Emerging from crisis

Chris Williams and Oliver Phillips share their insight on M&A in the Middle East, emphasising on current activity, future opportunities and critical points that buyers and sellers should consider.

The first half of 2020 presented governments, businesses and individuals with an unprecedented set of circumstances. The abrupt and large-scale shock of the coronavirus pandemic, along with subsequent shutdown measures designed to contain its spread, threw the global economy into a severe contraction.

The regional economies in the Middle East have been further impacted by the turbulence in oil prices. A supply glut — caused by a decrease in demand because of the COVID-19 pandemic), an increase in supply due to lack of agreement by OPEC+ and fierce competition from US producers — significantly deflated markets. Whilst these prices have stabilised somewhat, the forecasted average prices for oil in 2020 and 2021 (USD35-45 per barrel) will be significantly below the 2019 average (USD60 per barrel). This will directly affect public spending on development projects, which are a major part of regional GDP.

In response to the above crises, governments across the Gulf region have introduced stimulus packages to help support and bolster economic confidence. Much of this support has been targeted at enhancing liquidity and reducing the impact of the current economic situation for businesses and individuals alike.

However, whilst the support provided by governments has been welcomed by both businesses and consumers, it is evident that COVID-19 has not affected all sectors equally. For some sectors, such as hospitality, bricks and mortar retail, and travel and tourism, negative cash flow has been a prevailing theme of this crisis and has emptied the coffers of many businesses at a time when the age-old adage of "cash is king" has never been so relevant.

M&A ACTIVITY

Uncertainty is the ingredient that

has always killed deals, and this has unfortunately been the prevailing theme for much of 2020. As such, M&A activity in the Middle East in Q2 2020 has generally come to a standstill, and it is likely to stay in this state until there is enough certainty in the market to act as the basis for valuations. Depending on the waves of the virus and the shape of economic recovery (V, W or gradual), market certainty might not return until at least Q2 2021.

The few deals that were in the M&A pipeline in the region have largely been put on hold (build times in data rooms appear to be up 50 per cent) or kicked into the long grass. Both buyers and sellers alike have returned to their trenches to focus on their existing businesses and operational strategies.

OPPORTUNITIES AHEAD

For the trade buyers who emerge from the current crisis with strong balance sheets, there is likely to be real opportunity over the next 12 to 18 months to snap up attractive assets which will create long-term value and provide operational or strategic synergies.

For those who emerge from the crisis in a less fortunate position, they will need to focus on how to secure their balance sheet, especially in sectors such as travel, aviation, automotive and discretionary and non-essential retail and hospitality. This may come in the form of equity investments (for majority or minority stakes in the main trading business), an accelerated divestment of non-core divisions or through a consolidation of smaller players.

The winners from this disaster are already using this lull in M&A activity to map out their strategies (restructuring, M&A or otherwise). As a result, they are ready to pull the trigger at a time when there is enough certainty for it to be sensibly executed.

During this time, buyers and sellers should be speaking to law firms, accountants and other M&A advisors with regard to getting a feel of the market and communicating an interest in exploring various avenues for their strategies. Within the past few months, people have generally been more open to having exploratory conversations. A knowledge of what is happening with potential targets (or the ambitions of buyers) will ensure you are best placed to act fast and to meaningfully structure a deal that reflects what both parties really need and are looking for.

BUYERS

The first step of the M&A process is target selection. This can include like-for-like acquisitions to gain customers and obtain cost synergies; category or channel expansion to develop a new product offering); supply chain acquisitions to vertically integrate up or down in a value chain to guarantee availability and control of services required in the "new normal"; and/or the purchase of new platforms or know-how, as part of an omnichannel play. More shrewdly, there may be the opportunity to take advantage of bad will in targets to add further strength to the balance sheet.

Once a target has been selected, buyers may wish to alter the standard due diligence process to include COVID-19-related considerations, such as a review of all major contracts of the target to understand the ability to perform or terminate obligations under those contracts, including material adverse effect and force majeure clauses); a more-than-usual assessment of solvency risk of the target; and an assessment of its impact on covenants, if any, under any credit facilities used by the target and identifying supply chain risks and actions during and after COVID-19.

Buyer strategies are likely to include not only the conventional expression

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of interest to existing shareholders (via management) but also the utilisation of "loan to own" transactions (which notably were successfully implemented by certain sophisticated private equity funds in the aftermath of 2009) in which debt stacks are strategically bought at a discount and then such security is enforced to take ownership of the business.

FINANCING

Banks have reportedly been restricting the amount of available acquisition finance as they focus on supporting existing client business needs. In addition, it should be considered that lenders may have difficulty accessing capital due to portfolio volatility and limited capital markets options which will result in a more risk-adverse approach and may, in turn, result in increased time in executing a transaction.

As such, buyers should carry out a realistic assessment of balance-sheet strength and start to explore and engage in initial discussions with alternative funders, such as private equity (taking a debt like position instead of equity), investment grade bond issues and equity capital markets. This may also be an opportunity for large funds earmarked for offset programs to be used in the region.

The key during this time will be to keep in touch with investors and lenders and keep them abreast of any relevant information throughout the process.

SELLERS

The most critical point for sellers is evaluating whether this is the right time to sell their business and whether that business is ready to be sold so as to achieve the best value. If a seller is facing liquidity issues but decides this is not the best time to sell the business, they can consider other options, such as analysing cash disbursements to define critical and non-critical cash disbursements or a possible restructuring in order to reduce costs. If the business still needs to be re-capitalised, then sellers may wish to first evaluate other possibilities, either through refinancing, a divestiture of a business line or asset or sale-lease back arrangement.

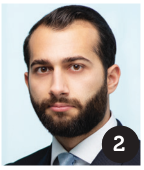
For those that decide to sell, shareholders and management can start working with advisors to prepare sale teasers, build data rooms and consider any pre-sale re-organisations that might need to take place to make the proposed transaction more attractive and to limit the requirement of any transitional service agreements.

In a similar vein, sellers can also start undertaking sell side legal and financial due diligence to start flushing out and fixing any red flags that could later hold up a transaction, lead to a price-chip or result in unnecessary withholdings or indemnities being given up as part of the sale documentation. In addition to the usual contents of the data room, buyers will want to see additional summaries and information to include the impact of COVID-19 on operations, supply chains, HR, quality of assets, financing, liquidity, commitments and contingencies.

Sellers can engage accountants to carry out an assessment of the accounts of the business, prepare details on commonly-contested items such as normalised working capital, cash like and debt like items for the particular business and also consider the presentation of a set of adjusted EBITDAC figures.

CONCLUSION

There is no fixed playbook on how this will all unfold, but ultimately we expect to see a significant acceleration in M&A as the crisis stabilises. COVID-19 has required us all to step outside of our comfort zone in various elements of life. The M&A market and its execution will be no different as we emerge from this crisis.



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