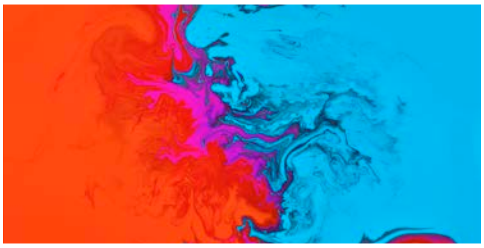

CATALYST // Exploring opportunities – M&A

Back but different

Rarely have events accelerated so rapidly or so radically as they have in the course of the Covid-19 pandemic. We expect the crisis to operate as a catalyst for change and, as a result, there will be opportunities for those with capital to invest or a desire to expand. In this briefing we look at how M&A has changed in light of the pandemic and some of the issues that those looking to undertake M&A in the coming months should consider.

In this briefing we look at:

- current M&A activity levels
- what has changed on M&A transactions because of the pandemic;
- considerations for public M&A transactions;
- some of the particular features of a distressed M&A transaction; and
- the potential impact of foreign direct investment controls and merger control on transactions.

For further information on how we expect the pandemic to operate as a catalyst for change, please see our Catalyst hub, and our Exploring opportunities: Investments and Acquisitions guide which looks at some of the structures and issues for those looking to explore opportunities emerging from the crisis.

Current M&A activity levels and trends

Levels of M&A activity are increasing around the world, having dropped off significantly when the pandemic first hit. Whilst we are seeing some distressed M&A as activity picks ups, government support packages (such as furlough schemes and moratoria on creditor proceedings) mean that we have not yet seen the levels we might otherwise have anticipated. We are however seeing many “quasi-distressed” deals, where companies need to dispose of assets to support their core business but are not on the verge of insolvency. We are also seeing “business as usual” M&A activity, as well as deals which were paused as the pandemic took hold being revived. Governments are also participating in M&A, with a view to boosting their economies or protecting skills and jobs.

We are also beginning to see some transformational deals, as well as increased activity by private equity and other financial buyers. Many of these transactions are early stage so may not ultimately come to anything but it is indicative of an increased willingness to engage in M&A. As stability returns to the markets, we are also seeing companies being more confident in rejecting what they perceive to be low-ball offers.

Another trend is the increase in the number of special purpose acquisition vehicles (SPACs) being listed – these are shell vehicles which are listed as part of an initial public offering (IPO) and the proceeds from the IPO are then used to acquire one or more companies in a particular sector or which meet some other specified criteria. This is mainly confined to the US at the moment but we expect to see increasing numbers in Europe too.

In terms of sectors, unsurprisingly, the healthcare sector has seen a lot of activity. Tech companies too have engaged in significant M&A activity in recent months. The energy and infrastructure sectors also remain active, especially in renewables and digital infrastructure.

Whether a transaction is stressed, distressed or "business as usual", the pandemic cannot be ignored or overlooked.

M&A in the new normal

Due diligence issues

The pandemic will likely mean a shift in focus in some aspects of the due diligence exercise:

- **Impact of the pandemic on the business** – The due diligence exercise will have to have an increased focus on certain key areas such as supply chain risk (including force majeure and the possibility of further waves of the pandemic). It will also be important to understand what steps the business has taken in response to the pandemic, for example as regards payment of rent, and what activities the target may have undertaken (or carried out differently) during the Covid-19 pandemic which could give rise to liability.
- **ESG** – A particular area of focus is likely to be ESG (environment, social and governance) issues. Even prior to the pandemic, we were seeing increased scrutiny on ESG issues and this has only accelerated in recent months. In particular a purchaser will likely be interested in employee issues, in particular health and safety and compliance with employment law. Buyers should ensure that ESG issues are explored in detail, both in the context of the law as it currently stands but also in light of how law, regulation and expectations will likely evolve, at least over the short to medium term, and any potential reputational risks.
- **Cyber and data risk** – The pandemic has seen a rise in cyber security and data privacy issues, which could lead to regulatory sanctions and reputational issues in the future. This should be a particular area of focus for buyers.
- **Companies that have drawn on government support** – Companies that have taken advantage of government support may be subject to restrictions on future transactions, such as paying dividends. Drawing on government support packages may also impact a business's future profitability – for example if it has deferred payment of tax which will become due in the coming months. It will be important to understand what support has been drawn on and any consequences for the business or investment model. Reputational considerations will also be important – we have seen some companies electing not to draw on or repaying government support packages, whilst other companies have come under close scrutiny where they have drawn on support and continued to pay dividends or large bonuses.

Consideration

The instability and disruption to businesses and markets caused by the pandemic will mean that reaching a mutually acceptable price may prove more challenging than normal.

- **Locked box vs completion accounts –** Given the disruption that many businesses have faced in recent months, parties may now opt for completion accounts due to the more detailed scrutiny they provide, rather than the more straightforward, but less rigorous, locked box mechanism for adjusting the purchase price on a transaction. However in some instances, the need for speed of execution and a cleaner position post-transaction will be more important, making a locked box more attractive. Where a locked box structure is used, buyers may seek additional warranty protection in conjunction with it, for example in relation to receivables.
- **Structures to bridge any value gap** – In the most affected sectors and businesses, where reaching a mutually acceptable price may even harder, we are seeing more parties explore earn-outs or deferred consideration as options to help bridge any value gap. We are also likely to see some less conventional solutions considered, such as "contingent value rights" to provide additional contingent consideration in the event of a particular set of events occurring. That said, whilst we expect these alternative options to be considered, we do not expect to see them implemented often in practice, due to the difficulties and lack of certainty they often entail.

- **Share consideration** – Where the buyer is a corporate, we expect to see them offering shares as consideration. This may help to bridge any gap in value expectations as the sellers will continue to participate in the enlarged business post-completion.

Period between signing and closing

More attention is being paid to the provisions of the share purchase agreement (SPA) governing the gap between signing and completion than was ever the case prior to the pandemic:

- **Compliance with the SPA** – We have seen several parties walk away from deals in recent months – sometimes just on a technicality. It is key that parties ensure that they adhere to the provisions of any agreement, even in the face of the challenges presented by the pandemic. In some cases, the right to terminate was used as leverage to renegotiate the price, but if a party wishes to take any action that is not in line with the letter of the agreement, a formal variation to the agreement should be agreed and documented.
- **Bespoke protection** – The ongoing impact of the pandemic in some jurisdictions and the possibility of further waves in others are leading some buyers to seek specific provisions to allocate risk in relation to the pandemic. This may take the form of detailed warranty or indemnity protection, or a material adverse change (MAC) condition to completion. However, many sellers are reluctant to enter into transactions that contain a MAC condition or termination right without a pandemic carve-out given the potential for further waves. Given the increased focus on ESG (as discussed above) from corporates, investors and lenders, a seller may also look for upfront diligence on the buyer. They may also seek some form of post-completion comfort from the buyer about how the business will be run in the future, for example in relation to treatment of employees, whilst balancing the need on the seller's part for there also to be a clean break.
- **Directors' duties** – Where a party has signed an agreement, and shareholder approval is required for completion, directors must monitor whether they continue to believe that the transaction is the right course of action for the company. If they are no longer of that view, they may need to change their recommendation to shareholders or seek some other form of 'out' from the transaction.

Logistical challenges

As lockdowns around the world are lifted and re-imposed, it is important for parties to anticipate any difficulties that they may face in getting deals executed, bearing in mind that the situation can change at the last minute.

- **Data room** – A seller wishing to undertake a disposal may still face challenges in collating the relevant material for the data room. This is likely to take longer than usual and should therefore be factored into any transaction timetable.
- **Management meetings** – A key part of an M&A process will usually be the meetings with management, site visits etc. These may remain challenging to carry out, depending on the level of lockdown and any travel restrictions in place. We are seeing parties adapting by using virtual meetings and tours but the restrictions may still impede some transactions.
- **Execution issues** – Particular issues may arise around decision making processes (such as board or shareholder meetings), getting documents witnessed or notarised, or ensuring filings are registered on a particular date. Whilst we have seen many governments introduce relaxations to regulations and requirements in light of the pandemic, these are time-limited in many cases so it will be important to check what relaxations are available and for how long.

Ancillary arrangements

Disruption to the markets for arrangements that are ancillary to an M&A transaction may also impact the ability to execute a successful transaction quickly.

- **Warranty and indemnity (W&I) insurance** – W&I cover may facilitate M&A transactions, albeit the process for obtaining cover may take longer and the cost may be higher than before the start of the outbreak. The pandemic has resulted in a reduction in coverage across certain areas, including on some deals general carve-outs for the impact of the pandemic, which of itself creates uncertainty in relation to the coverage that the W&I insurance will provide.

- **Financing** – Lender credit processes are taking significantly longer, particularly due to increased scrutiny of new transactions, and pricing has gone up. Sellers are likely to want buyers to confirm that their financing is on a certain funds basis, given the issues with the potential for defaults and the need for covenant resets or waivers. The buyers that will be most attractive to a seller are those with readily available cash and the fewest approval processes. We are likely to see renewed scrutiny of cash flows and forward projections, even in businesses that were seen as resilient before the crisis.

Public M&A

As public M&A activity picks up, we do not expect to see a dramatic change in practice but inevitably some aspects will feature more prominently than before.

- **Likely buyers** – We expect to see financial buyers (including private equity and sovereign wealth funds) leading the way as they are likely to be ready to move sooner than strategic buyers and many have plenty of "dry powder", that is committed but undeployed capital. They may also be able to make an offer with less conditionality, as merger control and shareholder approval are less likely to be required on a bid by a financial buyer. Where the bidder is a corporate, we expect to see more all-share mergers, in a desire to preserve cash and give target shareholders exposure to the business going forward to help address any perceived value gaps.
- **Material adverse change conditions** – On a public M&A transaction, parties should be aware that they are unlikely to be able to invoke a MAC condition on the basis of the impact of the pandemic. The position will vary according to the jurisdiction and the circumstances. In the UK for example the UK Takeover Panel refused to allow a bidder to invoke a MAC condition to its offer for Moss Bros (a formal menswear company) as a result of the Covid-19 pandemic. The bar for being able to invoke a MAC condition to a public offer in the UK is very high (driven by the desire to ensure market certainty) and the bidder's position in this case will not have been helped by the fact that it announced its offer the day after the World Health Organisation declared Covid-19 to be a pandemic, and that the Moss Bros board cited the "highly uncertain, but potentially significant, impact of Covid-19" in its background to, and reasons for, recommending the offer.
- **Value gap** – We may see parties seek to bridge any gap in value expectations by exploring structures such as a contingent value right (CVR) but, as on private M&A, in reality we do not expect to see these often used in practice because of the complexities and uncertainty they bring.
- **Distressed targets** – Where the target is in distress on a public deal, some relaxations from the usual takeover regulation may be available – both bidders and targets should ensure they understand what these are. There may also be some structures that a target may wish to use to facilitate the transaction – for example in the UK, we often see distressed targets use a "formal sale process" (akin to a private auction), which provides some dispensations from the usual Takeover Code requirements.
- **Cornerstones** – We expect to see financial (and indeed strategic) buyers seeking to take significant stakes in public companies, rather than acquire the whole company, as there is less risk and there are less likely to be regulatory issues. However, it is important to note that such a transaction will not necessarily fall outside all regulatory regimes, such as merger control – some regimes can be triggered by the acquisition of a non-controlling stake in a company.

Distressed M&A

We expect to see distressed transactions driven by companies needing cash or financial creditors forcing disposals. A distressed M&A transaction has a number of features that are not seen on other M&A transactions and which participants should be aware of.

- **The selling party** – A distressed M&A transaction may involve the buyer transacting directly with the seller (either as the seller tries to avoid insolvency or as it goes into an insolvency process) or dealing with an insolvency practitioner.
- **The need for speed** – Where a company is facing insolvency, any M&A process will have to executed as quickly as possible, sometimes over the course of a matter of days rather than the weeks or months

normally spent on a transaction. As a result, it is unlikely that a buyer will be granted an exclusivity period (or it will be limited) and any due diligence exercise is likely to be far more limited than usual.

- **Limited recourse against the seller** – An insolvency practitioner is unlikely to give any warranties or indemnities. Even if contracting with the corporate itself, rather than an insolvency practitioner, a buyer should not assume it will have recourse against the seller as it may be insolvent by the time a claim is made. Some W&I insurers have brought to market new "synthetic" W&I insurance products which can be used in distressed M&A scenarios but it remains to be seen to what extent buyers will look to utilise these products.

The need to execute the transaction swiftly, the limited due diligence exercise and limited recourse against the seller will all be reflected in the price that the buyer is willing to offer but may also mean that some parties are not willing to undertake distressed M&A.

A buyer that can move fast and has available cash is likely to be more successful than one with more conditionality, so securing financing on a certain funds basis will be more important than ever and will make a buyer a more attractive prospect.

Many governments have introduced changes to insolvency legislation in light of the pandemic. Whilst this may alleviate some of the immediate difficulties a company in financial difficulties may face, it is also important to understand whether the protections afforded may affect the buyer or target post-completion.

Where there is a merger control issue, the parties may look to rely on the "failing firm" defence discussed further below.

Regulatory issues

Regulators have been taking a more prominent role on cross-border transactions in recent years, and we expect the pandemic to accelerate this.

Foreign direct investment (FDI)

Governments around the world have been tightening their controls over foreign investment in light of the pandemic. This may be through:

- **Sectors –** Many have extended the sectors they scrutinise, for example to include pharmaceutical and healthcare companies as well as critical infrastructure and data/technology.
- **Thresholds** – Some have lowered the turnover thresholds at which they can intervene in a transaction, to maximise the regulator's reach and ensure that strategically important assets are caught.
- **Type of transaction in scope** – As well as purchases of entire companies, the acquisition of a minority stake in a company can trigger a notification requirement and some governments have lowered that threshold.
- **Identify of buyers** – The jurisdiction in which a buyer is resident may increase the risk of a transaction facing additional scrutiny. In addition, there may be particular sensitivity around acquisitions by certain state-owned or controlled entities (SOEs) where concerns as to the underlying motives for the transaction may exist.

Whilst a government might not seek to block a transaction outright, it may use its powers as leverage to secure undertakings and commitments from a buyer. Buyers should identify whether their transaction is at risk of intervention and factor that into their deal timetable, as well as considering what commitments it may be able to give to secure clearance. Our updated guide on FDI controls around the world is available here.

Merger control

Whilst we have not seen extensive changes to merger control regimes around the world in reaction to the pandemic, the disruption to the markets, in particular those most impacted by the pandemic (such as retail and travel) will likely mean that market shares and other measures used for establishing jurisdiction (for example turnover) have moved significantly in recent months.

Parties may also increasingly look to rely on the "failing firm" defence to get clearance for a transaction, which mainly involves arguing that if the transaction does not proceed, the target would exit the market. It will be important for parties to undertake a careful evaluation to identify any risk of disruption or delay to a transaction. Parties should also be careful to ensure they comply with the procedural requirements of any merger control regime, as regulators are increasingly focusing on these issues and pursuing parties for failures.

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If you have any questions or would like to discuss this further, our teams are happy to assist – please contact any of the people below or your usual Herbert Smith Freehills contact.

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