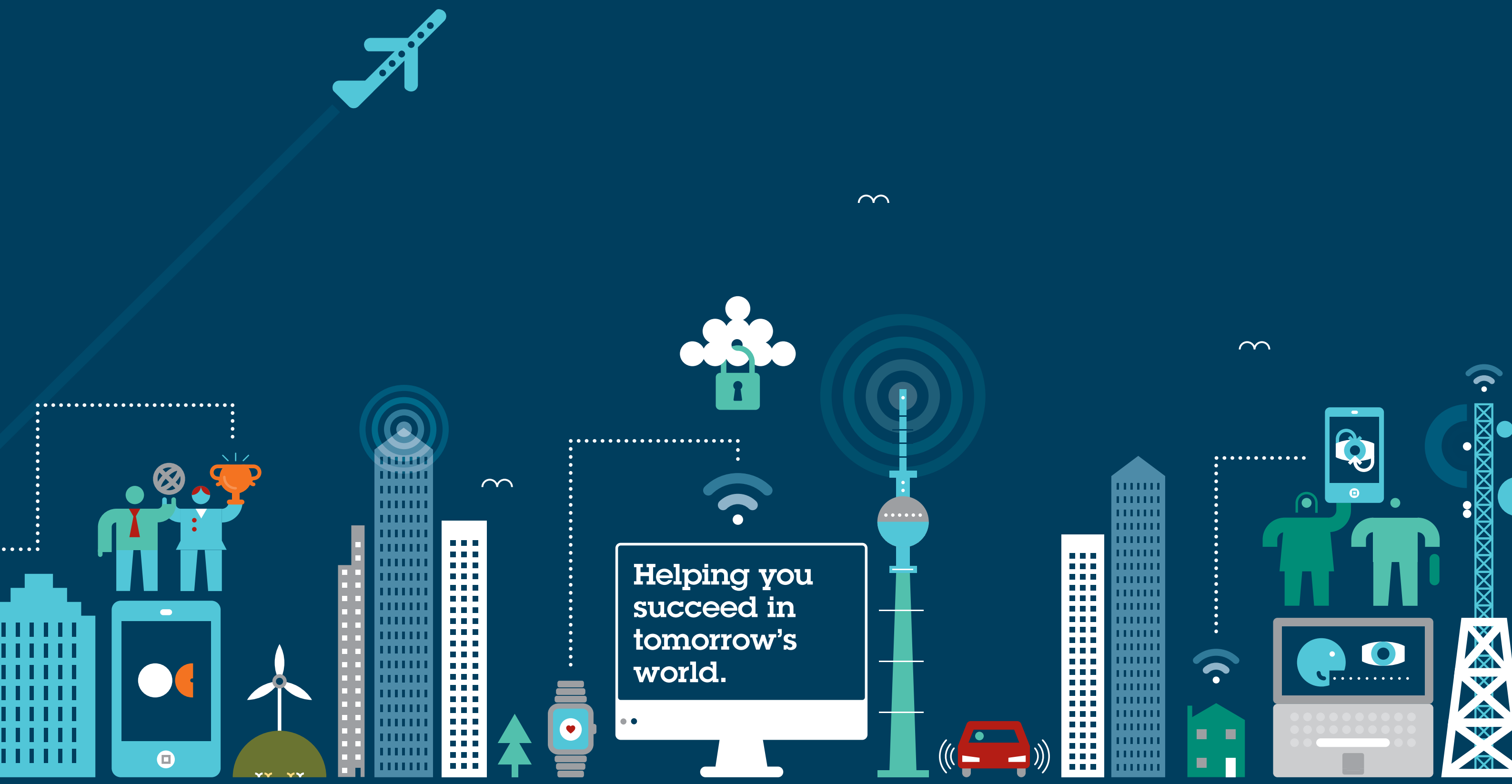
A view of the M&A landscape post lockdown

May 2020



Introduction

We're experiencing a general 'pause' in most M&A activity but, as with all M&A cycles, it will return. In this article, we examine the key influences which we think will kick-start M&A, and how deal structuring and execution will change compared to the pre-lockdown bull market:

- **Reaching the bottom of the well**: Some companies ultimately will run out of money – however, there's still a lot of acquisition 'dry powder' out there, and desirable assets for the bold investor in what will be a buyer's market. The challenge will be that, if history repeats itself, most investors will be wary of investing until we start coming out of the other side of the current market dislocation - preferring to leave some value on the table, rather than risk seeing things get worse before they get better post-investment.
- **Being pushed**: Investors are generally supporting their portfolio companies during the lockdown, which is positive - a great business now should still be a great business when we're through this. However, in time, some won't want to reach in their pockets again, and will want some form of realisation - those investors will be pushing for exits.
- **The haves and the have nots**: Most corporates with available facilities have taken steps to secure the availability of cash - often fully utilising undrawn facilities so they have cash on balance sheet now, even if not immediately needed. Added to this, the PE sector (not to mention the various family office and sovereign wealth funds) has $trillions of undrawn capital all looking for a good home.
- **Digitisation**: It's hard to imagine a greater stimulus to digital transformation than the current lockdown. If you are a large corporate with capital to deploy, this could be the time to accelerate digital disruption and 'future proof'- there are attractive, but struggling, tech-enabled businesses out there that are suitable for bolt-ons.
- **Consolidation**: The current market also presents an opportunity to team up, to consolidate or grow market share (e.g. O2/Telefonica and Virgin Media).
- **Rationalisation:** On the flip side, a slower market gives an opportunity to re-assess. Many will be looking to divest non-core or underperforming business lines, so they are leaner and fitter as the market returns.
- **Circumstances**: Some owners will still want to sell now, for various reasons – if it's the right deal, the right buyer and the right price it may still be compelling to proceed now, even if it's not a time of peak value. The pandemic will, we believe, cause some owner managers to re-evaluate their priorities, their long term plans and lead them to 'de-risk'.

Whilst we expect the M&A market to return, we don't expect the landscape to look exactly as it did pre-March this year for the above reasons. For example, we expect to see more M&A processes that have a longer planning and lead time, or may have a distressed element. It goes without saying that valuations will be impacted too.

What will change?

We set out some of the changes we expect to see below:

Earn-outs

In the final stages of last year, we saw an increasing number of seller-friendly 'locked box' and 'cash up-front' deals. As the market returns, we expect to see an increasing proportion of deals with contingent elements.

Given the market will remain uncertain for some time, we expect that for many deals a significant part of the purchase price will be contingent on future performance, such as via an earn-out. Although not liked by many, earn-outs can have genuine benefits for both buyers and sellers. For sellers, valuations are likely to be depressed post lockdown with lower multiples applying, so an earn-out gives a chance to claw back value if the business responds well in the post Covid-19 environment. For buyers, the opposite applies: if the market takes longer to return, or performance does not re-commence as expected, that will be factored into the final price. An earn-out also ties a management team or other talent in for a significant period to grow the business (which can be beneficial as we discuss below). Ultimately, pegging some of the price to future performance helps to take some of the risk out of the deal.

When looking at earn-outs (which can be structured either as a series of incremental purchase price payments, or as a 'tiered' sale where the shares in the company are purchased in tranches over time by a number of put and call options, each based on performance) the key issue for each party is to ensure that the other cannot do anything artificially to distort financial performance during the earn-out period (e.g. by slashing investment to give a short term boost to EBITDA if selling, or imposing inflated group management charges if a buyer). It is worth noting that earn-outs are often re-negotiated, and have varying degrees of success in tying in management.

A variation on the 'tiered' sale structure we are increasingly seeing is for corporates to take a strategic investment in a business with a one-way call option over the remaining shares. The option can be exercised within an agreed exercise window by reference to a pre-determined valuation mechanic (so-called 'try then buy' model). Such corporate venturing structures will often also include additional capital for the business. Whilst less desirable for sellers, specifically because of the absence of any 'put option' and limited ability to sell to anyone other than the option holder, it is a means of raising capital and the mechanism would allow sellers to claw back value at a future date if/when the call option is exercised.

Consideration Shares

As an general trend and where suitable, we expect to see more paper consideration and less cash as a preferred form of purchase price. In a similar manner to earn-outs, such a structure has the advantage of aligning both buyer and seller to the future performance of the combined business. Whilst we have seen busy equity markets recently, with a number of fundraisings getting across the finishing line, the desire to retain cash we expect will remain for some time, so paper will be an attractive funding option.

Debt funding

The availability of debt funding is currently mixed, with debt funds as you might expect taking a slightly more aggressive view of some of the available credit risks. Those PE funds able (and willing) to fully equity underwrite deals, on the basis that they will 'refinance-out' part of their investment at a later stage, will be able to drive hard bargains in terms of speed and deliverability of transaction, almost certainly leading to more competitive pricing.

In addition, and within the PE sector in particular, we have started to see discussions being opened with existing lenders to roll over, or even extend, existing debt facilities (particularly non-amortising ones) into the new buyer structure using a waiver of any change of control mandatory prepayment provisions, often with associated covenant resets. This comes at a cost, as facilities put in place some years ago are mostly at higher interest levels and, as such, this has led to the "higher" cost of debt being factored into pricing, with the benefit of any savings derived from a refinancing in the 6 months (or so) following completion being shared between seller and buyer.

Completion Accounts

As noted above, balance sheets driving initial valuations will become under increasing scrutiny, which we expect will result in a move away from the 'fixed price' locked box approach, and a return to completion accounts - with valuations being re-assessed (and possibly attacked) post-closing. There will be circumstances where locked boxes will remain suitable (e.g. auction processes for particularly attractive assets), so we don't expect them to disappear however.

Asset deals

In this environment, buyers may prefer an asset purchase to acquire only parts of a target they want (e.g. avoiding historic debt or disputes), rather than a 'warts and all' 100% share purchase. We may also see an increase in this type of transaction with large corporates divesting business divisions.

Asset deals are a well-trodden path, but they can have more complexities than share sales: relevant assets need both to be identified and effectively transferred/assigned/novated; creditors and debtors dealt with appropriately; employees transferred with additional processes such as TUPE; and there are a number of additional tax considerations. Buyers may also find that it is not as straightforward to avoid historic liabilities as they would like. As such, proper preparation, structuring and diligence is essential before implementing an asset purchase.

Due Diligence

Where a sale is not distressed or forced (such that it requires an expedited timetable), we expect diligence processes to become more thorough and to require longer to complete.

Nearly all businesses are having to implement defensive measures in their dealings with counterparties, to preserve cash and avoid onerous terms. At present, we are seeing that parties are generally supportive of each other and willing to help, but general sentiment is that this will not last forever and parties will be seeking to re-assert their rights more forcefully in the near future.

The above will lead to: (a) more disputes; and (b) a greater focus on agreed contractual terms (e.g. minimum purchase terms or change of control clauses that may entitle customers and/or suppliers to re-negotiate or get out of unfavourable deals) when undertaking due diligence and how binding (or not) any steps that have been taken to vary or avoid those are.

Further, we are now seeing additional specific Covid-19 related due diligence, especially around lockdown measures, the use of government incentives and the like.

Retentions and Deferred Consideration

In a more buyer-friendly environment, we expect to see an increase in retentions, whether those be traditional escrow accounts, 'hold-backs' from the purchase price, or deferred elements of the consideration that are contingent either on time or other milestones.

We expect to see an increase in such mechanisms, as accelerated or distressed M&A processes are likely to result in various issues and disputes not being fully identified or resolved (including, for example, the scale of potential future liabilities such as deferred rent or HMRC liabilities). Although always a point of debate, such a mechanism will allow a seller to realise some cash now (and potentially the balance in due course) whilst also giving the buyer greater certainty of recovery if there is an issue.

Tax

Across the world we are seeing unprecedented levels of government support and intervention, which has been essential during this period. The UK government was already reviewing the tax system prior to the current pandemic (e.g. reducing Entrepreneur's Relief), and it is highly likely there will be a further increase in taxes and reduction in reliefs in the near future to help pay for this government support.

Advance tax planning now, and tax structuring as part of deal execution will be key considerations in any M&A process, and there will be greater scrutiny on whether many tax advantaged schemes (such as employee incentives) remain effective, particularly where those are more 'creative' in light of likely greater regulatory scrutiny.

As a result, owners may look to other forms of tax-efficient exits, such as sales to Employee Ownership Trusts (EOTs), which both have many tax advantages for sellers and present an external 'good news' story (e.g. Richer Sounds).

Retaining talent

In distressed sales forced by an investor or lender, there may be little or nothing in the sale for the management team that is required to continue to run the business. Whilst some will just be happy the company has a future, others will need some form of management incentive to stick around. With depressed equity values, and what is likely to be a higher tax environment as we note above, careful thought will need to be given to what form those incentives should take, and we expect that this will be a developing space. The difficulty in setting the base line for share based employee incentives should also not be underestimated.

With regard to the tier below senior management, many will have been working from home and/or furloughed. We expect to see a growth in certain employees 'going it alone' with their own businesses, and also perhaps a reduction in job loyalty and greater movement of workforce. This will be another focus for commercial diligence and deal structuring.

W&I Insurance

We expect warranty & indemnity insurance to continue to be a popular product, particularly with distressed sales and low or £1 valuations. W&I insurance and warranties being given on an indemnity basis will be a common structure where sellers have little or nothing to stand behind the warranties, but buyers want some form of recourse. Whilst at the outset of the Coronavirus pandemic W&I pricing hardened, we are seeing (and expect to continue to see) a relaxation in terms of W&I premiums as underwriters fight for the reduced number of W&I policies being underwritten as a result of the depressed state of the M&A market.

The development of Covid-related W&I policies and exclusions, including the provision of synthetic warranty products, will also be an continually developing area worth monitoring.

Debt Purchases

There is sometimes more than one way to gain control of a company...

In addition to traditional debt-for-equity swaps, where lenders agree to convert some of their debt for equity in a company, we are likely to see the return of a more opportunistic type of transaction. Rather than acquire an asset in the traditional way, some investors may look instead to purchase crippling debt that the incumbent lenders are near to writing off, then seeking to effect a debt for equity swap to acquire the target by a different means – the so called "loan to own" proposition.

Conclusion

As indicated at the outset, we do not expect to see a material pick up in M&A activity until buyers are confident they have seen the bottom of the economic trough. When that increase comes, we expect the deal landscape to shift as we have set out. Careful advance thought now around planning, structuring and executing deals in the 'new normal' will significantly increase the likelihood of a successful transaction.

Simon Smith
Partner, UK
T +44 20 7105 7232
simon.smith@osborneclarke.com

Tim Hewens
Partner, UK
T +44 742 960 2120
tim.hewens@osborneclarke.com

Jonathan King
Partner, UK
T +44 20 7105 7046
jonathan.king@osborneclarke.com

Osborne Clarke in numbers

850+

talented lawyers
working with

270+

expert partners
in

25

international locations*
advising across

8

core sectors
with

1

client-centric culture

Where we work

Europe

Belgium: Brussels
France: Paris
Germany: Berlin, Cologne, Hamburg, Munich
Italy: Brescia, Busto Arsizio, Milan, Rome
The Netherlands: Amsterdam
Spain: Barcelona, Madrid, Zaragoza
UK: Bristol, London, Reading

USA
New York, San Francisco, Silicon Valley

Asia
China: Shanghai
India*: Bangalore, Mumbai, New Delhi
Singapore

*Includes Indian relationship firm

osborneclarke.com