Private M&A deal-making in the face of COVID-19

KPMG Israel Deal Advisory

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Opening remarks:

COVID-19 has dramatically impacted the lives of individuals globally and has disrupted the world economy, putting nearly every facet of business operations to the test. While some countries continue to focus on flattening the curve, other countries seem to be alleviating lockdowns and loosening restrictions. Nevertheless, it is becoming clear that COVID-19 will not disappear in the near term, forcing businesses to learn how to conduct their operations alongside the ongoing battle with COVID-19, and how to identify and realize business opportunities specifically in these times.

Such opportunities may include identifying potential M&A targets – whether they be agile organizations able to adapt quickly to meet consumers' changing demands, or businesses that have become distressed since the onset of the pandemic.
COVID-19 also raises many new considerations for the parties involved in proposed or pending M&A transactions. In this article, we highlight some COVID-19 related trends that are directly impacting negotiations and agreements of private M&A deals.

Valuations and deferred payments

In a COVID-19 uncertain and rapidly changing world, some of the key questions that a buyer will have is "How do I now value the target business? Is the historical financial information truly representative data for how a business is to perform on a going forward basis, taking into consideration a potentially disrupted supply chain, unusual inventory levels, and distorted accounts receivable and payable? What does this mean in terms of cash flow conversion? Do the business' financial projections and their underlying assumptions still hold water"?

Sellers may predictably take the position that the impact of COVID-19 is only temporary and that the fundamentals of business will remain unchanged throughout and after the COVID-19 crisis. Buyers could, in turn, suggest a partial deferral of the purchase price along with earn-outs. Because the earn-outs are contingent on the target business's performance post-closing, the parties will share the economic risk of the business during the earn-out period. The key challenge with earn-outs is ensuring that the parties build the trust and mechanisms required to avoid diverging incentives. The use of average results over a longer earn-out period to measure value, together with more flexible payment terms or payment deferral will tie the parties together for a longer period on the one hand, but may spark a more refined dialogue on governance and course of action on the other hand, often improving alignment of interests.

Pricing mechanisms:
Locked box vs completion accounts

COVID-19 has by all measures increased the degree of uncertainty in the deal-making process and naturally raised the question "How should the deal parties allocate business performance risk between signing and closing?"

On one hand, sellers in a strong bargaining position may prefer a locked boxed pricing mechanism – fix the final purchase price based on the financial statements of the target business on a specific date before the signing of the purchase agreement, or even before the COVID-19 outbreak. The locked boxed mechanism potentially allows the

economic risk of the business to be transferred from the seller to the buyers even before the signing date (i.e., from the locked box date).

Buyers, on the other hand, will gravitate towards a more traditional post-closing purchase price adjustment mechanism ("completion accounts"), where the purchase price is trued up (or "trued down") to the state of the business at closing. As such, the sellers will bear the economic risk of the business between signing and closing.

Each pricing mechanism carries its pros and cons, however in a risky environment, buyers are likely to be reluctant to use a locked-box mechanism and highly prefer the completion accounts mechanism in order to mitigate pre-closing risk. If a locked-box mechanism is preferred, close attention should be paid to the value accrual from the locked-box date to closing, given that it typically includes a forecast element of trading that may now not be achieved. If a completion accounts mechanism is applied, agreeing on a representative working capital target may be challenging if the target business' working capital requirements are now characterized by uncertainty. The adjustment calculation should be wisely tackled in the negotiation process, with attention given to potential cash flow risks in the short and medium term from closing, as well as potential post-closing funding implications for the buyer. Related definitions within the purchase agreement (such as working capital definition) should aim to incorporate such considerations.

Timing of transaction and buyer's financing

In addition to the impact that COVID-19 may have on valuations and pricing mechanisms, travel restrictions, office closures and quarantine requirements raise questions regarding the time required to close an M&A transaction. Both the buyer and the seller should take into account that because of COVID-19, the provision of key information (such as audited or interim financial statements, financial models or projections, etc.), due diligence process, third party consents and governmental approvals may take longer to finalize. If the purchase agreement sets an "outside date" when the closing conditions must be met or the deal may be terminated, the parties should agree to a longer interim period than they otherwise would. Timelines and expectations should be adjusted accordingly.

Another time sensitive topic that a buyer should foresee is raising third-party financing to fund the transaction, which in COVID-19 business conditions could take more time and efforts to obtain. In anticipation, the buyer may want to have a "financing out" condition, allowing it to walk away from the deal with no penalty if financing fails, while the seller, on the other hand, may consider negotiating a reserve break fee. Also, the seller may contemplate requesting an escrow for deferred purchase price payments and a guarantee from the buyer's parent.

Due diligence, representations and warranties

COVID-19 has become one of the front and center topics of due diligence. The buyer may assess different aspects of this topic, such as, (i) material breaches in commercial agreements with both customers and suppliers; (ii) force majeure clauses that excuse non-performance and any capped liabilities; (iii) risks to a target's supply chain, insurance coverage, counterparty risks, IT systems, business continuity plans, and remote working arrangements. The seller, at the same time, should appreciate the buyers' sensitivity and proactively share information about the possible impact of the virus and, where relevant, appropriate mitigation and contingency plans.

The definitive agreement documents may include COVID-19 specific representations and warranties, as well as more extensive and recent pre-closing disclosures from the sellers. The sellers may seek coverage under appropriate knowledge and materiality qualifiers, resist forward-looking representations and warranties, and carve out breaches or inaccuracies known to the buyers before closing from its indemnity obligations. The buyers, on the other hand, could push for a holdback of purchase price to secure payment of indemnity claims, as well as purchase price adjustments.

Material adverse effect between signing and closing

In a COVID-19 world the reality, regulation and markets can change dramatically from one day to another. A similar drastic change can happen to a target's business between the signing date and the closing date, especially if the interim period can sometimes last months. A common closing condition in a purchase agreement is that there is no "material adverse change" or "material adverse effect" (MAE) on the target business. Depending on the details of the terms, COVID-19 impacts could allow buyers to walk away from a deal without penalty.

The definition of MAE is generally set out in the purchase agreement and is heavily negotiated by the parties. The buyer generally argues for an extensive definition of what forms a MAE in the target (e.g., its financial condition, ability to close the transaction, the "prospects" of target, etc.) while the seller generally argues for an extensive list of events or circumstances that cannot be deemed to cause a MAE in the target business, particularly those that the target has no control over or those which did not cause the target business to be adversely impacted significantly more than a peer group of comparable businesses. Whether the negative effects of COVID-19 on the target business may allow the buyer to walk away depends on the language used to define the term of MAE, the law governing the purchase agreement, and the specific effect the pandemic has had on the target business. As such, both the seller and the buyer should endeavor to draft the MAE definition as clearly as possible.

Ordinary course of business during interim period

Usually, between the signing date of the purchase agreement and the closing date on which the target actually changes hands, the business is managed by the seller. To preserve the value of the target business in the interim period, purchase agreements include covenants that require the seller to operate the business in the ordinary course, i.e., not to pledge any of its assets outside of the ordinary course, not to terminate or change the compensation of employees, not to make any capital

expenditures over a certain monetary threshold without the buyers' consent, etc. However, in response to the COVID-19 outbreak and governmental recommendations, businesses are taking significant actions, which could generally be agreed to be outside of the ordinary course – but which may be in the best interests of the company. For example, companies may lay off employees, refinance debt obligations, and negotiate amendments to material contracts in order to minimize a financial hit to the business.

In drafting interim covenants in the context of COVID-19, parties must consider how to balance the sellers' fiduciary obligations and necessities to respond swiftly to the current volatile environment and the buyers' interest in ensuring the responses do not result in any erosion of the target's value. Trust, communication and true "good will" between the parties is the key to navigating these issues more than anything.

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As the business environment surrounding COVID-19 continues to develop, additional concerns and challenges will arise. This article may serve as a starting point when considering the impact of COVID-19 on M&A deal negotiations and relevant deal-making tactics and tools. We encourage you to reach out to a member of our team to continue the discussion.

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