

M&A - Emerging from Crisis

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The first half of 2020 has presented governments, business and individuals with an unprecedented set of circumstances to grapple with. As thoughts start to turn towards emerging from the crisis, people around the world have started to consider what the “*new normal*” will look like. As they do so, what is increasingly apparent, is that there will be clear winners and losers arising from this war against an invisible and elusive enemy.

By way of economic background, the USA has ended its historic 128 months of economic growth and has entered a recession. It is widely anticipated that COVID-19 will push the world into a deep global recession too, albeit yet to be declared (due to the technical requirement for there to have been a sequential decline in GDP for two quarters), but already being forecast to be more widespread and devastating than the Global Financial Crisis on 2008-2009 and more akin to that seen in the Great Depression from 1929 - 1933.

In the Gulf, the regional economies (which have been traditionally dependant on the petro dollar) have been further impacted due to the turbulence in oil prices. A supply glut caused by a combination of lower demand (as a result of COVID 19), increased supply due to lack of agreement between OPEC and Russia (commonly referred to as OPEC+) and fierce competition from US producers has resulted in significantly deflated markets. Whilst these prices have recovered somewhat, the forecasted average prices for oil in 2020 and 2021 will be significantly below the averages of 2019 and this will directly affect public spending on development projects, which constitute a significant portion of regional GDP.

In response to the above crises, governments across the Gulf region have introduced stimulus packages to help support and bolster economic confidence. Much of the support to date has sought to enhance liquidity and reduce the impact of the current economic situation. For example, in the UAE, action has been taken by the Central Bank of the UAE in the form of a AED 100 billion (USD 27.2 billion) Economic Support Scheme for retail and corporate customers affected by COVID-19. The purpose of the scheme is to facilitate the provision of temporary relief (in terms of payments of principal and interest) on outstanding loans for affected customers in the UAE. Furthermore, the Abu Dhabi Executive Council has announced a stimulus package to support economic activity, reduce the costs of living, facilitate business in the Emirate and protect the UAE's economic stability. Similarly, the Saudi Arabian government has announced a SAR 120 billion (USD 31.9 billion) financial stimulus package to mitigate the economic effects of the COVID-19 outbreak in the Kingdom. This stimulus package is made up of SAR 70 billion (USD 18.6 billion) to support the private sector and SAR 50 billion (USD 13.3 billion) from the Saudi Central Bank to support banking sector liquidity.

However, whilst the support provided by governments has been welcomed by businesses and consumers alike, it is evident that COVID-19 has not affected all economic sectors equally and for some, such as hospitality, bricks and mortar retail and travel and tourism, negative cash-flow has been a prevailing theme of this crisis and has emptied the coffers of many businesses. Even within these sectors, the health of balance sheets going into this crisis was not uniform and as such each company's ability to weather the pandemic storm has been fundamentally different. In hindsight, large dividends or share buy-backs in recent financial years may have used up much needed cash at a time when the age-old adage of "cash is king" has never been so relevant.

Current M&A Market

In the run up to COVID-19 we have seen significant instability across the Middle East, this was evidenced by the 2019 Abqaiq-Khuras attacks, the assassination of Qasem Soleimani, Lebanon defaulting on debt for the first time and the seemingly never-ending consequences of the Arab Spring to name but a few. These regional issues were set on a wider stage of global uncertainty such as the rise in populism and nationalism – as emphasised by Brexit in Europe and the US / China trade war.

Despite this backdrop, the global equity indices reached historic peaks and we saw the longest bull-market in history - for example the S&P 500 and STOXX Europe 600 indices both closed at record highs on 19 February 2020. This gave some confidence to the private markets, but whilst deals were still being done, prices were largely seen as too high and the number of M&A deals globally was on a downward trend. Consequently, there was a record amount of dry powder being held by those waiting to make their move. Whilst COVID-19 was not on anyone's radar, a macroeconomic event leading to a market crash (or at least correction) was being discussed in financial hubs across the world.

In the wake of COVID-19, the few deals that were in the M&A pipeline have largely been put on hold or (more often than not) entirely kicked into the long-grass. Both buyers and sellers alike have returned to their trenches to re-evaluate their business plans and operational strategies. In the last week of April, no merger or acquisition worth more than \$1bn was announced anywhere in the world – notably, this was the first time this had happened since 2004.

We have already seen some very high-profile deals aborted (some not some gracefully) - the partial divestment by L Brands of Victoria's Secret to Sycamore publicly fell apart, Woodward and Hexcel terminated their multibillion-dollar aerospace merger and Xerox ended their hostile bid for US printmaker HP. Further, we have even seen the semblance of buyer's remorse on deals that are reported to have already completed!

We now face a health crisis, a financial crisis and a commodity price crisis and until we get a vaccine (or hit the point of herd immunity whilst waiting for a vaccine which experts say, could take 12-18 months) there will be no resumption of the "old normal".

Opportunities ahead

"In the midst of every crisis, lies great opportunity."- Albert Einstein

Those who emerge with strong balance sheets - think those who kept cash on their balance sheet during the 10-year bull market and those sectors which have had a “COVID-19 windfall” (such as technology providers, healthcare, grocery retailers and logistics companies), in addition to the usual players in the market such as private equity and sovereign wealth funds (into which there has been a flight of capital from those who fled the extreme volatility of the equity markets) - are likely to put their funds to use as war chests to snap up attractive assets which will create long-term value.

For others who exit the crisis in a less fortunate position, their decisions will need to focus around how to secure their balance sheet (think sectors such as travel, aviation, automotive, discretionary and non-essential retail and hospitality). This may come in the form of equity investments (for majority or minority stakes in the main trading business), an accelerated divestment of non-core divisions or by way of a consolidation of smaller players.

Whilst in the short term there are naturally going to be a number of distressed sales and restructurings picked up out of insolvency, the reality is that not many deals are going to be getting completed. However, for the prudent players out there, this lull in activity should be anything but quiet and the winners will be those who use this time to map out their M&A strategy and in doing so, are ready to pull the trigger at a time when there is enough certainty for it to be sensibly executed. Completions will happen when risk allocation is more clear as to what buyers are really buying and stepping into and sellers understand what they want (or need) to be selling.

During this time, buyers and sellers should be speaking to law firms, accountants and other M&A advisors with regard to getting a feel of the market and communicating an interest in exploring various avenues for their acquisition or disposal strategies.

“History doesn't repeat itself, but it often rhymes” – Mark Twain

Time and time again, as we have emerged from recession, vast fortunes have been made by those who make investments when markets are at their lowest. The sovereign wealth funds, in the GCC, have already been on a shopping spree, similar to that seen during the 2009 financial crisis. Saudi Arabia's Public Investment Fund has already reportedly taken advantage of low share prices and has acquired stakes worth at least \$7.7bn in US and European blue-chip companies in Q1 of 2020.

Whilst the later stages of physical due diligence are currently out of the picture (travel limitations prevent buyers from going to see if the business asset physically exists), buyers have already started hiring M&A teams to start preparing strategic thinking on when and how to realise their strategic goals and begin the first step of the M&A process such as target selection – these could be like-for-like acquisitions (to gain customers and obtain cost synergies), category or channel expansion (to develop a new product offering), supply chain acquisitions (to vertically integrate up or down in a value chain to guarantee availability and control of services required in the “new normal”) and/or the purchase of new platforms or know-how (as part of an omnichannel play). More shrewdly, there may be the opportunity to take advantage of goodwill in targets to add further strength to the balance sheet.

Alternatively, to the extent buyers already own a minority stake in a business which has not weathered the storm of COVID-19 particularly well, this may also be a good opportunity to

build a stake in a business they already know and are comfortable with. In a similar light, there may be the opportunity to buy out (partially or entirely) certain joint venture investors who need to raise funds for other investments which may not have performed as well.

During these times, it has been our experience that people are generally more open to having explorative conversations. A knowledge of what is happening with potential targets (or the ambitions of buyers) will ensure you are best placed to act fast and to meaningfully structure a deal which reflects what both parties really need and are looking for.

Buyers

“Cash combined with courage in a time of crisis is priceless” – Warren Buffett

Once a target has been selected, buyers may wish to alter the standard due diligence process to include COVID-19-related considerations such as a review of all major contracts of the target to understand the ability to perform or terminate obligations under those contracts (including material adverse effect and force majeure clauses), a more-than-usual assessment of solvency risk of the target and an assessment of its impact on covenants, if any, under any credit facilities used by the target and identifying supply chain risks and actions during and post COVID-19.

For buyers, strategies are likely to include not only the conventional expression of interest to existing shareholders (via management) but also the utilisation of loan to own transactions (which notably, were successfully implemented by certain sophisticated private equity funds in the aftermath of 2009) in which debt stacks are strategically bought at a discount and then such security is enforced to take ownership of the business.

Reportedly, banks have been restricting the amount of available acquisition finance as they instead focus on supporting existing client business needs. In addition, it should be considered that lenders may have difficulty accessing capital due to portfolio volatility and limited capital markets options which will result in a more risk-adverse approach and may, in turn, result in increased time in executing a transaction. As such, buyers should carry out a realistic assessment of balance-sheet strength and start to explore and engage in initial discussions with alternative funders such as unitranche debt, other private debt providers or investment grade bond issues as part of their playbook. This may also be an opportunity for large funds earmarked for offset programs to be used in the region. The key during this time will be to keep in touch with the investors/lenders and keep them fed with related information throughout the process.

Sellers

“By failing to prepare, you are preparing to fail” - Benjamin Franklin

For sellers, the most critical point is to evaluate whether this is the right time to sell their business and whether that business is ready to be sold so as to achieve the best value. If a seller is facing liquidity issues but this is not the best time to sell the business, they can consider other options, e.g. analysing cash disbursements to define critical and non-critical cash disbursements or a possible restructuring in order to reduce costs. If the business still needs to be re-capitalised, then sellers may wish to first evaluate other possibilities i.e. through refinancing, a

divestiture of a business line or asset or sale-lease back arrangement.

For those that decide to sell, shareholders and management can start working with advisors to prepare sale teasers, build data rooms and consider any pre-sale re-organisations which might need to take place to make the proposed transaction more attractive and to limit the requirement of any transitional service agreements.

In a similar vein, sellers can also start undertaking sell side legal and financial due diligence to start flushing out and fixing any red flags which could later hold up a transaction, lead to a price-chip or result in unnecessary withholdings or indemnities being given up as part of the sale documentation.. In addition to the usual contents of the data room, we expect buyers will want to see additional summaries and information to include the impact of COVID-19 on operations, supply chains, HR, quality of assets, financing, liquidity, commitments and contingencies.

Sellers can engage accountants to carry out an assessment of the accounts of the business, prepare details on commonly-contested items such as normalised working capital, cash like and debt like items for the particular business and also consider the presentation of a set of adjusted EBITDAC figures.

“If you are not moving forward, you are moving backward” - Mikhail Gorbachev

We envision that the use of “big data” for data-backed analysis on what the “new normal” will look like post COVID-19 will be key to executing the most efficient acquisition strategies, looking at consumer trends and market forecasts. Opportunities will therefore arise for those buyers and sellers getting ahead of the game as COVID-19 evolves.

Furthermore, buyers and sellers will also want to think about active engagement with shareholders and management teams in advance of any such transactions. A solid plan for shareholder communication and winning the support of management can be key in delivering on an accelerated transaction in a matter of weeks as opposed to months.

There is no fixed playbook on how this will all unfold, but ultimately, we expect a significant acceleration in M&A as the crisis stabilises. COVID-19 has required us all to step outside of our comfort zone in various elements of life and the M&A market and its execution will be no different. In our view, the likely winners will be those who engage in serious and bold consideration of their strategic options and the losers will be those who fail to act and get on top of what the future looks like as we emerge from the crisis.

Touching on the theme of “Emerging from Crisis”, Bracewell and BDO hosted a joint webinar discussing these issues on 13 July 2020. This webinar included a thought-provoking session looking at who will emerge from COVID-19 as winners and losers and what the M&A landscape is likely to look like in the near to medium term. To access a recording of this webinar, please click [here](#).

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