Beyond the pandemic: the future of M&A

M&A monitor special edition

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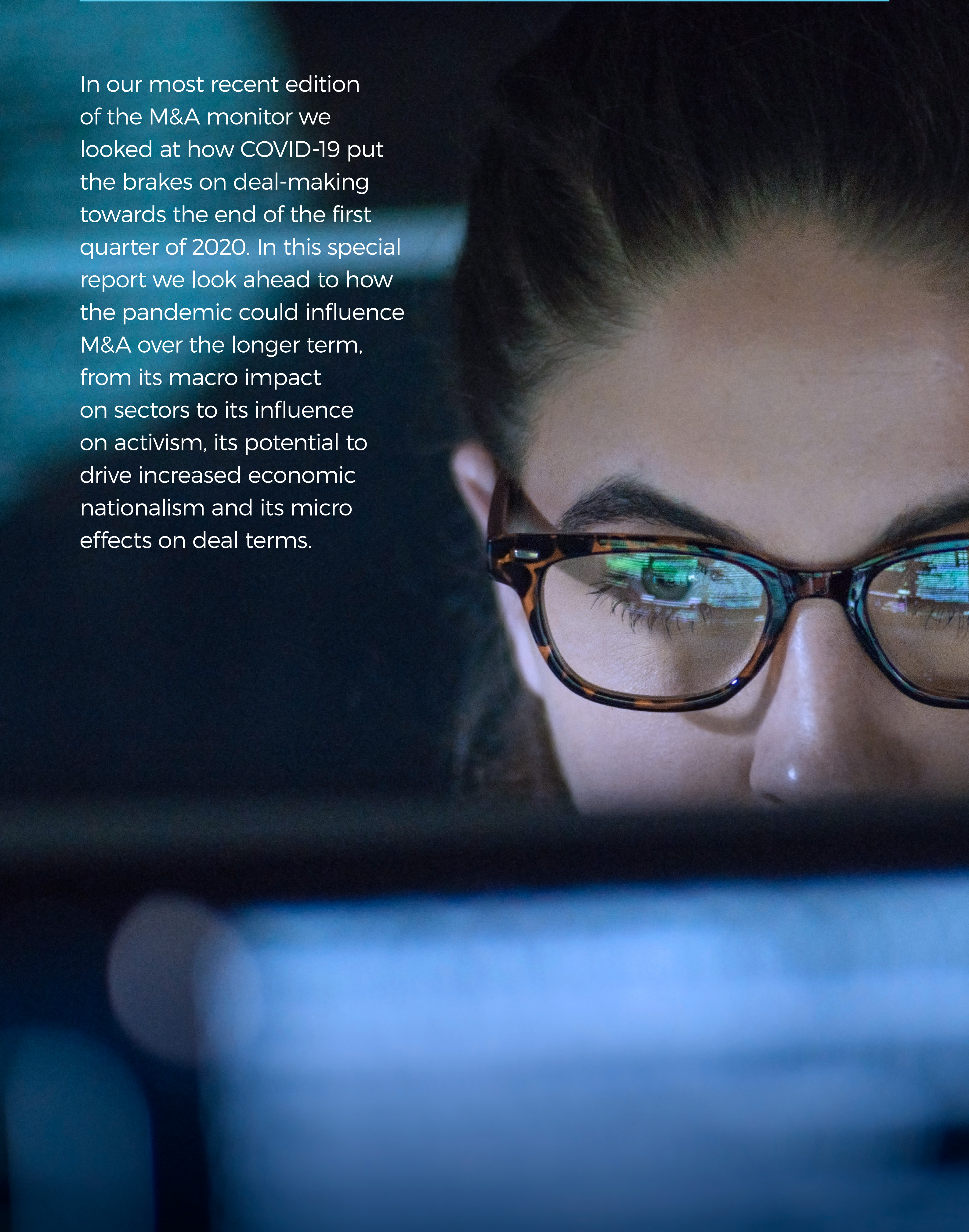

In our most recent edition of the M&A monitor we looked at how COVID-19 put the brakes on deal-making towards the end of the first quarter of 2020. In this special report we look ahead to how the pandemic could influence M&A over the longer term, from its macro impact on sectors to its influence on activism, its potential to drive increased economic nationalism and its micro effects on deal terms.

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Macro focus: predicting the unpredictable

Predicting the economic impact of a pandemic is notoriously hard to do. Forecasts made during the SARS outbreak in 2003 put its eventual cost at between $30bn and $100bn, and suggested the global economy would take two years to recover. In reality the outbreak had a negative impact on GDP in just three territories and curtailed economic growth in only five.

COVID-19 is an order of magnitude larger than SARS, indeed than any public health crisis in the past 100 years. Assessing even its current economic impact is fiendishly difficult because one of the consequences of lockdown restrictions has been to hamper the ability of national statistical agencies to collect data. However, a recent paper from the San Francisco Federal Reserve offers clues to its potential longer-term effects.

The study analysed 15 similar events over the past millennium and found they are typically followed by a long period of suppressed interest rates and increased levels of personal saving. If a vaccine is found quickly then all bets are off. But if not, and COVID-19 follows the pattern of previous health crises, the current fall in individual spending could be sustained. For a global economy that for decades has been driven by consumer behaviour – with a strong globalist/international mindset – we could be about to enter very choppy waters.

It is not just personal wealth and spending that will need rebuilding. Companies in sectors from bricks-and-mortar retail to oil and gas have had the rug pulled from under them by the sharpest drop in demand the world has ever seen. We have already entered a period of reckoning marked by a wave of consolidations and portfolio and balance sheet restructurings. But once this has passed we are likely to see many surviving businesses maintaining bigger cash buffers rather than entering into deals, despite research from McKinsey showing companies bold enough continue executing 'meaningful' acquisitions during the last downturn outperformed their less acquisitive peers by a factor of six. Dividends may also remain heavily constrained and share buybacks are likely to be rare, adding to the vicious cycle. In this scenario a large swathe of the global economy could be about to experience what Japan has lived through since the 1990s, where many businesses are cash-rich but their growth is curtailed by caution.

Virus acts as a deal accelerator – and a brake

At the same time some businesses have got stronger through the pandemic, not least the tech giants and innovators that have kept the world connected and the pharma companies that have had early success in supplying COVID-19 therapies. Likewise, those that operate online – outside hard-hit sectors such as travel – have proved among the most resilient. According to Microsoft CEO Satya Nadella, the pandemic has driven 'two years of digital adoption in two months', a development that will only accelerate the need for technological innovation and acquisitions to drive business model transformation. We believe logistics and warehousing assets will come into play as companies look to fortify (and potentially shorten) their supply chains. And, longer term, the crisis is set to further intensify interest in 5G as the world adjusts to a future in which many workers may not quickly return to 'normal' office life – if at all.

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Barriers to FDI grow

But while COVID-19 can, in certain circumstances and verticals, act as a driver of deals, it is also boosting some of the forces that weigh on them. Since the earliest days of lockdown, governments have been scrambling to protect domestic companies left weakened by the crisis. Spain has suspended plans to liberalise its foreign investment regime; Australia reduced to zero the value threshold at which it can call in deals for review; Japan has further tightened its rules; and India has become embroiled in a spat with China after announcing business from neighbouring countries would need to seek government approval for any inbound investments.

As the geopolitical rhetoric heats up over who's to blame for the virus, the barriers to FDI (which had been growing even before COVID-19) are likely to get bigger still before they recede. Potential buyers might need to consider carefully their 'nationality' in the eyes of some regulators – a point that is particularly acute for international financial sponsors with limited partners and investors spread across the globe.

More assets deemed critical to national resilience

The crisis has also caused governments to re-evaluate which assets will be critical to national security in the future. Regulators and politicians may choose this moment to push for the broadest possible interpretation of the term as they look to protect their economies, potentially taking us back to the days of 'strategic yoghurt' – when Pepsi was blocked by the French government from acquiring Danone – or worse.

The Committee on Foreign Investment in the United States (CFIUS) has always been able to examine controlling investments in the health sector. But recent rule changes give it the power to do likewise for certain non-controlling investments where the US business is involved in particular export-controlled technologies or collects large amounts of health data. Post-COVID, scrutiny of investments across a broader swathe of healthcare assets – from vaccines to medical equipment and protective gear – is likely to increase amid the scramble to build more resilient supply chains. And this is not a phenomenon limited to the US: at the end of March, the European Commission published guidance calling on all member states to be vigilant in the face of foreign bids for healthcare capacity and related industries such as R&D.

Is a paradigm shift under way?

It's also possible COVID-19 could be a catalyst for more fundamental economic and social change. The speed at which the coronavirus caused unemployment to spike in advanced economies – and the sheer number of businesses that have required emergency financial support – have laid bare the fragility of our current economic system. Likewise, the reported spread from animals to humans of a new and deadly pathogen offers further evidence of just how delicate our relationship with the environment has become. It is no surprise then that influential leaders are calling for post-COVID stimulus money to be used to drive a greener recovery. Taken together with numerous examples of businesses doubling down on their social impact commitments in the teeth of a downturn, there are signs a paradigm shift is upon us. If society does indeed reward companies that behave ethically during the crisis and beyond, the impact on investment flows, asset prices and deal-making could be profound.

Deal drivers: hedge funds beat a retreat

In the midst of a simultaneous supply- and demand-side shock, it's no surprise cash is currently the world's hottest commodity. Not only is cash conservation a growing focus for both consumers and corporates, our own analysis of court filings reveals a marked increase in money-related pre-litigation correspondence as companies look for ways to either obtain cash from others or avoid handing it over.

Against this backdrop activist investors are in retreat for the time being. Hedge funds have long urged companies with significant cash balances to use their reserves to buy back shares. But with those tactics leaving many targets exposed to the ravages of the downturn, their standing in the boardroom may take time to rebuild.

Activists shift focus away from M&A campaigns

The uncertainty of corporate forecasts has caused many activists to hit pause on new campaigns for now, and deal-makers also report a general dial-down in aggression as funds try to keep other stakeholders onside. While high-profile players including Carl Icahn and Starboard Ventures continue to attack, data from Lazard reveals that overall, hedge fund activism fell as COVID-19 took hold. In January and February activists targeted 42 companies, but by March this had dropped to 16. Just five of those campaigns had an M&A component – that is, were designed to force the divestment of a division or sale of an entire business.

Until the market outlook has stabilised, analysts are expecting a shift away from M&A and balance sheet campaigns towards those targeting perceived governance and operational performance failings during the crisis. There have been claims that more US corporates are adopting 'poison pills' to protect themselves from activists as COVID causes their equity valuations to fall. Our analysis, however, is that there's not yet enough of a rise to call a trend, despite some boards citing the pandemic as a factor in their thinking. Similar legal mechanisms exist outside the US (for example in the Netherlands), but in the UK, shareholder proposals are rarely adopted due to hostility from institutional investors and general opposition from regulators to weighted voting structures. That said, boards will be considering their defence options while the outlook remains uncertain, so we will be keeping tabs on the data in the weeks and months to come.

Financial sponsors to the fore?

There have been predictions that the coronavirus downturn would spark a boom in sponsor-led buyouts, with private equity reportedly sitting on $2.5tn in dry powder before the pandemic took hold. There were phenomenal levels of PE deal activity in 2019, including the largest European acquisition in more than a decade (the $18.7bn Advent/Cinven-led buyout of Thyssenkrupp's elevator business). In a world where stock prices have plummeted and businesses face a sudden liquidity crunch, there has been speculation financial sponsors are set for an M&A spree. That day is fast approaching, although the way those deals are done could be primed for change.

The classic PE leveraged buyout model is great for internal rate of return (IRR) on a successful exit, but it is likely to face significant pressure as businesses under, or exposed to, private equity ownership struggle for survival amid a cashflow crisis (car rental giant Hertz and UK-based restaurant chain Hawksmoor are just two in a litany of recent examples).

Just like other businesses, PE portfolio companies have been exploring the possibility of accessing state funds to ride out the crisis. That prospect has sparked criticism from commentators who argue that the number of jobs PE-owned companies support are of lesser relevance than the depth of their backers' pockets. These questions aside, the bigger issue is often whether such businesses are even eligible for state help given the way their finances are structured. In Europe for example, companies whose accumulated losses exceed 50 per cent of their share capital are not able to access government support packages under EU state aid rules. Many PE-backed businesses find themselves in this category because sponsors' use of debt tends to minimise their share capital, while the associated interest payments can result in statutory losses even when the business itself is generating cash. Against this backdrop, leverage may fall victim to the pandemic.

Synergies in the spotlight

Another favourite tactic among financial sponsors keen to put their best foot forward on valuations is to identify 'synergies'; efficiency savings that often involve employee layoffs. Post-COVID – as an entire generation of workers comes to terms with the first mass unemployment event of their lifetime – boards of target companies may feel emboldened to push back on bids that need these measures to be compelling. Private equity has a superb track record of reinventing itself, and the fundamentals that drive businesses to embrace sponsors will largely remain. But we expect a shift in emphasis in light of the pressure on jobs, with private equity instead set to focus on driving growth via improved governance and strategic focus.

We also expect a surge of interest in private credit investing among LPs and sponsors. Special situations and tactical opportunities funds are built for times of volatility, and made huge gains in the wake of the financial crisis thanks to their flexibility to invest across asset classes. No one did better than Apollo, which at the height of the credit crunch poured more than $1bn into debt from plastics manufacturer LyondellBassel. This was converted into equity when the company filed for bankruptcy and years later, after LyondellBassel was reborn through a successful listing, Apollo walked away with a $10bn profit. According to Bloomberg it remains the most successful private equity investment of all time.

Not all private credit plays flip into overall ownership in this way. But sponsors may not need traditional 'control' in order to succeed under current market conditions. The usual route by which sponsors exert influence over their investments (ie acquiring a majority of the share capital and installing their own directors) are less important in times of high financial stress. Against the backdrop of COVID-19, private investors who provide a financial lifeline for struggling businesses will carry a lot of influence in the boardroom – and could find themselves wielding as much power as they do when they own large chunks of shares.

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Will committed capital survive the shock?

While sponsors will have their eyes on deal opportunities, they will also need to manage their limited partners and investors with care. With so much financial stress in the system it's possible we may see defaults on capital calls as we did in 2008. LPs may also urge caution among general partners keen to strike out before the pandemic's full impact is understood. And GPs will have to clearly articulate their strategies if they want to play in the public markets. Data shows the number of PIPE deals more than doubled in the US in Q1, but LPs (who have an unprecedented understanding of investing in public securities), generally don't expect funds they have earmarked for private capital to be redirected to the public markets without very preferential terms or a compelling strategic rationale.

For corporates themselves, private capital is a welcome option given the strings attached to government support. In the EU for example, emergency state aid rules prevent any company participating in a government equity-purchase scheme from paying dividends or buying back shares until the investment is settled. Similar dividend restrictions apply where member states provide guarantees for financing (including for the larger support packages in the UK which remain subject to the same rules during the Brexit transition period), while banks extending government-backed loans are also imposing further operational constraints. It is common for debt documentation to include limits on acquisitions, and we expect these to be tightened for COVID-related loans even if the borrower has the cash available to invest. And with the IMF warning that banks themselves should think hard about returning money to shareholders while they are taking on so much risk, private investment is set to play an even bigger role in business life after the pandemic.

Micro-focus: how will deal processes change?

As well as its impact on macro deal-drivers, the COVID-19 crisis will affect M&A at a practical level, too. Lockdown restrictions have limited buyers' ability to conduct robust due diligence and engage with management in person, while auditors have been prevented from visiting facilities to provide assurances around the seller's financial statements. If this forms part of the 'new normal' for any meaningful period, then the way deals get done – particularly complex carveouts and financed transactions – will need to adapt.

From a buyer's perspective one of the biggest challenges with carveouts is to understand which assets – from intellectual property to IT systems, contracts and real estate – are being transferred, which will be shared, and which will remain with the seller after closing.

Understanding the liability side of the deal perimeter is equally important. What will the buyer be taking on and what is left behind? How much of the risk be indemnified? And what about successor liabilities?

Limits to due diligence force change in tactics

All these things are typically tested through due diligence with the help of (often) audited financial statements. This process allows the buyer, its financing sources and the provider of its reps and warranties insurance (which will become vital to M&A where information is imperfect) to get comfortable that the business being purchased – and its associated risk profile – maps across to the acquisition agreements.

In a world where detailed checks in an 'old school' way may not be possible (and where audit reports may be heavily caveated) positioning a carved-out business for sale will become an exercise in creativity and pragmatism. For the seller that will mean crafting compelling narratives to help guide buyers through less-than-ideal financial information. It may also mean providing more information in diligence than might otherwise be the case – for example by highlighting issues that show up in the data room or offering detailed breakdowns of pre-closing reorganisations and any gaps in the assets being transferred. Alongside this, the use of clean teams may become even more common.

It will also mean keeping the transaction structure and documentation as clear as possible to help each party understand what's being sold. It will mean offering tried-and-tested solutions to roadblocks in negotiations that minimise execution risk. It might even mean packaging up a broader combination of assets to compensate for buyers' inability to conduct detailed analysis (although this will inevitably come with a price).

Smart M&A participants however will recognise that COVID-19 has changed the limits of what would usually be considered 'deal perfection' – and will adjust their methods accordingly.

Deal terms evolve as power flips to buyers

These are plenty of other deal-making elements that will evolve in response to the pandemic. Some, such as closing long-stop dates (ie terms that govern the duration of deals by setting a date following which either side can 'walk' without penalty), will need to change to cover the impact of lockdown restrictions on regulatory approvals processes. Expiration of external funding commitments will also need to move in step.

Others will reflect the fact that, after years of sellers being in the ascendancy in M&A, the pandemic has created more of a buyers' market. Post-COVID, creditworthy purchasers will be in a stronger position to negotiate protections against downside risks in the form of walkaway rights, purchase price adjustment mechanisms and enhanced access to representations and warranties insurance – although we are seeing insurance providers more closely scrutinising deal documentation as they look to reduce their exposure to COVID-related risk.

Elsewhere, there has been a rise in material adverse event/material adverse change litigation emerging in the Delaware courts, which will be watched closely as the parties seek clarity on the allocation of business performance risks during the pandemic. And while the results will be widely publicised, dealmakers are well served to likewise focus on interim operating (pre-closing) covenants – including the very precise language around 'lead in' provisions and clauses allowing a buyer to withhold its consent. Indeed, interim operating covenants may be the most important elements of pending and future M&A agreements.

Re-evaluating financing orthodoxies

Just as we saw established orthodoxies challenged amid the uncertainties of the financial crisis (such as the wisdom of putting large sums in escrow with banks), so COVID-19 could have a similar effect.

In Europe we might see a shift away from 'certain funds' mechanisms towards more US-style 'sponsor methods' of allocating financing risks. US sponsor deals typically allow a buyer to terminate the transaction – subject to a reverse break fee – in defined financing failure circumstances. With all 'market' terms potentially upended, we could even see a return to true 'financing condition' deals from here on out.

'Certain funds' financings – by keeping conditions to drawdown to a minimum and, where possible, within the buyer's control – assure both sides that the acquisition financing will be delivered at closing. They give the lender few 'outs' as long as conditions to closing are met. One of those conditions however is that it is not unlawful for the arranging bank to fund the deal. Under normal circumstances this is a given, but as banks take on significantly more risk in support of government recapitalisation programmes, who's to say how legislation might change before the pandemic is over? With this in mind, it's possible parties may want to reconsider their options in search of something more flexible.

COVID-19 has cut some companies off at the knees and entrenched the power of others. It has reshaped consumer behaviour, given fresh impetus to new forms of regulation and radically altered the role of government in corporate life. It could push society along a path towards greater sustainability, open a window for private capital, diminish activist investors and fundamentally change the process of doing deals. How long this change lasts – and how far it could go – is impossible to predict right now. But what's clear is that M&A will play a pivotal role in shaping the businesses that thrive in a post-COVID world.

If you are interested in discussing any of the themes in this report, please reach out to your usual Freshfields contact.

For more insights on the current and future impacts of COVID-19, visit www.freshfields.com/coronavirus