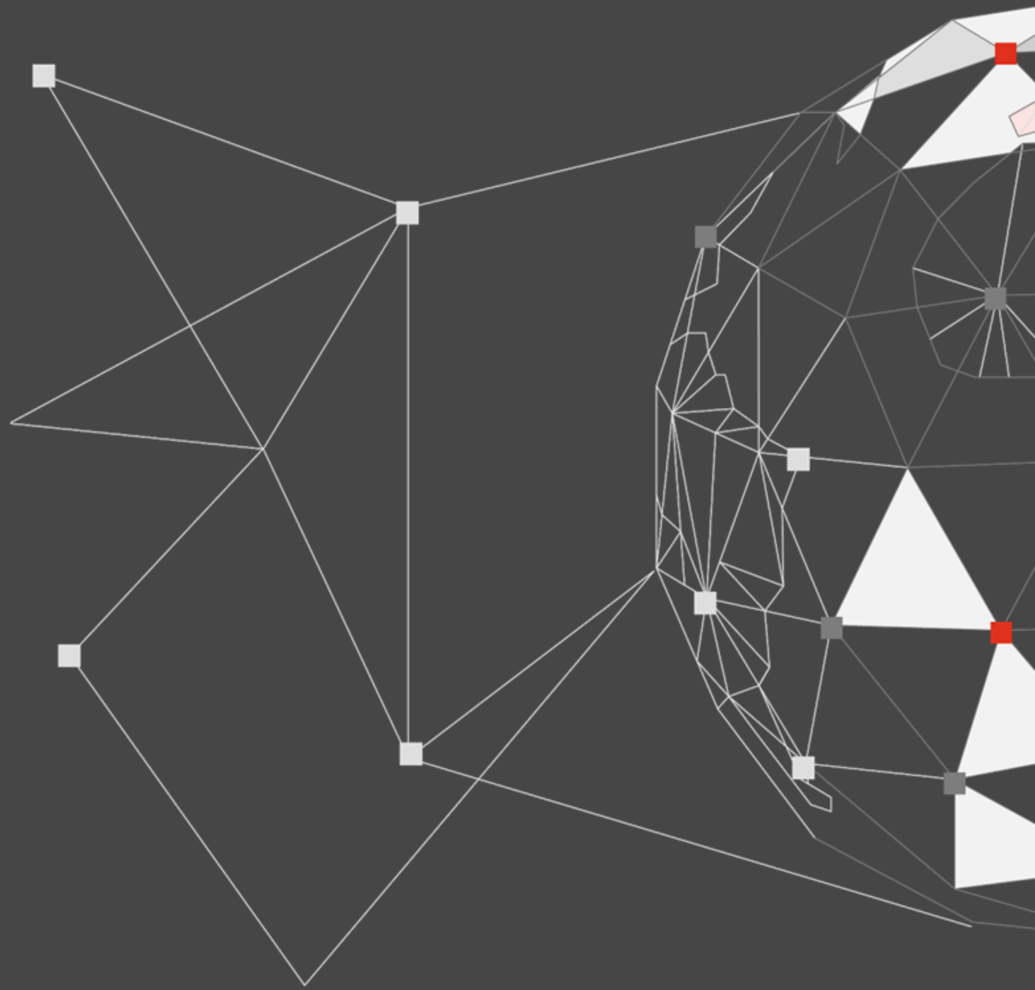
Deal considerations

in a COVID-19 world

pwc

Companies that made deals during uncertain times may outperform their industry peers

The view that companies should pursue acquisitions in a downturn is contrary to traditional thinking. But it's shaped by an understanding of what propelled past M&A cycles—the historical relationship between M&A and various economic and financial drivers—and what's different today.



Never more so is robust diligence required to establish and understand the financials of the target business. Different industries, sectors and geographies will have been impacted in varying ways.

Source: Succeeding through M&A in uncertain economic times (link)

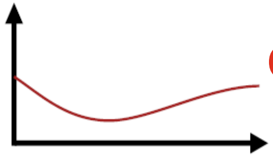
Recovery trajectories are expected to vary significantly across different industries and sectors

We illustrate below 6 potential revenue outlooks and their corresponding description and example markets

Down but not out

Demand suppressed or restricted during outbreak and never recovers to the baseline.

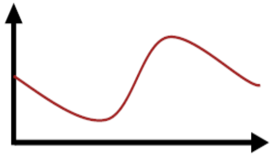
Example markets: Cruise lines, movie theatres, bricks and mortar retail, etc.



Gradual recovery

Demand falls during outbreak and slowly recovers to baseline.

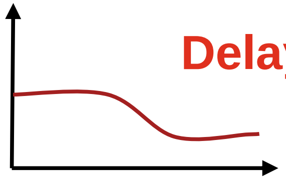
Example markets: Airlines, automotive, casinos and gaming, home furnishings, theme parks, elective surgery, Media production, etc.



Bounce back

Demand suppressed or restricted during outbreak but later spikes as a result of pent up or deferred demand.

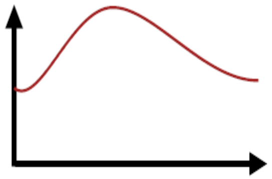
Example markets: Dentistry, salon / spa services, household appliances, smartphones, clinical trials, live events ticketing, employment agencies, etc.



Delayed impact

Demand is locked in for the immediate future with impacts felt in later periods.

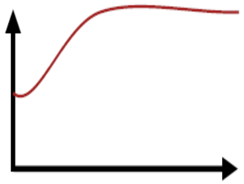
Example markets: Subscription based services, construction and other contracted services, etc.



Sugar rush

Demand surges in response to outbreak but stabilises at baseline over time.

Example markets: Grocery staples, personal hygiene and cleaning, packaged foods, at home fitness, Home improvement, OTC pharmaceuticals, consumer media, etc.



Step up

Demand surges in response to outbreak and sustains growth due to consumer behavioural changes.

Example markets: Video conferencing, telehealth, grocery delivery service, virtual education, streaming services, e-commerce site builders / hosts, cyber security and etc.

Source: Strategy&

Any deal consideration should take into account these 8 key areas

Value drivers

To what extent was the company impacted and have the key drivers that caused a destruction in value now abated to the point where the business can be considered stable? If there was a pick up in activity, is the benefit going to be lasting?

Data for decision making

Is the company able to generate the right level of information in a timely fashion in order to inform decision making? Have scenarios been considered?

Changing market conditions

How has the competitive landscape and relevant consumer habits changed as a result of COVID-19? Are these temporary or will they be sustained?

Acceleration of trends

Which industry and societal trends have been accelerated as a result of COVID-19 (e.g. working remotely, social distancing, digital strategy, shifts in consumer preferences)?

Health considerations

How will the longer term impacts of health considerations change the industry? Can the company adapt to these?

Extent of impact

Will the company be able to weather the storm and return to pre-COVID-19 levels (unlikely in many cases), or is there a “new normal” that needs to be considered?

Positioned for growth

Is the company able to seize opportunities that will allow it to grow and create value post the crisis?

Government measures

What level of government and industry assistance has been made available (e.g. Defer tax payment and land rental deadline extension under Decree 41)?

How companies quantify and explain the impact of COVID-19 to key stakeholders is important

FY19 / Last 12 month (LTM) pre-COVID-19

Represents the last “pure” period for historical analysis, and a comparative for future projections.

YTD20

Divide pre-COVID trading from the impacted period, assessing KPIs throughout (i.e. before, during and after)

FY20 outturn

Importance of understanding as much granular detail as available, including KPIs (financial and non-financial) to give as accurate an indication of the short-term future trading of the company.

FY21 projections

The company needs to adapt their operations to the many possible outcomes that may be ahead. The ability to create plausible, structured and transparent scenarios to allow for this variability will be key.

Longer-term - as we transition to what’s next

What will be the “new normal” for the business / sub-sector it operates in? Additional consideration should be given to longer term projections, built around different recovery scenarios.

When normalising earnings for COVID-19 related items, adjustments need to be supported

YTD20

Quality of Earnings

Ideally, companies put in place real-time tracking of COVID-19 impact to underpin decision making with quantifiable evidence. This may enable us to better assess management's actions and any proposed adjustments in diligence. In instances of less robust financial reporting, rigorous diligence will be needed, more so than in any other times, in order to understand the underlying value drivers and impact of COVID-19 on the growth profile of the business.

To quantify potential adjustments, best practices suggest they are:

- Well supported - not relying on too many assumptions
- Assessed over short periods (e.g. monthly)
- Calculated as discrete items (i.e. no high level calculations)
- Evaluated for impact across all P&L accounts
- For pro forma adjustments, consider if the company has operated on a "normal" basis in recent periods to support any adjustment
- Triangulated with any balance sheet impact / adjustments.

Duration of impact needs to be considered, i.e. temporary vs. permanent, to determine if a one-time or pro forma adjustment is warranted. Continually reassess the underlying facts and circumstances (given the ongoing evolution of the health and economic environment).

Less confidence would be placed on adjustments attempting to simply normalise the P&L to a pre-COVID level (i.e. "as if" scenario without the crisis), as it is probably not realistic and not meaningful as it would likely involve too many assumptions.

Type of Adjustment	Criteria / Examples
One-time / Non-recurring	Adjustments to revenues / costs for items which are non-recurring in nature, for example: 1. Employee severance due to short-term restructuring; 2. Costs to accommodate social distancing (beyond what are the new recurring amounts); 3. Costs to resume operations after a shutdown period; 4. One-time income from customer penalties.
Pro forma / Run rate	Revenues / costs in the historical periods (pre-COVID or COVID period) adjusted to the run rate level based on what is determined to be the "new normal", for example, due to: 1. Newly negotiated pricing with customers or vendors; 2. Returning to pre-COVID-19 revenue levels or costs to operate the business; 3. Fundamental change to business model which impacts profitability.
Other Consideration	Potential adjustment has COVID-19 related attributes but: 1. Cannot fully assess across both revenues and costs; 2. The duration and magnitude of the impact is unclear. These items would likely not be considered for normalised / pro forma EBITDA, but rather presented for other considerations.

FY20 outturn

Detailed focus on current trading trends is critical in order to assess a range of potential future performance scenarios

Current year trading

We highlight the importance of splitting historical trading into i) pre-COVID-19; and ii) post-COVID-19 periods in order to pick up a step or structural change in the business trends. Pre-COVID-19 periods or run-rate based on recent results can be used as a benchmark for future projections.

When analyzing historical profitability and trends, it is important to consider both financial and non-financial KPIs to understand the key underlying drivers of performance.

We recommend assessing granular transactional data (e.g. daily, weekly, monthly) to fully understand the impact of COVID-19 on the business and also, to the extent information is already available, the trends in the recovery phase.

Rigorous diligence would look beyond traditional financial data and blend financial with other macro economic, market and health data to understand the trends and assess the impact on the business comprehensively.

Current year outturn and projections

Current Year Outturn may not be a long-term indicator of performance, or indeed a base year for valuation, but it is important for cash generation and discounted cash flow (DCF) models.

Projections will need robust commercial insight due to current uncertainty, with investors potentially valuing businesses based on a view of a "new normal" to be achieved in FY21/FY22.

There will be fundamental reliance on integrating commercial and operational views, to arrive at a range of scenarios rather than "the answer". In addition, there is a possibility of an economic downturn / recession, triggered by COVID-19, which adds uncertainty to determination of a "new normal".

Historical growth trends may become irrelevant, given the likelihood of the "new normal" operating model / environment, but the most recent "clean" historical LTM period or run-rate based on recent results (i.e. pre-COVID) will be an important benchmark in assessing the reasonableness of any projections. Additional focus will need to be placed on the business model resilience and value drivers in due diligence.

It is important to note that due to the unprecedented impact of the pandemic, in reality there may be wide-ranging scenarios and significant variations to projections. From a buyer's perspective, M&A transactions will need to include sufficient downside protection, such as the use of an earn-out structure. We discuss SPA* considerations in more depth later in this document.

The more post-COVID recovery data available (not just from the company and local market but also from other countries that have exited lockdown earlier), the more informed views will be, and therefore, the narrower the range of scenarios.

*sale and purchase agreement

It is likely that companies may have taken on an increased debt burden to manage short term liquidity issues

FY20 outturn
FY21 projection

Net debt and debt-like items

In addition to the typical debt and debt-like items, we are expecting to see items relating to COVID-19 to be treated as net debt or be subject to indemnity in any sale and purchase agreement, for example:

- Earnings related exposures - if there is one-time COVID-19 related income or cost excluded from adjusted earnings, any related balance sheet items that result in a future cash outflow (or inflow) would be included in net debt
- Items stemming from contractual obligations with suppliers and payment deferrals, e.g. penalties for not meeting minimum purchase commitments, late payments penalties, deferred capex
- Employee liabilities, e.g. deferral of bonuses, compensation, restructuring and severance liabilities, pensions
- Government stimulus, e.g. tax incentives (deferral of VAT / payroll taxes), borrowing schemes to extent not forgivable, repayments of government aid relating to certain type of spend
- Contingent liabilities, as there is a higher risk of fines and litigation (e.g. inappropriately accessing government funding, customer claims, etc.)

Further liquidity considerations

1. It is likely that the company will have taken on an increased debt burden to manage short term liquidity issues, including full drawdown of existing facilities, as well as new, refinanced or restructured bank facilities and COVID-19 specific government backed lending schemes.
2. Principal and interest payments may be deferred, with significant balance sheet amounts accrued. There may also be unpaid fees or penalties for new or existing debt. Often fees incurred are capitalised, with debt presented on balance sheet net of such fees.
3. As companies raise / restructure debt and get government funding, it impacts the overall leverage. Impact on covenants and ability to leverage the company further need to be assessed (scenario analysis may be performed on the compliance of loan covenants).
4. Lenders may be less willing to offer or renew certain forms of finance, e.g. factoring, if the quality of the underlying assets used as collateral for the finance is perceived to have deteriorated as a result of COVID-19.
5. The tax implications of debt forgiveness or restructuring should be considered carefully so as to avoid risk to the buyer of future unexpected cash outflows.

COVID-19 is likely to have a significant impact (temporary or permanent) on net working capital and cash flows

FY20 outturn
FY21 projection

Net working capital

Net working capital (NWC) levels are likely to be impacted by i) external factors, e.g. governmental measures to aid solvency in the sector, customers and suppliers actions outside of the company's control, lenders not renewing certain forms of finance (e.g. factoring) (ii) measures driven by the company in the lockdown period and in the short-term to manage working capital (procurement, inventory management, renegotiation of contractual payment terms), and (iii) structural measures, either operational or commercial in the medium-to-long term. In each case, it is important to consider if the impact is temporary (and, if so, whether reversed prior to planned exit) or may be permanent.

For normalised NWC assessment in COVID-19 environment:

- Depending on the duration of impact, one-time or structural pro forma adjustments to NWC may be required.
- NWC impact of Quality of Earning (QofE) adjustments as well as items with a pure balance sheet impact would need to be considered.
- Additional rigor is required to analyse days outstanding (for receivables, payables and inventory), the composition of the balances, and potentially use benchmarking.

When setting the target NWC:

- Consideration of the "new normal" recurring revenue and profitability, time it will take to get to this level, and NWC required to support it would need to be given.
- Consider looking at more recent NWC balances for reference (rather than just the last 12 months), as historical balances become less relevant. In addition, an understanding of any changes in terms of trade as a result of COVID-19, and the likely permanence of any such changes, will be key to cutting through the 'noise' in recent NWC balances, e.g. a temporary revenue decline reducing receivables as a result of COVID-19.

Cash flows

It is important to consider net cash flows in pre-, during, and post-COVID-19 environments to assess the company's ability to raise and service additional debt.

Companies are likely to be in a 'cash-burn' scenario, with significant non-operating outflows (e.g. projected restructuring costs) and financing considerations.

Attention will likely need to be paid to short-term cash flows and cash runway analyses in order to assess liquidity and when the business may run out of cash.

Consider presenting scenario-based outcomes for the Current Year Outturn and 3-year projections, similarly to the methodology used for the P&L.

Capex analysis should consider any delayed capex and required catch-up (e.g. contractual or regulatory capex, capex underspend, etc.). Funds required to 'catch-up' the capex spend could be included as a debt-like item.

Expect a general shift in mechanisms and SPA terms that reflect a Buyers' market

The use of locked box mechanisms (frequently used in Europe) will decrease as buyers are less willing to bear the trading risk between the Locked Box Date and Completion (which is the economic effect of a locked box mechanism). We expect buyers to resist the use of pre-COVID-19 balance sheets for any remaining locked box mechanisms due to concerns about the recoverability of assets. There will be a corresponding increase in the use of completion accounts mechanisms as the economic effect of such mechanisms is that risk passes at completion and that any COVID-19 losses up to completion are accurately reflected in price.

We expect to see an increase in earn-outs: buyers are pushing to defer purchase price to subsequent years given uncertainty around projections and valuations as a result of COVID-19. Parties should decide on whether adjustments related to COVID-19 will be considered for earn-out considerations, recognising that such adjustments are likely to be subjective and, therefore, open to dispute. Parties may want to consider whether earn-out metrics should be measured after COVID-19 effects are expected to have reduced (although, again, this will be subjective).

Accounting Principles: sellers are likely to continue to use accounting hierarchies with specific policies around reserves. Buyers may prefer to be more flexible and introduce GAAP/IFRS prevailing language over past practices, given that past practice is unlikely to have taken account of COVID-19 effects.

Government loans/subsidies: any government loan amount that will not be forgiven needs to be treated as Indebtedness. The timeline for determining forgiveness may be uncertain.

Recently, we have seen some parties exclude these government loans from pricing, and either introduce a separate mechanism (for the purposes of not being beholden to the true-up mechanism timeline) whereby if the government loan is not forgiven, Seller will reimburse Buyer for any unforgiven amounts or address it through indemnification.

We have also seen Buyers considering setting aside escrows for these amounts for further protection. Furthermore, Buyers may consider introducing conduct of business restrictions around these loans to ensure Sellers comply with the terms.

Financial Statements representation: Buyers may consider seeking for additional representations and warranties over key/judgmental balance sheet reserves (e.g. inventory).

The impact from any subsequent waves may look different than from the first

How resilient are businesses and how have they adapted their business models? As companies potentially re-emerge, the risk of a second wave persists. New waves may be limited to certain local hot spots or ignite again around the globe.

External support from government and other public authorities may be limited in its magnitude for a second wave, as public debt levels have already significantly increased.

Stakeholders will be interested in understanding the impact on the business model and its resilience level after the first wave, in particular:

- What measures have been implemented by the company since the first wave (e.g. adjust product / services mix, sales channel, shift to regional / local sourcing of materials, diversification of supply chain, shift to remote working) to preserve value of the business?
- What areas are likely to be impacted in a second wave? What duration and depth of a second wave can the company sustain?
- How flexible can the company be / how quickly can it react, with respect to shift in demand, interruptions in supply chain, staff workload?
- Which remaining options post-COVID-19 can be used (after exhausting cash reserves, etc.)
- What areas are still lacking management attention (i.e. a second wave will hit the company unprepared)?

Effectiveness of the management's response, actions taken, and short-term impact may be important in assessment of management and resilience of the business.

One of the ways to assess the company's resilience facing a potential second wave is to run a simplified stress test with multiple scenarios (e.g. assume a local spread of the virus, or a recurrence of the global spread).

It will be important to assess the impact on cash flows if the second wave hits, as the impact may not be the same as during the first wave.

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