



Podcast transcript

Global M&A and restructuring in a post-COVID world

Podcast with Stuart Fuller, Global Head of Legal Services, KPMG International, Arco Verhulst, Global Head of Deal Advisory, M&A Tax, KPMG International and Leif Zierz, Global Head of Deal Advisory, KPMG International*.

Musical intro

Announcer:

Hello and welcome to the KPMG podcast series for tax, legal and mobility leaders.

We are focusing this podcast series on the ongoing global impacts of COVID-19, by looking at the tax, legal and mobility considerations and top-of-mind business issues that have resulted from this global situation.

In today's episode, we have Stuart Fuller, Global Head of Legal Services, KPMG International, Arco Verhulst, Global Head of Deal Advisory, M&A Tax, KPMG International and Leif Zierz, Global Head of Deal Advisory, also at KPMG International. Together we look at how global M&A activity has been affected as a result of COVID-19, what tax leaders should have in mind to be best positioned to execute deals in the current environment, as well as steps companies should consider if faced with restructuring or insolvency decisions.

Stuart, Arco, Leif, thanks for joining us today.

Stuart, Arco, Leif:

Hello, how are you, good afternoon.

Leif, I'd like to kick off our conversation with you if I can. Could you set the scene for us and explain how global M&A activity has been affected as a result of COVID-19?

Leif:

Yes, very happy to. What we have seen and quite consistently over the last four or five years before the crisis, was a very active M&A market. It was actually at \$4.1 trillion US dollars in total M&A value. And that is very close to the all times high we have seen of \$4.5 trillion dollars US in 2007. So, it was a very active M&A market but even more importantly, we have been in an

environment of disruption, of digitization, of sector convergence and environment of extremely low interest rates and record amounts of dry powder in the private equity industry.

And now COVID-19 came into it as a real shock and basically, due to the very high uncertainty that it has caused with respect to profit expectations and the general economic environment it has led to a, more or less a stop of M&A activity. So, for the first quarter, and for the global M&A market, we can already see a decline of the overall volume of about 40 percent. We don't have very good numbers for the second quarter, but I'm quite sure the numbers will be shocking in the sense that that market has more or less come to a stop, for now.

Announcer:

And to what extent is the crisis affecting the megatrends you mentioned earlier?

Leif:

Some of the megatrends will not go away, so the low interest rate environment with the crisis will not only not go away, but we can have the expectation that it will stay for long. And the liquidity is not going away, and with the low interest rate environment, we will see further inflows of capital into the institutional investors in some industry.

And, most importantly, the crisis is really serving as a catalyst for the disruption, and major changes that companies will have to make to their business models. The big question is, what is the time lag, when will that activity kick in again. And that will have to do, not just with the length of the recession that we are expecting, but also with the timing of very, very high uncertainty that we will see.

So, in other words my clear expectation is that we will go back to a very lively market, once expectations get clearer, and I'm not so much waiting for a recession that we will for sure see to end, but for the expectations to become clearer.

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Announcer:

Thanks Leif. Arco, are you also seeing the same effects to the M&A market?

Arco:

We've seen a significant contraction of the M&A market during COVID. The first period of COVID, those transactions that were in flight, so had significant progress, have in a lot of cases been completed. What we also see is those transactions that were in early stages basically are largely put on hold.

Interestingly, what we are also seeing is a couple of transactions where a purchaser probably tries to pull back from transactions that were almost done and dusted. So we also see that. And so we've seen a drop in transactions which is significant. It depends a bit on the statistics that roughly speaking between 50 and 70 percent down compared to the previous years.

Announcer:

Thanks Arco, those are quite dramatic figures. Stuart, what are you seeing in terms of deal execution and flow? What has been the experience so far across KPMG's legal services network?

Stuart:

What we're seeing as deals continue, even though they may not be completed is the need to be very creative and flexible. So, whether it's around the nature of the deal, the pricing adjustment, even down to what sort of representations and warranties and covenants are given, clients are adapting very quickly to the new environment and recognizing that there needs to be much more flexibility and creativity in the way that transactions are done.

And then finally, particularly to cross-border deals, we've seen over recent months a number of governments tightening their foreign investment laws. Many countries, whether it's the US, Canada, Australia, countries in Asia, the UK, and many countries in the EU, really to put in place approvals or timing limitations given the uncertainty of the markets and the impact on valuation and local economies. That will affect the timing of transaction and the certainty of particular bidders in transactions.

Announcer:

Arco, some trends in the deals space were already taking shape pre-COVID-19, how might the current climate accelerate those shifts and what other changes might arise on the other side? How do you think tax leaders might need to adjust their approaches in preparation?

Arco:

The COVID crisis has basically significantly increased the need for all sectors to have a bigger technology play in their service delivery, in their product delivery. So it will likely increase the trend of sector convergence.

Just to give you an example, digital companies have been able to purchase traditional supermarkets, traditional food stores, and have used their digital footprint to come up with a different way of delivery, a different way of serving their clients.

What COVID-19 has made quite clear is where supermarket, food stores were not on the digital path, they have been let's say receiving significant hits during COVID. Those that were prepared have come out in a much better shape.

So I think COVID-19 will just accelerate that sector convergence and the need to digitize stuff. And in doing that, that could be a driver for M&A once the COVID dust has settled a bit.

Announcer:

Leif, how are clients responding in the current environment and what kinds of conversations are you having?

Leif:

Well, the reaction of clients is for most of them that are active in the M&A markets both selling and buying, they first of all have become very cautious.

So what we see continuing, is activity around large and complex transactions that lead to preparation like carve out situations, or situations where we prepare companies together with our clients for IPOs. In this situation, our clients tend to continue the project, which shows us that they do have the expectation that once the preparation activity for these transactions is done, they come out with a much more favorable market environment again. Which is, as these activities shows, not seen as being too far away.

We are, on the other hand, also having lots of conversations with people now watching out for investment opportunities. For example, out of this current situation this crisis will bring, but I don't think people generally feel it's the time to act already.

Announcer:

Thanks Leif. Arco, what are the key considerations tax leaders should have in mind if they're to be best positioned to execute deals when the time eventually comes?

Arco:

I think in this environment with so much uncertainty, a sensible purchaser wants to do scenario modeling so they want to be able to see, okay, if this happens with the company in terms of financial performance how does it play out, so modeling and planning?

But that same question is also relevant from a taxation perspective. Essentially, leaders should be able to guide their deal professionals or their M&A tax department or their CFO. They should be able to explain what are the various options that we can see happening from a taxation perspective, what is our,

let's say, view as a tax person in the transaction, and how do you model out that uncertainty and the view likelihood of scenarios.

Announcer:

Arco, turning to the combination of tax reform and COVID related changes, how are these affecting the deal space? Are there any specific nuances for private equity firms as opposed to other players in the market?

Arco:

What we see is that tax is playing a significant role when it comes to the government support measures that a lot of governments have been issuing as part of the COVID crisis. So tax is a frequently used instrument to help support the economy. So it's about, deferral of tax payments, there's accelerated write-offs, there's carryback of losses to profit years, et cetera, et cetera.

So we've seen a lot of tax-related support measures. And to the extent deals still happen at this stage with a company that is asking for support, it is crucial to understand what these government support measures and the tax element mean from a deal perspective. So what we are now seeing after the first wave of government support measures is a second wave coming up.

And what we see is requirements where it relates to a company that is asking for government support in terms of ability to do dividend distributions, in terms of ability to pay out bonuses, et cetera. And definitely that is pretty critical from a deal structuring perspective to understand if a company has used support in any kind of means, what that means on the tax profile going forward.

Announcer:

Stuart, with all the additional financial pressures, many companies are undertaking refinancing, or restructuring measures of their debt. So, what are your thoughts around this subject for the upcoming months?

Stuart:

Yes. It's a great question and it's going to be a critical time, particularly if companies come through the next three months and business really recommences.

You come back to governance especially for companies considering undertaking a new transactional restructuring or raising new debt or equity capital. It's putting in place those internal processes and the right governance and oversight so that the company makes those decisions in the right way with the right stakeholders and in a way that's very transparent and verifiable to internal and external parties.

Very key at this time is, really, to look at existing arrangements as well as what's proposed. So, if a company is considering a refinancing or a restructuring, most of their clients will have external financing both from equity and debt markets, and really reviewing and adapting any covenants or undertakings or

provisions to which the company is subject now and which could be affected by a restructuring or refinancing.

So, going into any of those new transactions with your eyes very open about what the existing obligations are and how they may need to be managed with third parties. Thirdly, really, looking very carefully at whatever the new terms of the refinancing or equity issue may be and at a very basic level making sure the company can meet those obligations both financial and otherwise, and that would apply far more if the company was in any form of financial pressure or financial distress at that time.

And lastly, for the key managers and directors of the company, and this may be for smaller or for unlisted clients, sometimes where the third parties would require personal guarantees or undertakings from directors or shareholders or significant owners. And it's like in anything, any personal liability should only be taken on with your eyes very open as to what that liability may be and exactly why it's required by your counterparty.

Announcer:

And what steps should companies be taking if faced with restructuring or insolvency decisions?

Stuart:

Well, the first – first step is not to rush, particularly around the financial restructuring or an insolvency. These are business critical and legal critical issues for clients. So, first step is not to rush, and again, to put the appropriate governance and reporting in place so that the right decisions are made on the right basis and really the paper trail is established so that when third parties look at what the company has done, it's very clear.

The second key thing is to avoid changing financial obligations without carefully thinking them through. So any change in financial obligation that could create a new liability or a different liability and possibly create an ability for somebody to claim that that should not have been done is more important than ever. Undertaking scenario planning – so, it's a very uncertain world we live in at the moment and any transaction that starts with, let's say pre or post insolvency restructuring rarely finishes in the way that it starts.

And lastly, to work with and not against stakeholders, particularly financiers, so working very cooperatively with, rather than against, the interest of those internal and external stakeholders delivers the right outcome for every party.

Announcer:

Thanks Stuart. Leif, in the M&A market, Private Equity is obviously a key player, but do private equity firms have the same issues as other companies and how do you see their role emerging as we go forward?

Leif:

First of all, yes of course. As key participants in the M&A markets, they are of course affected like everybody. The times to come will be very interesting for private equity. A, I think they can even count with further inflows of capital and we'll see the

dry powders even increasing. So where, as I've said in the low interest environment, there will be a huge interest in investment through institutional investors. They will see the valuation levels slightly decreasing, but apart from distress activity at least for a certain time, they will at the same time maybe not find it easy to find opportunity. Because it needs sellers and/or businesses that are not necessarily getting into stress. It's clearly not an ideal time to sell for the owners of these businesses, so we will see of course transaction activity out of stress and out of restructuring. But this is a part of the market where only a part of the institutional investors in private equity are really looking at and can really look at, given how their funds are structured.

So, it depends very much on the product of private equity, whether activity can come back shortly or rather long-term.

Announcer:

Arco, do you see the same pressures on PE firms that corporate businesses are experiencing?

Arco:

It's perhaps more dependent in terms of modeling, in terms of determining what are the financial position of the company on going forward basis should look like is more dependent on leverage, the ability to play around with cash generated in the company than potentially corporates. And so to the extent that government support measures would inhibit the ability to, for example, payout dividends in a certain country because in that country there's been government support payout bonuses, et cetera, typically, you would expect that private equity is impacted more than corporate players as they generally have a bit more flexibility in working around the financing of their transactions and making sure that their debt is being serviced. So I would say the impact is a bit bigger for PE-backed firms than it is for corporates.

Announcer:

Stuart, what kind of new opportunities do you think will emerge for businesses?

Stuart:

We're relatively positive on where the opportunities will emerge because we think that it gives our clients the opportunity to actually accelerate some of the trends that we were seeing before. So, certainly opportunities in technology, digitization, will emerge and require companies to consider their business models, but also the principles in which they operate.

So, a model that's very relied on human capital and paper has been shown through these periods to be stranded when we're in a work from home, COVID environment. Certainly, a lot of opportunities around logistics and supply chain and corporate organizations. And we're seeing this already with clients looking at their supply chain from a resilience perspective, just not an efficiency perspective and creating optionality and diversification of supply chains but looking at a much broader range of issues.

And lastly, the rise of data. So, again, what COVID has shown is a company who has strong data and data analytics and a strong understanding and ability to analyze its own data can actually react to these market changes a lot more quickly.

And ultimately, this will lead to significant business model change for a lot of our clients and a lot of industries, in terms of both their financial structure, their capital structure, their corporate structures and then as I said before, their supply chains and logistics, all of those will need to be relooked at in the context of resilience and strength rather than simply efficiency.

Announcer:

And Arco, picking up on Stuart's points on restructuring, has the role of tax in restructuring become even more important in this environment?

Arco:

I think that tax is a significant value driver in restructuring activities. Tax often represents significant value for a company in distress. For example, tax attributes like unutilized tax losses, tax credits, et cetera. So in order to preserve these value adding attributes that's technically complicated, tax definitely plays quite an important role in preserving value in a distressed situation.

So I think we're in a situation where the role of tax is perhaps a bit similar as the global financial crisis. I think the difference with the global financial crisis, why tax may even be more important, is I think because of the magnitude of the economic impact that we're seeing.

The pace with which unemployment in the US has risen over the past couple of weeks and the amount of money that's being pumped into the economy in Europe, in Asia is unprecedented. So the level of restructuring activities that we will see I think is also likely to be unprecedented.

Announcer:

And Stuart, with all these financial pressures on business, I'd like to ask about the increased funding options in the market. What are we seeing in the debt markets now, in terms of supply and demand, and where do you expect them to be over the next 3 to 6 months?

Stuart:

So, what we're seeing from a KPMG perspective is no lack of funding and that is also, of course, supported at the moment by central bank support for liquidity for financiers and we would expect that to continue for the next 3 to 6 months.

What we're also seeing is at a borrower level, increasing interest and principal deferral. So, whether that's for business loans or personal loans, most financiers have given a lot of latitude to borrowers around repayment, particularly if they're in financial pressure. And that, of course, will affect the debt market as we go forward.

But what we're also seeing is that bank credit processes and assessments of credit are taking longer and I think it's a fair comment to say it's easier to get credit if you're a current customer of a financial institution or a credit provider compared to being a new customer for the first time.

And that really underpins the final comment which is, it's like in all of those times, there's a significant flight to quality for new loans and the credit process and the assessment process taking longer.

Announcer:

As the Global Head of Legal, beyond restructuring, what other legal considerations are top of mind for organizations?

Stuart:

Top of mind is still the health and welfare of both employees and customers. Also, we're seeing a lot of attention placed on resilience plans and business continuity plans. So, a business continuity plan has gone from something theoretical to something very real for all of us over the last three months.

There's a continuing focus on government programs in support so whether that short-term support or increasingly where a government will go with either tax policy or regulatory policy or even foreign investment policy, and what impact that might have on clients, particularly global organizations or clients who are involved in cross-border transactions.

And last but not least, my favorite topic around governance and litigation risk. So, in these times, of course, when a lot of decisions are made quickly and for the right reason at the time, it's also possible that in one year or two years' time, the third party may look at that and wonder why the decision was made.

So, all those factors sort of come up to our top of mind in most discussions with our clients.

Announcer:

Thanks Stuart. And finally Leif, how long do you think it will take for the M&A tax market to return to pre-COVID-19 conditions or levels? And will it actually ever be the same?

Leif:

Well as I said before, the M&A markets at really high levels, very close to their record high levels for years before this crisis. And I'm not so sure with the environment we're going into, we will see exactly these levels coming back really soon. But, as I also said, the key underlying factors and trends of that bullish market before the crisis, are still there.

What we will have to deal with is a gap in terms of pricing expectations between sellers and buyers. So we learned after all the previous crises that buyers adapt their valuations much more quickly than sellers tend to do. This can happen quicker this time, given the very strong trends that I described before. But it will take some time. But if you ask me, and you want a very short answer, I think the M&A markets will be very busy again in 2021.

Announcer:

Stuart, Arco, Leif – on behalf of our listeners, thank you for your time and thank you for providing your insights around how tax leaders are responding in the current environment and the conversations you're having about M&A activity, trends in the deal space, corporate reorganization, and the new opportunities that may emerge as we navigate through this period.

Stuart, Arco, Leif:

Pleasure, thank you. Okay, you're most welcome, thank you for your time. Much appreciated. Thank you, bye-bye.

Announcer:

For more information and resources on COVID-19, visit home.kpmg/covid19taxandlegal

Join us again next time and please email us with any questions you have about today's episode at tax@kpmg.com and we'd also love to hear from you with any suggestions you have for future episodes.

Musical exit