NAVIGATING DEALS IN THE COVID-19 ERA

KEY TAKEAWAYS

May 2020

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To discuss the complexities of the impact of COVID-19 on the deal making process, BDO in India and J. Sagar Associates hosted a web panel discussion on '**NAVIGATING DEALS IN THE COVID-19 ERA**' on **06 May 2020**.

The Webinar was attended by distinguished personalities from the PEVC community, conglomerate India, deal makers and the legal forum.

ON THE PANEL WERE INDUSTRY EXPERTS

BALA DESHPANDE, Senior Managing Director of MegaDelta Capital - a Growth Equity Fund focussed on the evergreen mid-market opportunity of India. Bala is a founding team member of Mega Delta (erstwhile NEA India) that served as an investment advisory firm for NEA Inc (one of the largest VC funds globally). She is also an Independent Director Board Member of Future Retail and Info Edge. Prior to joining NEA, Bala was with ICICI Venture and a Director on the boards of several companies. Her PE experience has seen the full cycle from nurturing young companies to executing multiple exits via IPO's, buy-backs, strategic sales, and capital market divestments.

MAHESH CHHABRIA, Managing Director of Kirloskar Industries Limited since July 2017. Prior to this, he worked as a Partner with Actis and advised Actis Global LLP to invest money in PE and buy-out space in India. Previously he worked at 3i India, where as a Partner in the firm's Growth Capital Group he led the Healthcare sector globally and contributed to 3i's investments in India and international markets. Prior to 2006, he was Co-head of Investment Banking at Enam, one of the leading domestic investment banks in India. He is a regular speaker at various industry forums and a contributor to most Indian business publications.

SAMIR SHETH, Partner & Head of Deal Advisory Services at BDO in India, with 22+ years of experience primarily in business advisory and transaction service assignments (from USD 2mn to USD 2bn). He has provided services across the deal continuum/sectors, though mainly focused on due diligence reviews. Prior to BDO, Samir was a partner with one of the larger accounting firms for 6 years. He shares significant experience in cross border deals and has served both financial and strategic buyers. He has carried out 700+ due diligences to date.

SAJAI SINGH, Co-Chair of J. Sagar Associates' Corporate Practice. An acclaimed transactional lawyer with 30 years of experience across industries/ businesses. He has a deep understanding of the issues that arise in major transactions and provides solutions to resolve these issues. Sajai is adept at corporate work related to regulatory matters, internal investigations and conflict resolutions. He regularly publishes insights and speaks on a variety of legal, regulatory and transaction topics.

AND THE DISCUSSION WAS MODERATED BY

LAKSHMI PRATURY, CEO - INK - India's foremost platform for the exchange of cutting-edge ideas and inspiring stories, founded by her in 2010. She is a speaker, host and curator of live events and an entrepreneur. Lakshmi is credited for bringing TED to India in 2009. She also serves as director of the SingularityU India Summit in association with INK. She has spent 20+ years in the technology, VC, and non-profit industries in the USA. As part of Global Capitalist Partners (VC firm), she focused on connecting India's software-development community with US tech. Lakshmi has featured on the list of '100 Most Powerful Women' by Forbes Asia in 2010.

INSIGHTS SHARED
AT THE WEBINAR HIGHLIGHTED

- Cash is King
  We are back to Balance sheet vs. Sheer profitability

- Survival is key
  It takes away the focus from profit-making

- Assess the Margin of Safety towards survival, managing operational expenses and WC

- War on Exceptional Talent - Managerial teams that can execute, think fast and be accountable for outcomes would be backed

- Deal slowdown to be severe in Q1CY20 and Q2CY20 with a gradual pick-up

- Assessment of pre-COVID EBITDA vs COVID period EBITDA and expected time taken to go back to pre COVID EBITDA levels is critical while evaluating deals

- Significant changes in the way diligence is conducted and that focus areas may shift

SUMMARISED BELOW ARE THE KEY DISCUSSIONS AROUND THE FOUR CRITICAL DIMENSIONS

The Economic Dimension | The Deal Dimension | The Sector Dimension | The Legal Dimension

and FAQs that couldn't be answered during the webinar but deserve a special reference.

THE ECONOMIC DIMENSION

The COVID-19 is an unprecedented health crisis and in terms of its global economic impact it is far deeper than any economic/financial crisis experienced in the past. As an economic event, it raises many uncertainties on the demand and supply balance and the resultant impact on global economy, growth (rather degrowth), profitability, cash flows and consumer behavior. This would involve a complete change in the game plan for all the stakeholders and a deep thrust on Healthcare and Prevention.

As a human race, we have been through such global predicaments in the past, like World War, Financial Crisis, Spanish Flu etc. Three factors that we need to keep in mind:

- There is an enormous amount of wealth in the world as indicated by global GDP numbers.
- Advancement in Technology and Ecosystem changes- WFH (Work from Home) is only the tip of an iceberg.
- Coming to our country India, the entrepreneurial culture that has been trending since the last decade is phenomenal. Investors are able to back entrepreneurs who have both the courage and intelligence to navigate through this uncertainty/ chaos. Entrepreneur weightage generally is 50% in majority of the deals; quality of entrepreneurs and management teams is very critical during these demanding times.

India Needs Higher Stimulus and Liquidity:

Pre-COVID India's GDP growth was declining quarter-after-quarter. COVID-19 has made everything a part of history and now everything is new.

The earlier economic packages on (1) The Economic and Social Welfare Stimulus by the Hon'ble Finance Minister Ms. Nirmala Sitharaman of INR 1.7tn (~USD 22bn or ~0.9% of India's GDP) that addressed majorly the bottom pyramid of the population and (2) RBI's Financial Stimulus to boost the system liquidity by INR 3.74tn (~USD 49bn) will be insufficient. Multiple suggestions by various authorities have been submitted to the Finance Ministry and RBI for availability of capital/ liquidity for businesses to stay operational. We clearly need more stimulus.

Panelists highlighted that India has many companies where cash flow velocity remains a concern. Receivables cycles stretch from 90 to 120 days, including for banks. Cash is one of most important variables to see at all times and its importance has only strengthened.

For Corporate Inc and Deals, the focus now shifts from "Profit Making" to "Survival" and the adage "Cash is King". Debt availability will remain a challenge for the next one year or so. Hence it is important to focus on the amount of cash that is available to survive and then grow, and how efficiently is WC managed. Even though there are talks of liquidity being made available (from possible stimulus, economic packages etc.), one needs to take things with caution.

The IT sector and large industrial houses are very skilful in managing cash. In these times, industrial houses which have always focused on "Cash on Balance Sheet" as a stated policy/ philosophy and never raised external equity money will command premium.

From a start-up perspective, players that have sufficient cash/runway for the next 12-18 months are fairly placed but those with less cash would find it challenging as fund raising is going to be difficult during these times.

Nonetheless, enterprise optimism is an equally important medicine during current times. They need to build on supply chain disruption opportunities that will surface on the way. Many MNCs/ Global 1000 companies may evaluate moving operations from China to India. India Inc. should be well prepared to capitalise on the same.

Even from the perspective of human capital, managerial teams that can demonstrate vision, execution, ability to act fast and be accountable for their acts will be backed/ supported. These times differentiate "Men Vs. Boys".

Investors will focus on funding those investee companies which would be able to get a follow-on funding.

THE DEAL DIMENSION

M&A activities share a strong correlation with the evolution of stock prices and risk. From 2000 through 2019, the correlation between the value of the MSCI World index and M&A volume was approximately 80%. With major indices including MSCI World and S&P 500 fallen by ~35-40% from record highs of February 2020, we are experiencing significant decline in deal activities.

As seen during the 2008 crisis, the overall deal and PE activity has significantly declined from its peak in 2019. PE deals have reduced 65% YoY from USD 9.6bn in Q1CY19 to USD 3.4bn in Q1CY20. M&A transactions have reduced ~17% from USD 18bn to USD 15bn but this too is camouflaged by PSU bank mergers *(Source: VCC Edge Database)*

We will see a further steep decline till Q2CY20 post which we may see a recovery led by:

- Opportunist PE funds utilising their dry powder to acquire/ invest in good assets Note: Dry powder available with PE is USD 1.45tn as at 2019 end (highest ever).
- Attractive valuations from buyer's perspective.
- Strategic investments by strong cash rich companies/ smart & savvy investors. E.g. The world's largest social media company Facebook is investing USD 5.7bn for a 9.99% stake in India's Reliance Jio Platforms, a three-and-a-half-year-old subsidiary of the nation's most valued firm Reliance Industries.

Good and niche transactions will happen even as they pass through deeper and demanding due diligence processes/ introspection. Business plans will be evaluated to the minutest possible levels with a binocular focus on cash flows and WC management over the next 12-18 months. In addition, how the management is reacting to such contingent situations and business continuity provisions/in-built systems will be an area of focus.

Under the current situation, the deals can be classified as:

- **Deals in the final stages and close to completion** – These may face some operational hurdles but will surely get completed
- **Deals midway in process / diligence phase** – These would face more detailed diligence and/ or renegotiation of the terms and may need to be evaluated with a new lens.
- **Deals at early stage** (being evaluated or at term sheet stage) – These will be more of a wait and watch approach and will possibly resume with completely different terms

We will see a temporary lull in deal making/ completion scenario and then see a gradual pick-up. Nonetheless, in the current situation many companies will be available at good valuations. Smart investments made during such tough times fetch disproportionate returns in the long term.

Valuations have changed completely

From the perspective of valuations we see a drastic change, typically where forward multiples (say FY21) were used, we would see a huge challenge now. Rather than just profitability, investors would focus more on balance sheet strength, cash flows and cash runway (months of expenses covered) as key attributes in valuations. Some may even resort to other modes/ structures like:

- Convertible structures: Investors would be looking at using more convertible instruments by defining the conversion formula linked to defined milestones. Escrows, earnout based structures, contingent considerations or stepped-up acquisitions would likely be the preferred structures to factor in economic uncertainty. These would however involve certain complex structuring considerations around tax, FEMA etc
- For VC type deals for early stage companies, the cash buffer they have with them or the ability to survive for longer periods of time will have an impact on valuation.
- In M&A, share-swaps may be one of the preferred options. As this approach also normalises the relative valuations between concerned players at the same time.

THE SECTOR DIMENSION

From an asset perspective, one would see less dependence on businesses where physical infrastructure is critical to business operations, whereas digital assets will play key. Physical asset ownership is going to get challenged. Sectors which would gain importance would be where the workforce is able to execute offline / remotely / from home.

Consumption, Healthcare, Entertainment, Fintech, Digital Economy and Enterprise Tech Sectors will gain prominence. However, even within Consumption we will see a change in preference towards select sub-sectors as consumption habits see a sea-change (FMCG will be preferred as people start eating more at home). Even niche Engineering and well capitalised NBFCs will attract the investor's eye.

In the last decade, flow of capital was distorted with money chasing select companies/ sectors and many of them will get disrupted / challenged in the current situation.

Panelists believe India's SME sector is a promising opportunity. The number of SMEs in India (~50+ mn) is huge and a good chunk hit a ceiling due to lack of capital during economic crisis. There will be good value in SMEs that are able to differentiate themselves, have niche business propositions, are margin leaders and have demonstrated prudent cash conservation principles. Many of these SMEs have exhibited their ability to grow and develop scale, remain niche and be relevant in larger ecosystems, consistently showcased low cost structures and delivered industry growth/ profitability. These enterprises will also be good candidates for larger companies in India to acquire.

THE LEGAL DIMENSION

Risk factors have certainly increased, which means we may see a more thorough due diligence and deeper dive into various aspects of business continuity, preparedness for disaster recovery, ability to walk away from deals, insurance coverage etc. On-site diligences will have to be replaced by virtual diligences. The COVID-19 pandemic crisis will give rise to many protective and secured clauses mainly in the favour of the investors/ lenders. Deal terms may get aggressive. Taking a clue from the USA, one of the panelists shared that an increasing number of commercial contracts are invoking “MAC” (Material Adverse Change) and “Force Majeure” covenants in the agreements which impact the very basis of investment thesis. These would unfold in many ways like representations, warranties, acquisitions, takeovers, renegotiations etc.

From a promoter’s standpoint, an in-depth internal diligence may help them ascertain what they should disclose to the investors or purchasers.

Even when the deals bounce back, given the lower risk appetite and unpredictable market situation a considerable amount of time may be spent in structuring consideration. Earnout structure, milestone payments, post-closing adjustment may be a norm for some time.

In acquisitions that involve takeover of people, certain legal factors would require additional considerations with respect to their health issues, travel practices etc. In deals involving promoter exits, purchasers/investors may introduce additional covenants in the definitive documents to ensure promoters co-operation in navigating the precarious situation that they are in. Purchasers/investors will have to identify the legacy issues relating to COVID-19, liability of which may pass on to them and result in potential cash leakage. Such contingency should be addressed in deal documents by way of indemnity.

FAQS THAT COULDN’T BE ANSWERED DURING THE WEBINAR BUT DESERVE A SPECIAL REFERENCE

What are the challenges you are facing during diligence, e.g. lack of physical verification, data verification etc.? How are you dealing with the same?	There are 2 types of challenges – the first relates more to the physical/ operational challenges – lack of physical access, data verification etc. Since a lot of diligence work was done virtually even in the past, it is not so much of a challenge for larger companies/ targets who have the ability to provide all data virtually. However, for mid-market early stage companies, one does face a challenge in getting reasonable level of data. Here, the concerned parties will have to adjust the expectations related to access to information and timelines for diligence completion and revisit any past work based on new facts. We are making extensive use of virtual data rooms and video conferencing. Additionally, the diligence has to be much more focussed, involving significant senior level time from the diligence team. Special attention is paid to Senior Management interviews to assess the robustness of Business Continuity Plans (BCPs) and execution challenges encountered during this crisis period. The second challenge which is more at the impact assessment level is more demanding – ‘How does one really factor the impact of COVID-19?’. Assessment of pre-COVID EBITDA vs COVID period EBITDA and the expected time taken to go back to pre COVID EBITDA have become very critical. A detailed assessment of medium-term business plans say over 3 years and monthly budgets for the next year will be a key part of any diligence going forward. Each disclosure made during the diligence period by the target company in connection with the on-going or potential issue should be analysed in great detail and investors/purchasers should take a call whether this is something which may impact the deal consideration. If yes, they may want to address these in the deal documents.

What are the specific areas where you would undertake more diligence due to the present situation?

Few areas which are occupying top of mind space during diligences are:

- Assessment of pre-COVID EBITDA vs COVID period EBITDA and the expected time taken to go back to pre COVID EBITDA
- Business plan on short-term and long-term basis
- Monthly cash flows for the next year including cash burn rates
- WC and associated funding
- Responses and preparedness to contingent situations like the current one – business continuity planning, cyber security etc.
- Deferred Tax Asset (DTA): Where DTA is created in respect of utilisation of tax losses, now the same may have to be revisited in light of the impact on business performance / profitability due to COVID-19
- Impact of not being able to comply with time bound obligations e.g. Export obligations
- Ability to walk away from their obligations under material contracts
- How companies are dealing with health data collected
- Insurance coverage and exclusion
- Potential covenants that the company may have breached

What additional safeguards entrepreneurs should take into consideration or investors should be guarded from, while investing in these unprecedented times?

For Enterpreneurs

- Entrepreneurs especially start-ups should assume that it will be very difficult to raise funding in the next 3 months and possibly longer. The objective would be to have 12-18 months of runway given the current macro environment.
- Valuations are being reset. It is more important to optimise for company runway than valuation at this point.
- A “flat round” or even a “down round” that extends your runway to at least 12 months is a good outcome in these times.
- Onerous terms such as personal guarantee (that impact personal assets of the promoters) should be avoided.
- An equity investment has an element of risk, if the investors try and attain a ‘risk free’ structure, promoters should examine it carefully.

For Investors

- Investors should not be emotional about deals; even if significant time has been spent on a deal, it needs look with a new lens. In case the issues arising cannot be taken care of in terms of renegotiated value or terms and walking away is the only option, then so be it.
- Do a very thorough diligence, factoring various scenarios.
- At the same time, don’t be closed to new deals…Investments made during difficult times have resulted in best returns when invested with due care.
- Look at more innovative ‘consideration’ structures, consider linking it to commercial milestones.
- More specifically look at ‘walk-away’ rights & see if objective thresholds may be built in.
- In strategic investments, other terms such as ‘step in’ rights etc., may also be looked at.

About BDO Global

BDO is a leading professional services organisation and are global leaders of the mid-tier, with a presence in 167 countries and over 88,000 people working out of more than 1,800 offices. We endeavor to deliver truly exceptional client service through a tailored solutions approach, while partnering with our employees and clients globally

About BDO in India

BDO in India offers Assurance, Tax, Advisory and Business Services & Outsourcing for both domestic and international clients across industries. The team at BDO in India consists of over 2800 professionals led by more than 150 partners and directors operating out of 14 offices, across 10 key cities

About J. Sagar Associates (JSA)

JSA is a leading national law firm in India, with over 320 professionals operating out of 7 offices located across key cities in India. JSA is recognised as a leading national law firm providing legal services to Indian corporates, Fortune 500 companies, multinational banks and financial institutions, governmental and statutory authorities and multilateral and bilateral institutions.

To access a copy of the recording, please click here

For any content related queries, you may write in to vcpeconnect@bdo.in

For any other queries or feedback, kindly write to us at marketing@bdo.in

All our COVID-19 related resources can be accessed at the COVID-19 Resource Centre on www.bdo.in

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