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CORONAVIRUS – DOING **M&A-**DEALS IN GERMANY IN UNCERTAIN TIMES

Coronavirus (Covid-19) is likely to lead to a period of volatility and uncertainty in global and domestic markets, making settling valuation and pricing, and achieving deal certainty in M&A transactions, more challenging. Sellers are likely to have a valuation outlook that assumes a short period of uncertainty; Buyers may worry about an extended or deep period of uncertainty.

In this briefing, we look at some of the techniques within an M&A process that are relevant to the German market and may be used by both sides to bridge a valuation gap or by a Buyer to retain some flexibility to walk away if the target business is more badly affected than expected.

M&A techniques/strategies

Adjusting your contractual deal terms

- Purchase price protection
- Conditions and termination rights
- Managing contingent liability risk

Alerting your strategy

- Buying or selling a stake rather than the whole company
- Investing in a different capital instrument
- Reducing your exposure (partnership and consortia)

ADJUSTING YOUR CONTRACTUAL DEAL TERMS

Purchase price protection

On the assumption that a Seller is not willing to simply agree a lower valuation and price, the key focus will be on whether the parties can agree a purchase price mechanism that gives sufficient certainty and protection on both sides. Assuming a split signing and completion we would expect a Buyer to push for a later valuation date, ultimately seeking protection by way of a completion accounts mechanic, so that negative impacts on the business in that period may be captured in the price.

This would be a shift away from the current position in the Central European market through 2018 where our market practice survey showed a locked-box mechanism was used in 54% and a fixed price concept in 15% of all private M&A transactions last year compared with only 31% of transactions using completion accounts. This position has been driven by the recent seller's market, and Sellers' preference for the certainty of a (historic) pricing point (usually the end of an accounting period shortly before signing) and locked-box protection mechanism (potentially with an interest ticker rate).

Where a Seller is unwilling to move to a full completion accounts process, a hybrid structure can be used where the price is set by reference to locked-box accounts, but certain balance sheet elements are tested at completion, most commonly cash (through a net debt adjustment) and working capital. These adjustments can either be structured as a reciprocal Euro-for-Euro adjustment against an expected level, or as floor values where an adjustment only occurs if the expected minimum level is not met.

Shifting to a completion accounts process, however, only provides protection as at (and therefore, until) completion. Under the current circumstances, parties may not be confident that the market will have settled by the time of completion and, for example, contracts re-negotiated to respond to customer demands or supplier needs during a crisis may have long-term repercussions.

Where a Buyer requires protection for the period after completion, it will need to seek provisions allowing for deferred consideration, retention of the purchase price, a valuation floor mechanism or an earn-out structure (see box).

A Seller will have limited control over the target business after completion and therefore may be reluctant to accept a pricing mechanism that links value to performance post-completion. As such, these structures are more common on the sale of a majority or minority stake (as opposed to 100% sales), where the Seller retains some oversight through its retained stake in the company. In any event, earn-outs are generally treated with caution as they can introduce significant pricing uncertainty and can involve complex accounting adjustments, for example, to reduce the adverse impact of choices a Buyer might make for the target business after completion.

Conditions and termination rights

Deal certainty and reduced execution risk is prized by both Seller and Buyer; and has been a key feature in the German market in recent years. In a period of market disruption, a Buyer may look for a degree of optionality through additional conditionality or termination rights, because there are circumstances in which the Buyer is not willing to do the deal at any price. At its most general, that optionality might be sought through a material adverse change (MAC) clause.

- To date, MAC conditions and termination triggers have been heavily resisted by Sellers in the German market (although they are expected by US Buyers) – our market practice survey showed that in overall Central Europe MAC clauses were only used in 26% of private M&A transactions in 2018 and very rarely in Germany. They are heavily negotiated, and in the context of Coronavirus, a number of issues would arise:
- Would it be a general MAC or a specific MAC? If the impact of Coronavirus is the issue, presumably the MAC should be specific?
- How is the impact measured? Simply ‘a material adverse effect on the target business as a whole’ or by reference to a specific financial metric (e.g. EBITDA reduction) or by reference to another KPI?
- What is material? Court decisions on MAC clauses in acquisition agreements under German law are rare (if only because such dispute would likely end up before an arbitration tribunal). However, Courts are expected to construe them narrowly, but will look closely at the terms of the clause and the agreement as a whole. You should therefore consider defining what you mean by ‘material’.
- How will you measure the MAC? Is there enough time in your gap between signing and closing for the impact to occur and be measured? Should the condition be capable of being invoked where an event or change has

Deferred consideration

Part of the consideration is agreed to be paid at a later date, without any conditionality as to that payment. As such, the deferral primarily assists a Buyer with more time to fund.

Retention

Part of the consideration is retained to be paid at a later date, on the assumption an event occurs (or, potentially, does not occur).

Valuation floor

Part of the consideration is withheld and only payable if performance (commonly measured by EBITDA) for a current period matches expectations (i.e. budget or forecast). So, for example, a deal with completion in September 2020, priced on historic accounts, could have consideration withheld subject to the EBITDA for FY2020 meeting the agreed floor.

Earn-out

A full earn-out mechanic sees part of the purchase price only paid by reference to performance of the business in the current and future financial years. The adjustment would be fully dependent on performance, and this approach is usually seen where a Buyer is trying to incentivise positive performance from a management team.

occurred which is 'reasonably likely to have a material adverse effect', rather than only where such event or change has had such effect before completion?

- Should there be any exceptions carved out of the MAC? Often a MAC provision will carve out events and changes affecting an industry generally (including epidemics and pandemics), except, importantly, to the extent the target business is affected disproportionately to its industry (a business MAC). This might be relevant, for example, if a business in one industry has a particular focus on customers in another industry who are badly affected.
- How do you assess and deal with indirect impacts? Can they be attributed to Coronavirus?

The answers to these questions will be deal specific. Interestingly, in the UK market we did not see an uptick in MACs in the aftermath of the Brexit vote, but rather Brexit was often expressly excluded. This perhaps reflects the fact that MAC provisions are designed to address the unexpected and provisions to address known risks such as Brexit and now Coronavirus are more likely to be specific and bespoke.

In our view, parties will likely focus on where they perceive the real risks and issues for the target business arising out of the Coronavirus outbreak, and narrow their condition directly on those issues, for example, a contract or contracts being terminated or re-negotiated. Such an approach provides both parties with greater certainty, but will require the Buyer to be confident that the impact and extent of the outbreak has been understood requiring thorough diligence and management challenge.

Closer focus will likely also be required to any regulatory conditions which might be affected by the financial condition and prospects of the target and the enlarged group.

Managing contingent liability risk

Buyers generally manage and assess contingent liability risks through diligence backed by warranties and indemnities. We expect to see a greater focus on disclosure by Sellers around the potential impact of Coronavirus. From a Buyer's perspective, contractual termination provisions, while always a concern for diligence, may receive greater focus as Buyers will likely want to assess the impact on the business of a counterparty coming under pressure to re-negotiate or terminate the contract. Buyers may also want to diligence more thoroughly key supply chains across different geographies and the potential impact of the outbreak on the ability of direct and indirect customers and suppliers to continue trading.

Consequently, a Buyer may seek the warranties to be granted also effective at closing and pay greater attention to interim operating restrictions for the gap between signing and closing and the dynamics of securing consents to the change of control under key contracts. Buyers may also take a tougher stance and have less appetite for risk around non-Coronavirus issues that are identified through diligence which they feel might put further pressure on the price, and may look for those issues to be addressed at the Seller's cost through an indemnity or adjustment to the price.

Where deals are using warranty and indemnity insurance we would expect the underwriting process to include detailed questions on the potential impact of

Coronavirus on the target, including questions focusing on the suitability of the target's disaster recovery policies and compliance with the same. Where satisfactory answers to questions from the underwriters are not provided, we would expect Coronavirus risks to be excluded from cover.

ALTERING YOUR STRATEGY

Following the demise of Lehman Brothers and the global financial crisis, we saw an increase in clients establishing strategic partnerships to develop new business, stopping short of full legal joint ventures. The uncertainty in the market saw clients look to drive the benefits of working together to build that business, without committing to shared costs and a longer term outlook. As the market became more predictable, those partnerships were formalised.

Coronavirus could have a similar impact, with Buyers and Sellers reassessing the way in which they approach M&A in order to capture the benefits but protect their downside exposure.

Buying or selling a stake rather than the whole company

Moving away from the sale of 100% of a company to a stake sale allows the risk on valuation at a given moment to be shared. Clearly, there are significant differences in approach to acquiring a minority or joint control position, rather than a majority or sole control position, but that approach can unlock valuation issues. The Buyer is not fully exposed to the risk; the Seller has not given up all of the value that it feels would be generated by the business in a more stable market. Transactions of this type may also see Buyers seek a route to control, or the Seller effect a full exit by way of further sale undertakings at a later date, whether formal or informal.

Investing in a different capital instrument

If a Seller and Buyer cannot agree terms around an acquisition of ordinary shares, it may be possible to structure a preference share or convertible shares to allow the parties to find an agreement on valuation. This would apply generally to a minority stake investment. For example, with a convertible preference share the investment could be made at a value at which the Buyer is comfortable (i.e. with a conversion ratio pegged to the Buyer's view of value as a floor) but where conversion would give a lower percentage stake if the Seller could deliver additional value by the conversion date. If the conversion date was pegged to a point at which the market is assumed to have stabilised, the Seller therefore retains the ability to deliver that value and achieve its desired price.

Where the transaction is a stake sale, similar outcomes could be achieved through using contractual provisions in the investment or shareholders' agreement that establish liquidation preferences or priority waterfall structures, although those provisions generally apply on an exit.

Reducing your exposure (partnership and consortia)

Consortia and club deals are becoming increasingly common in the current market, and present a potential solution to valuation issues, by allowing Buyers to commit less funding to an M&A situation and reduce their exposure to the valuation risk. Those consortia might consist of two (or more) financial sponsors, but equally could be a strategic trade buyer looking to have the valuation supported by a financial sponsor. Clearly, moving to this structure brings with it a number of additional issues that need to be worked through by the consortium members, but equally may allow transactions to happen that might not otherwise do so.

Where parties wish or need to finalise transactions during a period of significant business uncertainty, we expect that they will need to consider the various tools and approaches discussed above to mitigate and allocate the economic consequences.

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