M&A UPDATE

COVID-19's IMPACT ON GLOBAL M&A

By Jens Kengelbach, Jeff Gell, Georg Keienburg, Dominik Degen, and Daniel Kim

Throughout January and February, financial markets seemed to be resilient against the fallout from COVID-19, the disease caused by the novel coronavirus. Some market participants thought that the virus could be confined primarily to China or that countries with a strong health care system would not be hit as hard. Or, even if the disease were to become a global pandemic, they expected that markets would react the same way they did in prior virus crises like SARS and MERS: with a small dip followed by a quick rebound. By early March, it was clear that the COVID-19 crisis would play out differently. The financial markets are now pricing in significant fallout from COVID-19 on the global economy, with a recession seen as increasingly likely.

First and foremost, corporations are focused on keeping their employees and businesses safe in these turbulent times. Amid increasing uncertainty, however, many corporate leaders are being asked to make strategic decisions. For example, should they call off a transaction that has been in the preparation stages for many months or push it through to completion? Has the plunge of more than 30% in equity markets created buy-side opportunities? Against this backdrop, we look at the current state of the transaction market and offer advice on how dealmakers should proceed.

The Current State of the Transaction Market

Just as the spread of COVID-19 was accelerating around the world, global equity indices reached historic peaks. The MSCI World, S&P 500, and STOXX Europe 600 indices all closed at record highs on February 19, 2020. In a matter of weeks, the situation changed dramatically. From their peaks through March 18, 2020, these benchmarks lost between 30% and 35%. At the same time, volatility went through the roof, with the VIX index reaching 83%—a level last seen after the Lehman Brothers collapse in 2008.

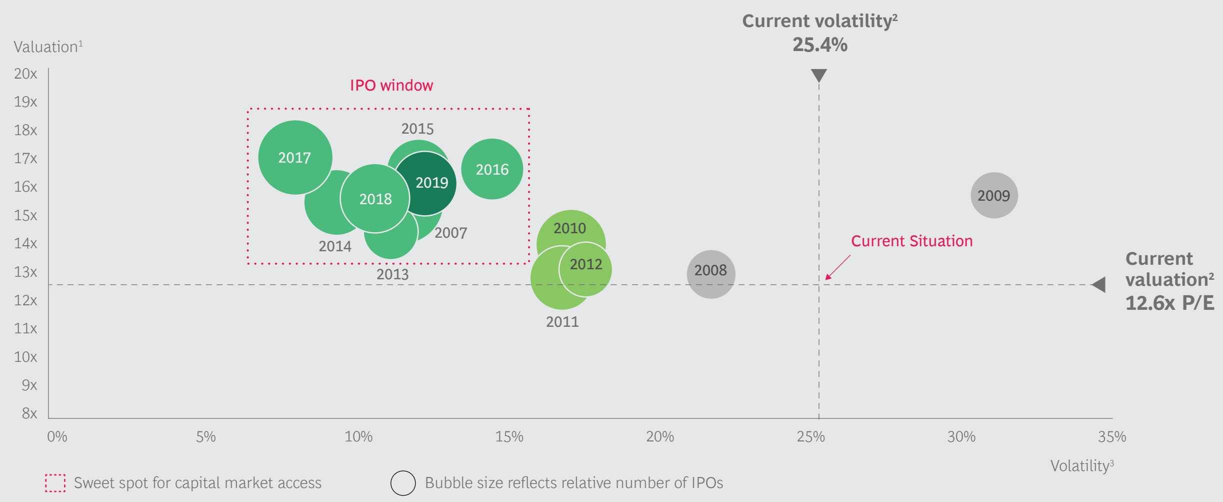
While the large losses obviously impact investors currently holding risky assets, it also means that the window for capital market access (known as the "IPO window") closed rapidly. (See Exhibit 1.) Although 2019 still offered decent market conditions, virtually all IPOs planned for early 2020 have been shelved for now as current levels of valuations and volatility make listings unfeasible. And we do not expect these conditions to improve significantly, at least not for the next several months. At the same time, the market for leveraged debt financing seems to be closed for now, and private-equity firms are telling their deal teams to stand down.

Turmoil in capital markets is often a forerunner of what happens next in the real economy. It is likely that the most affected countries will experience a recession this year. For Germany, Europe's largest economy, the Ifo Institute for Economic Research expects GDP in the second quarter of 2020 to decline by 4.5% compared with the first quarter and forecasts that it could contract by 1.5% this year. And the US has an 80% chance of recession this year, according to a recent Reuters poll. Additionally, historical data indicates that a bear market for the S&P 500 signals an 80% chance of a recession.

The M&A market, naturally, is affected by the deterioration of capital markets and the real economy. Prior to the crisis, the number of M&A deals globally was already on a slight downward trend (and deal value held up only because of several megadeals). This trend is likely to accelerate, at least in the short term. Historically, M&A activity has correlated strongly with the evolution of stock prices and risk, as measured by implied volatility. From 2000 through 2019, the correlation between the value of the MSCI World index and M&A volume was approximately 80%. (See Exhibit 2.)

The severity of the short-term effects on the M&A market is already evident in the fact that numerous deals have been pulled or delayed in recent weeks. For example, UK-based Cineworld's proposed acquisition of its Canada-based competitor Cineplex was announced in December 2019 and approved by shareholders in February 2020. Since then, however, the share prices of both companies collapsed amid concerns that the cinema business might dry up during the crisis. As a result, investors have started to wonder if the deal could fall apart. Similar issues have arisen recently in many financial investor-backed

EXHIBIT 1 | The Global IPO Window Closed Quickly in Early March 2020



Sources: Bloomberg; Refinitiv; BCG analysis.
Note: Analysis is based on 15,538 IPOs listed between 2007 and 2019. Simultaneous IPOs on several exchanges were treated as one IPO. Excludes listings by trusts and financial holding companies.
[1]MSCI All Country World Index forward P/E ratio (current market share price over earnings per share).
[2]As of March 18, 2020.
[3]MSCI ACWI 180-day historical volatility.

transactions in which promising bidders, such as Cinven and Goldman Sachs' PE arm, dropped out of bidding processes. The withdrawals were partially due to COVID-19-related concerns and changing deal circumstances, such as altered business plans. At the same time, many companies are likely to postpone their not-yet-announced acquisition plans, owing, for example, to the financing difficulty and contract negotiation complexity created by the crisis.

Notwithstanding these short-term developments, the longer-term impact of COVID-19 on the real economy remains uncertain. However, even if somewhat short-lived, negative effects on growth and fundamentals seem nearly inevitable. In this environment, savvy dealmakers can thrive, as we discussed in BCG's 2019 M&A Report.

What Should Dealmakers Be Thinking About?

When dealmakers are ready to focus again on their core pursuit, they will have plenty to think about. For companies that have built a healthy balance sheet during the economic boom of the past ten years, declining valuations create opportunities to pursue deals that create long-term value. Our research demonstrates that deals done during weak economic times create value for dealmakers and their shareholders. (See Exhibit 3.)

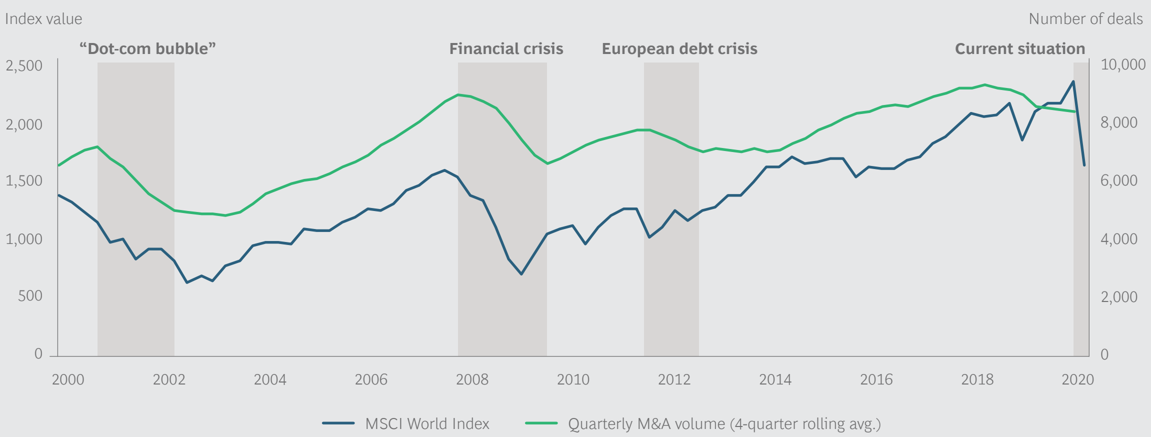
Lower valuations are not the only reason that weak-economy deals outperform. In a public takeover, the discount when acquiring targets might be lower than expected because shareholders demand significant premiums. During the Great Recession, for example, premiums jumped substantially above the long-term average of approximately 30%. Assets currently owned by corporate or private equity investors will probably see higher-than-average premiums, at least to some degree.

There is a more fundamental reason why acquisitions in weak economies create value: A company can take advantage of the environment to execute its strategic acquisition agenda and to position the business to exceed industry-average growth once the economy recovers and accelerates out of the recession. Additionally, a company can focus on integrating the target during the downturn—when competitors are busy trying to survive—and then fully benefit from synergies in the recovery.

What Are the Winning Strategies?

We find there are several winning strategies for transactions in a weak economy:

EXHIBIT 2 | M&A Activity Closely Follows Capital Market Development



Sources: Refinitiv; S&P Capital IQ; BCG analysis.
Notes: The total of 600,606 M&A transactions comprises pending, partly completed, completed, unconditional, and withdrawn majority deals announced between 2000 and 2019.

Exhibit 3 | Weak-Economy Deals Outperform Strong-Economy Deals

Sources: Refinitiv; Datastream; BCG analysis.
Note: Strong-economy (weak-economy) years are those in which the respective global real GDP growth rate is in the top (bottom) third of all growth rates in our observation period. The total of 9,987 M&A transactions comprises pending, partly completed, completed, unconditional, and withdrawn majority deals announced between 1980 and 2018 with a deal value greater than $250 million. Only deals with a public buyer were considered. The share price three days before the announcement date (T–3) equals 100. Share performance from T-3 to three days after the announcement (T+3) equals the announcement effect.

- **Look beyond your core business.** While acquiring targets in your core industry during a downturn creates value (one-year RTSR of 4.6%), you can benefit even more from non-core acquisitions (one-year RTSR of 8.5%).

- **Learn from experienced dealmakers.** Acquirers that regularly engage in M&A earn returns from downturn deals that are five times higher than those earned by occasional dealmakers. In the current situation, experienced dealmakers can fully leverage their well-honed, structured approach. This means conducting a focused due diligence process (without being distracted by external crises), deploying scenario planning in order to be prepared in a fast-changing environment, and rigorously integrating targets to jump-start value creation.

- **Don't take value creation for granted.** When acquiring underperforming assets during weak economic times, even experienced dealmakers create value in only half of their deals.

- **Consider de-risking your M&A strategy.** If your industry is being hit hard by the current crisis, consider deploying tools other than outright M&A. Forming strategic alliances, for example, could be a way to resolve short-term supply chain issues.

Additionally, corporate decision makers can take several concrete steps today:

- **Prepare.** If you don't have a wish list of targets that fit your strategic agenda, think about developing one now. There might be buying opportunities soon.

- **Don't panic.** Now is probably not the time to shed assets, potentially at fire-sale prices—even if investors might appreciate spinoffs and divestitures in the short term. In the long term, panic selling does not create value. In any case, the window for IPOs and other forms of divestiture has closed.

- **Be bold.** The current situation might tempt you to stick with what you know. But it is the bold dealmakers that utilize downturns to get ahead of the curve and come out stronger.

Corporate decision makers have no tried-and-true playbook to navigate this unprecedented global health and financial crisis. A certain amount of improvisation will be required to survive the crisis and accelerate out of the eventual recovery. For companies with strong balance sheets, M&A will play a major role. Preparation, steady nerves, and a willingness to be bold are the keys to success.

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