Harvard
Business
Review

Mergers And Acquisitions

The Case for M&A in a Downturn

by Brian Salsberg

May 17, 2020

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Summary. As companies begin planning for a post-Covid future, there may be opportunities to make one or more long-sought acquisitions. Deal premiums are likely to come down and assets that companies had been reluctant to sell may become available. But the window for... **more**

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Most companies are still in the early days of assessing the impact from the Covid-19 crisis on their business. But as they begin planning for the future, there may be opportunities to make one or more long-sought acquisitions.

Businesses are, or should be, examining their existing lists of potential acquisition targets and should be prepared to act, as deal premiums are likely to come down and assets that companies had been reluctant to sell may become available.

But the window for maximizing value could be relatively short, if history is any indication.

Learning From the Global Financial Crisis

Evidence from the global financial crisis (GFC) from late 2007 through early 2009 shows that companies that made significant acquisitions during an economic downturn outperform those that did not.

There are some caveats: The GFC was, as its name indicates, a financial crisis, and was somewhat limited to the financial services and real estate sectors. Governments needed to bail out banks as many companies were overextended. Consumers were crunched as the value of their homes dropped dramatically and some found their mortgages underwater.

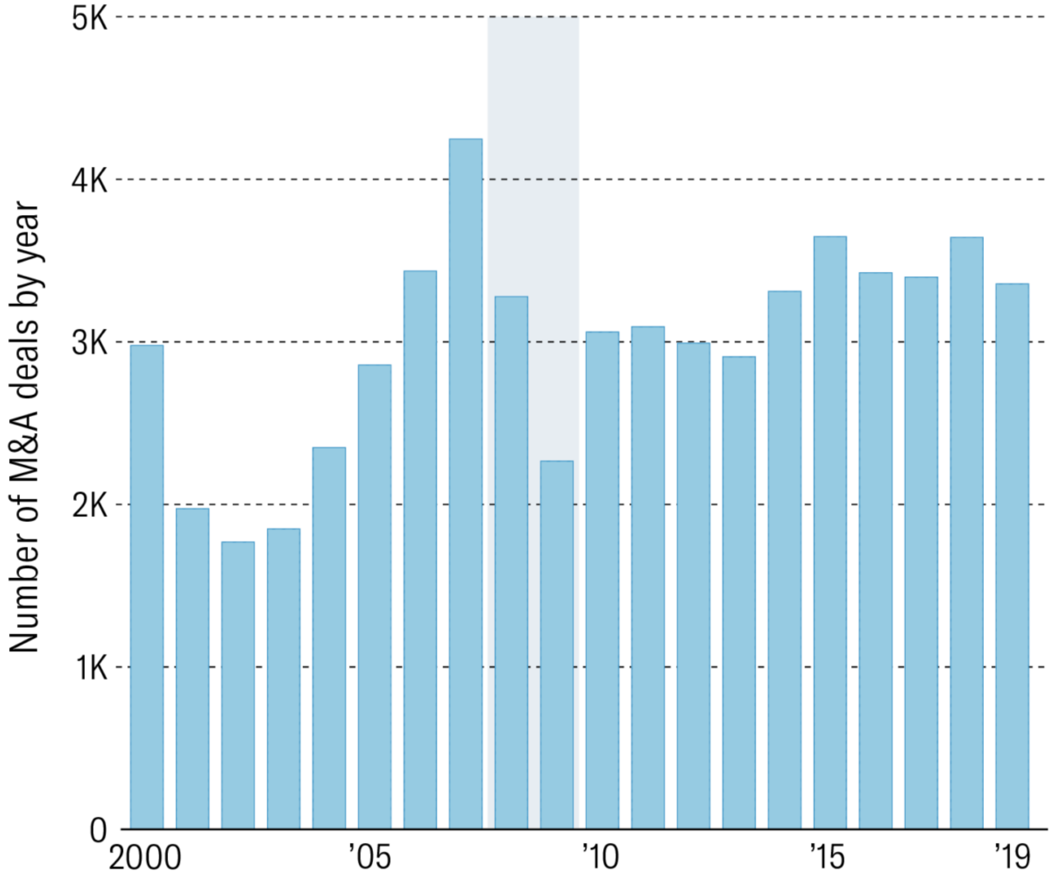
Today, we have almost the entire services sector of the economy immobilized and unemployment at a much higher level. The Covid-19 crisis is first and foremost a health crisis, and the progress of the disease is likely to be the key factor in determining the length of the downturn and, thus, the optimal

M&A window. Still, the GFC is the best modern example we must examine the ultimate shape of the eventual recovery from an M&A perspective.

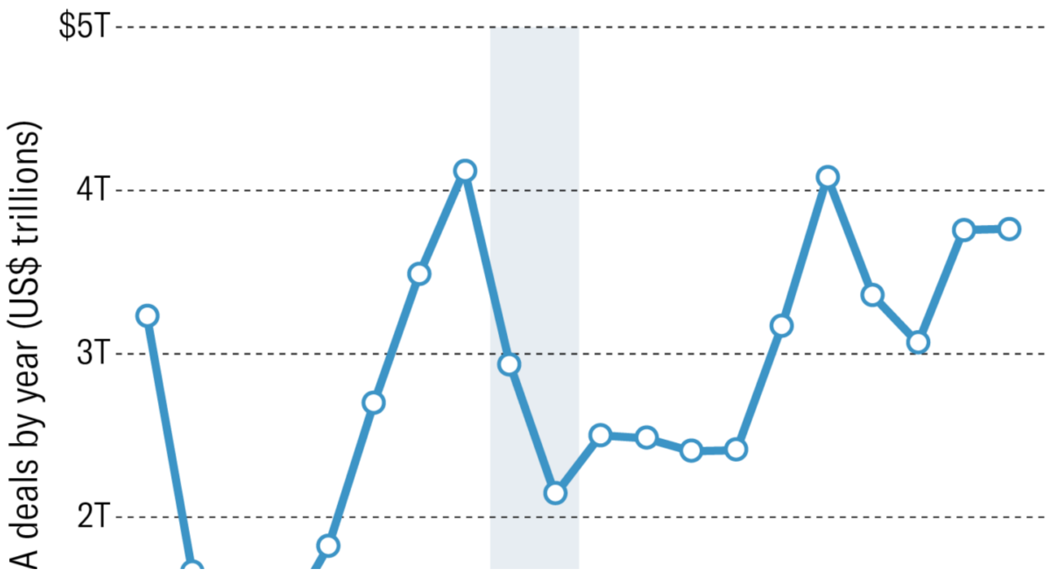
With regard to dealmaking, the recovery beginning in 2009 was very much U-shaped. That is, it took more than five years for deal volume to recover to average pre-crisis levels and deal value never quite recovered.

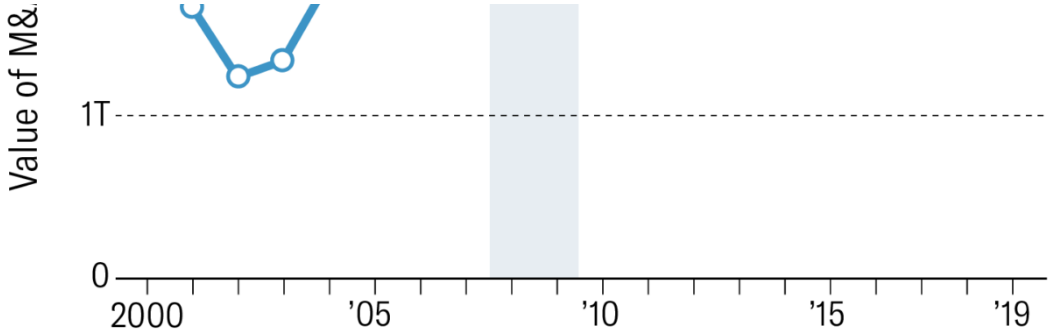
Global M&A Deals, 2000–2019

During the 2008 financial crisis, the **number of M&A deals** dipped by almost 31% year-over-year…



…and the **value of those deals** fell by about 27% in the same time period. Similar drops are possible due to Covid-19.





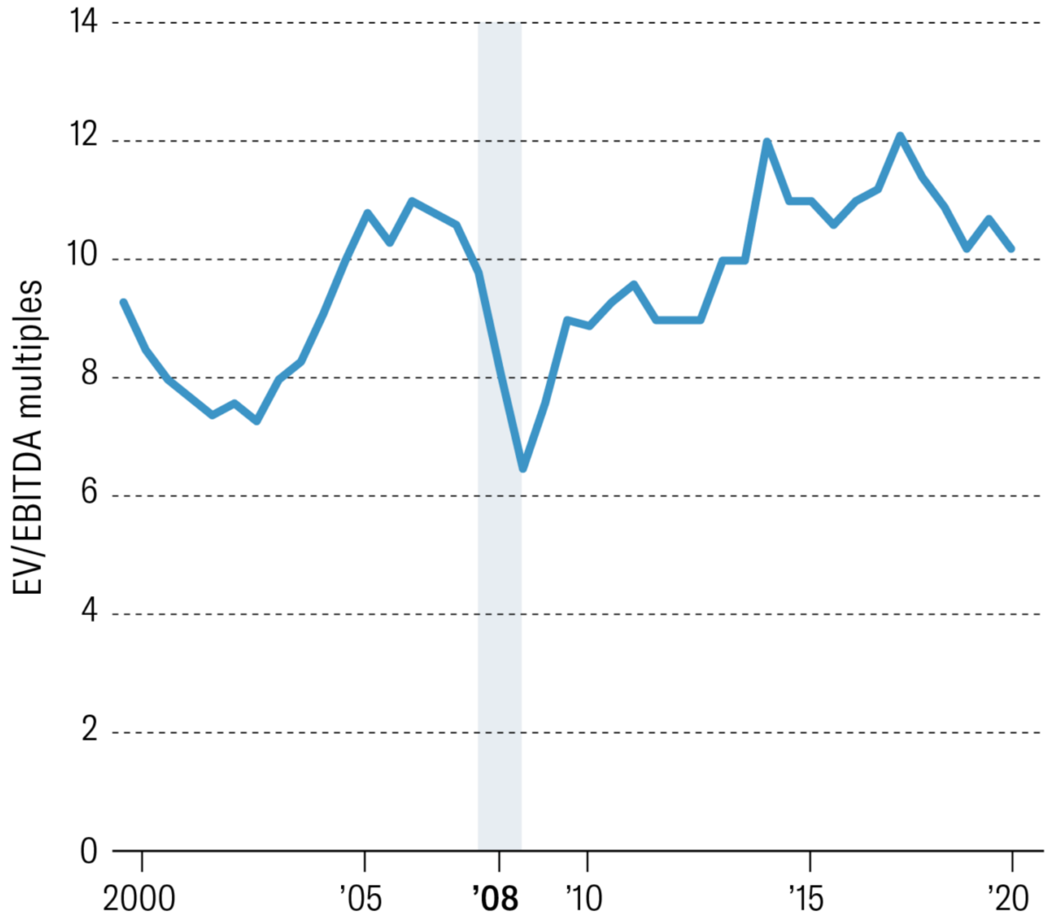
Note: Excludes real estate acquisitions. Volume based on deals of US$100 million or more.

Source: EY analysis and Dealogic

The story regarding deal multiples — defined as enterprise value divided by EBITDA (or, earnings before interest, taxes, depreciation, and amortization) — was somewhat different, with much more of a V-shaped recovery. Deal values plummeted from an average of 10.8x in the three years before the 2008 crisis hit to as low as 6.5x in 2009, before rebounding to the 10-year average of 11.6x by 2019.

Deal Multiples, 2000–2020

An examination of deal multiples — the ratio of enterprise value divided by EBITDA that is used to determine a company's value — during the 2008 financial crisis suggests that valuations that have or will decline during the current downturn are likely to bounce back somewhat quickly.



Note: EBITDA — short for "earnings before interest, taxes, depreciation, and amortization" — is a measure of a company's financial performance.
Source: EY analysis and Dealogic

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History suggests, therefore, that there will be a relatively short M&A window that opens as the Covid-19 crisis ends, during which bargains will be had by those with the liquidity and the risk tolerance to move quickly, and who have done their homework in advance.

Active Acquirers May Outperform

There are some qualifiers to consider when examining the data.

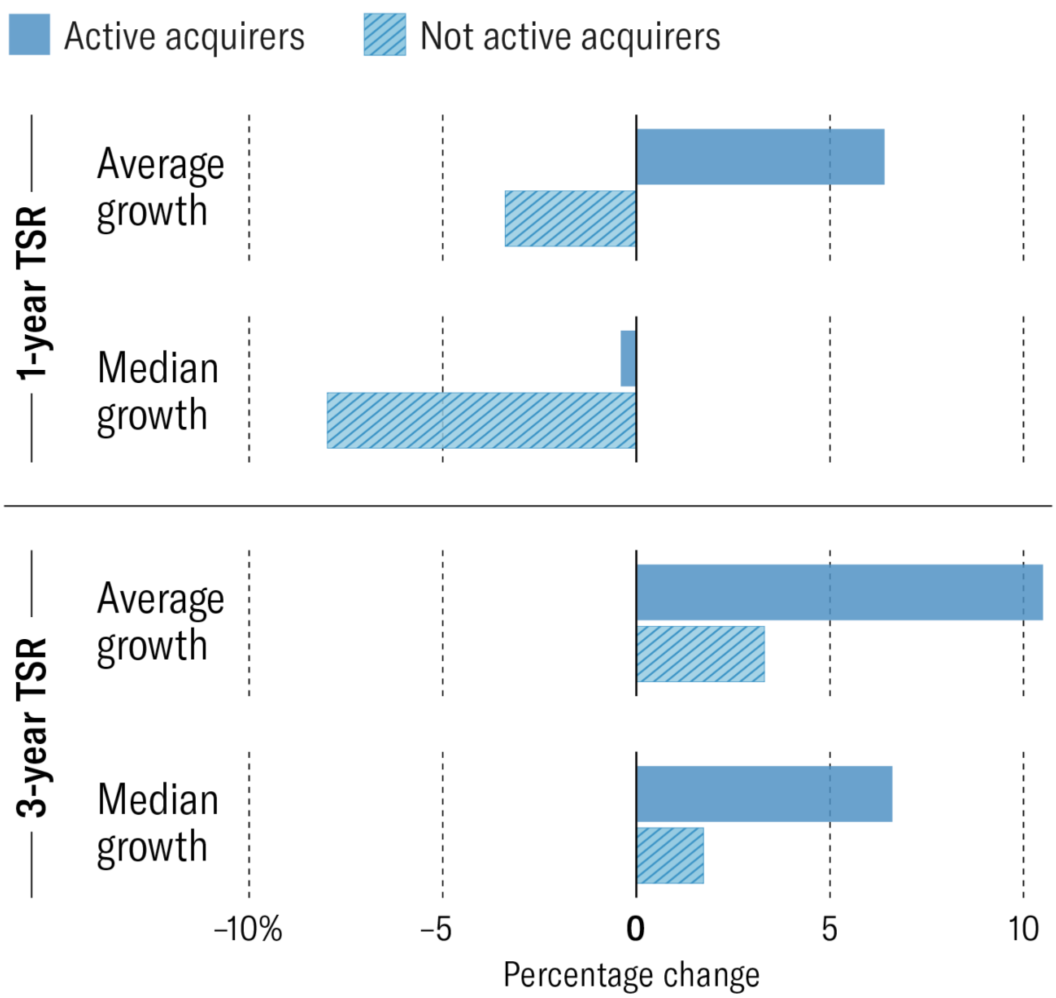
First, there can never be a true control in the M&A world to measure against — a company either does a deal, or it does not. Additionally, company performance as measured by total shareholder return (TSR) is the result of a mix of inorganic and organic activities, as well as any number of external factors, none of which can be totally isolated.

That said, we nevertheless can conclude the following:

- Those companies that made acquisitions totaling at least 10% of their market cap from 2008 through 2010 (active acquirers) had an average TSR of 6.4% from January 2007 through January 2008, compared with TSR of -3.4% for less active companies. (See Figure 3.) A similar difference was seen in median TSR.
- The trend continued over the period of January 2007 through January 2010, when average TSR was 10.5% for active acquirers, vs. 3.3% for less active companies.

Total Shareholder Return (TSR) Growth by Acquirer Type, 2007–2010

Firms that made significant acquisitions during the 2008 financial crisis outperformed those that did not.



Note: Analysis of companies on the 2008 Fortune 1,000 list; excludes financial services, real estate, and companies where the share price was unavailable on Jan. 1, 2007 and Jan. 1, 2012

Source: EY analysis, Capital IQ, *Fortune*

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TSR for active acquirers with strong liquidity positions (cash and short-term investments to revenue of at least 7.0% in 2007) increased by an average of 5.0%. In contrast, other companies saw an average increase of 1.7% over the period from January 2007 through January 2010. This gap continues in the long term (five years) with active acquirers' TSR growing at an average of 16.9% vs. 4.9% for other companies.

Deal Activity May Be the Best Option for Excess Liquidity

Companies with excess liquidity may find that shareholders and boards are more conservative about how this liquidity is used. Specifically, share buybacks, and possibly dividend payments, may be curtailed for several years and companies will need to keep a higher level of cash on hand. These factors will require them to use any truly excess cash to generate long-term shareholder value.

At the same time, with a focus on preserving the health of the economy and jobs, governments and regulators are likely to be much more tolerant of larger acquisitions in many industries.

EY analysis suggests it is not too soon to consider M&A opportunities and to be ready to act. CEOs, CFOs and heads of strategy and corporate development need to think strategically now about the "new normal" and which acquisitions would be accretive to their current business models. There are a few areas in the deal process that will no longer operate business as usual, particularly during this period of social distancing. Companies thinking about M&A will need to consider some of the unique aspects to getting a deal done, including:

- **Transaction Diligence:** Even if the majority of diligence can be concluded remotely, it is likely to take longer. Diligence requiring onsite visits, such as to physical plants, is much more difficult to do via video. Boards may also be reluctant to approve an asset or operations-heavy transactions without an actual site visit. Pressure-testing the strength of the balance sheet and forecasting expected cash flows for the next 12 to 24 months will be more critical than ever. Additionally, cyber diligence (that is, assessing the strength of the target's IT vulnerability) will increasingly become a focus area due to the accelerating reliance on technology.

- **Synergy Modeling:** Synergy modeling will need to be conducted with an eye towards the "new normal." For instance, resilient supply chains have more redundancies than efficient supply chains, meaning they are more expensive and have fewer opportunities to cut costs and achieve synergies.
- **Business Models:** Business models are likely to change in our "new normal," and it is not just what is obvious. For example, that hot new kombucha beverage with all the social media hype may struggle to find a space on the retail shelves of the future where grocery channels begin re-prioritizing established brands and safety stock over the next hot product.
- **Post-Acquisition Integration:** Maintaining employee morale and engagement is more critical, especially in this environment, as many will be focused on their own job security, so asking them to put their energy towards onboarding target employees may be difficult. While it is possible to work your way through much of the integration playbook remotely, the culture, and change management aspects can be tricky to accurately get over a videoconference call. Being considerate of working hours; ensuring various integration meetings stick to a reasonable timeframe; and infusing the process with the appropriate amount of "ice-breaker" activities (e.g. virtual happy hours) are some ways to ease the burden of the work-from-home context.

Ultimately, M&A requires significant rigor about understanding post-Covid-19 recovery curve scenarios that target companies are likely to experience coming out of the crisis, in addition to understanding the true liquidity situation of the target and any of the target's near-term capex or similar needs.

Special thanks to Rahul Agrawal, Manvi Gupta, Banipreet Kaur and Vaishali Madaan for their contributions to this article.

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Brian Salsberg is the EY Global Buy and Integrate Leader. In this role, he leads fully-integrated M&A management services across sectors for the EY organization. He has experience working directly with CEOs, executives, business teams and boards of directors, as well as PE-backed companies, in all facets of strategic planning, due diligence, corporate development and M&A.