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M&A ACTIVITY IN THE COVID-19 AND POST COVID-19 WORLD

May 2020

Since markets began to sell off in late February in response to COVID-19 concerns, we have seen a significant fall in global M&A activity, to 30-35% lower than previous Q1 and Q2 statistics year on year, amid a noticeable reduction in M&A announcements and postponement or withdrawal of some deals.

Whilst it is too early to predict the timing and shape of the downturn and subsequent economic recovery ahead, prior crises would indicate that there will be a **recalibration of M&A type and terms**. In addition, the COVID-19 crisis offers some **unique opportunities and challenges**. Unlike the Global Financial Crisis (**GFC**), for example, it is largely industry/sector- agnostic: it has affected pretty much all. A large number of industries therefore face rapid and significant changes at the same time. Governments and investors also continue to react with new policies and pressure that will shape the strategic decision-making of companies in both the immediate and long term.

We consider how the COVID-19 crisis might change the nature of M&A transactions. Both in form, as strategic consolidations and distressed, rescue and defensive M&A increase; and in substance, as we anticipate a development of market practice on transaction structures and negotiations.

Strategic, distressed or 'rescue' M&A and consolidations

For well-capitalised companies with strategic M&A agendas, the current environment presents an opportunity to position for transactions both during the crisis and as market volatility reduces. This may be in the form of **opportunistic**, **transformational M&A** or smaller **'bolt-on' acquisitions** by larger companies seeking to capitalise on the opportunity to expand with a lower level of investment. As we saw from the GFC, leveraged companies will focus on deals that increase their liquidity (for example, by monetising non-core assets or (reluctantly) selling high-value ones). In some instances, this may be driven by pressure from activists who have to date been largely quiet during the crisis, or by the changing interests and priorities of joint venture partners.

Some deals may also be driven by a perceived risk to **address specific issues** (for example, to re-engineer supply chains) encountered during the crisis.

Or it may be M&A in **distressed circumstances**, perhaps with buyers positioning for **'rescue' M&A**, at least in name, as they protect and support targets, and the persons employed by them and suppliers who rely on them, over the longer term through acquisition.

Consolidations within an industry facing significant financial pressure may also increase as companies constrain investments in R&D and other organic expansion. As in the GFC and its immediate aftermath, this may involve an increased reliance on **'failing firm'** arguments to try to achieve consolidation that may otherwise raise red flags with competition regulators.

The recent decision by the Competition and Markets Authority to provisionally clear

Amazon's investment in **Deliveroo** may also indicate a willingness from governments and regulators to clear transactions in which they may previously have intervened where the investment prevents an exit from the market during the height of the crisis and/or where COVID-19 gives rise to a significant risk of financial failure. As noted below, regulators are also focusing more on foreign investment, and we may see an increase in government intervention to preserve key businesses and services vital for the economy.

'Distressed' M&A - some key considerations:

- A **seller in financial distress** will likely need a simple, quick and clean transaction and will seek to maximise commitments, payment security and deal certainty at the outset, whether through letters of credit, deposits, break fees or escrow structures. This will be particularly relevant in a buyer-friendly market, or where the buyer or investor is reliant on third party financing.
- Prices may be lower, but parties should take care that pricing is at **a fair market value** to avoid any future creditor challenge (and all parties should ensure both price and structure is adequately documented).
- **Recourse to the seller** may also be limited, and necessitate the use of alternatives such as **escrow** and transaction **insurance** (although note the limitations set out in *Representations and warranties, W&I insurance and disclosure* below).
- At least in the short term, buyers of target businesses that are potentially in distress and/or have received some government support, at a price that may be considered to be **opportunistic or otherwise low**, will be mindful of the potential market, political and public reaction if, for example, they are seen to be taking advantage of a national / global disaster, in which we are "all in it together", for private gain. For the same reason, we may see a deployment of private equity capital to leverage expertise through **constructivist (rather than hostile) efforts**. **Communications** and **IR plans** will be important (also see *Increased investor scrutiny* and *political intelligence* below).
- Directors of a distressed seller will focus more intently on their **fiduciary duties**, which will influence the nature of negotiations. In particular against the backdrop of concerns that D&O policies may be tightened by insurers seeking to limit their exposure to COVID-19 related claims. Buyers must also take care not to trigger any **shadow directorship** concerns by being too closely involved in seller decision-making processes, including during the period between signing and completion where the current climate, and the position of the target business, may tempt a desire for greater control.
- On the flip side, a bolstering of **structural defences** and an inward-focus on a company's **own vulnerabilities** (and how to address them) may be prudent, whether in the context of opportunistic speculators or (for public companies) **shareholder activists**. Sharp declines in share price generally allow for easier opportunist and activist entry, and whilst activists have to date been largely, and sensibly, silent, companies will be mindful of the opportunity this crisis presents to those looking to take a position now and press for change in a future period of stability (see *ESG investments* below for more on this). **Proactive due diligence** may provide an opportunity for a company to identify weaknesses in their own existing processes and improve going forward.

Bespoke deal strategy and structure

Valuation is difficult at any time when there is market volatility and uncertainty. We anticipate such volatility and therefore uncertainty to remain in the medium term. Parties may therefore look to share the risk on valuation through more complex deal structures, such as:

- Use of **bespoke capital instruments** that allow for a conversion date when the market is more stable, with a ratio impact dependent on investment value at that date.

- **Share-for-share transactions** to preserve cash in the short term and shift price discussions to relative value.
- **Joint ventures** or **partial purchases** (rather than acquisition of 100% of the target) in the short term, to spare the buyer the entire valuation risk, allow sellers to retain some upside value (and influence) and provide for a **staged acquisition of full control** in due course (through options or other triggers). This may be particularly useful where selling management's input and insight would provide a degree of stability and continuity, and may be an attractive proposition for founders in need of private capital but not ready to part with control of their businesses. **Key person** provisions and insurance are likely to be important for business succession and protection purposes.
- **Financial sponsor** (minority) investments or **PIPE transactions** as a (necessary or preferred) funding alternative to debt or capital market financing. With a record $2.5 trillion in uncalled capital, **private equity funds** under pressure to put their dry powder to work can offer a quick deal, sector expertise, are less likely to trip competition hurdles and will be well-positioned to invest against a backdrop of depressed public markets and corporate buyers in cash preservation mode. Mindful of the likely government and public perception, in the short term at least, they are likely to wish to position this as 'rescue M&A' rather than opportunism. Funds distracted in part by portfolio management during the crisis, may also look to limit exposure to a **minority interest**.
- **Acquisition consortiums** to share risk and exposure between investors, and/or to leverage the lower cost of capital of long-term, non-traditional investors such as pension and infrastructure funds.

Where an **earn-out** is used, appropriate **contractual restrictions** on actions of the buyer during the earn-out period, and arrangements for the seller's **continued involvement** will also play into how the transaction documents are negotiated.

Joint venture and shareholders' agreements

In this context, JVAs and SHAs may necessitate a bespoke approach to otherwise broadly accepted principles, including:

- **Mandatory funding provisions** that ensure capital adequacy in the short to medium term and flexibility to adjust to market volatility without convoluted discussion and approval.
- **Lock-in periods** that at least ride out the height of market instability, and **mandatory exit provisions** that take into account the potentially increased risk of investor default (for example, a failure to fund).
- **Protective covenants** to limit multiple consortium members in one industry, or conversely, to expressly allow multiple industry investments for speculative investors and private equity funds looking to capitalise on sectoral experience.
- The process by which **operational** and **fiscal** decisions that deviate from an agreed business plan (or budget), or which constitute a reserved matter, can be taken in urgent or 'rescue' circumstances, and where the usual voting and escalation procedure would be inappropriate.

How the COVID-19 world may differ from prior crises

There has been a distinct focus by governments and investors on **equitable responses** to the crisis, and a call by some for greater scrutiny as we emerge from the immediate crisis response, to avoid the mistakes made after the GFC. Going into the crisis, supported by wider developments in corporate governance (for example, in the UK, the new Corporate Governance Code 2018), there was a widespread and growing expectation that directors engage clearly and transparently with all stakeholders and not just pay lip service to their company's stated goals regarding ESG matters. One effect of COVID-19 seems to be an acceleration and galvanisation of this trend, as companies and governments are under more pressure than ever before to deliver support to all stakeholders. We touch on this and the **shifting demands of society** following the COVID-19 outbreak in our 5 May client note, *The increasing demands of a social license to operate*.

We have already seen some **regulatory interventionism** in the form of Foreign Direct Investment (**FDI**) screening, and government support and regulatory initiatives seem likely (if largely unpredictable) in the short to medium term.

In the context of M&A, we may see:

- Governments and regulators taking a wider view of what constitute, and a more proactive interest in, **business-critical acquisitions**, particularly where investment promises to secure jobs. Public and government reaction should be borne in mind for **post-completion integration** and rationalisation plans and **transitional services agreements**, with drafting allowing for alterations in response to (soft or hard) regulatory pressure.
- **Increased regulation and protectionism** through foreign investment control rules and tax relief measures. We discussed the early calls for FDI screening in our March client note, *EU Commission urges FDI Screening to prevent a sell-off of critical European assets*. In connection with potential changes to UK foreign investment control legislation more generally, a parliamentary (Foreign Affairs Committee) inquiry was launched on 7 April with the remit of examining how the UK FCO assesses whether a potentially hostile party is seeking to secure significant influence or control over a UK company and in what circumstances the FCO should intervene.
- **Increased investor scrutiny** of announced transactions. Previously boilerplate **confidentiality** and **permitted disclosure / announcement** clauses are likely to be a source of greater focus, as messaging and wider stakeholder engagement becomes key, and parties ask themselves: who am I going to want / need to discuss this with?
- Greater focus on **ESG investments** and **stewardship practices** by so-called 'responsible investors', in respect of short term responses to the crisis but also in the future economic recovery phase amid calls to "build back better". The revived focus may be driven **organically** as COVID-19 brings to light the materiality of ESG-related risks, and sustainability generally, and the deep linkages between businesses and their stakeholders across the value chains; or by government intervention, with companies that prioritise long-term universal returns put **first in line for support**; or by private investor/sponsor **capital allocation**. It is notable for example, that high ESG-rated businesses and the ETFs that channel funds to them appear to have fared somewhat better in the recent weeks of market volatility. The move on 13 May by **Legal & General Investment Management** to pressure **ExxonMobil** over governance and climate change is poignantly timed.
- **Political intelligence** becoming a key transaction workstream from pre-signing to completion, in a move towards a more US-style engagement with policymakers.

COVID-19 impacts on transaction market practice

As a general observation, if the broad consensus around the emergence of a buyer-friendly market is true, we may see a move to a more US-style practice for private M&A transactions - in respect of pricing, repetition of warranties, scope of disclosure, walk-away rights and MAC provisions. Listed companies will also need to consider the impact of COVID-19 on the application of class tests. We touch on these issues below.

Class tests

As set out above, the current crisis may provide opportunity for transactions outside the ordinary course of business. For listed companies, the class tests used to compare the size of the company with the transaction may be **distorted** as market capital falls sharply in contrast to pre COVID-19 historic profits / revenues, and asset values diminish or are written off. In such a scenario, companies may consider a submission to the FCA to treat the impact of COVID-19 as **exceptional** for the purpose of the test. Or we may see an increase in the number of transactions requiring shareholder approval.

Pricing and valuation

We may see more of a return to a **purchase price adjustment** (or **completion accounts**) **mechanism** in view of the need to allow for uncertainties and fluctuations on value since the last accounts date or during the pre-closing period. The form of such adjustment may require a **bespoke COVID-19 approach**, for example:

- Where a post-closing **net working capital adjustment** is used, parties will need to consider how adjustments to working capital will be measured to take into account impacts of COVID-19 when setting the target working capital amount, and whether the risk of **fluctuations** should be limited by reference to a floor and/or ceiling. There may also be a need to scrutinise (alongside specialists) the **specific accounting policies** and principles that are applied to calculate working capital levels.
- An increased **reliance on debt** to manage cash flow constraints will necessitate an increased focus by buyers on **net debt levels** and the impact of net debt adjustments on price.
- The careful consideration of the treatment in closing statements of **COVID-19 specific extraordinary** and **non-recurring items**, and **receivables** and **payables** (such as stimulus payments or grants under government support schemes), particularly where a payment or rebate is due but not yet received, and there remains an element of risk as to certainty of payment (for example, in the UK, eligibility for furlough under the Coronavirus Job Retention Scheme).
- A greater focus on **change of law provisions** and the question of who takes the risk of, for example, a change in the terms of a government scheme that a target has accessed prior to signing and/or completion (for example, as to repayment or the imposition of business operational limits by government as a consequence of social participation).

Sellers in a strong negotiating position, particularly those with reason to argue that COVID-19 will not have a lasting impact on the business model (and thus value) of the target, will take a different view. A compromise may be a **hybrid structure** with price set by reference to a locked-box account date, items most susceptible to uncertainty and fluctuation as a result of COVID-19 tested at completion, and a £-for-£ price adjustment made against expected levels. Where to set expected levels and which items to test (particularly in respect of cash, receivables and working capital), will require similar considerations to those set out above. The strongest sellers and those able to run a competitive process, may be more inclined to require a **deposit** at signing.

We may also see a **renaissance of earn-outs** and **deferred consideration** arrangements to cater for the unpredictability of the future results of the target (although these are unlikely to meet the aims of a distressed seller). Certainty of payment and corresponding **liquidity concerns** will play into how these clauses are negotiated, as will the question of whether a customised metric is needed to **calculate the earn-out** (for example, if COVID-19 impacts (if they can be defined / specified) will be wholly or partly disregarded in the calculation). As we are seeing with shareholder commentary on long-term executive compensation plans, sellers / buyers, and their respective shareholders, will be keen not to hand a windfall bonus to the other simply through the timing of the original valuation and relevant earn-out period.

Conduct of business between signing and completion, material adverse change (MAC)

There will be a new focus on what is meant by "**operating the business in the *ordinary course* and consistent with *past practice***" if the new ordinary in a COVID-19, and post-COVID-19, world is one where government-imposed restrictions may significantly impact operations, and companies and industries face rapidly changing market events.

Buyers will want consultation (and perhaps veto) rights over key decisions that have a material effect on operations, and sellers will want latitude to take **rescue measures** without seeking consent. Parties may consider a more collaborative (rather than exhaustive) approach with specific reference to COVID-19, including allowance for **good faith measures consistent with actions taken by others** in the industry, or joint development of a **response plan** with permitted actions agreed at the outset (although in distressed circumstances this may give rise to unacceptable shadow directorship risks for buyers who should avoid involvement with decision-making pre-completion).

Earn-outs may be a useful solution to bridge this gap in priorities. We may also see a move towards more **US-style walk-away rights** for a buyer for breach of pre-closing covenants, where an assessment of damages would seem far less straightforward. Timing for **'bring down'** or repetition of **representations** and **warranties** will be even more hotly debated than before (see *Representations and warranties, W&I insurance, disclosure* below for more on this).

In a break from recent UK market practice, parties will likely place greater importance on **MAC clauses**, with buyers wanting a more US-style standalone condition or representation, and sellers focusing on specific COVID-19 and pandemic carve-outs (with or without a proportionality test). Defining the MAC has always been the subject of intense negotiation and scrutiny, even at times when it was possible to comprehend the status quo from which circumstances might 'change'. 'Market MACs' may no longer suffice in the face of the uneven effects of COVID-19 on markets and segments around the world.

If parties include a MAC, an (even more) **bespoke** and **fact-specific** approach will be required, perhaps one that combines proportionality with identified COVID-19 vulnerabilities or issues of concern with the target, its business or operations.

In the UK, courts have historically been reluctant to invoke MAC clauses, and so even the most thoughtfully drafted clauses may remain difficult to invoke. Likewise the practice of the UK Takeover Panel has not been to allow bidders to walk away from a formal offer on the basis of an alleged MAC. The Panel's statement on 19 May regarding the acquisition of Moss Bros Group Plc by Brigadier Acquisition Company Limited indicates that this is likely to be one constant in the maelstrom of change.

Acquisition financing

Given uncertainties in the credit markets, the availability, terms and conditions of acquisition financing (including bridge financing) is likely to impact negotiations and transaction documents more keenly.

- Financers are likely to require more in-depth **due diligence** on both the target and the buyer. For this reason, a strategic buyer may consider commissioning **diligence on itself** as it considers opportunities.
- Contractual provisions in the financing agreement to protect the lender(s), including covenants, MAC clauses and termination rights, may need to be **mirrored in the Sale Agreement** to avoid the risk that the buyer is obliged to close without financing. Buyers may increasingly request a '**financing out**', with sellers insisting on corresponding **reverse break fees** or deposits forfeitable on financing failure. Customary '**flex provisions**' in financing commitment letters (particularly those with private equity sponsors) may be more closely scrutinised as lenders look to exercise their rights to modify terms (including pricing) to ensure a **successful syndication** in such a turbulent market.
- Lenders may require increased **step-in rights**, **reporting obligations** or **board representation** to obtain greater scrutiny. A **tightening of covenants** generally can be expected, which will be a particular challenge, even contention, for private equity funds used to the easy money environment of the last few years and whose interests may not be aligned with those of lenders.
- As **multiples compress**, buyers on leveraged acquisitions will have to contribute more equity to get deals done in the short to medium term (as we saw in the aftermath of the GFC). Some lenders are being asked to size loans based on **earnings before COVID-19** by effectively treating COVID-19 as a non-recurring item - something that becomes harder to do as time ticks on.

Due diligence

Process

- Whilst such limitations should ease as the lockdown is lifted, country by country around the world, certain critical diligence activities including site visits and inspections of physical assets may be **impossible or severely limited**. Sellers may also find it difficult to prepare a data room in good time, or at all. **Management presentations** or due diligence sessions may be held remotely, but if so, buyers will no longer be able to rely on face to face meetings and hospitality with managers to be persuaded they are backing the right team. Depending on the type of asset, buyers may consider **desktop due diligence** as an interim measure, or reliance on **historic reports**, and **bolster contractual protections** to mitigate gaps in the diligence process (including conduct of due diligence during the interim period if circumstances allow).
- We are starting to see company end of year / period **audits** taking longer to complete, supported by regulatory guidance for issuers and their auditors not to rush and to take the necessary time, combined with some relaxation of regulatory deadlines, and so the preparation of special purpose accounts (if required) will likely take longer. This will need to be factored into transaction timetables. External **accountant comfort** is also likely to come with at least an additional COVID-19 warning disclosure.

Scope

COVID-19 has shone a new light on risks, temporary or permanent, with the business model of most companies, whether by **exposing vulnerabilities** or by testing the **adequacy of a company's crisis response**. The following COVID-19 related issues may be relevant when diligencing a target, and may feed into price adjustments or specific COVID-19 related indemnities:

- Broadly speaking, buyers may be more inclined to undertake a **focused review of the geographical scope and dependencies** of a target's operations, and how other pandemic-style disruptions might affect the business. This may include, for example, supply-chain dependency and resilience, business continuity planning, IT infrastructure and ability to work remotely, insurance coverage (and exclusions), the terms of key commercial contracts and the quality of the underlying relationships with customers and suppliers. It may also be useful to verify whether **operational measures to bolster liquidity** (such as sale and leaseback of assets, suspension of dividends, or renegotiation of payment terms and rent payments) are legally feasible. For **private equity** funds in particular (and their lenders), the pandemic has highlighted the importance of modelling a range of scenarios in due diligence, and factoring in foreseeable but unpredictable disruption will likely become a standard part of the process in at least the immediate future.
- The impact of COVID-19 continues to impact **employees** enormously. It will be necessary to asses if the target has complied, and is able to comply in the future, with all regulatory requirements regarding employee safety, and all employer obligations regarding information and transparency, and is and has been GDPR-compliant when handling medical (and other personal) data. For applicants under the Coronavirus Job Retention Scheme, eligibility of furloughed staff, and reputational impacts for future decisions, will be important.
- The 2019-20 financial year will certainty go down in history as one of unprecedented upheaval to the otherwise systematic and ordinary course **corporate governance** and **financial calendar**. We have widely advised on methods to deal with AGMs, financial reporting, disclosure and dividends and to comply with statutory duties when taking crisis-related decisions. The adequacy of a company's response to the crisis will be an important piece of diligence for a buyer.
- In the short to medium term, a target's ability to withstand **liquidity issues** will impact a buyer's assessment of the target's **solvency** (and indicate the **covenants** that will be included in any acquisition financing).
- A new lens of assessment for **commercial contracts** has emerged amid a rise in invocation of termination rights (including force majeure) and price adjustment clauses, and damages claims under contracts with customers and suppliers. Whether a target's existing contracts, including signed joint venture, shareholder and acquisition agreements, are '**crisis-proof**' will be an important question.
- Buyers will be interested in whether existing **insurance** policies cover any losses that have already occurred or are likely to occur as a result of COVID-19 (for example, business disruption, health and safety and an inability to fulfil own contractual obligations).
- If the target (or the seller) benefitted from emergency **government funding, support** or **tax relief**, it will be important to understand the terms and conditions and repayment provisions of that support, how these might change and the impacts if they do, and the reputational impacts on future decisions. Also, the potential for future rule changes that might affect wider aspects of the business and its operations (for example, no dividends prior to repayment). Eligibility for future (or retrospective) measures may be a worthwhile assessment.

Representations and warranties, W&I insurance, disclosure

COVID-19 specific representations and warranties are likely (and will play an important role in eliciting information that a buyer could not otherwise obtain due to the diligence constraints outlined above), but timing for repetition will require careful consideration. We may see another move to US-style practice with buyers wanting repetition of all warranties at completion and questioning the (largely accepted) UK practice of whole data room disclosure.

COVID-19 has called into question the availability of W&I insurance, and the output of insurers' ongoing evaluation of risk in underwriting policies will likely give rise to even broader exclusions. We also expect to see an acceleration of the trend for W&I insurance to be given on the back of 'synthetic warranties' negotiated directly with the insurer and with no recourse to management, particularly in distressed deals where management participation in the proceeds is limited.

Closing conditions and procedural / practical matters

Standard closing conditions such as merger clearance, regulatory approvals, change of control consents from key suppliers and customers or joint venture partners, pre-completion carve-outs (and related long-stop dates), and closing steps that require personal participation (such as notarisation) have featured high on the agenda for signed deals looking to complete amid the crisis.

As we start to see lockdowns lifted across the world these will be become less relevant, but restrictions in place at the time of signing future deals should be considered as we (contingency) plan for any future waves of infections.

Unsurprisingly, amidst COVID-19, the M&A market and the motivations of investors are changing. However, in that change we see some reasons to be positive. Against an almost decade-long growth in M&A activity there are obvious signs of retreat and unease as the market, and its participants, reel from the immediate shock and take time to recalibrate to the new world that is emerging. But history, and the exceptional nature of current conditions, would indicate a constructive recalibration with positive market impacts for those who proceed thoughtfully as indicated above.