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Failing Firm Merger Analysis in the Shadow of COVID-19

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Competition agencies around the globe have been responding in various ways to the COVID-19 pandemic and government policies to contain it. For example, many agencies have permitted coordination between suppliers of essential products,[2] the European Commission has asked companies to delay filing merger notifications, and the Federal Trade Commission has emphasised the adequacy of existing laws to deal with the changed circumstances.[3]

Among its responses, the ACCC released a statement on 27 March 2020, which included the following:[4]

> *We expect that the current market environment is also likely to result in additional merger proposals related to concerns and uncertainty regarding the ongoing financial health of some firms. Where such mergers are proposed, we will assess each on a case-by-case basis. Importantly, this will take into account not only the present situation but also the longer-term impact on competition of any change in the structure of markets. This assessment goes beyond the current impact of the crisis on the profits and share value of the merger parties.*

Although not explicit, this statement can be read as a warning that any "failing firm" justification for a merger should rely on evidence beyond merely what is happening to cashflows of the target firm during the pandemic and related shutdown. In general, this seems very reasonable, although it is plausible that there are categories of business for whom the current crisis really is the death knell, regardless of the ability of the economy to recover afterwards. Broadly, we can categorise the firms that fail as a result of the crisis three ways, each of which would require different evidence:

1. **Firms whose business models were fragile pre-crisis:** Many business models were already under significant pressure, having been disrupted by factors unrelated to the current pandemic. For example, traditional media, linear pay TV, and some brick-and-mortar retailers have seen a significant shift in the competitive landscape due

to technological disruption. For some of these businesses, the pandemic may merely bring forward the inevitable. An example that probably falls in this category is the New Zealand business of Bauer Media Group, a magazine publisher that announced on 2 April 2020 "its intention to close its publishing business in New Zealand due to the severe economic impact of COVID-19";[5]

2. **Firms whose business models are permanently disrupted by the current pandemic:** Otherwise healthy businesses pre-crisis may find their business models no longer make sense post-crisis. Consumer preferences (e.g., the willingness of people to congregate in large groups, handle goods others may have handled, or travel) and patterns of supply may change in ways that render certain business models unprofitable even in the long term; and

3. **Good businesses unable to weather the current storm:** Firms whose business models would remain sound post-crisis may become insolvent due to an extended period of not being able to trade. This would essentially be a liquidity/cashflow issue.

The widespread effects of a pandemic could also mean that failure may not be confined to (one or more of) the parties to a given merger application, leading to situations where:

- Competition agencies may have to consider parallel acquisitions in the same market simultaneously, complicating the counterfactual;

- A merger between two healthy firms might become problematic if a non-merging firm (or firms) in a market is failing, or otherwise impacted by the crisis in a way that lessens its competitive constraint; or

- If a merger between healthy firms requires a divestiture and the planned buyer is in financial distress, that might put the original deal in jeopardy.

Returning to the ACCC's statement, what might be "the longer-term impact on competition of any change in the structure of markets"? We do not really have any precedent to guide us here. The 1918 flu pandemic took place in a significantly different economy and also resulted in high death rates for 18–44-year-old adults (i.e., working age adults) and healthy adults.[6] In contrast, COVID-19 is deadlier for older people and those with underlying health issues.

Similarly, while there are some policy lessons from the Global Financial Crisis (for example, the need for government assistance to be very fast), the causes of that crisis were quite distinct (forms of market and regulatory failure), and many of the effects probably were too.

Of course, "the longer-term impact on competition of any change in the structure of markets" will vary from market to market. However, in the table below we identify some types of changes that might occur.

Feature or Performance of Market	Potential Changes (Generalisations)
Demand	In most markets, demand has dropped precipitously, due to physical constraints on movement and cashflow concerns.[7] Demand is likely to recover only slowly, and in some cases demand patterns may change permanently as a result of changes in consumer preferences brought about by the pandemic: • Even as government-imposed constraints are lifted, many consumers will be cautious about physical interactions. This could be a problem particularly for businesses with products that assemble people closely together (e.g., airlines, stadiums, and even retail). • Patterns of behaviour developed during periods of isolation may actually increase demand for certain products or distribution channels. For example, online shopping may become more prominent at the expense of brick-and-mortar and contact payments. • Incomes will likely take a while to recover. • Uncertainty about pandemic recurrences and economic recovery may result in households saving (including paying down debt) rather than spending. • Export demand may be affected by increased transport costs (e.g., due to reduced aircraft cargo capacity; The Economist reports that air freight rates have essentially quadrupled as airlines have cancelled flights)[8] and perhaps a rise in protectionism (e.g., if governments worry about self-sufficiency). On the other hand, if trade volumes fall by more than GDP, as occurred after the Global Financial Crisis, ocean shipping capacity might become cheaper.
Supply (Variable and Fixed Costs)	In many markets, supply will be restricted and/or more expensive, as: • Overseas links in the supply chain are restricted due to lockdown or reduced capacity (e.g., in aircraft cargo holds or factories practicing employee distancing) and potentially a rise in protectionism (e.g., governments focusing businesses on their own domestic consumers). • Firms rebuild labour force capacity after downsizing during the pandemic. • Firms having to start again from scratch, following pandemic-induced closure. These features may reduce the responsiveness of firms. On the other hand, firms with large fixed costs and spare capacity following the slump in demand would have an incentive to aggressively expand. There are likely to be broader effects for property and labour costs. For example: • Demand for commercial and retail property may decrease as more people work remotely and shop online. • Wages may fall, or not increase as fast as they otherwise would have, as unemployment rises. • We might also observe greater vertical integration in certain sectors if firms' input markets are disrupted and/or suppliers are unreliable or are at risk of failing.
Innovation	As is often the case in competition analysis, we might see contrasting forces at play here. On the one hand, the pandemic and subsequent recession might stimulate new business models and ideas to address the changed economic world. For example, having been forced to do more things remotely during the lockdown, consumers might be more open to remote appointments with GPs or optometrists. On the other hand, three other features might limit firms' ability to invest over the medium term: • Cashflow is likely to be tighter, as firms pay off pandemic-induced debt. • The cost of external capital (debt and equity) may rise. To date, corporate debt yields have already risen substantially.[9] (Complicating matters is the fact that central bank interventions are intended to suppress benchmark interest rates.) • There might be continued uncertainty caused by the possibility of recurrences of COVID-19 outbreaks and, accordingly, government intervention, as well as uncertainty about demand. This uncertainty will likely steer capital towards business models that are less likely to be affected by a recurrence.
Competitive Interactions	In some countries, we are observing increased state ownership (or at least that possibility) of large, "strategic" firms (e.g., airlines). This will raise issues of competitive neutrality, as might the more widely available government-offered or guaranteed loans. Dissatisfaction with profit levels might be a spur to collusion. On the other hand, increased uncertainty is likely to make coordination more difficult. For the reasons discussed earlier, imports may be more constrained. Relevant to this potential constraint will be what happens to exchange rates over the medium term. We might also see supply chains becoming less "just-in-time" and increased use by importers of local storage facilities.

Regardless of how quickly economies recover from the COVID-19 pandemic and attempts to constrain it, it is likely that demand and supply features will change in many markets, with implications for innovation and competition.

Notes

1. We are grateful for the comments of our colleague Dr. Subramaniam (Subbu) Ramanarayanan.
2. For example, the Federal Trade Commission and Department of Justice have announced expedited procedures for providing guidance to firms (competitors) looking to collaborate during the course of the pandemic. See https://www.ftc.gov/news-events/press-releases/2020/03/ftc-doj-announce-expedited-antitrust-procedure.
3. See, for example, Ian Conner, "Antitrust review at the FTC: staying the course during uncertain times", Federal Trade Commission, 6 April 2020, available at https://www.ftc.gov/news-events/blogs/competition-matters/2020/04/antitrust-review-ftc-staying-course-during-uncertain?utm_source=govdelivery.
4. "COVID-19 pandemic – what it means for ACC merger clearances, authorisations, notifications and CTMs", Australian Competition & Consumer Commission, 27 March 2020, available at https://www.accc.gov.au/update/covid-19-pandemic-what-it-means-for-accc-merger-clearances-authorisations-notifications-and-ctms.
5. See Bauer Media Group at https://www.bauermedia.co.nz/.
6. Sergio Correia, Stephan Luck, and Emil Verner, "Pandemics Depress the Economy, Public Health Interventions Do Not: Evidence from the 1918 Flu", 2020, 5-6.
7. Of course, this point applies not just to direct demand, but also to derived demand. For example, we would expect suppliers to the tourism industry to be facing materially reduced demand.
8. "Trucks, queues and blues", *The Economist,* 26 March 2020.
9. For example, data from the Federal Reserve shows that at the beginning of 2020 spreads between baa corporate bonds and 10-year treasuries fluctuated between 150 and 250 basis points, whereas the spread rose to 423 basis points on 20 March 2020. See "Moody's Seasoned Baa Corporate Bond Yield Relative to Yield on 10-Year Treasury Constant Maturity", Federal Reserve Bank of St. Louis, available at https://fred.stlouisfed.org/series/BAA10Y.

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