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CORONAVIRUS:
MAKING DEALS IN A VOLATILE MARKET

Coronavirus (Covid-19) is likely to lead to a period of volatility and uncertainty in global and domestic markets, making settling valuation and pricing, and achieving deal certainty in M&A transactions, more challenging. Sellers are likely to have a valuation outlook that assumes a short period of uncertainty; Buyers may worry about an extended or deep period of uncertainty.

In this briefing, we look at some of the techniques within an M&A process that may be used by both sides to bridge a valuation gap or by a Buyer to retain some flexibility to walk away if the target business is more badly affected than expected.

M&A techniques/strategies

Adjusting your contractual deal terms

- Purchase price protection
- Conditions and termination rights
- Managing contingent liability risk

Adjusting your contractual deal terms

Purchase price protection

On the assumption that a Seller is not willing to simply agree a lower valuation and price, the key focus will be on whether the parties can agree a purchase price mechanic that gives sufficient certainty and protection on both sides. Assuming a split signing and completion we would expect a Buyer to push for a later valuation date, ultimately seeking protection by way of a completion accounts mechanic, so that negative impacts on the business in that period may be captured in the price.

This would be a shift away from the global market standard position where a locked box mechanism was used in the majority of all private M&A transactions last year. This global market position has been driven by the recent strong seller's market, and Sellers' preference for the certainty of a historic pricing point (usually the end of an accounting period shortly before signing) and locked-box protection mechanic (potentially with an interest ticker rate), although in Turkey completion accounts mechanism is still heavily used.

Where a Seller is unwilling to move to a full completion accounts process, a hybrid structure can be used where the price is set by reference to locked-box accounts, but certain balance sheet elements are tested at completion, most commonly cash (through a net debt adjustment) and working capital.

Shifting to a completion accounts process, however, only provides protection as at (and therefore, until) completion. Under the current circumstances, parties may not be confident that the market will have settled by the time of their completion and, for example, contracts re-negotiated to respond to customer demands or supplier needs during a crisis may have longer term repercussions.

Where protection is required by a Buyer after completion, the Buyer will need to seek provisions allowing for deferred consideration, retention of the purchase price, a valuation floor mechanic or an earn-out structure (see box).

A Seller will have limited control over the target business after completion and therefore may be reluctant to accept a pricing mechanic that links value to performance post-completion. As such, these structures are more common on the sale of a majority or minority stake, where the Seller retains some oversight through its retained stake in the company. In any event, earn-outs are generally treated with caution as they can introduce significant pricing uncertainty and can involve complex accounting adjustments, for example, to reduce the adverse impact of choices a Buyer might make for the target business after completion.

Conditions and termination rights

Deal certainty and reduced execution risk is prized by both Seller and Buyer; and has been a key feature in the market in recent years. In a period of market disruption, a Buyer may look for a degree of optionality through additional conditionality or termination rights, because there are circumstances in which the Buyer is not willing to do the deal at any price. At its most general, that optionality might be sought through a material adverse change (MAC) clause.

To date, MAC conditions and termination triggers have been heavily resisted by Sellers and in the context of Coronavirus, a number of issues would arise:

- Would it be a general MAC or a specific MAC? If the impact of Coronavirus is the issue, presumably the MAC should be specific?
- How is the impact measured? Simply ‘a material adverse effect on the target business as a whole’ or by reference to a specific financial metric (e.g. EBITDA reduction) or by reference to another KPI?
- What is material? You should consider defining what you mean by ‘material’.
- How will you measure the MAC? Is there enough time in your gap between signing and closing for the impact to occur and be measured? Should the condition be capable of being invoked where an event or change has occurred which is ‘reasonably likely to have a material adverse effect’, rather than only where such event or change has had such effect before completion?
- Should there be any exceptions carved out of the MAC? Often a MAC provision will carve out events and changes affecting an industry generally (including epidemics and pandemics), except, importantly, to the extent the target business is affected disproportionately to its industry (a business MAC). This might be relevant, for example, if a business in one industry has a particular focus on customers in another industry who are badly affected.
- How do you assess and deal with indirect impacts? Can they be attributed to Coronavirus?

- **Deferred consideration:** part of the consideration is agreed to be paid at a later date, without any conditionality as to that payment. As such, the deferral primarily assists a Buyer with more time to fund.
- **Retention:** part of the consideration is retained to be paid at a later date, on the assumption an event occurs (or, potentially, does not occur).
- **Valuation floor:** part of the consideration is withheld and only payable if performance (commonly measured by EBITDA) for a current period matches expectations (i.e. budget or forecast). So, for example, a deal with completion in September 2020, priced on historic accounts, could have consideration withheld subject to the EBITDA for FY2020 meeting the agreed floor.
- **Earn-out:** a full earn-out mechanic sees part of the purchase price only paid by reference to performance of the business in the current and future financial years. The adjustment would be fully dependent on performance, and this approach is usually seen where a Buyer is trying to incentivise positive performance from a management team.

The answers to these questions will be deal specific.

In our view, parties will likely focus on where they perceive the real risks and issues for the target business arising out of the Coronavirus outbreak, and narrow their condition directly on those issues, for example, a contract or contracts being terminated or re-negotiated. Such an approach provides both parties with greater certainty, but will require the Buyer to be confident that the impact and extent of the outbreak has been understood requiring thorough diligence and management challenge.

Closer focus will likely also be required to any regulatory conditions which might be affected by the financial condition and prospects of the target and the enlarged group.

Managing contingent liability risk

Buyers generally manage and assess contingent liability risks through diligence backed by warranties and indemnities. We expect to see a greater focus on disclosure by Sellers around the potential impact of Coronavirus. From a Buyer's perspective, contractual termination provisions, while always a concern for diligence, may receive greater focus as Buyers will likely want to assess the impact on the business of a counterparty coming under pressure to re-negotiate or terminate the contract. Buyers may also want to diligence more thoroughly key supply chains across different geographies and the potential impact of the outbreak on the ability of direct and indirect customers and suppliers to continue trading.

Consequently, a Buyer pay closer attention to interim operating restrictions for the gap between signing and closing and the dynamics of securing consents to the change of control under key contracts.

Where deals are using representations and warranties insurance we would expect the underwriting process to include detailed questions on the potential impact of Coronavirus on the target, including questions focusing on the suitability of the target's disaster recovery policies and compliance with the same. Where satisfactory answers to questions from the underwriters are not provided, we would expect Coronavirus risks to be excluded from cover.

Where parties wish or need to finalise transactions during a period of significant business uncertainty, we expect that they will need to consider the various tools and approaches discussed above and come up with different commercial solutions to mitigate and allocate the economic consequences.

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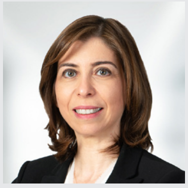

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