M&A Insights

Q1 2021

So far, so good

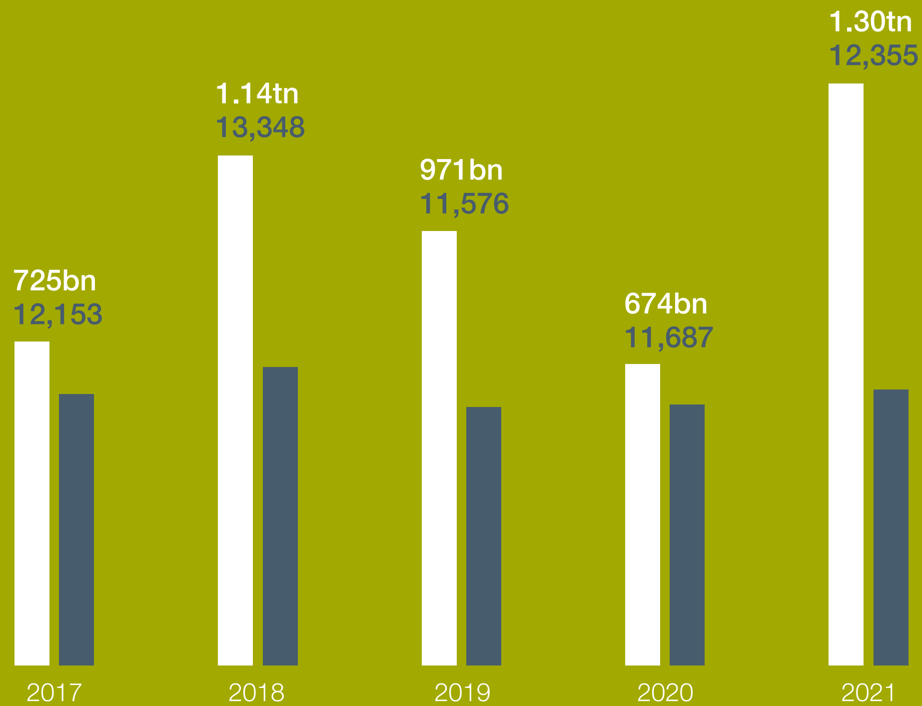
Contents

This PDF includes elements of interactivity throughout

While there is good reason to believe the recovery can be sustained in 2021, there are reasons to be wary too. The pandemic is not yet under control and the scope for longer term economic shocks remains very real.

Global M&A Q1 2021 snapshot

Largest first quarter on record



Increase in global deal value
Q1 2021 vs. Q1 2020

93%

Increase in global deal volume
Q1 2021 vs. Q1 2020

6%

Note: Figures represent deals announced between 1 January and 30 March 2021.

Data provided by REFINITIV™

Compelling signals from a recovering M&A market

The question at the end of 2020 was whether the strong recovery in M&A activity could be sustained in 2021.

Evidence from the first quarter data looks remarkably positive overall. It is the largest first quarter on record and the second largest overall quarter on record, after Q2 2007 (USD1.4 trillion). But there is still a way to go.

Deal value has shown strong growth, up by 93%. Deal volume, too, has grown, albeit by a more muted 6%. The number of deals is up in most regions and sectors, with only a few notable exceptions.

The continuing recovery in transaction value has been helped by the return of big transactions.

Acquisitions with a public target are another area of the market where both value and volume are climbing, up by 88% and 12% respectively.

There has been a 76% growth in the value of domestic deals. But there has been an even sharper increase in the value of cross-border deals, up by a robust 135%, in spite of the fact this is a category that had been under pressure for some time.

Deals over

▶ USD5bn

have grown in value and volume, by 92% and 133%, respectively, and account for 37% of total M&A activity

Deals over

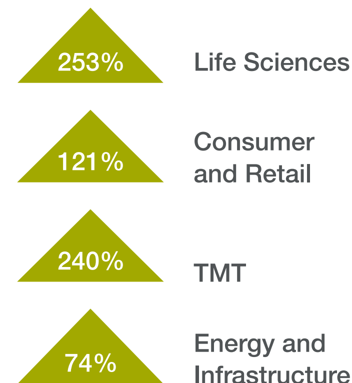
▶ USD10bn

have rebounded by 37% in value and 50% by number of deals, accounting for 17% of total M&A activity

Regional and sector breakdown

Virtually all markets show an increase in deal volume. Notable exceptions include the United States (down by 3%) and Eastern Europe (down by 7%). In contrast, deal value shows a remarkable recovery, including a robust 370% in MENA and 160% in the U.S.

The picture is similar from a sector point of view. For the most part, volume is up (except for energy and consumer and retail, where volume is flat, and in real estate where it has declined by 26%). Deal value is up, including:



SPAC boom continues

One trend that has grown exponentially since Q3 2020 is Special Purpose Acquisition Companies (SPAC), which raise money in the IPO market, then go looking for a target.

They continue to raise extraordinary amounts of capital for acquiring targets, running at an all-time quarterly and annual record.

However, a key question remains. Can this level of SPAC activity be maintained as competition for assets intensifies?

Overall, the outlook for transactions appears robust, but the lingering economic impact of the pandemic remains a significant concern.

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Covid-19 triggers rapid shifts in private M&A tactics

From standstill to strong recovery, Covid-19 created a year of two halves for transactions in 2020, forcing buyers and sellers to adjust their tactics in the private M&A market.

Global transactions ground to a near standstill in the first half of 2020 as Covid-19 swept the world.

However, there was a remarkable resurgence in activity during the second half of the year, and this has been sustained in the early days of 2021.

Some commentators speculated that the economic impact of the coronavirus would lead to the return of a fully-fledged buyers' market in private M&A.

But our research, drawing on analysis of some 1,400 private transactions that Allen & Overy has advised on globally over recent years, shows a far more nuanced picture.

2020 was not just a year of two halves in terms of deal volume, but there were also significant shifts in the tactics used by buyers and sellers.

Fewer auctions, more competition (eventually)

Auction activity had already been in decline in 2019.

That decline continued in the first half of 2020, with just 41% of our private deals done by auction, compared to 46% the year before, and with just 34% of those being highly competitive.

We saw even fewer auctions in H2, but there was a sharp uptick in competition in those deals that were conducted as auction processes, with strategic and financial bidders entering contract races and even putting in pre-emptive bids.

Deals conducted by auction		Highly competitive auctions
40%	2016	65%
41%	2017	55%
53%	2018	53%
46%	2019	45%
41%	H1 2020	34%
33%	H2 2020	50%

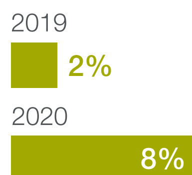
Private equity increasingly dominant, but few distressed deals

The surge in confidence after the summer of 2020 was particularly evident among private equity (PE) funds, which dominated the market, particularly in the final quarter of the year, as positive news on vaccines fuelled optimism and activity. Our figures even show that the proportion of auctions on which we advised involving a PE buyer or seller was higher in 2020 than the year before.

Surprisingly, given the difficulties faced by businesses in certain sectors, we only saw a slight increase in distressed deals, up from 2% in 2019 to 8% of the private deals on which we advised.

Distressed activity may increase later this year, particularly when government support schemes for troubled businesses are withdrawn (see our article on distressed deals and insolvency in this report).

Distressed M&A deals



Sellers' focus on execution risk intensifies

Having seen signed deals unravel during the early stages of the pandemic, sellers became noticeably more focused on execution risk.

The proportion of our deals that contained conditions to completion decreased from 79% in 2019 to 73% in the first half of 2020 and again to 65% in H2. Two factors were at play here. First, if more than one deal was on the table, sellers would take the unconditional over the conditional. And second, sellers resisted 'non-mandatory' conditions, such as those designed to deal with a due diligence issue.

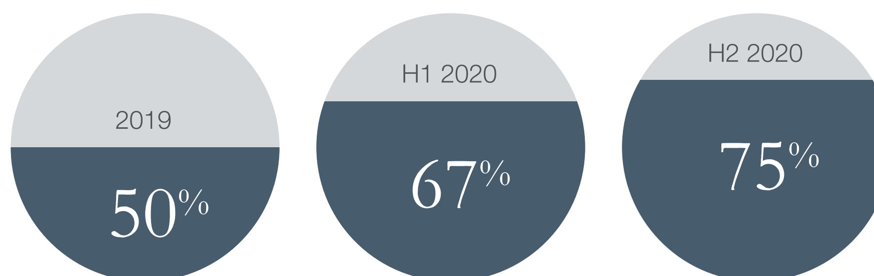
Where deals required antitrust or regulatory approval, sellers tried to push execution risk onto buyers through "hell or high water" clauses, committing buyers to do everything in their power to clear regulatory hurdles.

Such clauses appeared in half of our PE exits requiring antitrust approval in 2019. In H1 2020, that number had risen to two-thirds of deals, and to three-quarters in H2.

One big surprise from our review was a decline in H1 2020 in the use of reverse break fees. Appearing in 10% of conditional deals in 2019, they were used in just 3% in the first half of last year. But there was an about-turn as the year progressed, with 14% of conditional deals involving such fees in the second half.

Indeed, there was a further change. Previously, most reverse break fees were payable only if the buyer failed to gain regulatory or antitrust approval. In 2020, some 70% of such fees were payable if approvals were obtained, but the buyer then chose to walk away.

Hell or high water obligation on buyer (private equity exits)



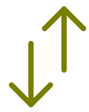
Shifting price structures

The pandemic rendered many business models instantly out-of-date, making it very hard to value assets and price deals.

As a result, we saw dealmakers adopt new pricing structures in an attempt to mitigate risk and bridge valuation gaps.

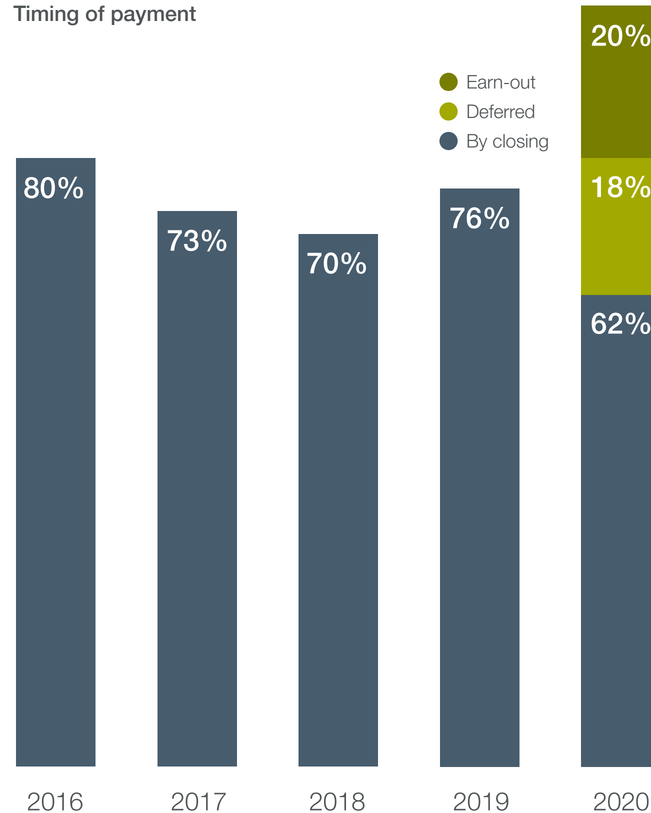
Between 2016 and 2019, the deal price was paid in full by completion in 70% to 80% of private transactions. In 2020, however, that figure dropped to 62%, with the remaining 38% involving either an earn-out or a deferred consideration.

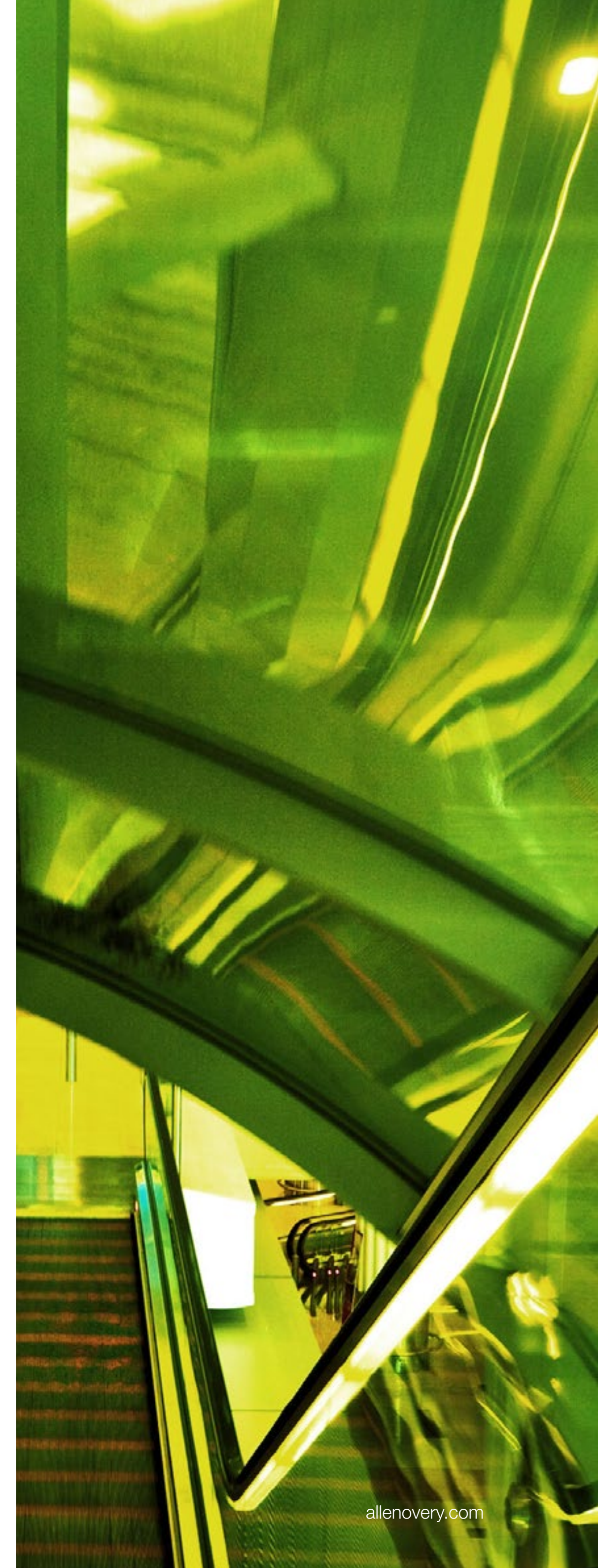
Earn-outs were seen in 20% of our deals in 2020, compared with just 9% in 2019



The proportion of deals involving a deferred payment rose from 15% in 2019 to 20% in the first half of 2020, but fell back to 13% later in the year as the market rallied

In a further significant change, we saw the use of price adjustments increase, leaving the seller at risk of fluctuations (pandemic-related or otherwise) up to completion. In 2019, 37% of our deals included a price adjustment. But this figure climbed to 44% in the first half of 2020, and to 47% in the second.





Warranties and indemnities as buyers regain lost ground

Sellers took a very cautious approach to warranty and indemnity packages in the first six months of 2020, using various strategies to dilute the coverage they provided – a sign that they preferred to see risk priced into the deal upfront, rather than chance an erosion in value later on.

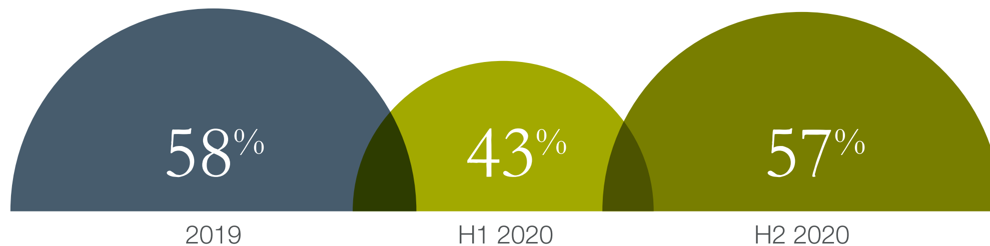
However, buyers regained the upper hand after the summer, signalling that they were only prepared to return to the market if they were properly protected. Sellers sometimes had no option but to concede and we saw coverage return to normal levels, with fewer materiality and so-called "sellers' knowledge" qualifiers and higher liability caps.

One notable change was in relation to warranty repetition, which gives buyers the right to claim damages if a warranty is incorrect at closing.

Although market practice on warranty repetition varies by region, it consistently appeared in some 58% of our deals globally between 2014 and 2019. But its use dropped to 43% in the first part of 2020 – with fewer sellers willing to stay on risk past signing of the deal given the unpredictable market environment.

As the year went on, however, levels of repetition returned to a more normal 57%.

Warranty repetition (2020)

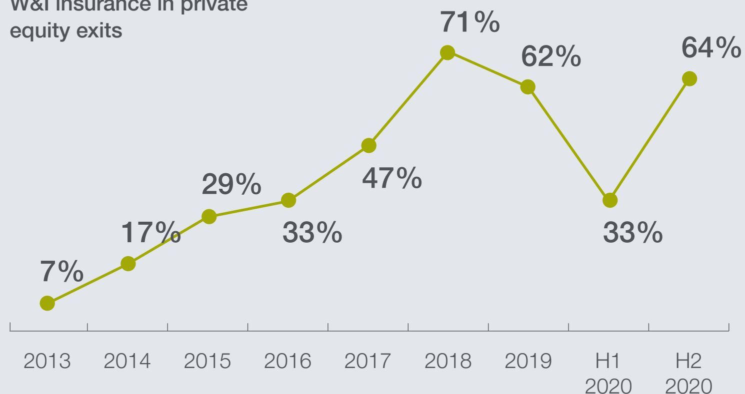


W&I insurance back on track

In early 2020, we saw a reversal of the trend towards greater use of warranty and indemnity (W&I) insurance, as underwriters tried to exclude the one issue that was at the forefront of their minds: Covid-19.

Consequently, W&I insurance featured in just a third of our PE exits in the first half of the year, compared to 62% the previous year, and in just 16% of other sales (down from 23%).

In the second half of 2020, that decline completely reversed. Covid-19 related exclusions disappeared or were specifically tailored to the target business, and the product was once again used in 64% of PE exits and a quarter of other sales globally.



Foreign direct investment controls surge

One other area where the two halves phenomenon was apparent was around foreign direct investment (FDI) controls (something we discuss in greater detail in our article on merger control later in this report).

With FDI scrutiny being tightened across the world, including in Europe, the U.S., Australia and Japan, we saw a significant increase in deals conditional on FDI clearance as the year progressed. In the first half of 2020, just 7% of our deals required approvals. That had increased to 19% in H2.

% of deals subject to foreign investment approval

Period	%
H1 2020	7%
H2 2020	19%

This upward trend is only likely to continue as more regimes take effect. There is another side to the story though. In some jurisdictions – the UAE and Indonesia, for example – rules are being liberalised to attract inward investment.

Outlook

In the private M&A market, as elsewhere, the question is whether the recovery in transactions seen in the second half of 2020 and Q1 2021 can be sustained.

While there is good reason to believe it can, there are reasons to be wary too. The pandemic is not yet under control and the scope for longer term economic shocks in its wake remains very real.

If you would like a full briefing on global trends in private M&A, please talk to your usual A&O contact.

Antitrust authorities stay tough in a difficult market

Antitrust authorities remained highly active in 2020, despite the pandemic reducing overall global M&A, according to our latest annual survey of global merger control enforcement trends across 26 jurisdictions.

Antitrust authorities across the world continued to frustrate transactions at a significant rate in 2020.

A total of 29 deals were either prohibited or abandoned during the year. This represents a 28% decrease in enforcement activity on 2019 due to two main factors:

- **a sharp reduction in M&A activity, particularly in the first half of the year as the pandemic took hold**
- **reluctance by some companies to tackle highly strategic, transformational deals of the sort that would normally attract most attention from antitrust authorities**

Overall, we do not believe the lower levels of enforcement in 2020 signal a more relaxed approach by antitrust authorities.

UK leads the pack

We saw record levels of activity in several jurisdictions, once again led by the UK where the Competition and Markets Authority (CMA) frustrated nine deals. This was one more than in 2019, with four deals prohibited and five abandoned.

2020 also saw the CMA increase its interventions in the form of remedies. There were eight phase 1 remedy cases and four at phase 2, compared with four and one, respectively, the year before.

All the signs are that the CMA is continuing on this path, at a time when the UK government is considering calls for the CMA's enforcement powers to be strengthened and its workload is expected to grow as a result of Brexit (and the consequential disapplication of the EU Merger Regulation's "one-stop-shop" principle).

Across the world, the digital sector has become a priority for antitrust authorities. This is only likely to intensify in the year ahead.

U.S. hits a new peak

A peak in challenges by the U.S. antitrust agencies resulted in a record 10 deals being abandoned – double the number seen in 2019 – with one prohibition. This reflects an increased appetite by both the Department of Justice (DOJ) and the Federal Trade Commission (FTC) to intervene.

The election of Joe Biden as President will likely increase this appetite further. A number of sectors are expected to be in the spotlight, including consumer-facing, digital and pharmaceutical companies.

Much will depend on key appointments at the FTC and DOJ, and it might be some time before the impact is fully felt.

EU quiet, China steady

By contrast, EU-level data shows a very different picture. Here there were no prohibited deals and just one transaction abandoned. While there are a number of on-going in-depth reviews, our report suggests that many of these appear more suited to remedy solutions rather than prohibition.

Enforcement activity in China was steady in 2020. The average duration of merger reviews fell, despite the disruption caused by the pandemic.

One consistent trend across the world was a move to establish or strengthen foreign investment controls. This was the case in 17 of the 26 jurisdictions we surveyed.

Digital sector targeted

From a sector perspective, life science transactions were particularly in the frame. They accounted for 22% of deals subject to antitrust intervention, despite accounting for just 8% of total M&A activity.

Transport and infrastructure deals also attracted a high level of attention, representing 9% of interventions while accounting for only 2% of activity. Remedy cases accounted for all this activity. All interventions in this sector resulted in remedies.

But across the world the digital sector has become a priority for antitrust authorities. This is only likely to intensify in the year ahead as reform proposals make their way onto the rulebooks. Although approaches differ, three main areas of focus are apparent:

1. **introducing new and separate merger control rules for digital firms, a route considered in the UK, U.S., Australia and South Africa**
2. **using deal value thresholds to catch so-called "killer acquisitions" where a major tech firm buys a smaller business to stifle potential future competition**
3. **reframing the way that digital mergers are assessed**

Fines and remedies – no sign of easing

Overall, procedural merger control fines reached an unprecedented EUR6.65 billion in 2020. However, almost all of this amount related to action by Poland's Office of Competition and Consumer Protection (UOKiK) against six energy companies for alleged gun-jumping.

Other fines amounted to EUR53 million compared with EUR145m in 2019, while the number of procedural enforcements (excluding the Polish case) fell from 40 to 33.

We do not believe this dip in the numbers should be read as a signal for companies to relax compliance. Antitrust authorities around the world show no sign of easing up on their activities.

Despite lower levels of M&A activity there was no reduction in remedy cases, which totalled 137 during the year. Of these, 44 were agreed at phase 1, 63 after in-depth reviews and 30 related to transactions in South Africa.

Where remedies are concerned, we find growing evidence of antitrust authorities working together across borders to design compatible packages.

Trends for 2021

Looking ahead, it is clear that a number of trends will be of particular interest:

- **continued focus on scrutinising digital deals, as current proposals translate into action**
- **possible surge in "failing firm" cases, especially in key, vulnerable sectors such as retail and hospitality**
- **greater clarity about merger control policy in the U.S. as Biden appointees settle into their roles**
- **growing focus on the impact of common shareholdings on competition**
- **authorities taking sustainability issues into account in their deliberations**

Dealmakers should expect greater scrutiny coupled with more sophisticated merger control assessments.

For more information on our report into Global Trends in Merger Control Enforcement, please get in touch with your usual A&O contact.

Distressed or insolvent M&A: navigating the pitfalls and opportunities

Opportunities to acquire distressed or insolvent businesses look set to accelerate later this year. What should buyers be thinking about?

One of the surprising features of the pandemic, given the damage it has caused to businesses in many sectors, is how little M&A activity we have seen so far involving distressed or insolvent businesses.

The expectation at the outset of the crisis was that distressed M&A would almost immediately be a very busy area of the market.

With the exception of some high-profile retail deals and activity in the tourism, hospitality and automotive sectors, distressed activity to date has been relatively limited.

There are various contributing factors including:

- **government employment and financial support schemes have allowed companies to put off what may still be the inevitable**
- **the temporary suspension in some jurisdictions, such as Germany, of insolvency filing obligations, has given troubled businesses time to breathe**

As support schemes end and usual of insolvency rules are reapplied, we are likely to see a sharp uptick in deals targeting distressed or insolvent companies. Some market watchers expect to see a surge in such deals in the second half of 2021.

Buyers prepare

For buyers contemplating acquiring a distressed or insolvent business, there are many issues that distinguish such deals from normal M&A transactions.

For example:

- **deals usually need to be executed at high speed**
- **opportunities to carry out deep due diligence may be curtailed**
- **normal contractual protections that buyers are used to, such as warranty cover, may be limited**

Understanding the pitfalls and the opportunities, and being able to identify "red flag" issues from the outset, can often be the key to success.

Questions to ask upfront

Who's selling? Is it a controlling shareholder, the company itself or an insolvency practitioner?

What state is the target company in? Is the target facing difficult times, in the twilight zone immediately ahead of becoming insolvent, or already embroiled in formal insolvency proceedings?

Are there cross-border considerations? This could dictate where insolvency proceedings may be commenced and how parts of the business are sold.

How can the seller's concerns be met? Buyers should be mindful of the requirements of directors of distressed, but not yet insolvent, businesses to continue to meet their ongoing duties to stakeholders and their need to avoid personal liability.

What about integration? Failure to think in advance about how two businesses will be integrated can lead to big problems later on and an inability to realise the true value from the deal.

Deal structuring

Where the target business is a "going concern", buyers also need to establish what kind of sale process is most appropriate and what conditions may attach.

For example, cherry-picking selected assets might be a better bet than acquiring the shares of the company (and inheriting all its liabilities).

Negotiation of the sale on an exclusive basis may be possible. Alternatively, there could be a race to complete the sale, with the seller talking to other prospective buyers.

Understanding risk is crucial. In particular, the buyer should consider whether there is any danger of the sale agreement being set aside (or an order made for the payment of additional consideration) as a result of the transaction avoidance provisions that can apply in an insolvency proceeding. These provisions are in relation to transactions entered into in the period immediately before the commencement of the insolvency proceedings.

Moreover, because information about the company may be restricted, limiting the ability of the purchaser to carry out full due diligence, the buyer must assess the likelihood of recovering any amounts in respect of breach of warranty and any other red flags raised in assessing the target.

Some of these issues will have a direct bearing on the terms of the deal.

Potential red flag issues

Certain assets will be treated very differently in an insolvent sale compared with a solvent transaction, raising a further range of potential concerns.

For instance, special issues may arise in a management-sponsored buyout. There could be constraints on continuing to use the company's name and substantial property transaction considerations, while confidentiality issues may arise in respect of the seller and the management team.

Retaining all or part of the company's workforce could also land the buyer with significant potential liabilities. Careful scrutiny of relevant employment laws is vital.

Relevant pensions regulators may have the power to intervene. If so, it may be worth seeking confirmation that the regulator does not intend to take action.

Where property assets are involved, the onus is on the buyer to carry out the best investigation possible in a limited timescale.

Other issues to look out for include:

- **ensuring the release of security over shares and assets being acquired**
- **suppliers' retention of title claims over stock**
- **book debts and ongoing access to books and records**
- **consents and approvals required in different jurisdictions**
- **continued performance of contracts and change of control provisions**
- **ownership of intellectual property**

Changes afoot in UK for pre-packaged sales

The term "pre-pack" is used to describe the sale of an insolvent business agreed before a company enters formal proceedings.

The proposed insolvency practitioner will be involved in determining the terms of a sale in advance so that a deal can be completed quickly once, or shortly after, proceedings start.

Although not part of UK insolvency law, pre-pack sales are a mechanism that has commonly been used in practice in the UK, despite the fact that, until the practitioner is formally appointed, any commitment to sell is theoretical rather than actual.

Although popular, the mechanism is controversial, seen as lacking in transparency and denying unsecured creditors and customers a role in deciding the future of the business.

In response, the UK government laid regulations before Parliament in February 2021 which, if implemented, could either:

- **require creditor consent for pre-pack sales (something that, for the reasons set out in our recent publication on** pre-pack administration regulations**, we think is unlikely to be used much in practice); or**
- **require connected parties to provide the administrator with an independent opinion of the deal terms, most crucially on the issue of price**

The new regulations would probably push up the cost of the transaction for purchasers and we expect that they will come into force in relation to administrations commencing on or after 30 April 2021.

However, they may also, finally, quieten long-running criticism of pre-pack deals.

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