M&A and COVID-19

Charting New Horizons
A typical crisis plays out over three time frames: Respond, in which a company deals with the present situation and manages continuity; Recover, during which a company learns and emerges stronger; and Thrive, where the company prepares for and shapes the “next normal.”

1. Respond

As an organization responds to crisis, resilient leaders are defined first by five qualities which distinguish between surviving and thriving amidst crisis. Next, resilient leaders must take specific actions spanning three dimensions and evaluate them within the context of geographic location and sector. Finally, learnings from those experiencing the same crisis conditions should be leveraged to manage the response.

For more information on Respond, please explore The Heart of Resilient Leadership: Responding to COVID-19.

2. Recover

Resilient leaders view recovery as a journey for their organization, teams and stakeholders. There are five imperatives within the Recover phase to guide the business from Respond to Thrive:

1. Understand the required mindset shift;
2. Identify and navigate the uncertainties and implications;
3. Embed trust as the catalyst to recovery;
4. Define the destination and launch the recovery playbook; and
5. Learn from other’s successes.

For more information on Recover, please explore The Essence of Resilient Leadership: Business Recovery from COVID-19.

We have developed supporting material across these priority areas to support leaders as they develop the recovery playbook:

- Valuing Trust
- Command Centre
- Strategy
- Workforce
- Business Continuity & Financing
- Supply Chain
- Customer
- Technology & Digital Cyber
- M&A
- Environmental, Social, and Governance (ESG)

3. Thrive

Preparing for the next normal. Supporting materials to come.
Insight in Brief

• The post-COVID world will unleash structural and systemic changes and it is widely expected that recovery will be highly asymmetric across regions and sectors. Most sectors will need to reinvent themselves in order to thrive and M&A activities will have a strong influence in shaping the “next normal” environment. Periods of high uncertainty can be an opportune one as well - indeed historically, M&A deals during such periods have created more value.

• We believe a combination of defensive and offensive M&A strategies will emerge as companies strive to safeguard core markets, accelerate transformation, and position themselves to capture unassailable market leadership. Redefining M&A in terms of rebound scenarios and strategic choices will bring much needed clarity of purpose while confronting uncertainties.

• This also means, beyond traditional M&A, companies need to deploy a wide range of inorganic growth strategies such as - partnerships with their peers, co-investments with private equity, investment in disruptive technologies, cross-sector alliances with specialists and work alongside governments.

• As companies prepare for a new world with fundamentally reshaped economies and societies, it is inevitable the deal making environment will also materially change. Corporate purpose that intertwines sustainability with commercial success, resilience and building trust across a wide coalition of stakeholders will be at the cornerstone of deal making in the new era.
Charting new horizons

At the start of the new decade, it looked as if momentum of mergers and acquisition activity would continue where it left off in 2019 – when global deal activities crossed the US$3 trillion mark for the sixth year in succession. Then the COVID-19 pandemic came and changed everything. Uncertainty has understandably put a pause on deal activities; some $570 billion worth of deals were announced in the first quarter, down by 28 percent compared to same period last year. However, there is strong historical evidence that M&A markets tend to recover quickly once uncertainty subsides. In April, Deloitte conducted a snap poll of 2,800 US companies and 70% of the respondents indicated they will continue with M&A and in some cases accelerate their deal activities over next twelve months. Indeed, unique times create unique opportunities.

The immediate priority for most deal makers is to resolve in-progress transactions. With $804 billion worth of pending deals from the last six months, deal makers are re-evaluating strategic and financial assumptions and taking appropriate actions to safeguard their positions. For the deals that do get completed, deal makers need to accelerate the integration and synergy capture process in order to create value for the shareholders.

Eventually companies need to prepare for a world that will have fundamentally reshaped economies and societies. Last year, 181 chief executives of some of the largest companies in the world signed a declaration to make it their corporate purpose to deliver value to the communities and countries in which they operate. The extraordinary human and social impact of COVID-19 pandemic will unquestionably bring the spotlight back on corporates to urgently address areas beyond economic motivation.

We believe M&A activities will have a strong influence in shaping the “next normal” conditions. The S&P 1200 companies have a record $3.8 trillion in cash reserves and the ability to service debt in a dovish monetary environment, and the private equity sector has $2.5 trillion worth of dry powder ready to be deployed on opportunities. At the same time, we expect to see broader recognition of social and environmental responsibilities driving not just scrutiny of deals but also reshaping portfolios through acquisitions and disposals to align with these goals.

More so than ever, trust will be the connective tissue that binds all these initiatives together. M&A professionals need to show authenticity and consistency while dealing with ecosystem partners, demonstrating collective gain. Showing empathy towards the financial, health and safety considerations of their workforce, alongside safe and ethical use of data, will become key characteristics of successful M&A activities. And finally, companies will need to demonstrate to governments and regulators the long-term benefits of their M&A actions against a backdrop of protectionist instincts that are clouding some cross-border M&A situations.
Past as Prelude

While it’s still too early to determine the full impact of COVID-19, it is clear many strategic imperatives for M&A will shift or need to be rewritten. Lessons from the great financial crisis provide useful reference points for deal makers.

In 2008, when the crisis unfolded, it resulted in sharp but predictable declines in M&A, as the focus shifted to capital preservation and survival. The companies that emerged the strongest were the ones that took decisive measures to rebuild their balance sheets through a combination of rigorous cost optimization programs and divestment of non-core assets. While financial conservatism helped companies weather the worst of the crisis, some companies got stuck in a circle of cash accumulation at the expense of investing in growth and ended up lagging behind their competitors during the recovery years.

A Deloitte study called “The Cash Paradox” analyzed corporate attitudes towards cash and investment during the crisis and recovery periods and found the markets more rewarding of companies that invest in the pursuit of growth, while maintaining a robust balance sheet.

Downward cycles present unique opportunities for M&A. The private equity funds of 2008 and 2009 vintage were the best performing funds in 20 years since they invested during the depth of crisis. Our analysis of mega-deals done during the last downward cycle of 2009 to 2013 show such deals yielded over three times the total shareholder returns of those made in the upward cycle that followed. This is due to a confluence of factors: the price-to-earnings multiples tend to drop turning previously inaccessible companies into appealing targets; there are fewer competitive bidders; and, most importantly, during such periods, deal makers are able to apply greater focus to integration and post-deal value creation.

A crucial difference compared to the 2008 crisis is that now many companies have record levels of cash reserves and this gives them a solid foundation to build the road recovery. Successful leaders heed the lessons from the past, taking decisive measures with speed to safeguard companies in the immediate term, but remaining focused on the horizon and actively investing to accelerate growth.
Redefining the Role of M&A

The post-COVID world will unleash structural and systemic changes and it is widely expected that recovery will be highly asymmetric across regions and sectors.

We expect a greater focus on intra-regional and domestic deals. Our recent “Deal in Focus” survey shows two-thirds of the deal makers from Asia-Pacific region are considering cross-border deals, but a majority prefer deals within the region because they want to mitigate integration risks during these uncertain times.

Some sectors like aviation, automotive, hospitality and leisure have been severely disadvantaged, while conversely health, grocery, technology and telecom are experiencing a boost in demand. Most sectors will need to reinvent themselves in order to thrive, and many will use M&A to accelerate the transformation.

We believe companies across all sectors need to incorporate scenario-planning tools to determine the strategic choices they need to make as they navigate through unchartered waters. This will help companies decide the direction of their strategy, identify the new capabilities required, and prioritize the markets where they need to operate in order to drive growth and profitability. Redefining M&A in terms of these scenarios and choices will bring much needed clarity of purpose while confronting uncertainties.
M&A Strategy Framework

A combination of defensive and offensive M&A strategies should emerge as companies strive to safeguard existing markets, accelerate recovery, and position themselves to capture unassailable market leadership.

**Level of Impact assessment:** Consider the impact of pandemic on economic recovery and market supply/demand dynamics, your people, customers and competitive environment.

**Ability to act assessment:** Consider your liquidity position, balance sheet strengths and ability to raise capital from the markets in relation to the resilience of your business operating model and those of your suppliers and partners.

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**M&A Deal Archetypes**

**Defensive M&A**

- **Salvage value**
  - Identify ways to raise capital
  - Improve operational efficiency or increase business flexibility
  - Prepare the business for the “new world order”

- **Safeguard markets to maintain competitive parity**
  - Adjust operating models in response to competitive dynamics
  - Pursue deep synergies from recent acquisitions
  - Rebalance your portfolio

- **Transform the business to safeguard the future**
  - Rebalance your portfolio
  - Capture additional revenue in adjacencies

**Offensive M&A**

- **Change the game**
  - Define the “new world order” through power of networks
  - Invest to scale at the “edge”

- **Transform the business to safeguard the future**
  - Orchestrate a web of multilateral partnerships and alliances
  - Acquire capabilities to accelerate digital transformation

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**CEO Priority**

- **Salvage value**
- **Safeguard markets to maintain competitive parity**
- **Transform the business to safeguard the future**
- **Change the game**

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For companies propelled into survival model by COVID-19, they may turn to M&A — whether by choice or necessity — to safeguard their future.

For companies who have been able to ride the upswing in demand for new, digital operating models, and services, they may turn to acquisitions to lay the groundwork to capture unassailable market leadership.
Defensive M&A

The impact of the COVID-19 pandemic has almost immediately propelled many companies into survival mode. Companies in sectors like aviation, hospitality and real estate have been particularly disadvantaged. As a result, many companies will turn to M&A – whether by choice or necessity – to safeguard their future.

1. M&A to salvage value

Companies that have been severely impacted by the crisis and are in a financially vulnerable position, will need to take decisive measures to secure their survival. Some will pursue M&A activities to salvage value. We anticipate these defensive plays to materialize in several different ways:

Portfolio optimization and divestment of non-core assets:

Portfolio optimization is essential in crisis times to increase capital efficiency and identify assets that drain scarce resources. Real estate footprints will be under particular scrutiny, as some of the health and safety interventions such as remote working become an integral part of business models for some companies.

It is likely that portfolio optimization initiatives will identify assets that lack strategic fit and will lead to divestment of non-core assets. Based on Deloitte’s soon-to-be released global divestitures survey, 45 percent of the surveyed executives are considering between one and five divestments over the next 24 months. Sellers need to be aware that during crisis times there will be fewer buyers, so they should maximize attractiveness of assets by engaging in rapid turnaround interventions to increase asset value and avoid fire sales.

Deloitte analyzed divestment activities during times of crisis and recovery in a report called “Creating shareholder value” and found in most instances, divestments create greater shareholder returns for both buyers and sellers. One of the main reasons for out-performance during uncertain conditions is because shareholders are looking for business focus. This means well-planned divestment activities send a strong signal that sellers are concentrating on their core business and buyers are investing strategically to deliver a well-defined growth plan.

Prepare to wind down underperforming businesses:

Some companies may need to consider radical actions including distressed asset sales to salvage value from loss-making divisions and preserve the viable core business. In crisis situations disposal of distressed assets requires utmost speed in execution to maximize value. In some cases, where sale is not possible, the hard choice of a managed exit through an accelerated wind down and closure may be needed. Rebuilding trust with the workforce, customers and suppliers alongside a distressed sale or wind-down takes patience and will need to be a strong area of focus for companies.
2. M&A to safeguard markets and maintain competitive parity

Companies where the impact has been less severe, but remain in a financially vulnerable position, could use M&A to safeguard their markets and maintain parity with their competitors. We anticipate these defensive plays to materialize in several different ways:

Extract deep synergies and prepare for predators:

In current conditions, building financial resilience is a key imperative for all companies. This is particularly the case for companies that have recently completed acquisitions and face added pressure from shareholders to deliver value from such deals under difficult conditions. Taking decisive measures to integrate these acquisitions and capture deep synergies in an accelerated manner will help them free up valuable working capital to weather the crisis.

Based on analysis of publicly announced global deals since 2017, we estimate that the annualized cost synergies represent, on average, 3% to 4% of the transaction value. This means that companies have committed to achieve between $215 to $290 billion worth of annualized synergies. And if all the announced cost synergies are realized and sustained, this could add an estimated $2.8 to $3.2 trillion to the value of these companies, before consideration of the premium paid and associated integration costs.\[xv\]

Up to $3.2 trillion of the value could be added to companies. If they achieve and sustain the publically announced cost synergies

\[\text{Source: Deloitte analysis}\]
Well-planned integration programs can deliver on average 1.3 times more benefits than the publicly announced synergies.\textsuperscript{xv} Tax synergies are sometimes ignored, but critically important, as these can represent as much as 20\% to 30\% of the total. Using analytics and artificial intelligence (AI) tools in the synergy realization process can help companies make better decisions when the stakes are high and timeframes are compressed.

**Explore opportunistic deals and alliances to safeguard the core business:**

Companies that have capital constraints should consider alliances and pursue co-investment opportunities to reduce risk and capital outlay. For example, since the health and safety of customers and workforce will be of paramount concern for all sectors, three of the largest recruitment businesses in the world have formed an alliance to develop common best practices on health and safety protocols to help their clients plan for safe workplace environments.\textsuperscript{xvi}

Companies should also explore opportunities with private equity and other pools of private capital, accessing their significant funds to deploy in such value enhancing opportunities. For example, a prominent consumer goods company entered into a partnership with a private equity firm to establish vertically integrated near-shore supply chain links to deliver higher margin customized products lines.\textsuperscript{xvi}
The COVID-19 crisis has demonstrated the attraction of new digital channels, agile operating models and supply chain links. Many companies will need to actively pursue transformative acquisitions to rapidly adapt to the irrevocable changes to their business models.

Certain sectors are more resilient. There has been an upswing in demand for services such as digital health, remote working technologies, enterprise security, and media streaming. Companies that find themselves in such favorable situations will pursue acquisitions to lay the groundwork to capture unassailable market leadership.

3. M&A to transform the business and safeguard the future

Companies that have a strong balance sheet but expect a significant degree of structural disruption to their sector could use M&A to safeguard their customer base and supply chain links and accelerate long term transformation to their business models.

Pursue acquisitions to prepare for “next normal” conditions:

In the post-COVID19 environment, restarting and normalizing the supply chain will be of critical importance to most companies. Companies could seek opportunistic M&A deals to restore and protect vital supply chain links, as well as build new diverse supply chain links in near-shore locations as a hedge against a slow-down of globalization. Tax implications impacting supply chain redesign will need to be identified and managed. For instance, recently a fast-growing consumer brand with an asset-lite digital only model acquired its main supplier in order to safeguard its supply chain and enhance its valuation.

All sectors are undergoing significant technological disruption and our analysis from the Disruptive M&A report “Small gains, big wins” shows in the last few years, companies have spent nearly $1 trillion on such disruptive acquisitions. The impact of COVID-19 has caused many sectors to accelerate the adoption of digital in their business models. Companies, particularly from the non-tech sector, will pursue technology acquisitions to build agile operational and customer channels. For instance, a major conventional retailer recently acquired an AI imaging start-up to bolster its visualization capabilities for its digital sales channel.

Explore acquisitions and alliances to close gaps in your portfolio:

Companies should actively scan the market for underperforming peers and high growth start-ups that are struggling under funding constraints. Valuations for many such businesses are down and sellers have readjusted value expectations, thus providing a unique opportunity to acquire at attractive prices. For instance, recently a major media conglomerate with a large traditional cable offering acquired an ad-supported over-the-top (OTT) video streaming platform to enhance its portfolio with a digital streaming offering.
4. M&A to change the game

For a select few companies that are resilient and strategically well placed, this crisis gives unique opportunities to use M&A and other investment activities to capture unassailable market leadership in their chosen markets and sectors.

Orchestrate a web of alliances to capture cross-sector convergence opportunities:

The “next normal” is likely to accelerate sector convergence underpinned by new customer behaviors and spending patterns. This will create opportunities for non-traditional players to enter established markets with new market offerings and, in some instances, effectively displacing the market incumbents.

In order to capture such opportunities, companies should orchestrate a web of alliances that includes both large specialist partners as well as start-ups from the innovation ecosystem to bring a diverse set of skills and collaborate to shape new market offerings. For instance, the recent uptake of digital and remote services for triage and testing in the health care sector has resulted in a flood of investment into digital health start-ups including a telecom company that went into an alliance with a digital health start-up to provide tele-health services to its customers.xxiii

Use M&A to scale at the edge:

The post-COVID long-term structural changes will be heavily influenced by exponential technologies and shifts in consumer attitudes in areas like environment and climate. It is critical that companies develop market sensing capabilities to monitor the shifts and understand their implications on the evolution of their sectors.

This will give companies the confidence to build a portfolio of strategic acquisitions and investments on the edge of the existing businesses. Companies can use those investments as the springboard to launch new market offerings that will shape their sectors in the future. For instance, the corporate venture arm of a major industrial conglomerate recently invested in a quantum computing start-up to gain early understanding of how to use this breakthrough technology in industrial design and productsxxiv.
Conclusion

While M&A is set to be at the heart of recovery, it is inevitable that deal making has to change to reflect the new priorities of the post-crisis world. This means, beyond traditional M&A, companies will need to deploy a wide range of inorganic growth strategies such as acquisition of disruptive innovation technologies, portfolio optimization, divestments of non-core assets, partnerships with their peers, co-investments with private equity, cross-sector alliances with specialists, and partnerships with governments to aid recovery.

The post-crisis M&A environment will be materially different. Corporate purpose that intertwines sustainability with commercial success, resilience and building trust across a wide coalition of stakeholders will be at the cornerstone of deal making. Well-planned, bold moves will cement lasting industry leadership and incontrovertible societal gain.
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Endnotes

1 Deloitte analysis based on data from Thomson.
2 Deloitte analysis based on data from Thomson.
3 Uncertainty is the “new normal” - Deloitte M&A Index 2017
4 Deloitte analysis based on snap poll conducted on April 20, 2020
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14 Deloitte analysis based on data from Thomson and Deloitte Synergy database
15 Five value creation principles for your next M&A transaction
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