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Tomorrow's deal dynamics for mergers and acquisitions

By Ong Tiong Hooi
Partner of Transaction Services
PwC Vietnam

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There are several factors that potential investors must take into account before entering partnerships and determining the value of a deal

Today's economic environment is uncharted territory. The ways in which a business makes money in this new world will not necessarily be the same as before. Different skill sets are required, technological transformation will need to be accelerated, and supply chains may need to be adapted or localised.

What is clear is that the strategic rationale for seeking a deal has not changed and everything companies have needed to complete a transaction is still in place. This view is supported by a quarter of respondents in a recent PwC COVID-19 survey of more than 900 global CFOs, stating they would use mergers and acquisitions (M&A) to rebuild or enhance their company's revenue streams.

However, the economic recession brought by the pandemic has affected the deals landscape. Based on what we have seen to date, it appears that some deals will be a matter of survival. Others will be purely opportunistic and tactical, as new opportunities emerge and weaker businesses flounder – but many will be driven by a need to adapt quickly to a future that looks very different from before.

Thankfully it is not all doom and gloom. In the latest Euromonitor M&A Investment Index report, Vietnam was ranked the world's second-most attractive M&A market out of 50 economies. This reflects the expected level of investment, activity, and attractiveness of the global M&A market amid macroeconomic and financial shocks. In short, Vietnam has emerged as a safe and attractive M&A investment destination.

Companies that approach M&A as part of a long-term strategic plan will be in a better position to capitalise on the opportunities presented in this challenging climate. In addition, history shows that those who engage in M&A early in periods of economic uncertainty see higher average returns than those who wait.

For a deal strategy to thrive in 2020 and beyond, it is helpful to understand the broader dynamics that can influence current performance and future expectations that relate to deal making. This can be done through five new drivers that could influence deals in a post pandemic world.

Firstly, this crisis is different. The majority of companies across industries are facing fundamental changes in their business, from changing consumer behaviour to new challenges in workforce management. This is unlike previous recessions in which business challenges were about driving an organisation's evolution or pulling off large-scale growth.

Next, sector success is widely dispersed. There have been different business results seen in the current market, at both the sector and individual company level. Certain businesses are struggling to convince buyers that their fundamentals are still sound and that any mishaps are only temporary. Other companies are stable or even thriving as workforce, data, technology, and other needs and practices are evolving. For these companies, their focus will likely be on how to execute a transaction in a time of high growth while avoiding the broader value compression in the deals market.

Third, business models are transforming. Shifting priorities and limited management capabilities have increased uncertainty in achieving the transformations necessary to stay competitive. Transformational initiatives such as those pertaining to branding, market strategies, and geographic expansion will affect businesses' baseline earnings power and market or sector relevance. One big question that remains to be answered is what happens to businesses and their earnings when these actions are deferred.

In addition, carve-outs and divestitures have more appeal. Consistent with behaviours in past recessions, some companies will try to reposition themselves or raise funds by selling pieces of their organisation. While we do expect more carve-outs in the near future, the nature of these assets is more difficult to assess. Carve-outs have more uncertain earning profiles since they rely on certain centralised functions of the overall company. Earnouts can be a potential insurance policy against the risk of the decreased operability of a carved-out entity.

Lastly, credit markets tighten temporarily. Short-term compression of the credit market can affect valuations. While credit market compression may be temporary, a reduction in enterprise value due to limited credit available to execute a transaction has a permanent impact on transaction value for both buyers and sellers, making it even more difficult to bridge the value gap when closing a transaction.

It can be tempting to chase an acquisition simply because it becomes available. It is important to also evaluate how an individual deal might affect other potential transactions that could be necessary for executing the company's overall growth plans. Considerations in three key areas will help businesses determine the implications for deal value.

Strategic positioning

It is important to identify where value accrues in the value chain to determine where a company should participate directly. Given that the basic beliefs around consumer behaviours may no longer apply, businesses will need to adapt as different sectors, products and services thrive in the new environment.

In connection to this, companies should closely examine the recovery trajectories for targeted markets in both the short term and long term and recognise that different capabilities are needed to capture the greatest value.

Capital efficiency

This new M&A landscape has given rise to a refocus on capital allocation. Investors need the discipline to redeploy if returns on capital are not appropriate and to divest under-returning (not necessarily under-performing) businesses. Where possible, businesses should consider calibrating working-capital investment with value-chain alignment and where payback and returns drive further investment, capital expenditures should be deployed.

In addition, attention should be given to tax efficiency, debt and capital structure optimisation, and to sources of capital that are best suited to the organisation's business model.

Operational excellence

There are ongoing and potential disruptions in terms of business operations, given the current impacts of COVID-19. New opportunities that embrace technology are rising. Besides addressing supply-chain reconfigurations with an emphasis on resilience, there are questions businesses should ask relating to operational excellence.

Such questions include: what inorganic opportunities are there for capturing a greater share of the value chain? What levers are available to create greater value, from channels, market and, pricing to supply chain, production, and talent? Which capabilities should be focused upon – outsourced capabilities or your organisation's own? And how can best practices be implemented around aspects of talent and safety in the work environment?

Dealmakers are accustomed to facing uncertainty, but the scale and speed of COVID-19 have shocked both the global economy and the M&A market. It appears that volatility will be here to stay. We have already seen convergence across industries as technology continues to disrupt and fundamentally change many business models. Multinational organisations will also need to learn how to navigate in an increasingly localised world. There is a definite opportunity for companies to seize the moment and rethink M&A strategy and adapt it to their long-term strategy.■

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