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Corporate M&A

Latvia

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Trends and Developments

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Overview of 2020 M&A Activity

In March 2020, the European M&A market came under a significant pressure due to the various political, economic and social developments in the EU and beyond. The global COVID-19 pandemic became the key factor holding sway over the economy and fanning the flames of the smouldering intra-European division instigated by the refugee crisis and Brexit-like movements in other EU member states. The COVID-19 pandemic precipitated an unexpected and unprecedented economic crisis that will, most probably, redefine the world for the years to come.

M&A dynamics in the first half of 2020

Unsurprisingly, the COVID-19 pandemic caused a considerable decline in M&A activity at the end of the first quarter and throughout the second quarter of 2020 across the European market, including its Latvian segment. Negotiations in a number of inbound M&A deals were terminated due to the cautious approach of the bidders to the expansion of their business in a turbulent macroeconomic environment. However, an absolute majority of the buyers, who passed the due diligence phase by the end of the first quarter, remained firmly committed to proceed with the acquisition, subject to revision of the terms and conditions designed to accommodate previously unforeseen risks.

One devastating effect of the crisis was a dramatic decrease in the number of air passengers in the second quarter of 2020. The financial support measures adopted by the Latvian state to mitigate impacts of the pandemic on the

transportation sector culminated in the largest local 2020 disclosed M&A transaction, involving capital injection of EUR250 million into the Latvian national air carrier Air Baltic Corporation AS in exchange for an additional capital stake of 10.95%. Unfortunately, state aid support mechanisms have been used less efficiently to support other heavily distressed sectors, sowing seeds of doubt among representatives of the consumer, retail and leisure industries in the ability of the state to manage the crisis.

M&A dynamics in the second half of 2020

During the third quarter of 2020, a series of consolidation activities by the European, Nordic and Baltic players followed, taking advantage of the opportunity to establish or bring their presence on the local market to a new level. The most prominent example of the consolidation trend in the distressed sectors was the largest pan-Baltic 2020 disclosed M&A transaction, valued at EUR65 million, for the sale of 100% capital stake in the Estonian cinema operator Forum Cinemas OÜ, including its Latvian branch. Despite the relative weakness of domestic GDP growth in the third quarter, Latvian M&A activity picked up the pace, encouraged by the uptick in investor and consumer confidence.

An impressive recovery of the Latvian M&A market continued into the final quarter of 2020, in line with the surprisingly positive M&A trends on other European markets. The second largest local 2020 disclosed M&A transaction, valued at EUR120 million, for the sale of an 83.14% capital stake in a leading European fibre-glass

manufacturer, Valmieras Stikla Šķiedra AS, is considered the crown jewel of the fourth quarter. The intensity of the Latvian M&A activity in the second half of 2020 was solid enough in terms of aggregate volume and value to surpass the results of 2019.

Due Diligence Trends

Apart from the significant drop in the M&A deal volumes, the COVID-19 pandemic has also substantially transformed M&A deal-making practices. Indeed, it is one thing to overcome lockdown restrictions by getting used to videoconferencing platforms but quite another to learn building trustworthy relationships virtually. The virtual world provides much less opportunity for the emotional “handshake deals” that create a positive momentum and enable corner-cutting, when time is short. A completely detached and pragmatic approach based on the outcome of the rigorous due diligence is becoming a prevailing trend, putting an extra pressure on the legal professionals to deliver irrespective of the pandemic restrictions.

Transformation of the due diligence process

Obviously, virtual data rooms are not new to the Baltic region. A remote engagement with the executive management of the target, on the contrary, requires new approaches to interview techniques and cross-examination tactics. A limited ability to attend onsite inspections demands new rules of conduct and technological solutions, particularly when the core assets of a target comprise infrastructure, manufacturing capacity or real estate. In addition to the various procedural adjustments, the material scope of the due diligence has also evolved to cover new risks posed by the COVID-19 crisis, notably:

- the current state of grants, loans and tax deferrals designed to address the adverse effects of the pandemic;

- compliance of the representations and warranties forming part of the existing loan facilities;
- compliance with the commercial lease agreements;
- compliance with the new requirements of health and safety;
- impact of the lockdown on the supply chains of the target company;
- non-performance of the contractual obligations by the target due to the business interruptions;
- changes in the terms and conditions of the insurance policies, etc.

Other due diligence considerations

Due to the growing number of consolidations as of the third quarter of 2020, we have been increasingly involved in the so-called “clean team” arrangements to review competitively sensitive information revealed by the sellers as part of the due diligence process. We have also noticed a rise in the number of vendor due diligence (VDD) requests, which demonstrates an overall commitment of the stakeholders to adjust their exit strategies in the light of the new reality. The minimal VDD scope has now been permanently extended to include a full-fledged review of the General Data Protection Regulation (GDPR) compliance risks. The threat of the reputational damage and significant increase in the amplitude of the fines has elevated GDPR compliance to the level of a potential deal-breaker in such booming sectors as: technology, media and telecommunications (TMT); and pharma, medical and biotech (PMB).

Share Purchase Agreement Trends

COVID-19 pandemic restrictions are gradually creating more of a buyer’s market, in comparison with the previous couple of years when sellers used to find themselves in the ascendancy. Unsurprisingly, buyers are using this switch in the balance of power to adjust terms and condi-

tions of the share purchase agreements (SPAs) in their favour. The COVID-19-era SPAs tend to reallocate risks between the buyers, sellers, as well as, to some extent, providers of the representations and warranties insurance.

Material adverse change clause

During SPA negotiations, buyers have been actively arguing for the introduction or revision of the material adverse change (MAC) clause to boost their protection against downside risks. In essence, a MAC clause allows the buyer to walk away from a deal without penalty if a material change adversely affecting the business of the target occurs at any time between signing and closing. A typical MAC clause consists of two basic elements: (i) a general or specific definition of the event, occurrence, fact, condition or change, which is expected to produce an adverse effect on the assets, business, financial condition, or prospects of the target; and (ii) exclusion of the specific events, which usually reflect systematic risks affecting the market generally, unless such effect on the business of the target is disproportionate to the effect on the similar businesses. Whether or not the adverse effects of the COVID-19 pandemic are capable of triggering termination rights of the buyer under the SPAs signed before the outbreak would ultimately depend on the wording of the specific MAC clause in the light of the circumstances of each individual case. As a rule of thumb, however, the standard MAC clauses do not cover the impact of the COVID-19 pandemic on the business of the target.

It is a challenging task to draft and negotiate wording of a MAC clause in such a way as to ensure termination rights of the buyer as a result of the COVID-19 pandemic. First of all, the pandemic is a foreseeable risk from now on, which means that the emphasis has to be shifted away from the general impact of the crisis towards the specific measurable effects caused by it, such as

long-term closure of the production facilities, frequent interruptions in the supply chains, significant decrease in the number of customer orders and/or termination of the strategic supply agreements. When the buyer is willing to go beyond the internal business processes of the target to capture risks inherent in the market environment, it is preferable to define MAC based on the specific quantitative measurements, such as reduction of EBITDA or any other industry-specific financial metric by a certain value, which will trigger termination rights upon arising. Despite significant imbalance in the negotiation powers, the sellers, however, tend to meet an excessively wide list of termination triggers with a severe resistance leading to a deadlock. A more suitable solution is to address COVID-19-related risks through the classic pre-closing covenants requiring the seller to continue operating in the ordinary course of business.

Pre-closing covenants

The main purpose of the pre-closing covenants is to ensure “business as usual” up to the date of closing, which may prove to be an unattainable task during the COVID-19 crisis. The contracting parties, therefore, may find it extremely difficult to agree on the wording of the ordinary course undertakings. The sellers tend to insist on a flexible approach enabling adjustments of the business model to the realities of the lockdown restrictions, new health and safety requirements and other organisational measures. The buyers, on the other hand, tend to express deep concerns about the prospect of the pandemic being used by the sellers as an overbroad excuse to justify strategic failures, imprudent financial decisions or loss of key personnel. The compromise between the two extremes is usually found in the extended wording of the “ordinary course” definition to include actions ultimately required by laws (as amended) to combat the pandemic or activities recommended by the industry, such as specific good practices approved by the rel-

evant associations in response to the pending material events or changes.

Representations and warranties

The buyers are also seeking revision of the typical representations and warranties, as well as introduction of the new ones to address COVID-19-related risks. The representations and warranties contained in the contemporary SPAs are extended to include:

- compliance with the emergency and contingency plans for ensuring continuity of the business in “the new normal” environment;
- compliance with the national laws and regulations, guidelines and recommendations related to the COVID-19 pandemic, including health and safety requirements;
- compliance with the national laws and regulations regarding COVID-19-related financial grants, loans and/or tax deferrals;
- compliance with the material agreements, including reductions, delays, terminations, actual and potential defaults due to the pandemic;
- resilience of the IT infrastructure to sustain remote operation and secure data privacy.

Nowadays, it is becoming extremely difficult to negotiate with the sellers any forward-looking warranties, which are heavily disclosed against or framed “so far as the seller is aware”. Although representations and warranties insurance (RWI) remains a fairly new instrument for the Latvian M&A market, it might become a plausible solution for deals negotiated in the present times. Regrettably, RWI providers have excluded from the policy coverage most of the COVID-19-related risks. Nevertheless, RWI may unlock a plethora of risk-management tools for sellers and buyers, as the exact scope of RWI coverage remains negotiable. We expect RWI to play a more engaging role in future Latvian M&A transactions due to the noticeable erosion of the

insurance premiums, as well as a genuine interest on the part of the RWI providers to expand their services into the small and medium-sized enterprises (SMEs) segment.

Recent Local Legislative Developments

Latvia is actively nurturing its domestic innovation and start-up ecosystem to boost the TMT sector. The most recent legislative initiatives aiming at reduction of the start-up operational costs at the early stage of their development included: amendments to the Commercial Law (as amended on 17 December 2020), the Personal Income Tax Law (as amended on 17 December 2020), as well as the Law on Aid to Start-up Companies (as amended on 3 September 2020).

The amendments to the Law on Aid to Start-up Companies paved the way for an unprecedentedly favourable start-up payroll tax regime, subject to eligibility criteria. The amendments to the Commercial Law extend employee stock option plans to the limited liability companies as a means of incentivising the SME employees. The amendments to the Personal Income Tax Law extended payroll tax reliefs to the employee stock options issued by the limited liability companies, subject to certain holding period requirements and other eligibility criteria. These initiatives demonstrate an overall commitment on the part of the legislator to support start-ups unicorning in Latvia.

Overview of 2021 M&A Trends

The COVID-19 pandemic has precipitated a major shift in the European and Latvian M&A market, which will provide some tailwind for M&A activity in 2021. An increased attention on the part of foreign and local bidders to the TMT sector resulted in a number of mid-range M&A deals at the end of 2020. Latvian telecommunication service provider Baltcom SIA embarked on an acquisition spree among independent cable television and internet service providers

toward the end of the year. As technology will continue to drive innovation and digitalisation across most sectors of the regional economy, TMT will remain in the limelight.

A rare example of an outbound acquisition featured purchase by the Latvian healthcare service provider Repharm AS of a controlling stake in a leading Lithuanian medical clinics chain operated under MediCA klinika and Kardiolitos Klinikos (Kardiolita) brands towards the end of the third quarter of 2020 highlights growing interest among the regional bidders to the PMB sector. We observed a significant increase in pre-M&A activities within the sector by the regional players considering consolidation. The sheer amount of private equity and corporate dry powder may give rise to sizeable leveraged buy-outs in the Latvian PMB sector this coming year. Undoubtedly, PMB M&A activity will remain one of the defining trends of 2021.

One of the largest local 2020 disclosed M&A transaction, valued at EUR77 million, for the sale of a 34.1% capital stake in the Latvian unified natural gas transmission and storage operator Conexus Baltic Grid AS to the Latvian state-owned energy transmission operator Augstsprieguma tīkls AS vividly demonstrated that stable income-generating assets in the energy and utilities sectors remain in high demand irrespective of the crisis. Moreover, the rise of environmental,

social and governance (ESG) conscious investing encourages private equity funds to recalibrate their approach in an attempt to embrace the Latvian renewable energy market. The race to meet the ambitious climate-neutrality targets may result in a fresh start for the Latvian renewable energy sector in 2021.

The ongoing changes in the Latvian logistics environment will stimulate M&A activities in the transportation sector. There are clear indications of upcoming market exits due to the changes in the transportation flows resulting in a gradual decrease of freight transport demand during the previous years. The transportation sector is one of the current distressed M&A front-running candidates alongside consumer, retail and leisure.

Concluding Remarks

The number of distressed M&A transactions constantly grew throughout 2020. Most of those early birds, nevertheless, had been experiencing considerable financial difficulties before the COVID-19 pandemic. Obviously, the intensity of distressed M&A activity hinges on the effectiveness of the state aid support mechanisms. The European Commission (EC) has just announced allocation of another EUR240 million of financial aid to Latvian companies affected by the COVID-19 pandemic. Whether or not this funding will reach distressed market participants in time to save their businesses remains to be seen.

Eversheds Sutherland Bitāns is part of the global law practice Eversheds Sutherland and is a leading law firm in Latvia, offering its clients a unique mix of more than 20 years of local experience and a global network of 69 offices in 32 countries. Its team of more than 35 lawyers and staff provide the full range of legal services to a global client base which includes some of the world's largest multinationals. The corporate and commercial team assists clients with corporate issues of varying complexity, from the formation of corporations to large cross-border

acquisitions and restructuring transactions. It has extensive experience advising on complex global M&A projects as well as regional and national M&A transactions. The firm's clients include major local and international manufacturing and service companies, banks, funds and financial services providers. Most recently it advised a leading glass fibre manufacturer in Europe, Valmieras Stikla Šķiedra AS, on matters related to its refinancing and restructuring of assets as well as majority share sale transaction.

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