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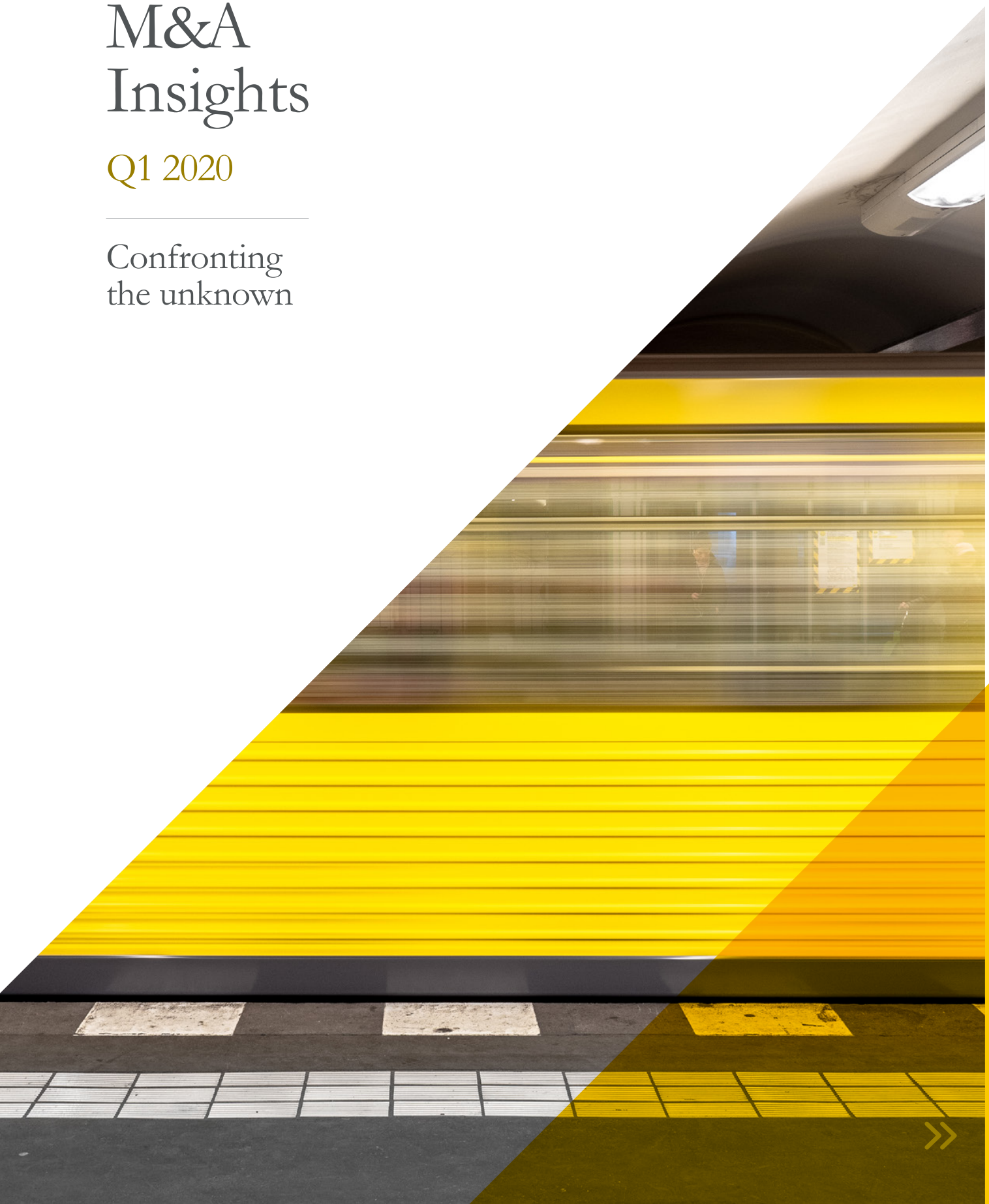
Confronting the unknown



Covid-19 coronavirus: Confronting the unknown

The Covid-19 coronavirus pandemic is bringing the global transactions market to a near standstill with a sharp slowdown in dealmaking likely to persist until the public health crisis is brought under control. Even then, the market, and the motivations of investors, may look very different.

During the record-breaking bull run in global transactions that began more than six years ago, it has at times felt like the M&A market had become impervious to external shocks.

Despite the mounting economic and geopolitical uncertainties of recent years, investors have remained remarkably sanguine, and markets, with some inevitable peaks and troughs, have stayed at or close to historic highs.

Although the question of when this extended cycle would end had increasingly nagged at the minds of market watchers, it had begun to feel like almost nothing could shake the nerves of investors who, buoyed by strong fundamentals, were often determined to carry out huge, highly strategic deals.

While all cycles do eventually end, few guessed that it would be one catastrophic event that would eventually drag the market to a sudden halt, but the onset of the coronavirus (Covid-19) pandemic has done just that – at least in the short term.

As growing numbers of countries move into "lockdown" to contain the spread of the virus, it is no exaggeration to say that the pandemic has, in just a few weeks, changed the world, and will potentially have a much longer lasting effect.

Its impact is felt most obviously in our daily personal and working lives and in the travails of companies across most sectors now struggling, at best, to navigate this period of unpredicted adversity and, at worst, fighting for their very survival.

This outbreak has also provoked the most intense volatility in equity markets since the Global Financial Crisis (GFC), with investors apparently unmoved in the early days by unprecedented interventions from governments and central banks to bring a sense of certainty in a time of deep economic insecurity.

In this environment, global M&A markets are expected to go into reverse after their longest ever period of sustained growth, with the likelihood that activity will remain minimal until it is clear the pandemic has passed its peak and some sense of real social stability has been restored. Data from 20 March 2020 already showed a dip of 18% in value, and a 16% decrease in volume from Q1 2019. As at 20 March, Q1 2020 was the weakest quarter since Q3 2004[1]. However, it is clear that these numbers do not reflect the full impact that the pandemic will have on M&A activity.

[1] Refinitiv – note these figures represent deals announced between 1 January and 20 March 2020.

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Initial impact

The crisis has had an immediate impact on deal activity, and across our global network we have seen that impact follow a familiar pattern.

As the pandemic has spread, transactions at an advanced stage have often continued as dealmakers hurry to get them across the line. We have seen some investors push through deals at swift speed, and a rapid, noticeable spike in clients asking if they can get out of agreements entered into, whether the crisis classifies as a material adverse change (MAC) or Force Majeure event, or if pre-completion covenants can be challenged. Even in the U.S., where MAC clauses are more common than in most jurisdictions, our advice has been that, for now, buyers have little legal leeway to get out of agreements, provided that all other conditions are met.

Extreme volatility knocks investor confidence, and wariness and extreme caution are the words that describe the mood of buyers and sellers in most markets right now.

For instance, we have seen examples of bidders trying to buy time and extend processes to get a better sense of where things are heading. Sellers, although eager at first to secure deals on higher terms, are seeing their valuation assumptions challenged and are increasingly also taking the view that it might be better to wait it out.

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Activity here has slowed very sharply, with the majority of such deals being either abandoned or put on hold indefinitely. That has left the short-term pipeline of deals suddenly running very dry for the first time in many years.

It is possible that as a result of the uncertainty, different types of deals will start to come into the pipeline. For example, distressed deals, restructurings, consolidations and state interventions are likely to come to the fore as some companies struggle to stand up to the pandemic. We expect this may be the case in sectors such as travel and tourism, which have been hit particularly hard by the disruption of the outbreak.

Even if there is a small uptick in distressed deals in the coming weeks, we fully expect the drought in new processes to continue until some semblance of stability is restored. At best, that could be the summer or maybe the autumn, but all bets are off while so much uncertainty and anxiety abounds.

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Logistics and valuations

Two factors are at play here: logistics, and the severe difficulty of valuing assets in this febrile environment.

Deal processes traditionally have involved high levels of human interaction, and that remains the case even though we are seeing automation, AI and data analytics feature increasingly in transactions, particularly during the laborious task of doing due diligence. Indeed, we have recently closed a near USD1 billion investment in China almost entirely remotely.

While some argue that this crisis will, in essence, be like the asteroid that made dinosaurs extinct, and hurry in the era of virtual dealmaking, for many investors the preference remains to transact in person. How do you progress a transaction if you cannot travel to management presentations, meet with shareholders, or get a hands-on feel for what you are buying?

The pandemic has also made it very difficult to place a value on assets. It struck at high speed and rendered most companies' business plans immediately out of date. They have not yet been able to assess, with any certainty, what impact it will have on their future earnings and, without reliable financial projections, it is very hard to price a deal.

Even if the buyer has an understanding of the intrinsic value of a target business, other factors may be at play, and act as a deterrent. Shareholders of public companies – worried about how long the crisis will last and how deeply it will damage earnings – will be putting pressure on boards to conserve cash rather than splash out on M&A. Even PE funds, free of such shareholder pressure but often under higher pressure to invest their accumulated dry powder, will probably want to wait until they have a better perspective on valuations.

We are seeing some novel tactics being deployed. In a highly unusual move, Xerox has, for example, publically withdrawn its hostile USD34bn bid for HP, arguing that it needs to safeguard the health and wellbeing of employees and affiliates during the Covid-19 coronavirus outbreak. By contrast in Germany – where public offers cannot be postponed or withdrawn once made – those unlucky enough to have submitted bids before stock markets went into freefall have no choice but to ride out the storm.

Against this backdrop, investors remain anxious as the pandemic takes its course. Investors in China, for instance, pushed the pause button in late January hoping that stringent efforts to contain the virus would prove effective, as they have, allowing economic life to begin to return to normal.

By mid-March – with cases elsewhere in the world outnumbering those in China for the first time – they were, in common with investors around the world, quickly adjusting to the new reality of a global health crisis with the power to spark a global recession.

Across Europe, the U.S. and Australia, deal activity has slumped dramatically with companies quickly turning their attention to conserving liquidity and finding ways to trade their way through the crisis while keeping their employees and their own families safe, often in an environment where political leadership has been, at best, unclear.

Even in jurisdictions where the impact of the crisis has been felt later, the Middle East and Latin America for instance, the outlook for new transactions in the pipeline has become increasingly clouded, even if some existing processes, some very sizeable, remain busy and are proceeding as planned.

Overall, it's important to remember that this is a public health crisis and a human tragedy rather than an M&A market event. The downturn in activity is, therefore, likely to persist until there is some greater clarity about the likely trajectory of the pandemic – and, for now, that still seems some way off.

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But for how long?

Right now, fear abounds and questions are in more plentiful supply than answers. But, seeking cues about when and how normal life will resume – albeit surely in a dramatically changed fashion – can also be reassuring and a welcome focus on the future.

It is very difficult to predict how long this initial stage will last, and how quickly activity will pick up once it is past its peak. Is it possible to find some clues in past events? For instance in 2009, after the GFC – the last time the M&A market experienced anything like this kind of slump – there was a six-month hiatus before levels of activity picked rapidly up.

Yet, there are big differences between the two scenarios. The GFC stemmed from banks and companies overburdening themselves with debt through an asset pricing bubble. This time banks have more robust capital bases and company balance sheets were stronger ahead of the crisis, but, here, we are already seeing supply chains under severe pressure and markets collapse in a wide range of sectors, notably in aviation, travel, hospitality, sport, construction and manufacturing, with the likelihood that solid businesses could go to the wall or need significant bailouts. Mass job losses could have a secondary effect on banks, not least as low interest rates have encouraged households in many jurisdictions to accumulate high levels of debt, leaving them with limited savings to see them through.

Given that level of anticipated deep disruption to numerous sectors, it is not surprising that we are already seeing a significant pick up in restructuring work. A return to M&A activity will, as we've argued, take longer to materialise.

But when global economic activity does in time return – including, eventually, mergers and acquisitions as one critical measure of business confidence – it could involve a very wide range of deal tactics. Alongside conventional bid activity, we could see boards considering recapitalisation proposals, joint ventures, disposals of non-core assets, consolidation moves to achieve much needed cost efficiencies and efforts to do deals that help companies to re-engineer supply chains.

One salient lesson from the financial crisis is that, in the early days, companies may have to focus on deals that increase their liquidity. To do so they may well be forced to sell good, high-value assets (rather than poorly performing ones) that, in better times, they would perhaps have preferred to retain.

However, once the transaction market does begin to revive, buyers and sellers could find themselves facing a familiar conundrum that was apparent before the crisis ensued – that their relative price expectations remain wildly out of line, which could in turn lead to litigation over management decisions as people look to extract value.

Intervention

The shape of the market will depend in no small measure on how effective government stimulus packages prove to be in supporting key sectors through the crisis, and in protecting jobs and incomes of ordinary workers. So far, these proposals – which are multiplying by the day and appear to involve eye-watering sums – have not been enough to calm equity markets to any great degree. The same applies to action by central banks to cut interest rates to the bone or to give banks greater flexibility to lend to companies.

Direct intervention by governments to protect key industries could yet have an impact on the future shape of the transactions market. Airlines remain a prime candidate for such intervention with even the strongest carriers cutting capacity by up to 90% and clearly in a fight for survival as travel bans take effect. Italy has already abandoned the planned sale of Alitalia, instead opting to renationalise its flag carrier. We can expect further intervention in airlines across the world in the form of direct government investment, state aid, grants and tax relief. Nevertheless, the sector could see a new spate of consolidation in the wake of this crisis, some of which might be partially government-led.

In addition, intervention may extend to sectors that would not normally be seen as being as strategic as aviation, including certain consumer sectors, for example. In addition we may see governments taking even stronger action to protect key industries on national security or public interest grounds in a wider range of industries including airlines and healthcare. We got a taste of that when the German government objected to rumours that the Trump administration was trying to buy exclusive U.S. access to a Covid-19 coronavirus vaccine being developed by the German biopharma group, CureVac. The message was clear – vaccines should be available to all, not just to the highest bidder.

What lies ahead?

During this uncertain and challenging time, the biggest immediate priority is to take exceptional action to combat the pandemic and protect public health.

The material shock and dislocation that has hit global markets – owing to the swift action taken to shut down parts of the economy to protect against virus spread and an even bigger crisis – will surely trigger a painful global economic slowdown in the months ahead.

The rapid and extraordinary way that the global economy has suddenly ground to a halt – plus the aggressive fiscal policies implemented by governments and central banks as stimulus packages – may hold out the hope of an equally rapid return to growth once the virus has been contained and is clearly in retreat. When that time comes, what might be the shape of things to come in the M&A markets?

It would be logical to assume that a public health crisis that has forced countries to close borders, cut transport links and lock down communities might deal a further blow to globalisation at a time when it was already under severe attack.

Indeed, one striking feature of the M&A market before the crisis struck was that cross-border deals were in quite a steep decline, with investors turning their attention to domestic markets to do the biggest and most transformational deals. Will that persist?

If the crisis passes its peak in late spring or early summer as some now predict – and if it does not return with equal force in the cold months of next winter – we could in fact see dealmakers quite swiftly return to investing, both domestically and across borders as global trade reboots.

Investors have not lost their appetite for deals that offer access to key technologies, resources or new sales channels in both developed and emerging markets. Stimulus measures, if successful, should increase their liquidity and their firepower to do such deals, with the prospect that cross-border transactions could come back on the agenda.

If so, opportunities will not be in short supply. Latin America is a case in point; GDP forecasts have been cut in many countries across the region, but devaluation of key currencies means that assets are likely to be increasingly affordable for foreign investors. Following recent turmoil in the equity markets, shares in many of Brazil's top 50 companies – including Banco do Brasil, Banco Itaú-Unibanco and Petrobras – are trading well below their per share book value, meaning there are likely to be plenty of targets. And despite the short-term interruption to far reaching privatisation plans, the government remains determined to re-launch the programme once the immediate crisis has subsided, so the market could eventually rebound in unexpected, even counterintuitive, ways.

We believe there are real reasons to be hopeful that the transactions market will revive, and quite strongly. The world has changed, but change can often be a big spur to innovation.

However, before the crisis is brought under control and some stability has been restored, forecasting the timing, the scale and the shape of that recovery remains a matter of speculation.

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Merger control – latest developments

Merging parties should be prepared for delays in obtaining merger control approvals for deals during the global pandemic. First, a number of antitrust authorities are asking parties to delay making merger notifications, especially where they are non-urgent (among them the European Commission, and authorities in Belgium, France, Hungary and Ireland). Second, given the challenges in conducting and completing the necessary inquiries with merger parties and other market participants, merger review deadlines are being suspended (eg in Argentina, Italy and Spain) and are likely to be extended. In the U.S., for example, the practice of granting early clearances from waiting periods has been discontinued and the DOJ is asking companies to add 30 days to timing agreements. In addition, many authorities are only accepting electronic filings (the U.S. authorities for example have set up a temporary e-filing system). And with staff working from home, teleconferences and videoconferences are replacing face-to-face meetings and hearings. We expect to see more announcements from authorities across the globe in the coming days and weeks. While all this means uncertainty for deal timetables, we do not expect the authorities to show a more lenient attitude to mergers raising anti-competitive issues.

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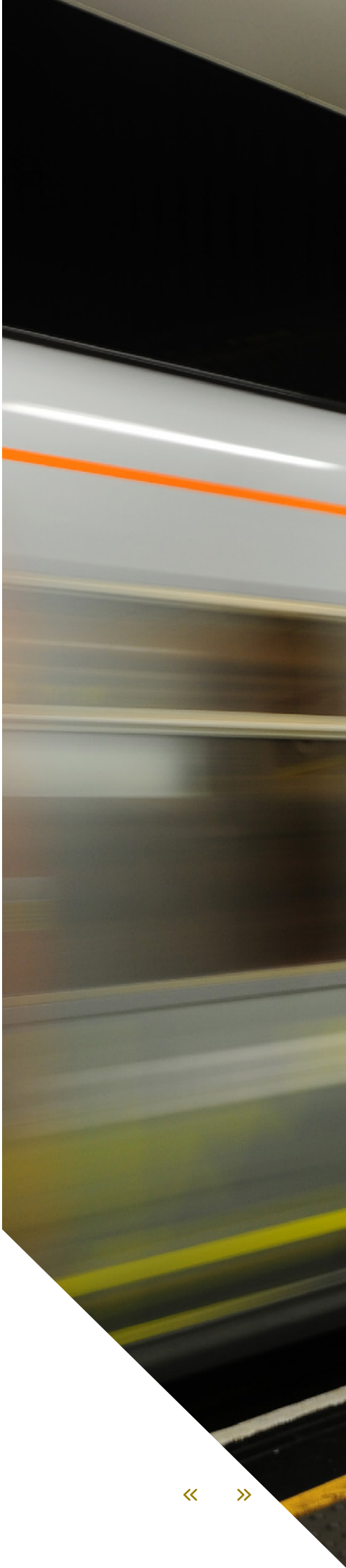

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