americans who lost their jobs in 2020 will follow the same or similar paths.

Meanwhile, other workers will try to maintain the work-life balance that remote work allows and will change jobs to do it. A recent Harris Poll found that 40% of Americans want to continue to work remotely, with 35% preferring a hybrid model. Only 25% want to go back to the office full time.

Takeaways: People want stable employment, and they want *careers* - not jobs. A clear progression up through the ranks of the company, job training, or educational benefits all help your employees see a future for themselves at your company. Employees also want to maintain or improve work-life balance, and employers who offer remote work or flexible scheduling

[7] California State Employment Development Department. (2021, June 14). *Unemployment Insurance – Statistics. https://edd.ca.gov/about_edd/pdf/qsui-Avg_WBA.pdf*

are going to attract better candidates in the labor market. Competition will ensure that remote work and flexible/hybrid scheduling models are here to stay.

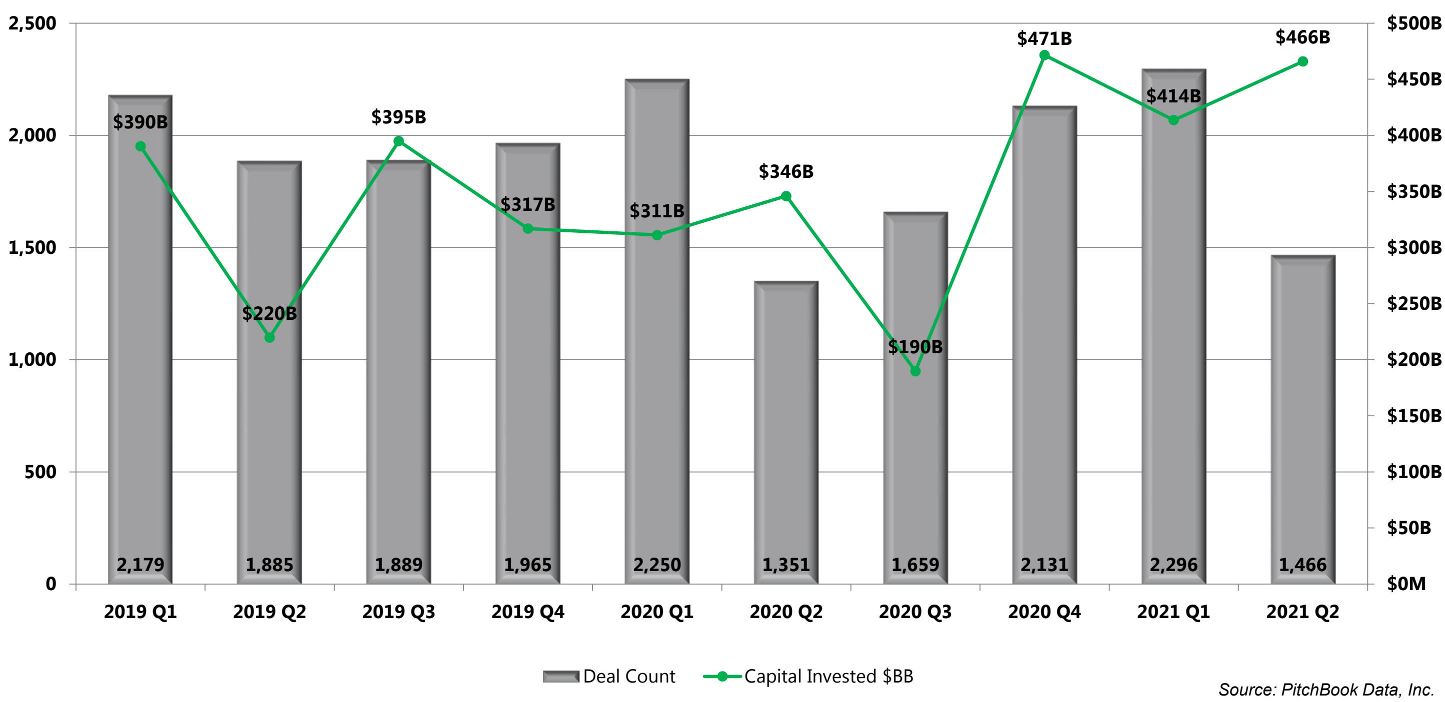
M&A Activity:

Buyer Activity and Available Capital: Private equity (PE) and SPACs may contribute a lot to M&A deal volume in 2021.[8] In 2020, financial sponsors, such as private equity firms, faced obvious headwinds in raising new capital, but also put less capital to work. The net effect is that by the end of 2020, they were sitting on a record $2.9 trillion of available capital.[8] This volume of "dry powder" (investment capital not committed) foreshadows an increase in financial sponsor-backed deals.

Similarly, capital is flowing into special purpose acquisition companies (SPACs) at a staggering pace. SPACs are shell companies that go public to raise funds (a so-called "blank check") to acquire or merge with a private company. Thus, creating a new pool of potential buy-side investors and greater access to capital without a corporate or PE buyer. In 2020, 248 new SPACs raised $82 billion in the U.S.—more than five times 2019's total volume.[8] While SPACs are expected to remain a more significant player in M&A, increased scrutiny by the SEC is likely to reduce the number of SPAC deals with extraordinary valuations.

Deal Activity, Trends, and Projections: The M&A recovery that began in the second half of 2020 is expected to accelerate during 2021. As shown above, the number of closed M&A transactions rose from 1,659 in Q3 of 2020 to 2,296 in Q1 of 2021. This positive trend is echoed by forecasts from industry-leading practitioners.

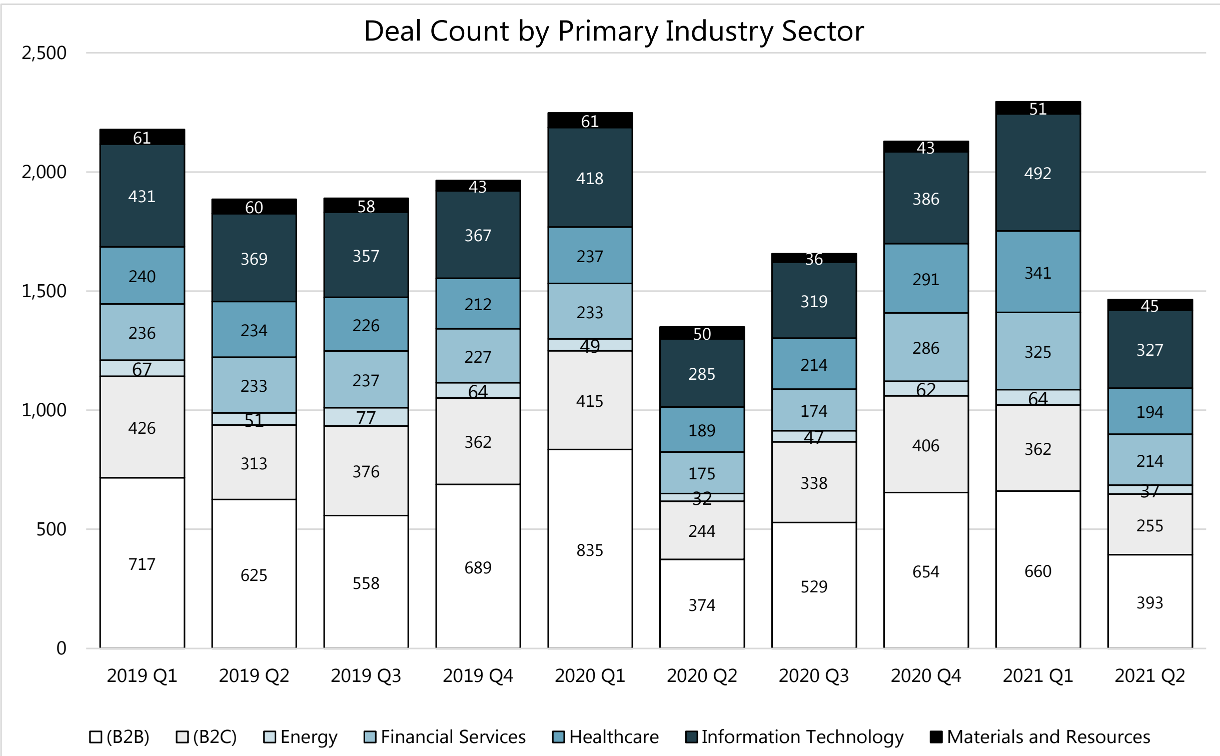
Deal Count and Capital Invested



Source: PitchBook Data, Inc.

[8] Healy Co-Head of Americas M&A, B., Healy, B., & M&A, C.-H. of A. (n.d.). *M&A in 2021: Recovery and Acceleration*. Morgan Stanley. https://www.morganstanley.com/ideas/mergers-and-acquisitions-outlook-2021-rebound-acceleration.

According to Rob Kindler, Global Head of M&A at Morgan Stanley. "All the elements are there for an active M&A market in 2021, from corporations looking for scale and growth to private equity firms and SPACs looking to invest capital."[9] There are multiple reasons why M&A activities are picking up. Two main causes of the hot M&A market are the historically low cost of capital, and the broader economic recovery as COVID-19 vaccines are successfully deployed. Motivations for these transactions vary, with some acquirers seeking growth and scale through consolidations within their industry and others trying to revamp their business models through cross-sector acquisitions. Many of these cross-sector deals involve non-tech companies buying tech firms or assets, which may help advance digital transformation.[10]



Source: PitchBook Data, Inc.

M&A data shows that most deals occurred within the Financial Services, Healthcare, and Information Technology sectors.

Tax Considerations: A final driver behind some transactions is a fear of higher taxes. The new administrations stated intent to raise capital gains and corporate income taxes, while cracking down on other tax minimization strategies, spurred many to accelerate go-to-market or acquisition plans. However, as we are nearing the close of Q2 2021, there have been no major revisions to the U.S. tax code. This is due to the focus of the new administration on prioritizing COVID-19 relief, and gridlock in government. Still, many business owners have indicated a desire to close transactions in 2021 in order to lock in the current tax structure.

Takeaways: M&A activity is hot and showing no signs of slowing down. Financial and strategic acquirers have significant amounts of capital to work with and are making up for lost time, while sell-side mandates that were paused during COVID-19 are going back out to market. We expect this trend to continue into 2022.

Whether or not business owners have a short or long-term exit plan, businesses should be prepared to take advantage of opportunities today. That means ensuring you have a growing, cash generating, scalable business model, and limit dependencies on key personnel, suppliers, and customers.

[9] Healy Co-Head of Americas M&A, B., Healy, B., & M&A, C.-H. of A. (n.d.). *M&A in 2021: Recovery and Acceleration*. Morgan Stanley. https://www.morganstanley.com/ideas/mergers-and-acquisitions-outlook-2021-rebound-acceleration.

[10] PricewaterhouseCoopers. (n.d.). *Deals industry insights*. PwC. https://www.pwc.com/us/en/services/deals/industry-insights.html.

About ClearPath Business Advisors:

ClearPath Business Advisors is a multi-faceted, high-end consulting & advisory firm delivering on our perspective that business owners should create a healthy, sellable business whether they plan to sell or not. Everything that builds a sellable business, creates a stronger business and a more balanced life for its leaders and teams.

We are a team of seasoned, multi-disciplinary business executives with finance, accounting, operations, sales, and legal expertise. We strive to become a part of our client's teams, working closely and alongside business owners and their management.

We are also a firm with a heart, guided by our core values in creating high value for our clients while delivering on our promise of being a different type of consulting and advisory firm. We lead with our core values of Integration, Convergence, Service, and Every|One, and we donate 25% of our M&A transaction success fees to charity.

Ultimately, we just want to work with good people who could use our help.

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