COVID-19: Mergers & Acquisitions. Implications

Introductory aspects

It is a truism to say that the Mergers & Acquisitions will take a severe blow. Not only the private investments go hand in hand with the status of economy, predictability in laws making and good social and political climate, but investments are driven by other key-factors as well. Besides the purely legal side and behind the financial rationale, M&A projects are backed-up by various behaviours which generate enthusiasm, allowing one to have an appetite for spending or an appetite for taking risks.

Well, it is exactly these psychological factors that may recover at a slower pace, long after the pandemic would be formally over. Things like social ethics, reminders that vulnerabilities capable of bending the global economy in a matter of weeks do exist, the loss of confidence, discussions on true priorities and the fact that resources are not unlimited are expected to take the stage for a while.

But, like in any turmoil, there will be winners. And of course, the ones with cash at hand acquiring distressed businesses is the first thing that comes to mind.

List of affected topics

We have analyzed this from both sell side and buy side, by reference to each M&A stage.

PRE-SIGNING

1. The targets

More than before, acquirers must understand the target's business and how can this be impacted, because:

- some businesses were simply closed down under the law;
- some businesses may fall under state's requisition (e.g., industrial facilities, private healthcare units);
- potential recovery may be easier for some businesses (e.g., general retail, leisure) than for others (e.g., luxury goods).

2. The preliminary documentation (e.g., Letters of Intent, Memorandums of Understanding, Non-binding Offers, Non-disclosure Agreements)

Re-consider the timing that is usually agreed under these documents (e.g., exclusivity periods, due diligence calendar, submission of offers) as the process could be much lengthier than in the past.

Assess carefully how to put on hold a negotiation or how to exit the process. Align in good-faith the expectations as regards resuming the process at some point.

3. Due diligence

Re-consider the timing for conducting due diligence, because:

- teams working remote may not be that effective (at least not right from the start) in rendering their assessment;
- targets not already working with digital tools could have a hard time compiling the required documentation to upload in virtual data rooms;
- virtual data room providers may have difficulties in maintaining the service at the previous quality levels.

Uncertainty would require full flag due diligence, in the detriment of high-level/ red-flag reports.

There will be a re-positioning in the legal areas to come under review. Several points here:

- commercial agreements – reviewing commercial agreements has always been important, but usually this was done under selective criteria (e.g., agreements generating more than a certain yearly amount, top 10 clients, etc.). Now, assessment of the force majeure clauses and identifying which agreements would be expected to terminate may become a priority.
- labour law – labour aspects have always been important too, but now would require more focus. Assessing the manner in which workers' problems were addressed by the employer during the turmoil may be essential, as this could show what is the climate and who is still on board.
- financing – this will come under radar as well, because depending on how the targets decided to use the options offered by the banks to ease the lending, financing institutions may have a great say. As well, it is important to pay attention to uncommitted facilities and cases of acceleration to be potentially invoked by the banks.
- insolvency – specific analysis for checking potential insolvency state will be thoroughly required.
- insurance – the insurance area, business disruption policies and continuity plans will also come under scrutiny.

4. Valuation

Certain valuation methods could become irrelevant for a while. Performing a valuation based on EBITDA or DCF would seem useless as past performance could no longer be replicated, while cash flows are also a big unknown.

Assessing some of the financial metrics that were influenced during the pandemic crisis will become challenging. For example, some companies may have a major increase of sales in certain categories (e.g., hardware and software enabling remote work, cleaning and hygiene products), but these would be nothing but extraordinary incomes, with less relevance for the usual income model.

Decoding the true values of Net Debt and Working Capital will also be tricky. For example, while receivables due for more than a certain period would normally qualify as bed debt, and carved-out from the Working Capital, this rule could now become deceitful. Even usual top clients may face difficulties in settling debts if there is a fracture in their segment, but this could be only temporary.

5. Structuring the investment

Structures with an earn-out component are expected to drop, mainly because the sellers would have no incentive in accepting this any longer.

6. Financing the investment

Buyers holding cash would have a great advantage over those resorting to other’s financial resources, so this could lead to ad-hoc pricing arrangements based on ad-hoc needs.

Leveraged deals are expected to drop for a while. Even if cash is available, banks would probably have a difficult time assessing whether the proposed investment is viable.

SIGNING

1. Timing

Share deals and mergers could be potentially impacted if third parties decide to use more thoroughly the opposition rights available to them under the Company Law.

Business transfer agreements might also be delayed, especially if real estate is involved, mainly due to notarization proceedings and physical presence requirements for signatories.

Conditions precedent and interim operations would take longer to fulfil, especially if actions of authorities or other third parties are required. Long stop dates to be re-considered because of this.

2. Merger control

Due to the drop in 2020 turnover, some of the acquisitions to be completed in 2021 that would normally qualify for merger control, may fall outside this under the new circumstances.

Certain targets and whole industries, until now outside of CSAT’s usual range of interest, could now become strategic and enter CSAT radar.

3. Change of control

Financing institutions will take longer to assess if they agree with the change in shareholding. Denying the transaction is expected to occur in those projects where the acquirers are no longer considered healthy.

4. Representations, Warranties and Indemnities

Sellers may generally be required to accept an increased allocation of risk in these areas.

Potential longer warranty periods to be agreed, mainly because:

- certain statute of limitations may be suspended for while;
- certain prerogatives of the authorities would be halted for a while (e.g. tax authorities stopped their investigations);
- the pandemic crisis may be a period during which many companies, intentionally or not, breached certain regulatory (e.g., competition, GDPR).

Difficulties in securing R&W insurance, mainly because:

- insurance companies will need a while to design new mechanics for the new context, especially when it comes to coverage and exclusions;
- even some of the classic representations & warranties could now become untrue.

5. Material Adverse Change, Force Majeure and Hardship

For a while, such concepts will be under the highlight, with each party paying better attention at securing its rights during exceptional events.

CLOSING

1. Post-closing adjustment

More likely for parties to enter into disputes concerning post-closing adjustment of the price and earn-out structures.

2. Buyer’s rights to recover

The number of claims will generally increase, buyers are expected to be more vigilant about indemnification rights or any other scenarios aimed at recovery of sums paid (especially if, as a result of an extended due diligence, the buyer’s awareness on the target has increased).

3. Payment in instalments

Due to lack of financing or resources available all at once, sellers may be forced to accept various instalments arrangements. This may help with the deal getting through, but post-closing the seller may face a risk due to this. Various security arrangements are expected in order to secure sellers’ rights (e.g., letters of commitment from the acquirer’s parent company, share pledge).

4. Integration and synergies

Integration is always one of the biggest challenges in post-closing. Even a very successful target, in the wrong hands, can become a failed acquisition due to clash of personalities, different cultures, different business models, lack of transparency and so on. Buyers are expected to address this better and find ways of maximising synergies.