COVID-19: Immediate deal issues and a catalyst for change in M&A agreements

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It is an uncertain time for buyers and sellers as they are forced to consider new and immediate deal issues in light of COVID-19. What impact will there be on the deal timeline? Will the deal get to completion, or not? If the deal completes, what impact will there be on completion and the completion price adjustments?

Both M&A agreements already signed and those to be drawn up on future deals are likely to come under closer scrutiny, with an increased risk of dispute arising between parties on those already signed. Additionally, COVID-19 is serving as a catalyst for change in future M&A agreements as parties search for a way to protect themselves against the current - and any future - global pandemic.

Deals completing now: Managing the risks

Getting to completion – or not?

For a raft of M&A deals signed in late 2019 and early 2020, buyers are either already dealing with COVID-19 business disruption alongside the additional disturbance of taking control of and seeking to integrate a business, or are nervously contemplating completion in the near future.

In these circumstances there are some key areas to consider immediately. Target businesses impacted most significantly by lockdown may now be experiencing significant negative cash flow. Demands for cash immediately following completion could stress or even break the agreed deal funding, and consequently the ability of the buyer to keep the target business solvent – particularly on leveraged deals. As a result, some buyers are considering whether they can delay completion or even cancel the deal.

MAC clauses

Material adverse change (MAC) clauses are one common contract element that provides a buyer with a possible "get–out" if the target business is impacted by a significant adverse event. Typically, however, such MAC clauses exclude issues affecting not just the target but others in the same market or industry – and so are unlikely to offer much hope of cancelling the deal due to COVID-19. Nevertheless, we expect to see buyers looking carefully at these clauses to establish whether they can be applied to current circumstances.

Conditions to completion

Delaying completion is a tactic being contemplated by some buyers. This has potential benefits to buyers in that the acquisition may be pushed to a date beyond the immediate impact and disruption of lockdown, allowing the target to be acquired in a more "normal" environment.

To the extent the conditions to completion are under the control of the buyer, this could potentially be used to push completion further into the future. If there is a long-stop date, the deal may even be killed completely. Any financial penalty this would trigger is a further factor for the buyer to weigh up. Clearly this is far from ideal for sellers, but we anticipate both buyers and sellers will be looking carefully at the relevant parts of the agreement on deals which haven't yet completed.

Delay may not help much on locked box deals. Under this mechanism, the buyer takes on the risks and rewards of the business from the locked box date (often the most recent financial year end of the target) with a, more or less, fixed price payable to the seller. The buyer will be exposed to the consequences of worse than expected performance between the locked box date and legal completion as a result of the current climate, meaning they inherit lower net assets and net cash in the business at completion.

Importantly, the buyer will not control the target business during this period, so will have limited ability to influence the actions taken in response to COVID-19 disruption.

A seller will typically give contractual undertakings to run the business in a certain way during the period between signing and completion. Such undertakings often refer to "the ordinary course of business". The times we live in are anything but ordinary, and so we see significant potential for disputes over whether actions taken in response to current circumstances are in line with these undertakings. This is particularly relevant to plant closures and redundancies.

Steps taken by the seller with a view to managing short-term cash flow may well be at odds with a desire on the part of the buyer to preserve the capabilities of the target business and get back into a growth phase as soon as possible after lockdown ends. It is critical that buyers and sellers engage in a sensible dialogue on key business decisions prior to completion, to reduce the potential for disputes later. Careful focus on agreement terms, setting out those transactions for which the seller must obtain the consent of the buyer, may well aid such a dialogue.

Dealing with completion and price adjustments

The planning period for taking control of the business is more critical than usual, given the target business may be acquired in a financially stressed or turnaround situation not envisaged just a couple of months ago. Gripping the business quickly and getting on top of crisis cash management at a time of double disruption, both from COVID-19 and from the change of control, is critical.

In terms of deal pricing, the completion accounts adjustment process also becomes more important. For deals that include a completion accounts mechanism, the adjustment may provide buyers with an opportunity to reflect the impact of pre-completion disruption in the final purchase price, particularly where the buyer is responsible for preparing the initial draft completion accounts.

Where completion accounts are used, it is clear that parties may encounter issues with the sufficiency of the preparation and review periods set out in the signed SPA, given the restrictions of working from home, and also where the target's focus has moved to sustaining operations and cash flow. This may lead one or both parties to seek to amend the timelines via a variation agreement. The impact of this should be carefully considered, in particular any bearing it may have on the adjusting events "cut-off" date (the point at which new information can no longer be taken into account in the preparation of the completion accounts),.

We have historically seen an increase in the incidence and magnitude of completion price adjustment disputes whenever there is an economic downturn, as the cash impact of the price adjustment becomes more important to each party. We do not expect the current environment to be any different in this regard.

Areas where we perceive there is an increased risk of disputes between seller and buyer include:

— Whether the impact of COVID-19 on the value of assets and liabilities represents an adjusting post-balance sheet event. This will depend in part on the timing of completion, and buyers and sellers will have to take a view as to whether, at completion, conditions existed that have an impact on asset recoverability. For completion dates after an economy is in lockdown it may be difficult to argue this is a non-adjusting event. For deals which completed prior to this, say in January or February, the position may be much less clear.

— Judgemental elements of accounting that place reliance on forecast information, for example balances relating to long-term contracts, will present particular challenges, with the potential for widely differing views of the future on the part of buyer and seller.

— Contracts which might not otherwise have been problematic may become "onerous" in the current environment. Buyers may seek to recognise onerous contract provisions as a means of mitigating the wider impact of COVID-19 on business value; and

— Net realisable value of inventory may become more subjective and contentious, and even the execution of completion stock counts may become problematic due to social distancing requirements.

Deals being negotiated now: Dealing with COVID-19 driven issues

Whilst the level of M&A activity has certainly reduced over the last couple of months, deals are still being negotiated. A number of practical issues are emerging in relation to deal structuring and pricing.

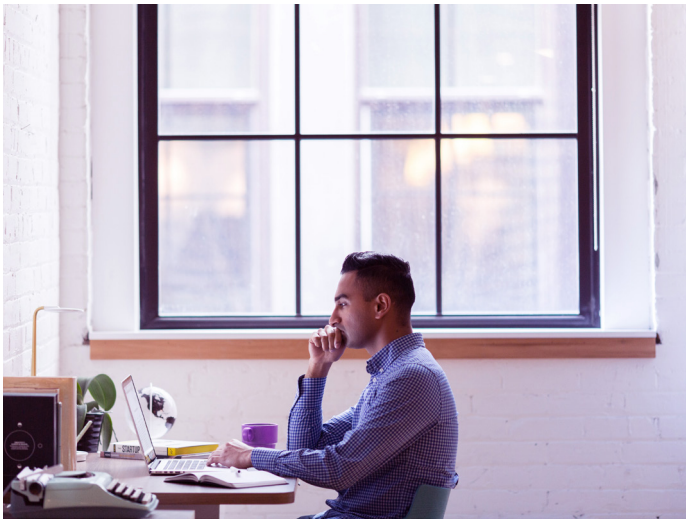
Headline price approach

Analysis of earnings before interest, tax, depreciation and amortisation (EBITDA) and use of Comparable Transaction (CoTrans) Approach EBITDA multiples has been pervasive in deal negotiation over the last decade. The effects of the current situation should act as a reminder that historical EBITDA and multiple-driven valuations are only ever a proxy estimate of the future discounted cash flows of a target business. This is useful for stable businesses in relatively stable markets but flawed if the future is expected to be materially different from the past.

In the current market environment, recent (e.g. last 12 months') EBITDA is no longer a reasonable guide to future performance, and hence to value. "Normalising" current and historical trading results to account for the current situation is at best a "finger in the air" exercise. Both buyers and sellers will need to look to fundamental valuation methods if they are to avoid poor pricing decisions.

Fixing a target for working capital

If your headline price is a cash-free, debt-free enterprise value, then translating that to an equity price will present further challenges, including setting an appropriate target working capital level. A typical approach is to analyse monthly balance sheets for the last twelve months, in order to eliminate the effects of seasonality. However, at present such analysis will provide anything but a "normal" picture of the business cash requirements.



Just as with headline value, buyers and sellers are likely to have to go back to basics in their thinking – looking at trade terms and payment cycles – in order to analyse working capital requirements and arrive at a reasonable "normal" business requirement.

Careful early thinking in relation to these areas is key, as we expect an increasing portion of new deals to be driven by financially stressed or forced sellers, and to be conducted on accelerated timelines. In such circumstances, where less diligence can be done, further protection through warranties and indemnities may not always be practical, making the basis of price adjustments even more important.

Deals in the future: How might the approach to pricing change

In the current crisis, many businesses are – rightly – operating in survival mode, focusing their energies on withstanding the present challenges rather than planning into the future. However, when M&A activity revives, we expect to see a number of changes to the pricing mechanics in agreements.

Locked boxes out of favour?

During this period of significant uncertainty, buyers may shy away from locked box deals, particularly if the locked box balance sheet was prepared at a date before the effects of COVID-19 had become apparent. They may instead prefer to have the opportunity, afforded only by the use of completion accounts, to adjust the price based on a balance sheet reflecting the actual position of the target business at the point of acquisition.

In addition, agreeing an "equity ticker" (a daily amount added to consideration from the locked box date to completion, to compensate the seller for their ongoing legal ownership after economic ownership has effectively transferred to the buyer) is likely to prove more challenging than previously. The ticker is often based on forecast profits, but increased subjectivity around budgeting and forecasting is likely to mean that buyers and sellers will need to spend more time negotiating this figure.

Furthermore, while uncertainty over the effects of COVID-19 continues, the longer the period between signing and completion, the greater the risk of divergence between the agreed ticker and the actual trading results of the target business.

Completion Accounts modifications

Completion accounts are typically drawn up using the same policies and practices as were used in preparing the last statutory accounts, except in areas where specific treatments are agreed by the parties and set out as "specific policies" in the agreement. Where the last statutory accounts were drawn up in a pre-COVID-19 environment, it may not be desirable, or even possible, to prepare the completion accounts on the same basis. We anticipate that, for as long as the current situation persists, there will be more extensive use of specific accounting policies, setting out detailed methodologies for items where there is a heightened risk of dispute, such as asset valuation and recognition of provisions. It should be noted that any such policies will need to be drafted with the greatest of care, as ambiguity in the drafting of specific policies is itself a leading cause of disputes.

For target businesses in capex intensive sectors, we also anticipate that more deals will include a price adjustment in respect of capital expenditure, to compensate the buyer in the event that capex is postponed in the period prior to completion as a cash saving measure.

Increased number of Earn-outs?

A key concern, of course, is whether there will be a fundamental long-term change to the target's business model and its sustainable performance, as markets move to a "new reality" following COVID-19.

Where the parties are keen to do a deal, but cannot agree on the value of the target business, earn-outs can be a means of getting the deal done. Under this mechanism, part of the consideration is deferred and made contingent on the future performance of the business, the intention being that the seller receives full value if the business performs according to expectation, and the buyer is protected if it doesn't.

Seismic events such as COVID-19, and the financial crash of 2008/09, typically arrive suddenly and have a dramatic downward impact on valuations. When these events happen, it is perhaps understandable that buyers are quicker than sellers to reflect the impact in their valuation of a target business. This will tend to increase the valuation gap. The underlying reasons for entering into a deal may not have changed, so the parties may still be keen to progress to a deal despite the outbreak of COVID-19. In these circumstances an earn-out mechanism offers the possibility of bridging the valuation gap, but in reality the parties may find they have only deferred, rather than resolved, their dispute over the target's value.

In the current environment, a seller is likely to want either to exclude the effects of the pandemic or to wait until it has passed, and trading returned to "normal", before commencement of the earn-out period. Either approach will present commercial and contractual challenges, the complexity of which will vary according to the size, nature and/or sector of the target business, and the scale of impact that COVID-19 has had.

There will need to be careful consideration as to how a "fair" earn-out mechanism can be achieved. This may involve deferring the earn-out period into 2021 or beyond (if the seller can wait that long), or changing the basis of calculation, e.g. from EBITDA to gross profit or revenue, to remove some elements of uncertainty over costs.

Earn-outs have been around for a long time and are fraught with difficulty, due in part to inherent uncertainty about future events. Uncertainty over the medium and long-term impact of COVID-19 makes for an even greater challenge than normal. It seems likely that the feasibility of using an earn-out mechanism to help get a deal over the line will depend heavily on the specific circumstances of the target business.

Risk in the period before the buyer has control

Competition clearance and employee consultation obligations mean that many deals will still have a lengthy delay between signing and completion.

Where parties are still keen to transact in the current environment, there may be merit in the buyer and seller agreeing more granular conduct of business undertakings for the period between signing of the SPA and completion.

This additional granularity could take the form of a wider range of transactions requiring consent from the buyer and/or lower materiality levels for transactions for which the buyer's consent is required (such as acquisitions/disposals of businesses, hiring/firing of key management, capital expenditure etc.). It could also include more detailed definitions of "ordinary course", to help clarify the extent to which responses to major economic events (such as COVID-19) fall within or outside this definition.

This could potentially extend to changes in the basis for the MAC clause, such that it encompasses a right to delay or exit the deal as a result of future global disruptive events.

Such approaches could serve to mitigate the risk to the seller of claims for breach of conduct undertakings and, at the same time, give the buyer more influence over decisions of the seller which materially impact the value of the target.

Overall, on both current and future deals, we anticipate that the M&A agreement is going to become increasingly important for both buyers and sellers in trying to protect deal value. For further advice, contact our SPA team who can assist you in resolving value issues and achieving a more robust agreement.

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