NAVIGATING M&A DEAL ACTIVITY

DURING AND POST COVID-19

WESTERN AUSTRALIA - APRIL 2020

NAVIGATING M&A DEAL ACTIVITY DURING AND POST COVID-19 WITHIN WESTERN AUSTRALIA

During the last quarter of 2019, experts predicted 2020 to surpass 2019 as the fourth strongest year for M&A in the last decade. However, since the outbreak of COVID-19 things have changed dramatically. The unpredictability of the magnitude and uncertainty of its potential impact is affecting business confidence and the deal environment globally.

The global business environment is currently witnessing an unprecedented challenge. Although lockdowns and restricted social activity are essential to deal with the current pandemic, this will result in enormous disruption in supply chains, cash flow issues and funding gaps.

It is difficult to predict the consequences of COVID-19 and the long-term lockdowns that are impacting every aspect of daily life. With such uncertainty and unpredictability, during and post crisis the focus of business owners and managers is likely to be managing the core business and its recovery and as a result any inorganic M&A activity may take a backseat.

Conversely, the COVID-19 shock may actually result in global M&A activity increasing in some areas particularly areas such as capital raising as businesses raise funds to bolster depleted balance sheets, acquisition opportunities as valuations retreat, player consolidation and/or distressed acquisitions and insolvency opportunities

From crisis arises opportunity and this could be an incredible opportunity for corporates with strong balance sheets and cash reserves to execute on strategically significant deals at reasonable or even bargain valuations.

Now is the time for proactive planning and strengthening deal capabilities and engaging with advisors who understand the changing market as well as facilitate closure of transactions. M&A deals require a different approach since most conventional tactics may no longer be relevant in the current circumstances.

When you look back on this period after the crisis is over, those businesses who executed on a successful M&A playbook will emerge stronger and will see both accelerated growth and long-term shareholder value-creation in the post COVID-19 period.

Success in M&A will be measured by an ability to identify opportunities, assess risks and factor these risks in the deals appropriately, without limiting the transaction approach by applying existing practices and yardsticks of doing deals.

M&A STRATEGY DURING COVID-19

At BDO M&A we believe that a balanced approach to business continuity planning combined with a disciplined approach to M&A could be mutually beneficial to both buyers and sellers during these unforeseen market times.

Important things to consider when navigating your M&A strategy include:

1. Look for businesses in markets that you understand well and where you have insight into the drivers of revenue for the business
2. Act quickly in order to take advantage of opportunistic market conditions (for example where there is a sudden cash flow shortage)
3. Private Equity (PE) options can be an alternative source of funding during these times. PE firms are ready to deploy capital especially if a well matched bolt-on to a corner stone or platform asset
4. Consider what additional due diligence (DD) needs to be undertaken to understand risks relating to COVID-19 as well as whether there are any additional sale agreement protections needed to address virus related impacts. Items to consider during DD include:
    - Supply chain disruption risk and the impact on strategy, stakeholder relationships and financial implications;
    - Suspension and termination rights under material contracts, including whether you can rely on force majeure clauses;
    - The risk of data privacy breaches;
    - Business continuity and crisis management procedures,
    - The potential impacts of COVID-19 on industry and competitors
5. Structure deal terms in ways to mitigate immediate risks through deferred terms and earn-out options. A recent example of this is a transaction completed by BDO that was in the final stages of negotiation as COVID-19 hit the market. Terms were settled and agreed by all parties that incorporated business performance forecasts for FY21 and FY22. Deferred payments allow the business to recover from any immediate COVID-19 effects, in this case, exchange rate concerns, while allowing for management to meet performance forecasts in the following financial years when the business and the market has a chance to return to more normal operating conditions. If the business does not perform, the vendor has not overpaid and the seller has the opportunity to both reach the original price, as well as exceed it if the business outperforms (relatively normal) expectations.

WESTERN AUSTRALIA SPECIFICALLY

The mining sector remains strong and government is supportive as mining continues to be such a large contributor to Australian Gross Domestic Product (GDP). Some specialised FIFO workers are allowed to travel from the East Coast provided they fulfil necessary quarantines.

In our discussions with buyers interested in the mining and mining related sectors, they are still considering acquisitions and believe there is strong future growth in iron ore (BHP, Rio Tinto and FMG seem to continue to be performing well).

There is also significant interest in IT, managed services and companies that service long standing tier 1 clients. There is particular interest in security businesses and any that can bolster resilience during this extended COVID-19 period of remote working.

Investment Banks are looking to deploy capital where they believe the market thematics are strong, particularly in IP based, asset backed, differentiated technology enabled mining services that are production related.

INTERACTING WITH BANKS & PRIVATE EQUITY

Banks are continuing to work with, and lend to, their already existing client network, however are reluctant to lend to new clients and are reserved around transaction activity. Like many financial institutions, they are waiting to see how the market is affected by COVID-19 before making any large commitments.

The general sentiment is that the banks are managing with the current market and their clients funding needs, however should there be a second round of funding required there may not be enough personal equity amongst their client groups to provide personal security for further bank loans.

PE firms on the other hand are looking to deploy capital during this time. Recent discussions with a number of local PE firms have indicated that those with a diversified portfolio of companies have managed to hedge their risk. In most cases, they are continuing to perform, whilst others who have less diversified portfolios or are partially exposed to retail, hospitality and tourism continue to be impacted. Those with a balanced investment approach are continuing to deploy capital and look to replace debt in several situations. One particular firm commented *"we know that the crisis will end. We also know that companies will require access to equity capital. We fully expect to be investing in new platform deals as well as generating bolt on opportunities for our portfolio. We have several deals going on at the moment."*

WHATS NEXT?

When considering M&A activity in this unprecedented time we believe there are four key areas that need special focus and consideration for possible COVID-19 impacts being due diligence, valuation, structure and documentation. All four areas and the way forward in today's climate are explored over the page.

THE TOP 4 SPECIAL FOCUS AREA'S:

DUE DILIGENCE
Increased depth of scope to assess risks and outcomes relating to COVID-19

VALUATION
Sensitivities to business model assumptions to arrive at a viable price

STRUCTURE
Flexibility to adjust consideration and simplicity in post deal integration

DOCUMENTATION
Contractual protections and risk mitigations included to address COVID-19

AREA / CHALLENGES	SPECIAL FOCUS ITEMS	WAY FORWARD
DUE DILIGENCE • Lack of physical access to business and executives • Travel restrictions • Remote working arrangements • Sensitive data on employee health • Any COVID-19 related government loans	• Cash burn rates and business continuity assessment • Impact on revenue • Costs associated with supply chain alternatives • Obligations under material contracts, including exercising force majeure • Special adjustments to working capital due to slower pace of collections, etc. • Counterparty risks • Assessment of pre-COVID EBITDA vs COVID period • EBITDA and expected time taken to go back to pre COVID EBITDA • Insurance coverage • Emergency preparedness and management succession plan • Employee welfare liability • Cyber safety assessment	• Adjust expectations related to access to information and timetables for diligence completion and revisit any past work based on new facts • Extensive use of virtual data rooms and video conferencing • Significant senior level time from diligence team • Management interviews to assess business continuity robustness and challenges encountered and surmounted during the crisis period • Assess any government loans accessed during the pandemic such as The JobKeeper Payment Scheme
VALUATION • Uncertainty in forecasts • Lack of benchmarks to support projections • Market multiples severely distorted • Assessing short term cash flows as well as post COVID-19 cash flows	• Liquidity assessment of business • Revenue impact during and post crisis period • One-time/special costs/debt-like obligations to return to normalcy • Factor deal structure aspects on the business • Extensive sensitivity analysis under different scenarios • Choice of comparable companies and data	• Avoid locked-box and fixed pricing; offer deferred or staggered consideration • Agree post-closing purchase price adjustment mechanisms to adjust consideration to reality post COVID-19 • Agree on a post COVID-19 cash flow position taking into consideration the effect on certain items such as supply chain, reduced costs from flexible working arrangements, reduced travel costs etc.
STRUCTURE • Limited deal financing • Unquantified risks and exposures due to COVID-19 • Deal structuring to take into consideration any COVID-19 implications	• Tax and regulatory considerations of transaction structure on all parties • Legacy issues and potential penalties/claims related to COVID-19	• Consider cashless/share-swaps where feasible • Build in escrow or holdback • arrangements • Factor tax waivers / benefits / concessions that may be available • Upside deal structuring taking into consideration COVID-19 cashflows and valuations
DOCUMENTATION • Material Adverse Change (MAC) clause • Drop-dead dates • Reps and warranties (R&W) • Sellers authority between signing and closing	• Consider full authority to have an ability to terminate upon MAC • Factor realistic time to obtain government /regulatory approvals and other change of control approvals or third-party consents • Interim operating agreements with powers balanced for action to be taken as a result or in anticipation of consequences of COVID-19	• Careful wording of MAC clause • Flexible extension in drop-dead dates to factor contingencies • Greater emphasis on comprehensive interim operating agreements with specific information rights and reserved matters till closing • Agree on situation specific R&W against general R&W and specific indemnities and accept only specific disclosures in disclosure letters, against generic ones

Experienced transaction advisers will play an important role in assisting and defining the framework for doing deals with robust diligence, sensitivity in modelling projections and most importantly, a flexible mindset towards negotiation and closing transactions.

Each deal and transaction requires a fact-based approach and customised solution. Our cross disciplinary team of M&A, valuation, and diligence professionals offer guidance at every stage of the business deal, providing value added solutions along with timely identification and resolution of any roadblocks.

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