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M&A Insights for the New World

The restrictions enacted to combat the COVID-19 pandemic have resulted in a significant setback to the U.S. mergers and acquisitions (M&A) market's recent historic performance. As states gradually start to reopen their economies and the country finds a path forward, it is time to turn our attention to the new world wrought by the pandemic and the anticipated change to the M&A market in the near term. This article highlights high-level issues that buyers and sellers should consider as they navigate post-COVID-19 M&A transactions.

Diminishing Demand

While the current level of inactivity will not continue, sellers should prepare for a much less frothy market in the near term. It is likely there will still be mandatory or self-imposed restrictions on travel and in-person activities, which will have some negative impact on M&A activity. Many private equity and other financial buyers, as well as strategic buyers, will be focused on keeping portfolio companies and business lines alive, rather than considering new purchases. Notwithstanding the Federal Reserve's efforts to maintain liquidity in the market generally, tightening credit markets may also drag down M&A activity. There will still be uncertainty in the market as to future consumer behavior, government reactions, the true value of a business and other factors that will keep many buyers on the sidelines or will substantially dampen their views on business valuations.

Considering these circumstances, sellers should expect that leverage may begin to swing back to buyers. This will be especially true in those industries disproportionately affected by COVID-19, such as transportation and hospitality. However, it is fair to note that, as mitigating factors in favor of sellers, there remains significant dry powder that will need to be deployed, there will likely be interest in distressed transactions, and many private equity and other financial buyers may begin to look for more add-on acquisitions as they attempt to grow their existing portfolio companies, much like strategic buyers. So, while the leverage

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pendulum may be swinging back toward buyers, there are counterbalances that may limit the swing.

Sale Timing and Homework

For sellers that were considering a sale in the near term prior to the COVID-19 pandemic, it may well be prudent to prepare for a transaction but wait until later in the year to determine the proper time to pursue a sale, unless there is an urgent need to sell or a unique value-maximizing opportunity (for instance, your business involves remote work capabilities or another product or service that has suddenly become critical due to the pandemic). Notwithstanding such a delay, there is homework to be done. During this "wait and see" period, a seller could effectively invest in itself by performing a COVID-19 impact analysis, implementing process improvements, analyzing and preparing its management presentation, organizing its records for inevitable due diligence requirements and taking other sale-related actions.

The COVID-19 impact analysis may be the most critical of these potential actions. The pandemic's impact on a seller's business will be a significant issue to address in any potential sale transaction. The more comprehensive, thoughtful and organized a seller is in its analysis of those impacts, the more comfortable a buyer will be in its ability to assess the value and viability of the business going forward. In fact, the analysis of, and response to, the pandemic could be viewed as management's audition for a continued role with the business and, if done correctly, could provide a potential buyer with greater confidence in the strength of the business.

Valuation Challenges

One of the most fundamental components of a sale transaction is the determination of value. The COVID-19 pandemic has created uncertainties regarding the impact of the pandemic on both the historical operations and future prospects of a business, which in turn have made the determination of a business's value more challenging than ever. Further exacerbating this challenge is the reduction in market comparable sales data brought on by the reduction in M&A activity. While the pandemic has made valuation

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more challenging, buyers and sellers occasionally have to deal with significant disagreements over value in the normal course. Some of the mechanisms used to bridge those gaps in the past could be used, possibly with modifications, to address challenges brought on by the pandemic.

Stock-for-stock transactions, for instance, provide some measure of protection, as any over or undervaluation of the purchased company stock may be offset by a similar over or undervaluation of the buyer's stock; however, stock transactions are often not feasible or not preferred and usually do not satisfy a seller's desire to exit the business and achieve immediate liquidity. Equity rollover transactions (where a seller takes stock of the buyer or its affiliate as a portion of the sale price) provide similar benefits and have similar drawbacks to stock-for-stock transactions, but to a lesser degree because only a portion of the purchase price is paid in stock. But such transactions may be more acceptable to sellers and, therefore, may be more readily available to address valuation gaps.

Earnouts typically are a contractual right by which a seller is entitled to an additional post-closing payment if certain agreed-upon targets are achieved. While earnout provisions often are difficult to negotiate, they do provide for more precision in identifying and quantifying additional value drivers; however, it may be that earnout targets need to be specially tailored to the impacts of the pandemic, such as customer retention, rather than more customary financial metrics. Seller financing may enable a buyer to agree to a seller's view on valuation and, if properly structured, could serve a similar function to an earnout. Finally, a high-quality COVID-19 impact analysis mentioned above should only help the valuation negotiation, regardless of the value gap bridging measures available to the parties.

Financing

Similar to the swing in the buyer's market, the credit facility drawdowns and operating uncertainties created by COVID-19 will likely cause the debt and equity financing markets to become more lender and investor-friendly. Additionally, funding sources for non-traditional or unregulated lenders may be drying up as a result of

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the pandemic fallout, further reducing access to key financing.

With recent historical financial results and near-term viability for many companies being clouded by the pandemic, it is prudent to expect that lenders and investors may tighten loan terms, including shorter maturities, tighter covenants with shorter triggers, increased borrowing costs, reduced leverage, enhanced preferred liquidation preferences and expanded voting protections, as applicable.

It is also worth noting that traditional, regulated financing sources, who are generally more risk-averse and methodical about their underwriting process, may reassert their dominance in the market, which, coupled with the lender-/investor-friendly changes noted earlier, may make financed transaction closings less certain and more time-consuming. In this environment, preparation and organization will be key to a successful financing, including having a solid grasp on the pandemic's impact on the business in the past and the future.

Transaction Timing

With the entire world dealing with the ramifications of the COVID-19 pandemic, buyers and sellers should expect to throw the typical M&A transaction timeline out the window, at least in the near term, as lingering restrictions, uncertainties, backlogs, reprioritization and new market dynamics continue to impact a wide range of transaction activities. Social distancing and remote work arrangements will add time to even the simplest of tasks. Analyzing the impact of the pandemic on the business and performing diligence on sensitivities, such as supply chains, may add time to the process. But this additional time may be minimized if a seller has done its homework and prepared a COVID-19 impact analysis. Negotiating purchase price may also take more time, as buyers and sellers struggle to determine the true value of the business. Federal and state government agencies that have developed a backlog of transfer and approval applications due to reduced operations will struggle to respond in anywhere near their normal timeframes.

As noted above, it likely will take longer to obtain financing. Even when limitations on travel and larger in-person gatherings are lifted,

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it may be some time before people are comfortable resuming normal business activities. This may add further delays because, while management meetings can be conducted by videoconference and plant tours may be performed virtually, many buyers might not be willing to close without performing those activities in person. In this environment, it will be critical for buyers and sellers to acknowledge the new challenges and plan for a flexible, extended timeline that will allow the diligence, financing and negotiation processes to proceed in concert with one another.

Purchase Agreement Impacts

As the purchase or merger agreement is the primary document governing an M&A transaction, it is reasonable to assume it will be impacted by the various changes triggered by the COVID-19 pandemic. Potential impacts include:

- *MAE/MAC* – The Material Adverse Effect or Material Adverse Change definition typically impacts a seller's disclosure obligations and a buyer's closing obligations. The issue raised by the pandemic will be whether the MAE/MAC definition includes (buyer's position) or excludes (seller's position) the results of an epidemic, pandemic or other significant public health crisis and, if included, whether the results are included in their entirety or only to the extent they disproportionately affect the business. Alternatively, the buyer and seller could include a provision in the MAE/MAC definition that includes the results of epidemics, pandemics or other public health crises only if they have a negative impact on the business in excess of a specific dollar threshold (note that such a provision could also apply to any or all other events included in the MAE/MAC definition).
- *Financing* – The reduced availability of financing may require a loosening of the covenants regarding a buyer's financing efforts, which may also necessitate the inclusion or modification of termination fee provisions for the benefit of the seller.

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- *Timing* – Various closing conditions and termination rights place deadlines on sellers' and buyers' rights and obligations to take certain actions. Given the timing challenges noted above, the parties should carefully consider the appropriate deadlines for these actions in the near term.
- *Pre-Closing Operating Covenants* – The ongoing restrictions and impacts of the COVID-19 pandemic, as well as the actions necessary to recover from it, present significant challenges to sellers and significant risks to buyers. During the pre-closing period, sellers will need to be comfortable they have the flexibility to comply with ever-changing restrictions and address the COVID-19 impacts and recovery efforts. Buyers, by comparison, will want protection from unexpected risks and material changes to the business, such as changes to supply chains, production volumes and the workforce.
- *Representations and Warranties* – A seller may wish to make general disclosures about the pandemic to qualify its representations and warranties regarding the business. While this desire is, in some respects, understandable, a buyer's willingness to accept such general disclosures likely will be impacted by the risk or value associated with the operational area being addressed and the buyer's visibility into the risk from sources other than the seller. A buyer, on the other hand, may be interested in having increased representations and warranties in areas more significantly impacted by the pandemic, such as A/R collectability, supplier and supply chain issues, customer orders and relationships, and labor and employment.
- *Indemnity* – Given the uncertainty created by the COVID-19 pandemic, a buyer may attempt to broaden and strengthen its indemnity rights against a seller by reducing deductibles, increasing caps and/or requiring larger escrows or holdbacks. Such attempts may increase if, as preliminarily appears to be the case, issuers of representation and warranty insurance, which has become a more common component of certain M&A transactions, exclude COVID-19 impacts from coverage under those policies.

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Takeaways

While economic uncertainty probably will continue in the very near term, buyers, sellers and their advisors can proactively chart a path forward through this uncertainty. Fortunately, past events, while very different from the impact of COVID-19, have given us many tools to use or modify for these times. Some of those tools are noted above, but no doubt others will be developed over time.

By now, all have heard, or been reminded, that we should never waste a crisis. There are many lessons to be learned by the business community from this pandemic. The importance of supply chain redundancy and worker safety are currently at the forefront. But, as we transition forward, less immediate but more constant and transferable lessons can be learned or reinforced, including the importance of continuous business planning and experienced, trusted business advisors.

For more information, contact Bryan Mattingly, Keeana Boarman, or any attorney in the Mergers & Acquisitions Practice Group or Private Equity Industry Team.

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