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# THE CERTAINTY OF CHANGE

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**MERGERS & ACQUISITIONS  
IN A PANDEMIC –**

**What should you  
be doing now?**



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## MERGERS & ACQUISITIONS IN A PANDEMIC –

### What should you be doing now?

**R**ight now M&A activity has been significantly decreased, and the projected numbers for foreign direct investment and Gross Domestic Product in many countries are concerning. However, we must remember that we have been through many crises over the years, though this is the first one that directly relates to a disease - at least since 1918.

It is therefore likely to have more of a global effect than some of the other 'financial crises'. At this moment it seems unlikely that there will be much M&A, but what previous crises have shown us is that life will return (maybe in this case more gradually) to the norm, even if this norm involves more remote working than ever before.

## The bull market is dead

We have to remember that, fundamentally, this crisis is not a financial crisis. Central Banks have acted very quickly to provide additional leverage. However, we have to accept that the eleven year bull market is now dead. Prior to the Coronavirus crisis there were similarities, in terms of M&A, to the last boom in pre-2007/8, most notably risk was not being priced fully into transactions. Just like 2007/8, it was easy to do deals without any reps and warranties and with limited due diligence. Interest rates are low, and with quantitative easing providing a monetary stimulus over many years, in addition to the introduction of fiscal measures to encourage business further, with small government intervention being the trend, the M&A market was hot, if not over-boiling.

In 2008, it took a couple of years to get back to any semblance of normality. In 2020, it could be even quicker. A lot will depend upon consumer confidence and what damage, if any, has been done to supply chains. There will be a number of fundamental changes that are likely to take place.

I am, therefore, confident that come the final quarter of 2020 and certainly going into 2021, there will be significant M&A activity, both private and public, though there will be Coronavirus issues which will change the way in which M&A is carried out, particularly on due diligence.



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There is also likely to be a number of business failures in the short-term, primarily due to lenders at the end of the coronavirus crisis re-assessing which businesses they believe are able to pay back their debt; and so those lenders may well force a number of accelerated M&A processes. This article does not touch specifically on accelerated M&A, which is the subject of a [separate article](#), however, you can find 'Ten Tips for Buyers and Sellers' in relation to accelerated, or distressed, M&A at the end of this piece. But what should buyers and sellers be doing now?

## Supply chains revisited

Everybody is looking at supply chains. They need to be re-examined and potentially restructured. The "just in time" manufacturing model has proved challenging during the current crisis. Also, vertical supply chains may have too many chinks in them, so there could well be a vertical as well as horizontal consolidation of supply chains, as the ultimate customers review risk and what control they need.

Many countries are now re-assessing what is essential manufacturing. This will inevitably involve a re-shoring, particularly from Asia. Certain essential manufacturing sectors will become "core" businesses for major Western countries. This could include, as well as steel and energy, healthcare products and a significant widening of national security interests and "essential business rules", which will restrict foreign ownership of key industries. This was already a trend pre-coronavirus. This will only expand post-pandemic. Protectionism will come back, particularly as it becomes popular amongst the electorate, which will inevitably have an effect on increased tariffs and cost of logistics.

New legislation is being introduced to deal with government financing, loans and grants and furloughing, which is intended to keep the economy going during the pandemic. However, the breakdown in social protection, while stated to be temporary, could result in a weakening of employees' rights. Addressing long-term employees' incentivization and recognising the weakening of employee rights will be an important part of M&A going forward, particularly in the EU.

# THE CERTAINTY OF CHANGE

## MERGERS & ACQUISITIONS IN A PANDEMIC –

### The time is right

Both from a buyer and seller perspective, this is a perfect time to review strategic plans, with buyers with strong balance sheets or access to capital identifying what businesses they wish to acquire, and for sellers it is the right time to prepare their businesses for sale.

From a sales side perspective, this is the time to prepare vendor due diligence, focusing on both pre-coronavirus issues, the current pandemic and post-pandemic opportunities. Inevitably there will be a lot of sensitivity modelling that will need to be done but budgets should be prepared or revised, based on longer and shorter term disruption timelines.

A seller needs to tell their story based on what life was like outside of the pandemic and how they can recover from disruption caused by coronavirus.

There is not a better time to review all contracts, real estate, insurance, compliance with laws, etc, in order to provide buyers with accurate and up to date information in any VDD or in a data room. Every contract should now start to be digitalised. The risk of having something in a building which you cannot access has shown already to be an issue on the M&A transactions that are currently being carried out.

Buyers and sellers need to think of the right way in which to do management presentations and this is where tele-living can be used. Sellers should already be preparing videos and making sure that they have adequate video-conferencing arrangements in place, assuming that there are still going to be restrictions on movement for some time to come. Where possible, pre-emptive audits on health and safety, environmental and general compliance should also take place. Preparing a more digital, or online, VDD approach including, for instance, interviewing key managers as if they were asking questions of a buyer is something that should be considered in advance. Both financial sponsors and strategics will see the lack of the ability to visit a site and to interview management as a clear price issue going forward and indeed without adequate seller preparation, there could be issues for the buyer community to be engaged fully.



**THIS IS A PERFECT  
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### Data rooms and AI

Getting the data room together and having dummy data rooms which are constantly updated is also strongly recommended. I strongly believe that buyers will take a more forensic view of adequacies of data rooms and gaps in them. I believe buyers will take a tough position in relation to perceived gaps in information that are contained in data rooms, particularly now they are getting used to working offline.

There will be a further increased traction in terms of the use of artificial intelligence tools. The historic resistance from bankers and sellers to the use of AI will inevitably start to waver as it becomes more important for the buyer community to have such access.

Other technology that will be used will include, for example, a move from physical completions to using products such as DocuSign. It is likely there will be a lack of physical face-to-face negotiations and people will get even more used to just marking up documents and doing due diligence remotely.

### **Due diligence hot topics**

The sorts of issues that will now be covered in due diligence will include:

- (a) What action did sellers take in relation to furloughing? What other changes may have been made to employees' remuneration or pension arrangements, bonus arrangements and stock option plans? On an acquisition or disposal, how will these arrangements that have been put in place for coronavirus be valued or reviewed? It will be even more important for buyers to understand what steps the sellers took vis-à-vis employees and how comfortable they are with the processes that took place.
- (b) More focus on health and safety issues. Manufacturing and distribution sites will need to be reviewed from a social distancing perspective. Regulations may well change, which means that factories and sites need to be reconfigured. For example on a deal right now, productivity has been reduced, due to the time it takes to cleanse a factory between shifts.
- (c) Existing financing. What extension of finance arrangements have been put in place or what covenants have been waived and also, where companies were taking advantage of government funding schemes. Often the arrangements are loans, they are not grants and so therefore are repayable and will become repayable on a change of control. The traditional locked box, which has been very much dominating the market is going to either have to adapt to adjust to the unusual nature of coronavirus issues, or at least for a period of time will go out of fashion, as there is more focus on working capital, how strong payables and receivables are and net debt and net cash arrangements. We would anticipate a lot more deals with working capital arrangements and we would also expect a lot more arguments post-deal in relation to working capital arrangements due to the focus that has been taking place in negotiating locked boxes up front
- (d) Insurance arrangements. Understanding business interruption cover but also other insurance that might be in place, such as credit and trade insurance which relate to specific supply chain issues or the failure to make payments, due to cash flow issues anywhere in the supply chain. We would anticipate DD to be particularly heavy in the insurance area.
- (e) Travel restrictions. Often global businesses have relied on senior management to travel on a regular basis, but if there is going to be long-term restrictions on travel arrangements, local management will need to be stronger and also reporting arrangements and mechanisms will need to change. Buyers will need more talent locally.
- (f) Business contingency plans and general continuation plans relating to businesses and how they have coped with the circumstances. Historically these have been seen as integration issues to be sorted out later, but now they are so fundamental they may determine whether a deal can proceed pre-signing.
- (g) With people working from home, data privacy issues and cybersecurity issues again are coming to the fore. Thorough resilience testing on IT issues, which again is often done as an integration issue, are now being focussed on pre-deal. There is inevitably going to be resistance from sellers to this approach as this requires access to sellers' IT systems and some sellers are going to try and offer certificates or some other protection in relation to IT resilience instead. We will have to see where TSAs end up and how they are drafted in these circumstances.
- (h) Focus around the supply chain not just looking at the supply chain agreements but how, actually, does the supply chain work. Where are the weaknesses in terms of logistic providers, production shutdowns, inability to pay up and down the chain. This has always been a critical area but is often done as an integration issue. It is now very much a due diligence issue up front, which needs to be understood for a deal to complete. This is not simply about force majeure clauses, it is much more fundamental.

# THE CERTAINTY OF CHANGE

## MERGERS & ACQUISITIONS IN A PANDEMIC –

### Old locked boxes are meaningless

As a result of all this 'due diligence', inevitably there will be different types of warranties. While historic fundamental warranties have been around title and capacity and even insolvency or sometimes environmental, we may well see now fundamental warranties including issues like contingency planning and IT resilience or some sort of boxing of those warranties.

It will also be interesting to see the approach that is taken to disclosure. I would expect buyers to resist coronavirus disclosures and require that to be built into price and negotiation. I would also expect financial sponsors to still resist giving any reps and warranties, but strategic buyers will be focusing yet again as they did maybe ten years ago on risk and may not be so willing to pass that risk on to warranty and indemnity insurance, particularly if coronavirus is an exclusion to the policy. We will inevitably see warranty and indemnity insurance policies coming out with a 'Covid' wrapper. This could result, at least in the short-term, in higher premiums and the buyers will be looking to pass on those costs to sellers. We could also see situations where buyers are not prepared to accept warranty and indemnity insurance and insist that if this is the approach taken by a financial sponsor seller, the price must come down.

So what does this mean for pricing and valuation? Clearly the short and long-term impact of the virus is going to make valuations challenging. While inevitably there will be really competitive situations which may look beyond coronavirus, by far the majority of deals are likely to see a downturn of valuations. Earnings forecasts are being reduced and cash is king. As stated above, we are likely to see less locked boxes and more traditional completion accounts, working capital statements etc. A locked box dated 31 December 2019 is meaningless right now in the current situation we have.

I am also seeing deferred and staggered consideration payments, which are being contingent on the number of aspects. This could be recovery of receivables, which historically would have seemed to be good but have been delayed by coronavirus. This could relate to other factors like non-termination of supply chain issues, guarantees of customer orders, opening or the closure of certain markets, the lifting of travel restrictions and unfortunately the recurrence of coronavirus.

This will lead to more analysis being done as to what security a buyer or seller can have in relation to deferred or staggered payments, but it is highly unlikely that on the sell-side they will get a first security position and will instead end up being significantly subordinated to other security holders. I suggest that seeking security is not the right way forward but instead a parent company guarantee would be more appropriate, particularly if the buyer is a public company. If the buyer is a financial sponsor looking for some sort of comfort from the financial sponsors, LPs may also be appropriate. Though this will inevitably be resisted by the financial sponsors, they are going to have to look at ways to provide comfort on deferred or staggered payments, if that is the approach they take.



**EARNINGS FORECASTS  
ARE BEING REDUCED  
AND CASH IS KING.**

### Our old friends: earn-outs

Earn-outs have obviously been around a long time and it is fair to say that many earn-outs end up in disputes. The longer the earn-out, the more likely there is going to be a dispute. The buyer will want to run the business as it thinks fit, whereas the seller wants to know that the buyer is not doing anything to adversely affect the ability to get the earn-out. There will be a lot more focus on drafting earn-out covenants and there will also be inevitably a lot of negotiation as to what the earn-out is dependent on. Sellers often bank the earn-out whereas the buyer sees it as a contingent arrangement. The traditional earn-outs around revenue targets or in some cases profits may well be replaced by specific events, which if triggered or not triggered, result in a further payment.

Where there isn't an earn-out or a staggered payment, you may even see vendor financing, again to bridge the gap between the perceived value each party has. Remember cash is king, so if a vendor is prepared to finance some of the consideration, a buyer will be quick to take this up. This may involve the vendor taking loan notes or even taking equity, where the buyer is a public company, (though this could even be where the buyer is a private company, and the vendor in effect is sharing the risk and the reward in how the buyer builds its business). This could be attractive for a seller to get an appropriate yield.

I believe there will be a significant increase in equity raising for M&A transactions. While debt has been cheap for many years and therefore issuing dilutive equity has not been popular, I have seen immediate consequences of the coronavirus crisis leading to a number of accelerated book-building processes. There is no reason why this could not also apply post-virus in relation to acquisition financing. Either the seller could take an equity stake itself or equity could then be placed in the market via a vendor placing arrangement so that the seller gets cash, but is in effect funded by the public markets. Where the seller takes a stake, there will have to be arrangements around stabilisation of the market in terms of the seller realising the equity interest it has received as part of the consideration.

I am even seeing examples where buyers are looking for a dowry from a distressed seller. In other words, the seller leaves some cash in a business, which is to be paid to meet operating costs of the business going forward. The buyer gets it 'for free'. This is a solution where it is better for the seller to sell by leaving cash in the business, than for the business to fail with the consequences for the rest of the seller's business.

Other issues which need to be carefully watched:

- (a) There will no doubt now be a discussion on force majeure or MAC clauses and what those should contain.
- (b) We may see an increase in the number of break fees around termination around coronavirus issues.
- (c) We may see completion deliverables turning into conditions. While in a standard SPA, if a completion deliverable is not delivered, the party has the ability to either stop the deal or continue as it wishes and these clauses are very rarely negotiated or looked at. In a coronavirus situation, these are real clauses.
- (d) Interim covenants will become more important, i.e. what can be done by the seller between exchange and completion.

### Summing up

This may seem like a very full explanation, dealing with the coronavirus situation, but in simple terms, this is about preparation, both from a sell-side and a buy-side. Sellers should now be preparing their businesses for sale. Buyers should be preparing their new deal books with what they will require going forward. There is absolutely no reason why M&A can't return to the levels it was at in 2019 but, at least in the short-term, COVID-19 will become a very real issue in terms of M&A activity and how M&A transactions are structured.

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### Top 10 tips for **sellers**

1 Preparation is key.

2 Start building a virtual data room early. We have also seen evidence that where documents are not digitalised, sellers are finding it difficult to get hold of documents which might be locked in a business premises which no one is entering for the time being. As warranties may not be given the buyer will do more due diligence and want fuller information. A poor data room will cause value to be lost.

3 Anticipate buyers' requests around encumbrances/group sharing issues/customer/supplier issues/what is driving the process.

4 If you have borrowed money during COVID-19 from governments, look at the terms. If you have furloughed people understand the consequences of a sale.

5 Anticipate enough time to deal with potential buyers. You are going to have to devote at least two to three weeks to the process.

6 Keep all stakeholders, particularly creditors fully informed, especially if the sale does not represent full repayment.

7 Stick to deadlines and make sure potential buyers do.

8 Where time is of the essence a certain deal, even with a lower price, may be better than a higher price which has strings attached.

9 Recognise some buyers are simply unable to move fast so discount them early.

10 Recognise the duties that the directors may have, particularly if they are subsidiary management in relation to any process.

## Top 10 tips for buyers

1 Again, preparation is key.

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2 Due diligence will be the most important part of the process as if the sellers ultimately do go into insolvency, you will get no warranties and indemnities from a seller and even on a solvent sale, as stated above, warranties and indemnities may be of limited value in the long term depending on the covenant strength of the seller.

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3 There has been some talk on reps and warranty insurers offering product. Don't let that distract you from doing your own DD.

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4 It is absolutely vital to ensure you understand what assets you can buy and whether they are unencumbered.

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5 Addressing employee costs and the transfer of employees will be important so you may need to factor into the price e.g. any future redundancy costs in relation to employees that you inherit under the operation of law need to be factored in.

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6 One issue that comes up many times is group sharing arrangements where you are not buying the entire business. Making sure you understand what is owned by who within the group, for example, intellectual property and any other cross-charging arrangements is vital.

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7 Even if you are assuming payables, understanding which suppliers may be aggrieved is important to any goodwill you are buying.

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8 Often, an initial solvent sale process ends up being an insolvent sale process which adds additionally to the risk.

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9 Consider alternative arrangements with sellers if the risks are too high e.g. taking an equity stake, setting up a JV instead of outright purchase or offering an earn-out down the line with a reduced price upfront.

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10 Where there may be antitrust concerns with an acquisition consider upfront any failing business arguments to be put to the regulators.



# THERE IS ABSOLUTELY NO REASON WHY M&A CAN'T RETURN TO THE LEVELS IT WAS AT IN 2019.

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