Differentiated due diligence under COVID-19

KPMG in Thailand

Foreword

"Successful deal execution hinges on robust diligence"

The COVID-19 pandemic brought economies around the world to a halt. Continuing efforts to combat the various waves of the pandemic have resulted in disruptions in business operations with drastically reduced revenue and cash flows, and profitability in many cases wiped out.

It is an uncertain time for buyers and sellers in the world of Mergers and Acquisitions (M&A) with both being forced to rethink new and immediate deal issues in light of COVID-19, as well as the long-term recovery to whatever 'normal' may ensue.

All of the usual metrics buyers use to value a company – market landscapes, macroeconomic factors, growth drivers, projected cash flows, etc., are becoming unreliable and out of date.

The extent of the impact has been felt in varying degrees across different industries. This paper aims to highlight key focus areas and the importance of robust diligence in understanding target businesses in the COVID-19 world.

KPMG

Why Differentiated Diligence is of utmost importance in doing a Deal during COVID-19

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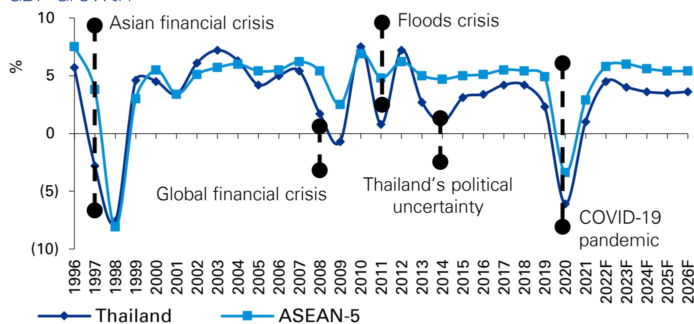
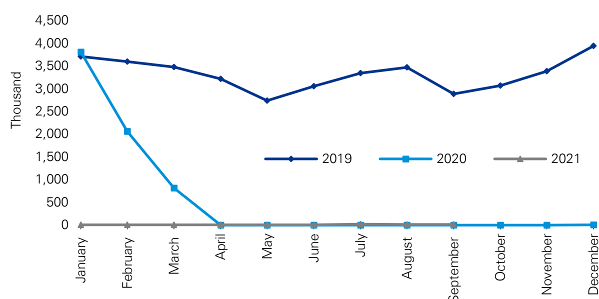
GDP Growth



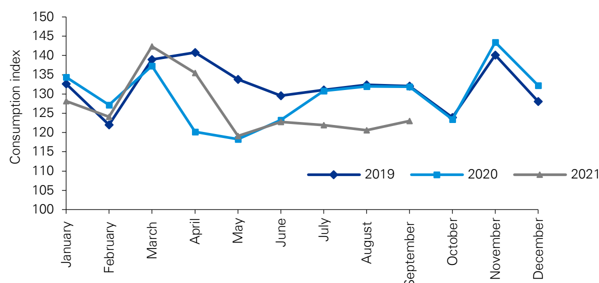
Note: ASEAN-5 comprised Indonesia, Malaysia, Philippines, Thailand and Vietnam.
Source: (1) IMF (2) Macrotrends

International tourist arrivals



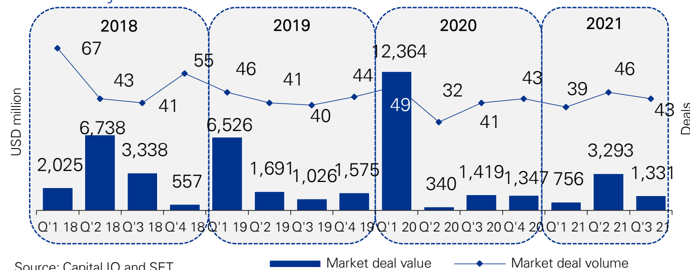
Source: Ministry of Tourism & Sports and Bank of Thailand

Private consumption index in Thailand



Source: Bank of Thailand

M&A Activity in Thailand



Source: Capital IQ and SET

Economic overview

Thailand has been severely impacted by COVID-19 with a negative GPD growth at almost the same level as the Asian financial crisis. This is partly due to the economy's reliance on the tourism sector which contributed 22% of Thailand's GDP in 2019, and the shrinkage of export goods. The private consumption index also dropped in 2020 and 2021 following the economic slowdown caused by the pandemic.

2019 saw a record of 39.8 million international tourists visit Thailand, but this came to an almost complete stop following the outbreak of COVID-19. Despite the additional measures to stimulate domestic tourism in the fourth quarter of 2021 such as the "We Travel Together" and "Travel around Thailand" campaigns, the economy continued to stagnate due to the prolonged pandemic wave. Given the current situation and the recent removal of the 14-day quarantine for fully vaccinated visitors from approved countries, it is uncertain whether the economy will be able to grow by 0.7% in 2021 and 3.7% in 2022 as forecasted by the Bank of Thailand in June 2021, especially given the impact of the emerging Omicron variant at the time of writing.

M&A activities

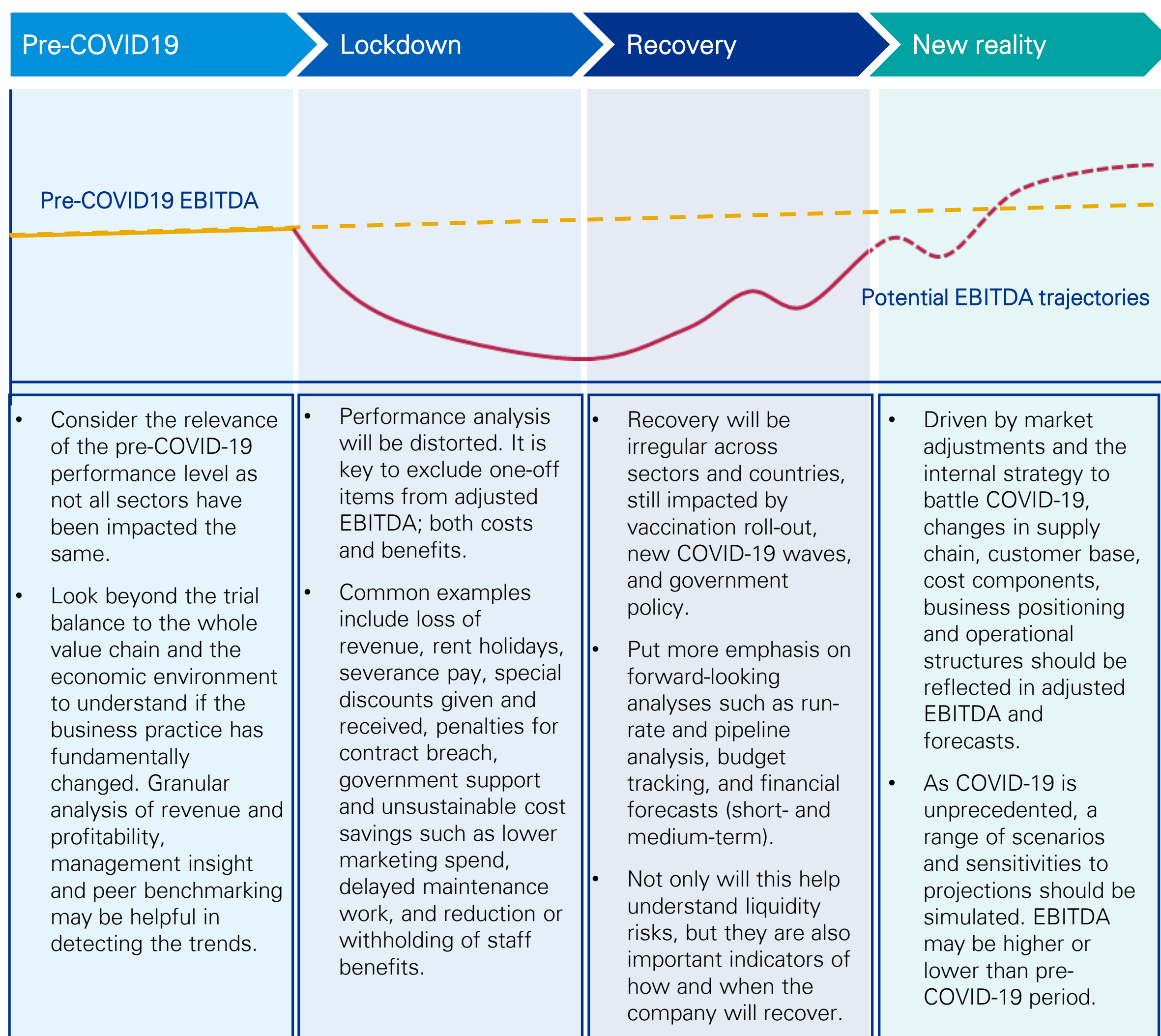
2020 proved to be one of the most challenging years for mergers and acquisitions (M&A) given the increased uncertainty and volatility brought about by the pandemic. However, the M&A market in 2021 is on the rise globally, especially booming in North America and in parts of Europe. In Thailand, despite the third wave of the pandemic hitting hard, many businesses are still continuing their expansion projects. According to the Board of Investment of Thailand (BOI), the accumulated value of private investment spiked 158% during the first seven months of 2021 year-on-year. During the same period, BOI announced Thailand attracted THB279 billion in foreign direct investment, the biggest investors being companies from Japan, the US and China.

In response, KPMG have developed some robust considerations and key takeaways in further understanding and evaluating various implications when doing deals during COVID-19 period.

Understanding the 'New normal' key business drivers is key in assessing underlying, sustainable performance

Financial performance and EBITDA

Understanding and quantifying impacts which COVID-19 has had on a target company will be the main challenge for deals conducted in FY22. The pre-COVID-19 profitability measurement may no longer be relevant and the magnitude of impacts on business and the recovery horizon vary across industries. In practice, buyers need to be focused in differentiating the temporary impact and the permanent. Businesses are most likely to come out differently after the crisis depending on the overall economic outlook, industry trends and strategy shifts.



Projection

When preparing a projection, it is important to understand the impact of COVID-19 towards historical performance and carefully evaluate possible scenarios for the recovery period in addition to possible changes to the long-term operation in terms of supply chain, customer base, or cost structures going forward.

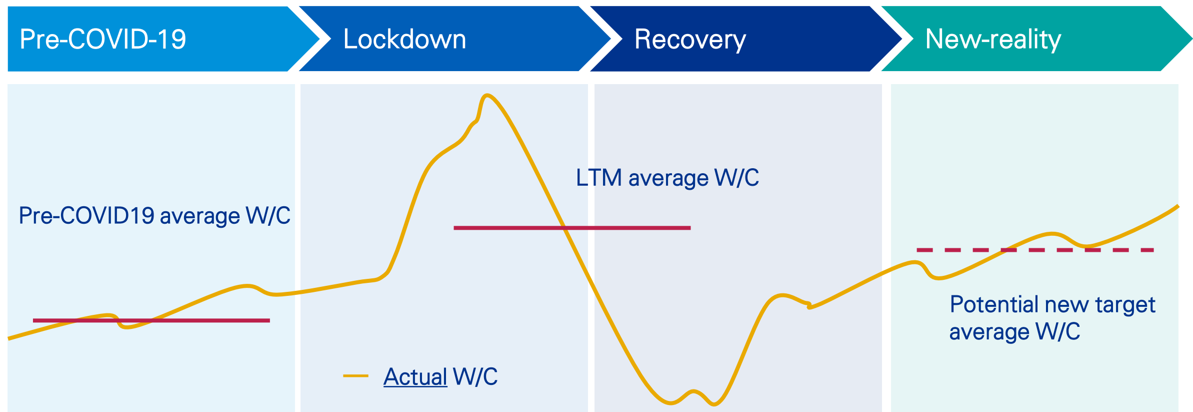
In order to navigate the uncertain business landscape, possible forecast analyses which can be used by businesses include:

- Sensitivity analysis which allows buyers to evaluate financial outcomes using different assumptions, and 'what if' scenarios;
- Up-to-date market research in order to understand the new normal of the industry in which a target company operate; and
- Detailed analysis of cash flow projection and strategic plans to enhance EBITDA and cash flow opportunities.

New-normal changes should be reflected in working capital level and funding requirements

Net working capital (NWC)

As businesses deal with and emerge from the COVID-19 pandemic, the historical working capital profile may no longer reflect the normal level of working capital requirements going forward. Changes in market conditions, government measures, supply chain issues, disruption in operations or changes in payment terms (e.g., customer and/or supplier may request longer or shorter payment terms) during the COVID-19 period would have an impact on net working capital, and therefore cash, requirements.



Most M&A transactions include clauses in the Sale & Purchase Agreements (SPA) that the business will be delivered with a 'normal' level of working capital, with a $-for-$ adjustment of the purchase price at closing for any excess or shortfall. How to determine what this 'normal' or 'target' level of working capital for a business is has always been subjective, but is even more challenging given the disruption that we are seeing due to the pandemic. Taking an average of net working capital over the last 12 months (LTM) may no longer be relevant due to temporary impacts on sales, supply chain disruption causing higher inventory levels, high debtors due to payment holidays to support customers, etc., however it is uncertain when (and even if) trading performance and working capital profiles will return to pre-pandemic norms.

As with the need to adjust EBITDA, considering whether impacts to working capital are temporary or permanent is equally important to determining what the normal level of working capital is likely to be going forward, and therefore being able to budget for adequate cash flows, credit facilities and liquidity. Diligence focus should be placed on reviewing long-outstanding trade receivable (are they still recoverable or should be written off), inventory (increased risk of excess and obsolescence), and payables that are long overdue as a result of businesses deferring payments.

For businesses that have been heavily impacted by the pandemic while the transaction negotiation is ongoing, it is crucial to understand the funding and liquidity requirements in the short and medium term. Preparation of monthly cash flow forecasts and sensitivity analysis for multiple scenarios and identification of items which could be released to cash or unwound are key.

New-normal changes should be reflected in working capital level and funding requirements

Net debt, debt-like items and long-term funding requirements

Extra focus during COVID-19 on potential debt-like and other items in working capital that could impact equity value includes:

Employee liabilities: Businesses may have undertaken cost-cutting measures with regards to employees, which could lead to additional legal obligations including outstanding severance liabilities, deferral of bonus or other compensation. Forward-looking changes to employment models need to be reflected in employee benefit obligation provisions.

Long-outstanding payables: Overdue payables caused by liquidity challenges may be treated as debt-like items if they are essentially used as a source of funding, particularly related party payables. If they are treated as such, they should be clearly defined in the SPA in order to avoid double counting in both net working capital and net debt.

Contract penalties: Any contractual commitment (e.g., purchase commitment, service level agreements) which the company failed to comply with could lead to penalties. Closure of branches or changes to committed expansion may incur penalties and dilapidation costs.

Breach of loan contracts: Any material contract including loan agreements should be reviewed for potential breach of covenants or commitments. Without a formal waiver, any breaches may lead to a technical default, penalty interest and even recall of the loan facility.

CAPEX plan: It is possible that maintenance CAPEX has been reduced to improve liquidity. Analyzing maintenance spend in historical years can help understand if fixed assets are well invested , or if additional 'catch-up' maintenance or replacement CAPEX spend may be needed post-deal.

Further consideration of liquidity issues should be assessed. Many businesses have taken on more debt either through government-backed loans, new or existing credit facilities or refinancing in order to maintain cashflow. It is vitally important to evaluate these new facilities and their key terms particularly on penalties, covenant breaches that may have been waived or deferred, and potential tax implications of debt forgiveness.

Understanding risks arisen from tax and legal perspective will be crucial

Tax

Traditional approaches to deal negotiation may need to be re-adjusted in the context of tax risk identification and assessment during the COVID-19 pandemic. While it may be an opportune time for buyers to find and acquire businesses at a relatively lower price, historical and contingent tax liabilities and risks should be carefully factored in.

Debt restructuring and working capital requirements may pose tax and transfer pricing risks at home and abroad.

While governments may have reacted with tax and non-tax relief measures, COVID-19 has put pressure on businesses to change how they operate and transact with customers and related parties. Businesses may need to renegotiate debt and contractual terms resulting in bad debts and income from loan forgiveness. They may also experience liquidity shortfalls which necessitate additional or alternate sources of funding. Related party transactions may be employed as a way to fund under-performing business units or markets. These may pose significant tax risks especially when the current transfer pricing arrangement is not appropriate – considering where profits are earned, and losses are made within the group. Potential ramifications at home and abroad may include uplifting taxable income, non-deductibility of costs and intercompany recharges and local tax authorities' challenge on the ability to utilize withholding tax credits, tax losses or tax depreciation deductions.

Additional tax obligations and liabilities may arise as a result of the 'new normal' of working remotely.

Due to travel restrictions and the 'new normal' of working remotely, businesses may be susceptible to adverse tax consequences overseas including permanent establishment and tax residency risks. While tax administrations in some countries may be more lenient provided these issues are a direct result of the pandemic, other jurisdictions would apply their ordinary rules without any concessional treatment. Payroll and personal income tax obligations would also become relevant when there are senior executives or expatriates working away from their usual place of business in different jurisdictions.

Identification and assessment of potential tax liabilities and tax attributes aid the parties to set a level playing field in deal negotiation.

To this end, sellers may be incentivized more than ever to insist on indemnifying buyers against potential tax liabilities or giving protection only if those liabilities are known and quantifiable. On the other hand, buyers may place value on tax attributes (e.g., tax losses and refunds) if available in the business to the extent they are well preserved or exceed quantifiable potential tax liabilities. Buyers may in this respect not place much value on tax losses, and associated deferred tax assets, if the losses are fast expiring and the imminent return to profitability is uncertain. Alternatively, buyers may consider carving out certain entities or pursuing an asset deal to avoid taking on historical tax risks.

In addition, deferred tax assets/liabilities and estimated tax payments will have to be evaluated in light of both new tax rules and updated financial projections that consider the impact of COVID-19 on a business.

Fiscal pressure on tax collection is likely to increase the level of tax scrutiny and controversy.

With fiscal pressure on tax authorities to collect more taxes against the backdrop of COVID-19, the level of scrutiny on taxpayers and future tax controversy with tax authorities is expected to increase. Comprehensive tax due diligence is as important as ever in this environment. Assumptions used in quantification of tax exposures in pre-COVID environment may no longer be appropriate. Buyers may need to be more cautious in assessing the likelihood of tax risks crystalizing. Reaching an agreement on value impact and mechanisms to address tax exposures is likely to be one of the key focus in a deal negotiation.

In successful deals, tax due diligence findings give the parties useful insights that enable them to make an informed decision as to the potential tax impact and deal parameters the buyer and seller should focus on during deal negotiation.

Understanding risks arisen from tax and legal perspective will be crucial

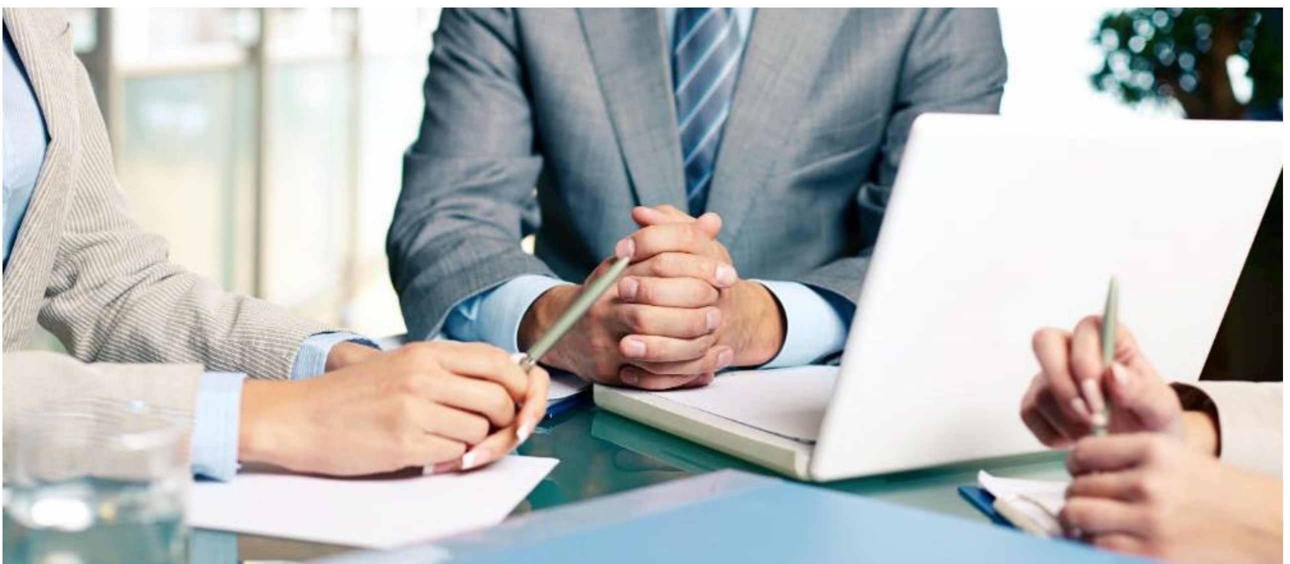
Legal

The COVID-19 pandemic and government responses place extra emphasis on legal matters when executing M&A. It is important for the due diligence investigations to understand the impact of the pandemic on the target so that we know how to mitigate the risks that may impact the transaction. Examples of potential areas of legal concern include:

- Employment issues:
  - Employment termination caused by the pandemic;
  - Legal compliance with employment, health and safety and other laws as part of a company's COVID-19 response plan;
  - Other changes to the employment conditions, benefits or cost-cutting measures; and
  - Related disputes or claim from terminated employees.
- Change of law and regulatory compliance including the extent to which the target's operations are compliant with applicable new emergency laws and regulations relating to the COVID-19 outbreak, e.g., regulations for shareholders' and board of directors' meetings, filing and registration processes with local government authorities.
- Potential breach of contracts and financial covenants including termination rights under existing contracts, risks of events of default, potential delays of deliverables under contracts or other termination rights being invoked by the counterparty as a result of the pandemic.
- Insurance arrangements, including losses arising from a business slowdown or stoppage.
- The logistical aspects of the due diligence process are to also be reconsidered and the travelling to conduct due diligence and site visits have become challenging. Face-to-face meetings, including management meetings or presentations may be more difficult. For instance, with restrictions on site visits, the buyer may not be able to fully observe actual business operation or the location of the target.
- Restrictions for foreign investors – it is vital to understand various aspects of restrictions and regulations for foreign investors to acquire and/or operate businesses in Thailand (e.g., restricted business activities for foreign entities under Thai law, foreign business license needs, land ownership, etc.) and to explore the available incentives for business operations granted by local government authorities.

Therefore, it is important to focus on identifying potential COVID-19 related risks during the due diligence investigation process and to evaluate the impact that the pandemic has had on the target. To mitigate risks during the pandemic, there are many tools that have been using to reduce the impact e.g., using more functional technology solutions such as virtual data rooms which are already a common feature of many transactions, keeping all documents as electronic files instead of hard copies, or virtual site visit of the target.

In addition, due to rapid changes of the impact of the virus, business operators should follow and keep updated of new laws and other new emergency laws, regulations and internal policies in order to comply with all conditions and restrictions declared and enforced.



Ongoing COVID uncertainty can give rise to a more robust SPA terms that Buyers seek as protection

We expect a marked alteration in closing mechanisms and SPA terms

Pricing mechanics: During this period of uncertainty, the use of locked box completion mechanisms is likely to decrease as buyers are less willing to take the risk of current trading between the locked box date and the Closing date. Buyers are likely to resist taking on risks of using historical Balance Sheet date for locked box mechanisms due to concerns on asset recoverability and leakage.

Completion account mechanisms on the other hand will become increasingly attractive since impacts of changes in circumstances can be accounted for as purchase price adjustments at Closing date. It should be considered to add protection against any fluctuation/manipulation of working capital balance in pre-completion obligations.

Valuations and deferred payments: Earn-outs are likely to increase due to the uncertainty on projections of the target business. Not only do earn-outs offer a possible solution to bridge valuation gaps between buyer and seller, they allow the seller to receive full value if the business performs as expected but also protect the buyer if it does not. Determining how long an earn-out period and what earn-out metric (e.g., EBITDA, gross profit, revenue) should be applied is subjective and will be key commercial negotiation points between parties.

Representation and warranties: Buyers should consider what specific representations and warranties with reference to the COVID-19 impact on the target's business should be added. For example:

- Financial statements: Buyers may consider additional representations and warranties over key judgmental areas e.g., provisions.
- Liabilities: As a result of the pandemic, there is a greater risk of breach of material contracts which may cause penalties, and there may be additional liabilities associated with the pandemic (e.g., severance pay for terminated employees). In addition, some regulatory compliance shall be added to ensure that the target's licenses for operation are in full force and effect.
- Customers and suppliers: Buyers may expand the representations and warranties considering the impact of COVID-19 on the relationship between the target and its key customers and suppliers (e.g., delay of its performance or default under the contract, insolvency or bankruptcy).
- Extended period for tax: Buyers may request to extend the period for tax warranties and indemnities against the backdrop of the expected aggressive revenue collection and thus the likelihood of tax exposures crystalizing (e.g., where circumstances around related party transactions may be skewed during the COVID-19 pandemic without appropriate transfer pricing adjustment and documentation reflecting it).

Conditions precedent: Successful renewal of material contracts where negotiation process is prolonged by COVID-19 may also be added to ensure that the business will be able to operate as normal.

Closing obligations: COVID-19 may cause changes of practice and internal policies in local government authorities, such as on the filing and submission of registration application for the closing obligations which the parties may expect some delay in the registration process.

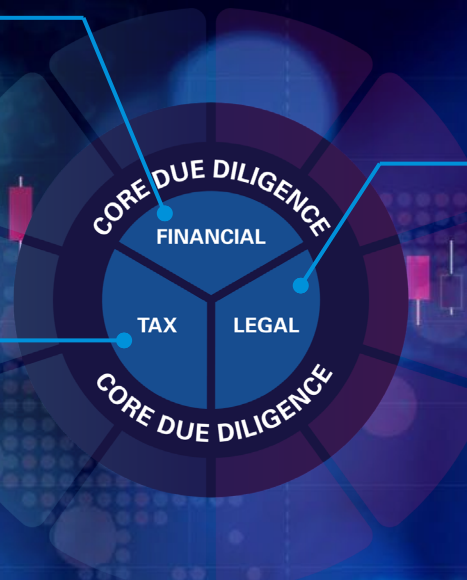
Where we can help

For any transaction, our clients will typically seek to undertake Financial, Tax and Legal Due Diligence which covers key questions required across risk and price. At KPMG in Thailand, we can offer an integrated team to provide a one-stop, coordinated service across the core due diligence pillars of finance, tax and legal.

KPMG's core Integrated Due Diligence service

Financial due diligence

Examine the fundamentals of the potential transaction, test the investment thesis, and provide a deep analysis of the critical areas that will enhance value. Identify adjustments to earnings, historical performance, benchmarking, forecast assumptions, the rights, and obligations that will be inherited through the balance sheet.



Legal due diligence

Identify legal risks, including regulatory and compliance gaps, which may create obligations and liabilities and impact the proposed transaction. In conjunction with the financial and tax findings, we provide practical recommendations and solutions to protect our clients. This may include the structuring of the transaction itself, along with contractual arrangements via the SPA and other transaction documents

Tax due diligence

Review, identify, and assess non-compliance historical tax exposures and tax attributes of the business. Our highly experienced M&A tax team can also help our clients take advantage of transaction opportunities, creating tax efficiencies including advising on tax efficient investment structures, corporate restructuring and post-deal support.

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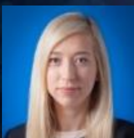

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